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NOTES

CORPORATE LIQUIDATIONS INCIDENT TO THE ACQUISITION OF ASSETS: A LOOK AT SOME CURRENT PROBLEMS ARISING FROM A SECTION 332-334(b)(2) LIQUIDATION*

The years since World War II have witnessed an era of unprecedented growth in the American economy.[1] As beneficiaries of four decades of prosperity, Americans today produce, grow, use, buy, and sell more goods and services than any other country in the world.[2]

At the heart of this postwar prosperity lies a rapidly expanding financial and industrial complex. Over the years, businessmen have frequently found that the best way to increase profits in the face of rising costs has been to expand production capacity, thereby achieving economies of scale and often competitive advantage. Sometimes new plant facilities are constructed and old ones are remodeled and enlarged. In other cases, however, mergers and acquisitions of existing corporations[3] have proved to be the most advantageous method of implementing a program of growth.[4] This has been particularly true in recent times. During the years 1965-1969, for example, corporate acquisitions in the United States increased to their highest level in fifty years.[5] If only the larger mining and manufacturing firms are considered,

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1. The Gross National Product (GNP) totaled nearly $212 billion at the end of 1945. During the next thirty years this figure increased 600% to reach the mind-staggering sum of $1.271 trillion by the end of 1973. INFORMATION PLEASE ALMANAC, ATLAS AND YEARBOOK 83 (D. Golenpaul ed., 28th ed. 1974).

2. *Id.*

3. The term "merger" is often used loosely to describe any type of business combination. Technically, a "merger is limited to a statutory procedure whereby one of the constituent companies takes title to the assets of the other one, which in turn loses its existence by operation of law." W. CARY, CASES AND MATERIALS ON CORPORATIONS 1622 (4th ed. unabr. 1969). An "acquisition" is a somewhat broader term, describing a transaction whereby assets are obtained by issuing stock as well as by expending cash. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD NO. 16, *Business Combinations* 284 n.2 (1970).

4. By acquiring an existing entity, corporations can eliminate much of the risk and expense associated with organizing a new business, thereby achieving instant diversification, economies of scale, and stability of operations without further competitive struggle. W. CARY, *supra* note 3, at 1623-24.

5. U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 484 (93d ed. 1972). The breakdown is as follows:

PERIOD	TOTAL
1920-1924	2,235
1925-1929	4,583
1930-1934	1,687
1935-1939	577

corporate mergers and acquisitions during that time totaled 8,213, nearly double the 4,366 reported for the previous five-year period and more than fourteen times the figure reported during 1935-1939.[6] Business combinations in 1970 and 1971 exceeded the 1,000 mark in both years, with over forty per cent of the acquiring entities having assets in excess of $50 million.[7]

While the antitrust laws[8] and economic factors weigh heavily in the decision whether to acquire additional facilities, the impact of the Internal Revenue Code invariably determines *how* it should be done. "There are in fact few areas in which tax considerations more completely dominate business decisions and in which the tax penalties for ill-advised action . . . [are] . . . more pronounced."[9] This note examines one of these tax-dominated areas, basis determination of property received in the liquidation[10] of a purchased eighty per cent subsidiary within the framework of sections 332[11] and 334(b)(2)[12] of the Internal Revenue Code of 1954. To this end, these statutory provisions and applicable administrative rulings will be analyzed with the hope of offering some insight into several current problems that have arisen in this area.

General Considerations

Since 1921, Congress has approved incorporation without the recognition of gain or loss[13] because of the belief that it was economically unsound to hinder business from going "forward with the readjustments required by existing conditions . . . ."[14] This type of legislation, however, encouraged the proliferation of complex corporate pyramids, prompting the lawmakers in

1940-1944	906
1945-1949	1,505
1950-1954	1,424
1955-1959	3,365
1960-1964	4,366
1965-1969	8,213
1970	1,351
1971	1,011

6. *Id.*
7. *Id.*
8. *E.g.*, Sherman Antitrust Act §1, 15 U.S.C. §1 (1970); Clayton Antitrust Act §7, 15 U.S.C. §18 (1970).
9. W. Cary, *supra* note 3, at 1630.
10. The process of liquidation involves the winding up of the corporation's affairs, which consists of collecting its assets, paying all claims and expenses, and distributing the remaining assets among the shareholders according to their liquidation preferences and rights. H. Henn, Law of Corporations 814 (2d ed. 1970).
11. Int. Rev. Code of 1954, §332.
12. *Id.* §334(b)(2).
13. Act of Nov. 23, 1921, ch. 136, §202(c)(3), 42 Stat. 230 (now Int. Rev. Code of 1954, §351).
14. S. Rep. No. 275, 67th Cong., 1st Sess. (1921), *reprinted in,* 1939-1 (pt. 2) Cum. Bull. 181, 189.

1935 to again hold out the tax-free carrot as an incentive for parent corporations to swallow-up their progeny and simplify their financial structures.[15]

Today, section 332 governs this latter situation. It generally provides that no gain or loss shall be recognized by a parent corporation on the receipt of property distributed in complete liquidation of a controlled subsidiary. Coupled with this nonrecognition treatment are the basis provisions found in section 334(b). The general rule, contained in section 334(b)(1), provides that the basis of property in the hands of a subsidiary shall carry over to the parent corporation upon a liquidation pursuant to section 332. An exception to this general rule appears in section 334(b)(2), which allows the asset basis to be stepped-up[16] to reflect the parent's purchase price of the subsidiary's stock. As one might guess, this exceptional treatment is subject to detailed statutory requirements and complicated administrative adjustments. Before turning to a current analysis of these provisions, however, it is appropriate first to examine their legislative history to aid in understanding congressional intent and purpose.

Legislative History

Corporate Liquidation: Section 332

Prior to the Revenue Act of 1935, amounts distributed in complete liquidation of a corporation were treated as being received in full payment for the outstanding stock,[17] with any realized gain or loss on the exchange[18] fully recognized under familiar rules.[19] Because this applied with equal force to the liquidation of a subsidiary,[20] parent companies often had little incentive to eliminate unnecessary corporations from their financial structures.[21]

On October 24, 1929—Black Thursday as it later was to be called—an overstimulated American economy and an erosion of confidence in business

15. Act of Aug. 30, 1935, ch. 829, §110(a), 49 Stat. 1020.

16. A stepped-up basis is not invariably the result, for the amount paid by the parent may be less than the subsidiary's adjusted basis in its own assets. This was the situation in Kimbell-Diamond Milling Co., 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718, 51-1 U.S.T.C. ¶9201 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

17. Act of May 10, 1934, ch. 277, §115(c), 48 Stat. 711 (now Int. Rev. Code of 1954, §331(a)). *See* Gulf, Mobile & N.R.R. v. Commissioner, 83 F.2d 788, 791, 36-1 U.S.T.C. ¶9282, at 9829-30 (5th Cir.), *cert. denied*, 299 U.S. 574 (1936).

18. Act of May 10, 1934, ch. 277, §111, 48 Stat. 703 (now Int. Rev. Code of 1954, §1001(a)) provided: "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) [now Int. Rev. Code of 1954, §1016(a)] for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized."

19. Act of May 10, 1934, ch. 277, §112, 48 Stat. 704 (now Int. Rev. Code of 1954, §1002) provided: "Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111 [now Int. Rev. Code of 1954, §1001(a)], shall be recognized, except as hereinafter provided in this section."

20. *E.g.*, Neptune Meter Co. v. Price, 98 F.2d 76, 38-2 U.S.T.C. ¶9384 (2d Cir. 1938); Ford Motor Co. v. United States, 47 F. Supp. 259, 42-2 U.S.T.C. ¶9711 (Ct. Cl. 1942).

21. J.C. Penney Co., 37 T.C. 1013, 1021 n.21 (1962).

caused the dramatic collapse of the stock market on Wall Street. In the ensuing era of financial uncertainty and depression, many corporations were forced into bankruptcy primarily because they had been built on unsound economic foundations.[22] This was particularly true of holding companies,[23] which could be used legally to avoid most forms of government and financial regulation[24] thereby making them popular vehicles for circumventing the antitrust laws.[25] Moreover, because holding companies were frequently organized by inversely pyramiding a controlling stock interest in the hands of a few men with the thinnest possible equity,[26] actual ownership could be divorced from control.[27] It is not surprising, therefore, that many of these topheavy giants collapsed under their own abusive weight,[28] bringing down in domino fashion otherwise healthy subsidiaries with them.

Consequently, many people came to believe that the "absentee ownership" attributable to these fiscal oligarchies was largely responsible for the economic depression.[29] The obvious cure for the depression, they reasoned, could be achieved by promptly liquidating all such irresponsible organizations.[30] Even President Franklin D. Roosevelt pointed out to Congress the need for remedial legislation, stating "we should seek through taxation the simplification of our corporate structures through the elimination of unnecessary holding companies in all lines of business."[31]

Congress responded in 1935 by enacting section 112(b)(6), which generally extended nonrecognition treatment to the liquidation of an eighty per cent subsidiary by its parent corporation.[32] By providing a tax-free method for liquidating unnecessary controlled subsidiaries, Congress hoped to encourage the simplification of complex corporate financial structures.[33] Its intentions

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22. 22 ENCYCLOPAEDIA BRITANNICA, UNITED STATES (OF AMERICA) 578, 673 (1973).

23. A writer of the 1930's defined a holding company as: "Any company, incorporated or unincorporated, which is in a position to control, or materially to influence, the management of one or more other companies by virtue, in part at least, of its ownership of securities in the other company or companies." J. BONBRIGHT & G. MEANS, THE HOLDING COMPANY 10 (1st ed. 1932).

24. *Id.* at 6-7, 35-37.

25. *Id.* at 32-35.

26. *Id.* at 4, 18, 30-32, 46.

27. *Id.* at 4.

28. Other abuses included the reduction of competition, perpetuation of control, manipulation of contractual and financial activities of the subsidiaries, and almost complete disregard of the rights and interests of the investing public. *Id.* at 12-49.

29. Colgan & Molloy, *Tax-Free Liquidations of Corporate Subsidiaries Under Section 112(b)(6) of the Internal Revenue Code,* 4 TAX L. REV. 305 (1949).

30. *Id.*

31. H.R. REP. No. 1681, 74th Cong., 1st Sess. (1935), *reprinted in,* 1939-1 (pt. 2) CUM. BULL. 642, 644.

32. Act of Aug. 30, 1935, ch. 829, §110(a), 49 Stat. 1020.

33. 80 CONG. REC. 8799, 10,270 (1936). *See* Cherry-Burrell Corp. v. United States, 367 F.2d 669, 674, 66-2 U.S.T.C. ¶9681, at 87,228 (8th Cir. 1966); Commissioner v. Kay Mfg. Corp., 122 F.2d 443, 445, 41-2 U.S.T.C. ¶9635, at 10,490 (2d Cir.), *cert. denied,* 316 U.S. 680 (1941); International Inv. Corp., 11 T.C. 678, 683 (1948), *aff'd per curiam,* 175 F.2d 772, 49-2 U.S.T.C. ¶9361 (3d Cir. 1949).

were noble but the statute soon proved to be poorly drafted,[34] resulting in difficulties in administration[35] that prompted the lawmakers to replace it in the following year with a more workable statute.[36] This revised section 112(b)(6) was essentially carried forward in the 1939 Code[37] and today appears as section 332 in the 1954 Code.

Basis: Section 334(b)

Like the liquidation statute it implemented, the 1935 basis provision[38] proved to be unsatisfactory and was only briefly used.[39] When Congress enacted the Revenue Act of 1936, section 113(a)(15),[40] the predecessor of section 334(b)(1), became the applicable rule for determining the basis of property distributed to a parent corporation in complete liquidation of a subsidiary. The new statute generally provided that the subsidiary's basis in its assets would carry over to the parent on the transfer. This was consistent with the idea that section 112(b)(6) was a tax-free exchange[41] effectuating a change of form rather than of substance.[42]

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34. Colgan & Molloy, *supra* note 29, at 306. The faulty design of §112(b)(6) was due partly to the fact that it was an apparent afterthought on the part of Congress. President Franklin D. Roosevelt, in his message to Congress on June 19, 1935, recommended that such a law be enacted. *See* note 31 *supra*. Hearings held before the Senate Finance Committee to consider this proposal disclosed that corporations were reluctant to liquidate their subsidiaries and recognize the resulting gain, as required under the existing revenue laws. *Hearings on H.R. 8974 Before the Senate Committee on Finance*, 74th Cong., 1st Sess. 170-71, 301-03 (1935). Apparently motivated by this testimony and the President's recommendations to simplify corporate structures, Senator Harrison, Chairman of the Senate Finance Committee, introduced on August 15, 1935, an amendment to the Revenue Act of 1935, providing generally for the nonrecognition of gain or loss upon the receipt by the parent corporation of liquidation proceeds from an 80%-owned subsidiary. 79 CONG. REC. 13,239-40 (1935). *See* J.C. Penney Co., 37 T.C. 1013, 1021 n.21 (1962); Busterud, *The Liquidation of Subsidiaries Under Section 112(b)(6)*, 58 YALE L.J. 1050 (1949); MacLean, *"Creeping Acquisitions,"* 21 TAX L. REV. 345, 348 n.6 (1966). A week later the House Conference Committee submitted Senator Harrison's amendment (with certain modifications) for full House consideration. The Act as amended was enacted into law on August 30, 1935. *See* STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE, H.R. REP. No. 1885, 74th Cong., 1st Sess. (1935), *reprinted in*, 1939-1 (pt. 2) CUM. BULL. 660, 662; Act of Aug. 30, 1935, ch. 829, §110(a), 49 Stat. 1020.

35. International Inv. Corp., 11 T.C. 678, 683 (1948), *aff'd per curiam*, 175 F.2d 772, 49-2 U.S.T.C. ¶9361 (3d Cir. 1949); 80 CONG. REC. 8799 (1936) (remarks of Senator George); Darrell, *Corporate Liquidations and the Federal Income Tax*, 89 U. PA. L. REV. 907, 927-28 (1941).

36. Act of June 22, 1936, ch. 690, §112(b)(6), 49 Stat. 1679.

37. Act of May 28, 1938, ch. 289, §112(b)(6), 52 Stat. 485; Int. Rev. Code of 1939, ch. 1, §112(b)(6), 53 Stat. 38 (now INT. REV. CODE OF 1954, §332).

38. Act of May 10, 1934, ch. 277, §113(a)(6), 48 Stat. 706 (now INT. REV. CODE OF 1954, §§358, 1031).

39. *See* 80 CONG. REC. 8799 (1936) (remarks of Senator George).

40. Act of June 22, 1936, ch. 690, §113(a)(15), 49 Stat. 1684 (now INT. REV. CODE OF 1954, §334(b)(1)).

41. STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE, *supra* note 34, at 663.

42. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 11-26 (3d ed. 1971).

Unfortunately, these provisions soon proved to be the germ of litigation. In the usual situation where the parent corporation claimed nonrecognition treatment in order to shield its realized gain, the Commissioner would sometimes argue that the statute was inapplicable because its detailed provisions were not followed precisely.[43] On other occasions, however, the parent would maneuver to avoid the nonelective clutches of section 112(b)(6), often by simply failing to comply with its express statutory requirements. Noncompliance proved advantageous, for example, whenever the statute precluded the parent from recognizing a tax loss where its basis in the subsidiary's stock exceeded the fair market value of the property received in liquidation.[44] Moreover, in keeping with the "change of form only" notion, the carryover basis rule completely disregarded the parent's stock basis in the subsidiary, even though the acquisition-liquidation resulted in neither gain nor loss to the parent.[45] Depending upon whose viewpoint was being advanced, the argument was frequently made that the form of the transaction should not prevail over its substance.[46]

This contention was particularly appealing where one corporation purchased the stock of another solely to obtain its assets through prompt liquidation. Looking to the realities of the transaction, a parent often argued that the general carryover basis rule created "an unjustified dichotomy between two otherwise similar methods of acquiring the assets of another corporation."[47] If those assets were purchased directly, the parent would have a cost basis in them.[48] If, however, the target company refused to sell its assets,[49] the acquiring corporation might purchase a controlling stock interest and then obtain the desired assets through liquidation. Unfortunately, this cir-

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43. *E.g.*, Cherry-Burrell Corp. v. United States, 367 F.2d 669, 66-2 U.S.T.C. ¶9681 (8th Cir. 1966) (§112(b)(6) held applicable even though the final liquidating distribution was made outside the statutory 3-year time limit, and despite the parent's failure to submit assessment waivers or protective bonds as required in the regulations).

44. *E.g.*, Burnside Veneer Co. v. Commissioner, 167 F.2d 214, 48-1 U.S.T.C. ¶9237 (6th Cir. 1948) (§112(b)(6) held applicable despite the absence of a formal plan of liquidation and taxpayer's failure to comply with pertinent Treasury regulations); Commissioner v. Day & Zimmerman, Inc., 151 F.2d 517, 45-2 U.S.T.C. ¶9403 (3d Cir. 1945) (§112(b)(6) held inapplicable and the subsequent loss on liquidation was recognized, where parent reduced its stock holdings below the requisite 80% level).

45. Additionally, a parent falling squarely within the inflexible framework of §§112(b)(6) and 113(a)(15) (now §§332 and 334(b)(1)) might be quite willing to recognize a capital gain on the distribution in order to obtain a stepped-up cost basis in the assets received and to avoid inheriting the subsidiary's earnings and profits. The nonelective status of §332, however, precludes this result.

46. *E.g.*, Commissioner v. Ashland Oil & Ref. Co., 99 F.2d 588, 38-2 U.S.T.C. ¶9580 (6th Cir.), *cert. denied*, 306 U.S. 661 (1938); Helvering v. Security Sav. & Commercial Bank, 72 F.2d 874, 4 U.S.T.C. ¶1343 (4th Cir. 1934); Prairie Oil & Gas Co. v. Motter, 66 F.2d 309, 3 U.S.T.C. ¶1142 (10th Cir. 1933); Koppers Coal Co., 6 T.C. 1209 (1946).

47. B. BITTKER & J. EUSTICE, *supra* note 42, at 11-35.

48. Act of May 10, 1934, ch. 277, §113(a), 48 Stat. 706 (now INT. REV. CODE OF 1954, §1012).

49. Factors might include an inadequate purchase price, a desire to continue existing operations, inability to replace assets sold due to scarcity or increased costs, and the usual reluctance of buyers to assume existing and contingent liabilities when purchasing assets.

cuitous route often activated the nonelective provisions of sections 112(b)(6) and 113(a)(15), resulting in a carryover of basis that precluded the indirect purchaser from taking his real cost basis in those assets.[50] Evidently, Congress had overlooked this type of transaction, for the legislative history of these sections is primarily directed toward the liquidation of corporations operated for some time as subsidiaries.[51]

Addressing this inconsistent result, a number of pre-1954 cases looked through the ostensible form to the realities of the underlying transaction.[52] In the landmark case of *Kimbell-Diamond Milling Co.*,[53] the petitioner corporation, after one of its flour mills was destroyed by fire, purchased for cash all of the outstanding capital stock of Whaley Mill & Elevator Company. The petitioner's minutes clearly showed that its sole purpose in acquiring the stock was to obtain Whaley's milling facilities by complete liquidation "as soon as practicable after the purchase . . . ."[54] Three days later the company was liquidated, and all assets were transferred to the parent corporation in complete cancellation of Whaley's capital stock. In order to carry over Whaley's basis in the assets, which exceeded the purchase price of its stock, the petitioner argued that sections 112(b)(6) and 113(a)(15) applied to the liquidation.[55] The Tax Court, relying on the governing principle of an earlier case,[56] held to the contrary. The court found it "inescapable from petitioner's minutes . . . that the only intention petitioner ever had was to acquire Whaley's assets."[57]

50. This carryover in basis, which represents the subsidiary's adjusted basis in its assets, would seldom equal the parent's purchase price for the subsidiary's stock, which reflects the fair market value of those same assets.

51. *See* United States v. M.O.J. Corp., 274 F.2d 713, 60-1 U.S.T.C. ¶9209 (5th Cir. 1960).

52. *See* cases cited note 46 *supra. See also* Henderson, *Voting Stock in a Two-Step Asset Acquisition: The* Kimbell-Diamond *Reorganization,* 25 TAX L. REV. 375, 381-82 (1970).

53. 14 T.C. 74 (1950), *aff'd per curiam,* 187 F.2d 718, 51-1 U.S.T.C. ¶9201 (5th Cir.), *cert. denied,* 342 U.S. 827 (1951).

54. 14 T.C. at 76.

55. It is interesting to note that it was the Commissioner who argued for the application of the step transaction doctrine, because this effectuated a "stepped-down" basis in the assets received. In subsequent cases, however, the *Kimbell-Diamond* rule frequently worked to the advantage of the taxpayer, giving him the benefit of a higher cost basis rather than a carryover basis under §334(b)(1). *See, e.g.,* Georgia-Pacific Corp. v. United States, 264 F.2d 161, 59-1 U.S.T.C. ¶9279 (5th Cir. 1959); Montana-Dakota Util. Co., 25 T.C. 408 (1955), *acquiesced in,* 1956-2 CUM. BULL. 7.

56. 14 T.C. at 80. *See* Commissioner v. Ashland Oil & Ref. Co., 99 F.2d 588, 38-2 U.S.T.C. ¶9580 (6th Cir.), *cert. denied,* 306 U.S. 661 (1938), where the taxpayer corporation purchased the capital stock of another corporation over the course of a year in order to obtain certain oil and gas leases through liquidation. The court combined the stock purchase and liquidation under the step transaction doctrine and held that the two transactions were in reality a purchase of assets. In reaching this conclusion, the court aptly observed: "The question remains, however, whether . . . the entire transaction, whatever its form, was essentially in intent, purpose and result, a purchase . . . of property. . . . And without regard to whether the result is imposition or relief from taxation, the courts have recognized that where the essential nature of a transaction is the acquisition of property, it will be viewed as a whole, and closely related steps will not be separated either at the instance of the taxpayer or the taxing authority." *Id.* at 591, 38-2 U.S.T.C. ¶9580, at 10,718.

57. 14 T.C. at 80.

Noting the well-settled rule that "the incidence of taxation depends upon the substance of a transaction,"[58] the court viewed the stock purchase and liquidation as a series of closely related steps in furtherance of the single objective of purchasing assets, rather than as separate and independent events. Accordingly, section 112(b)(6) did not apply to the transaction, and petitioner was forced to take the lower cost basis in the assets received on liquidation.[59]

When Congress enacted the 1954 Code four years later, it added section 334(b)(2) as an exception to the general carryover provision in order to incorporate "rules effectuating principles derived from *Kimbell-Diamond Milling Co.* . . ."[60] In codifying this step transaction doctrine, Congress endeavored "to inject some degree of certainty"[61] by providing a mechanical test to replace a factual determination of the subjective intent of the indirect purchaser.[62] In general, section 334(b)(2) entitles the parent to a cost basis in assets received from its liquidated subsidiary if the detailed statutory prerequisites are met. In view of the unresolved questions that abound in this area, it is ironic that *Kimbell-Diamond*'s subjective intent standard may sometimes be easier to prove.

JUDICIAL AND ADMINISTRATIVE INTERPRETATIONS

Section 332

In general, section 332 is a nonelective[63] exception to the recognition provisions of section 331.[64] If its statutory conditions are met, section 332 pro-

58. *Id., citing* Commissioner v. Court Holding Co., 324 U.S. 331, 45-1 U.S.T.C. ¶9215 (1945).

59. 14 T.C. at 80.

60. S. REP. No. 1622, 83d Cong., 2d Sess. 257 (1954). In Georgia-Pacific Corp. v. United States, 264 F.2d 161, 163, 59-1 U.S.T.C. ¶9279, at 71,602-03 (5th Cir. 1959), the court succinctly explained the *Kimbell-Diamond* rule: "[W]hen stock in a corporation is purchased for the purpose and with the intent of acquiring its underlying assets and that purpose continues until the assets are taken over, no independent significance taxwise attaches to the several steps of a multiple step transaction. The final step is, therefore, viewed not as independent of the stock purchase but simply as one of the steps in a unitary transaction, the purchase of assets."

61. American Potash & Chem. Corp. v. United States, 399 F.2d 194, 207, 68-2 U.S.T.C. ¶9472, at 87,633 (Ct. Cl. 1968).

62. *Id.* The purchaser's intent, for example, was to acquire oil producing properties in Commissioner v. Ashland Oil & Ref. Co., 99 F.2d 588, 38-2 U.S.T.C. ¶9580 (6th Cir.), *cert. denied,* 306 U.S. 661 (1938); to obtain substantially similar milling equipment to replace its flour mill destroyed by fire in Kimbell-Diamond Milling Co., 14 T.C. 74 (1950), *aff'd per curiam,* 187 F.2d 718, 51-1 U.S.T.C. ¶9201 (5th Cir.), *cert. denied,* 342 U.S. 827 (1951); to obtain equipment and oil and gas leases in Kanawha Gas & Util. Co. v. Commissioner, 214 F.2d 685, 54-2 U.S.T.C. ¶9508 (5th Cir. 1954); to acquire a large timber tract in Georgia-Pacific Corp. v. United States, 264 F.2d 161, 59-1 U.S.T.C. ¶9279 (5th Cir. 1959); to continue the business operations of the acquired corporations in United States v. M.O.J. Corp., 274 F.2d 713, 60-1 U.S.T.C. ¶9209 (5th Cir. 1960), *followed in,* Rev. Rul. 60-246, 1960-2 CUM. BULL. 462.

63. Section 332(a) provides that "[n]o gain or loss *shall* be recognized." (Emphasis added.) *But see* B. BITTKER & J. EUSTICE, *supra* note 42, at 11-30 n.51 for an interesting argument that can be advanced in support of the elective status of §332.

64. INT. REV. CODE OF 1954, §331 generally treats the amounts distributed in complete

vides that no gain or loss shall be recognized by a parent corporation on the receipt[65] of property[66] distributed[67] in complete liquidation of an eighty per cent subsidiary within specified time limitations.[68] Hence, neither the subsidiary corporation being liquidated[69] nor the minority shareholders,[70] who also share in the distributed assets, falls within the general rule of section 332(a).

To qualify under section 332(b)(1),[71] the recipient parent corporation must

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liquidation of a corporation as being made in full payment for the stock exchanged, with gain or loss to the recipient determined under §1001 and recognized as required under §1002, except as otherwise provided. Treas. Reg. §§331-1(a), (b). The nonrecognition provisions of §332 constitute one such exception to this general rule.

65. Section 332 applies only in cases where the parent receives at least partial payment for the stock that it owns in the liquidating subsidiary. Therefore, if the subsidiary is insolvent and the parent receives nothing on its liquidation, §332 is inapplicable, but §165(g) may allow a deduction for the loss on the worthless securities. Treas. Reg. §1.332-2(b). *See* Commissioner v. Spaulding Bakeries, Inc., 252 F.2d 693, 58-1 U.S.T.C. ¶9320 (2d Cir. 1958); Northern Coal & Dock Co., 12 T.C. 42 (1949), *acquiesced in,* 1949-1 CUM. BULL. 3; Iron Fireman Mfg. Co., 5 T.C. 452 (1945), *acquiesced in,* 1945 CUM. BULL. 4.

66. For §332 purposes, property includes money. Rev. Rul. 69-379, 1969-2 CUM. BULL. 48. *See* Cherry-Burrell Corp. v. United States, 367 F.2d 669, 675, 66-2 U.S.T.C. ¶9681, at 87,229 (8th Cir. 1966).

67. A mere intention to liquidate or even the dissolution of the corporation under local law will not suffice in the absence of an actual distribution of the subsidiary's assets among its shareholders. 1 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION §9.76 (1969).

68. Complete liquidation includes "any one of a series of distributions by a corporation in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation under which the transfer of the property under the liquidation is to be completed within a time specified in the plan . . . ." STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE, *supra* note 34. The liquidation is completed whenever the liquidating corporation and the receiver or trustees in liquidation are finally divested of all property, both tangible and intangible. Treas. Reg. §1.332-2(c). The retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence is permissible, since legal dissolution of the corporation is not required. *Id.* Yet, if *any* property is retained by the subsidiary for the purpose of continuing present business operations or engaging in a new business, then the liquidating distribution cannot qualify as a distribution in complete liquidation within the meaning of §332. Herbert A. Nieman & Co., 33 T.C. 451 (1959), *acquiesced in,* 1965-2 CUM. BULL. 6; Rev. Rul. 66-186, 1966-2 CUM. BULL. 112.

69. Koppers Co. v. United States, 278 F.2d 946, 950, 60-2 U.S.T.C. ¶9595, at 77,209 (Ct. Cl. 1960). Section 336 determines the tax consequences to the liquidating subsidiary upon the distribution of its assets in partial or complete liquidation. *But see* INT. REV. CODE OF 1954, §332(c) for a special nonrecognition rule accorded the liquidating subsidiary.

70. Treas. Reg. §1.332-5. In many cases the minority shareholders will recognize gain or loss on the liquidation under the rules of §§331(a), 1001, and 1002. This is not invariably the result, however, for they may be entitled to nonrecognition treatment under §333 (Rev. Rul. 56-212, 1956-1 CUM. BULL. 170; *see* Treas. Reg. §1.334-1(c)(8)), or to the special benefits of §337(d). *See* Treas. Reg. §1.337-5. Moreover, the transaction may take the form of a statutory merger that qualifies as a nontaxable reorganization under §§368(a)(1)(A), 354(a). In this event, neither the minority shareholders nor the parent corporation would recognize gain or loss on the transfer. May B. Kass, 60 T.C. 218 (1973), *aff'd without opinion,* 491 F.2d 749 (3d Cir. 1974); American Mfg. Co., 55 T.C. 204 (1970); INT. REV. CODE OF 1954, §332(b) (last sentence); Treas. Reg. §§1.332-2(d), (e).

71. *See* Rev. Proc. 73-17, 1973-32 INT. REV. BULL. 12 for a checklist of information to be included when requesting rulings under §§332 and 334(b).

own on the date[72] that the plan of liquidation is adopted[73] and at all times during the entire liquidation period[74] at least eighty per cent of the combined

72. Timing may become a critical factor, because the requisite 80% controlling interest must exist on the *date* that the plan of liquidation is adopted. Although §332(b)(2) expressly provides that shareholder adoption of the liquidating resolution "shall be considered an adoption of a plan of liquidation" if the property transfer is completed within the taxable year, neither the statute nor implementing regulations offer any further guidance as to when other acceptable methods are deemed to be adopted. Presumably, shareholder approval of the resolution authorizing the subsidiary's directors to liquidate pursuant to applicable state law constitutes the requisite date in most cases. This thought is reinforced by the §337 regulations, which explain that formal adoption of the liquidation plan takes place at the shareholders' meeting, and this is ordinarily the date on which the shareholders adopt the resolution authorizing the distribution of all corporate assets, other than those retained to meet claims of creditors, in redemption of all outstanding stock. Treas. Reg. §§1.337-2(b), -6(a)(1). The regulations, however, further state that the date of the shareholders' meeting is controlling only in certain situations (which are not relevant to §332), concluding with the qualification that "[i]n all other cases the date of the adoption of the plan of liquidation shall be determined from all the facts and circumstances." Treas. Reg. §1.337-2(b). In essence, the Treasury's position is that the date of the shareholders' meeting is normally, but not necessarily, the controlling date. *Compare* Rev. Rul. 57-140, 1957-1 Cum. Bull. 118, *with* Rev. Rul. 65-235, 1965-2 CUM. BULL. 88. This flexible approach appears warranted, albeit subjective, because the shareholders of a closely-held corporation might informally approve a plan to liquidate. Jessie B. Mitchell, 31 CCH Tax Ct. Mem. 1077 (1972) (involving §337). Additionally, applicable state law may allow a short merger, whereby the board of directors of the parent corporation can authorize its merger with an essentially wholly-owned subsidiary without shareholder approval of either corporation. N.Y. BUS. CORP. LAW ANN. §905 (McKinney 1963) (95% ownership requirement); DEL. CODE ANN. tit. 8, §253 (1969) (90% ownership requirement); ABA MODEL BUS. CORP. ACT ANN. §75 (1971) (90% ownership requirement).

73. The physical act of adopting a plan of complete liquidation will ordinarily present a more troublesome question than its adoption date. This is apparent in situations where the taxpayer seeks to *comply* with the nonrecognition provisions of §332 by increasing its stock holdings to the requisite 80% level immediately before adopting a formal plan of liquidation. On various occasions the Commissioner has taken a dim view of such last-minute purchases. Although ordinarily recognizing the shareholders' meeting as controlling in most cases, *see* note 72 *supra*, he may assert that the acquiring parent had informally decided to liquidate its subsidiary before purchasing the necessary additional shares. Distributors Fin. Corp., 20 T.C. 768 (1953), *acquiesced in*, 1954-2 CUM. BULL. 4; Rev. Rul. 70-106, 1970-1 CUM. BULL. 70; *cf.* Rev. Rul. 65-235, 1965-2 CUM. BULL. 88 (involving §337); Jessie B. Mitchell, 31 CCH Tax Ct. Mem. 1077 (1972) (involving §337). In other situations the Commissioner has successfully prevented the parent from *avoiding* the provisions of §332 and recognizing a loss, by asserting that the taxpayer's intent to liquidate is controlling, rather than the existence of a formal plan. Burnside Veneer Co. v. Commissioner, 167 F.2d 214, 48-1 U.S.T.C. ¶9237 (6th Cir. 1948); Service Co. v. Commissioner, 165 F.2d 75, 48-1 U.S.T.C. ¶9198 (8th Cir. 1948). This substance-over-form approach seems sensible, for otherwise a taxpayer could manipulate the nonelective provisions of §332 almost at will by calibrating his degree of compliance in adopting a formal liquidation plan with with his desire to fall within or without the statutory framework.

74. The question may arise whether a parent can avoid the nonelective clutches of §332 by disposing of enough stock in a subsidiary to bring its holdings below the requisite 80% mark before receiving all of the property in liquidation. Confusion arose under the 1939 Code, because §112(b)(6) not only required the parent to maintain a controlling 80% interest during the entire liquidation period, but also prohibited the parent from disposing of any stock in the subsidiary during this time. Thus, in Commissioner v. Day & Zimmerman, Inc., 151 F.2d 517, 45-2 U.S.T.C. ¶9403 (3d Cir. 1945), where the sale of stock

voting power of all classes of the subsidiary's voting stock[75] and at least eighty per cent of the total number of shares of all other classes of stock,[76] except for nonvoting preferred. Additionally, the liquidating distribution must totally cancel or redeem all of the subsidiary's stock and the entire transfer must either be completed within the taxable year[77] pursuant to the plan,[78] or where the distributions extend over a period of more than one taxable year, be accomplished in accordance with a plan that provides for the transfer of all property within three years from the close of the taxable year during which the first liquidating distribution is made.[79] If the transfer is not com-

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occurred after the decision to liquidate the subsidiary had been reached but immediately prior to any actual distributions, the court held §112(b)(6) inapplicable. When Congress enacted the 1954 Code it eliminated the no-disposition rule "with the view to limiting the elective features of the section." S. REP. No. 1622, *supra* note 60, at 255. Accordingly, §332(b)(1) merely provides that the requisite 80% controlling interest must exist on the date the plan is adopted and at all times thereafter until the property is received, and current regulations embody this congressional intent. *See* Treas. Reg. §§1.332-2(a), (c).

75. Generally, the security must provide for "significant participation in the management" of the corporation in order for it to be considered voting stock. *Cf.* Rev. Rul. 63-234, 1963-2 CUM. BULL. 148, 149.

76. The Treasury maintains that the phrase "80 percent of the total number of shares of all other classes of stock" requires the ownership of stock possessing at least 80% of the total number of shares of *each* class of outstanding nonvoting stock. Rev. Rul. 59-259, 1959-2 CUM. BULL. 115.

77. The Treasury has ruled that this requirement relates to the taxable year in which the transfer of property is made, rather than the year in which the plan of liquidation is adopted. Therefore, if the subsidiary is completely liquidated within one taxable year, §332 applies despite the fact that the liquidating distribution may be delayed for several years after adoption of the plan. Good business reasons, however, should require the delay because it subjects the plan and property distribution to careful scrutiny by the Service. Rev. Rul. 71-326, 1971-2 CUM. BULL. 177. The legislative history of §332 clearly supports the Treasury's position. *See* STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE, *supra* note 34, at 663.

78. For this purpose, §332(b)(2) specifically provides that "the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such [subsidiary] corporation in complete cancellation or redemption of all its stock shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution . . . ." The implementing regulation provides: "The plan of liquidation must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of each such corporation." Treas. Reg. §1.332-6(a). Prudence therefore dictates that the shareholders *formally* approve the directors' resolution to liquidate, or if state law permits a short merger, that the board of directors *formally* adopt the plan of liquidation. *See* notes 72-73 *supra*.

79. INT. REV. CODE OF 1954, §332(b)(3). *But see* Burnside Veneer Co. v. Commissioner, 167 F.2d 214, 48-1 U.S.T.C. ¶9237 (6th Cir. 1948), where the taxpayer corporation asserted that no formal liquidation plan existed, but even if one had been made, it failed to specify, as required by statute, that the transfer of all property was to be completed within three years from the close of the taxable year during which the first of the series of distributions under the plan was made. The court held to the contrary. It found that the taxpayer's board of directors had adopted unanimously a resolution that its 80% subsidiary "be immediately dissolved as provided by [North Carolina] law . . . ." Applicable law continued the corporate existence for three years, during which time the directors acting as trustees were to wind up the business of the corporation. Because the liquidation was actually com-

pleted[80] within this period,[81] or if the parent does not remain a qualified eighty per cent shareholder at all times until the property is received, then nonrecognition treatment will be retroactively disallowed and the parent must recognize gain or loss with respect to each distribution under the plan.[82] Because of this possibility, the Commissioner may require the taxpayer to post bond or waive the statute of limitations on assessment and collection, or both, whenever the transfer of all property is not in fact completed within the taxable year.[83] In this manner the assessment and collection of all income taxes attributable to the previously distributed property is assured.

The Code provides a special rule in situations where the liquidating subsidiary corporation is indebted to its parent corporation when the plan of liquidation is adopted.[84] Whenever section 332(a) applies to the liquidating distributions, then subsection (c) extends nonrecognition treatment to the *subsidiary* upon the transfer of appreciated or depreciated property in satisfaction of its indebtedness to the parent.[85] Section 332(c), however, has no application to the parent corporation, which must recognize any gain or loss when realized.[86] If, for example, it had purchased the subsidiary's bonds at

pleted within that time, the court found that the requirements of §112(b)(6) (now §332) had been met, even though no precise time for liquidation had been specified.

80. *See* note 68 *supra*.

81. "[T]he statute makes completion within the statutory period mandatory . . . ." Burnside Veneer Co. v. Commissioner, 167 F.2d 214, 218, 48-1 U.S.T.C. ¶9237, at 330 (6th Cir. 1948). *But see* Cherry-Burrell Corp. v. United States, 367 F.2d 669, 66-2 U.S.T.C. ¶9681 (8th Cir. 1966), where the settlement of lawsuits against the liquidating British subsidiary of an American corporation involuntarily delayed the final distribution beyond the requisite three-year period. (In this instance, final payment was made approximately 6½ years after the first distribution.) Nevertheless, the court held that the taxpayer was entitled to the nonrecognition benefits of §112(b)(6) (now §332), stating: "The intendment of the statute should not be thwarted by technical niceties. . . . The record discloses nothing indicative of purposeful delay in distribution . . . [because] one knows that a claim or lawsuit cannot be settled unilaterally. . . . The purpose of §112(b)(6)(D) was fulfilled. The corporate structure was simplified. The statute's three-year period strikes us as being primarily a significant indicator of the genuineness of the plan of liquidation. There is no question as to genuineness here. . . . Only the barrier of the English law prevented what is, at most, technical compliance with the statute's requirements. We are not inclined to impose a forfeiture of tax consequences because of this. If there was noncompliance here, the situation is one of excusable noncompliance and one which fits the maxim *lex non cogit ad impossibilia*." *Id.* at 676, 66-2 U.S.T.C. ¶9681, at 87,229-30.

82. INT. REV. CODE OF 1954, §332(b); Treas. Reg. §1.332-4(b).

83. INT. REV. CODE OF 1954, §332(b) (penultimate sentence). The implementing regulations make clear that although the "recipient corporation may be required to file a bond," it "shall . . . file . . . a waiver of the statute of limitations on assessment." Treas. Reg. §§1.332-4(a)(3), (2). A parent's failure to submit assessment waivers or protective bonds, however, does not amount to a forfeiture of the nonrecognition provisions of §332. Cherry-Burrell Corp. v. United States, 367 F.2d 669, 677, 66-2 U.S.T.C. ¶9237, at 87,231 (8th Cir. 1966). The Treasury maintains a contrary position, treating the required filing as a condition precedent to the applicability of §332. *Id.*; Treas. Reg. §1.332-4(b) (first sentence).

84. INT. REV. CODE OF 1954, §332(c).

85. Treas. Reg. §1.332-7. Except in this limited instance, the nonrecognition provisions of §332 have no application to the liquidating subsidiary. *See* note 69 *supra*.

86. Houston Natural Gas Corp. v. Commissioner, 173 F.2d 461, 49-1 U.S.T.C. ¶9211 (5th Cir. 1949); Treas. Reg. §1.332-7.

a discount and received the face amount on liquidation, gain would be recognized to the parent corporation.[87] Where the payments received are less than the parent's basis, a deduction for the worthless securities is allowed.[88]

Several collateral points also deserve mentioning. As in other areas of income taxation, state law is not controlling in determining whether a distribution is an ordinary dividend or whether it occurs pursuant to a liquidation or reorganization.[89] Moreover, it is not necessary for the parent corporation to continue the prior business operations of its subsidiary for the nonrecognition provisions to apply to the liquidation.[90] Finally, section 332 is inapplicable to the liquidation of a foreign subsidiary, unless the taxpayer obtains an advance ruling from the Commissioner that the proposed plan does not have as one of its principal purposes the avoidance of federal income taxes.[91]

Section 334(b)

Coupled with the liquidation provisions of section 332 are the rules for determining basis under section 334(b). Section 334(b)(1) continues the carryover basis rule contained in section 113(a)(15) of the 1939 Code,[92] by providing that the property received by a parent corporation in complete liquidation of its subsidiary under section 332 will have the same basis as it had in the hands of the subsidiary at the time of transfer,[93] that is, a substituted basis.[94] Moreover, the parent normally succeeds to the tax attributes of the

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87. Treas. Reg. §1.332-7. *See* INT. REV. CODE OF 1954, §61(a)(12); United States v. Kirby Lumber Co., 284 U.S. 1, 2 U.S.T.C. ¶1814 (1931).

88. INT. REV. CODE OF 1954, §165(g); Treas. Reg. §1.332-2(b). In this situation there is no distribution in complete liquidation as required by §332(b), because bondholders have liquidation priority over stockholders. Hence, the recipient parent will be entitled to a worthless securities deduction for the balance of the unpaid debt and for its investment loss in the subsidiary's capital stock. Glenmore Distilleries Co., 47 B.T.A. 213 (1942), *acquiesced in,* 1942-2 CUM. BULL. 8. *But see* Republic Steel Corp. v. United States, 159 F. Supp. 366, 58-1 U.S.T.C. ¶9337 (Ct. Cl. 1958) (note given by wholly-owned subsidiary to parent lacked economic reality and bad debt and worthless stock loss deductions were denied); Woodward Iron Co. v. United States, 59 F. Supp. 54, 45-1 U.S.T.C. ¶9180 (N.D. Ala. 1945) (advances to two wholly-owned subsidiaries, unsupported by notes or other evidences of indebtedness, were not deductible bad debts where no demand for payment was made).

89. Frelmort Realty Corp., 29 B.T.A. 181 (1933); INT. REV. CODE OF 1954, §332(b); Treas. Reg. §1.332-2(d). Moreover, in cases where there is a complete liquidation, §332 takes precedence over the reorganization sections. Kansas Sand & Concrete, Inc. v. Commissioner, 462 F.2d 805, 72-2 U.S.T.C. ¶9590 (10th Cir. 1972); INT. REV. CODE OF 1954, §332(b); Treas. Reg. §§1.332-2(d), (e). *But see* American Mfg. Co., 55 T.C. 204 (1970).

90. Rev. Rul. 70-357, 1970-2 CUM. BULL. 79 apparently clears up the confusion created by Fairfield S.S. Corp. v. Commissioner, 157 F.2d 321, 46-2 U.S.T.C. ¶9322 (2d Cir.), *cert. denied,* 329 U.S. 774 (1946).

91. INT. REV. CODE OF 1954, §367. *But see* Rev. Rul. 64-177, 1964-1 (pt.1) CUM. BULL. 141.

92. *See* text accompanying notes 40-42 *supra.*

93. Treas. Reg. §1.334-1(b).

94. INT. REV. CODE OF 1954, §1016(b).

subsidiary,[95] including its earnings and profits,[96] certain carryovers such as net operating losses,[97] capital losses,[98] and investment credit.[99]

In 1954, as a result of the decision in *Kimbell-Diamond Milling Co.*, Congress enacted a rather complex exception to the general carryover basis rule. If the parent can meet the detailed requirements, section 334(b)(2) provides that the parent's basis in the distributed property is to be computed with reference to its basis in the subsidiary's stock immediately before the liquidation.[100] In other words, section 334(b)(2) generally gives the parent a cost basis (with certain adjustments) rather than a substituted basis in the subsidiary's assets received on liquidation. To this extent the statute reaches the same result as *Kimbell-Diamond*, but it also replaces the "tenuous standard of subjective intent"[101] inherent in the judicial doctrine with more objective criteria.[102] In essence, the exceptional basis provision of section 334(b)(2) applies only to property received in a complete liquidation governed by section 332.[103] Once this threshold requirement is met, if the parent corporation had previously purchased at least eighty per cent of the subsidiary's stock, other than nonvoting preferred, during a twelve-month period and then caused the acquired corporation to be liquidated within two years from the last purchase, section 334(b)(2) provides[104] that the basis of all assets received by the parent is its adjusted basis in the subsidiary's stock with respect to which the liquidating distribution is made, subject to certain adjustments.[105]

In this manner the statute endeavors to treat the parent as a purchaser of assets. Thus, the over-all statutory pattern quite consistently provides that the parent does not inherit the tax attributes of its liquidating subsidiary,[106] yet this concept is not generally extended to require realization of gain or loss by the liquidating subsidiary on this indirect sale of its assets to the purchasing parent.[107]

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95. *Id.* §381(a)(1).
96. *Id.* §381(c)(2).
97. *Id.* §381(c)(1).
98. *Id.* §381(c)(3).
99. *Id.* §381(c)(23).
100. Treas. Reg. §1.334-1(c).
101. Lewis, *Cost-of-Stock Basis for Assets Received from Acquired Corporation*, 19 U. MIAMI L. REV. 159, 171 (1964).
102. Madison Square Garden Corp., 58 T.C. 619, 626 (1972), *aff'd in part and rev'd in part*, 500 F.2d 611, 74-2 U.S.T.C. ¶9618 (2d Cir. 1974).
103. INT. REV. CODE OF 1954, §334(b)(2); Treas. Reg. §1.334-1(c); Yoc Heating Corp., 61 T.C. 168 (1973). Thus, §334(b)(2) applies only to the parent corporation and not to the minority shareholders, who also share in the liquidation. S. REP. No. 1622, *supra* note 60; INT. REV. CODE OF 1954, §334(b)(4); Treas. Reg. §1.334-1(c)(8).
104. *See* Supreme Inv. Corp. v. United States, 468 F.2d 370, 377, 72-2 U.S.T.C. ¶9689, at 85,708 (5th Cir. 1972).
105. Treas. Reg. §1.334-1(c).
106. INT. REV. CODE OF 1954, §381(a); Supreme Inv. Corp. v. United States, 468 F.2d 370, 377, 72-2 U.S.T.C. ¶9689, at 85,708 (5th Cir. 1972).
107. See Commissioner v. South Lake Farms, 324 F.2d 837, 64-1 U.S.T.C. ¶9101 (9th Cir. 1963); INT. REV. CODE OF 1954, §336. *But see* Blueberry Land Co., 42 T.C. 1137 (1964),

With respect to the eighty per cent ownership requirement, section 334(b)(2)(B) substantially duplicates the wording used in section 332(b)(1), and it is entirely consistent with congressional intent and rules of statutory construction to interpret both phrases harmoniously.[108] Additionally, section 334(b)(2) specifies that the requisite control must be *purchased* during a twelve-month period.[109] In general, Congress intended "to limit the definition of the term 'purchase' to cases where the acquisition of the stock was made in a taxable transaction."[110] A "purchase" is thus defined in the statute[111] to include any acquisition of stock, except when it has been acquired in a transaction where the parent's basis carried over from the prior owner[112] or by inheritance from a decedent,[113] in a section 351 exchange,[114] or from a related person where the attribution rules of section 318(a) would be applicable.[115] In essence, the first three exceptions were designed to prevent a parent from obtaining a possible stepped-up basis in assets distributed with respect to stock acquired in a nontaxable transaction,[116] while the latter provision was enacted to prevent manipulation among related persons.[117]

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aff'd, 361 F.2d 93, 66-1 U.S.T.C. ¶9420 (5th Cir. 1966), where the court held that the "parent" corporation served no real or useful economic purpose and that the acquisition-liquidation transaction was a sham, with gain recognized to the transferor corporations.

108. *Cf.* Madison Square Garden Corp., 58 T.C. 619 (1972), *aff'd in part and rev'd in part*, 500 F.2d 611, 74-2 U.S.T.C. ¶9618 (2d Cir. 1974).

109. Normally, the twelve-month period runs from the date on which the parent makes its first purchase in furtherance of obtaining a controlling interest. INT. REV. CODE OF 1954, §334(b)(2)(B)(i). In situations where the controlling stock of the desired corporation [S-2] is acquired from an existing subsidiary [S-1], the twelve-month period commences from the date on which the parent acquires at least 50% of S-1's stock, if this represents the earlier date. *Id.* §334(b)(2)(B)(ii); Treas. Reg. §1.334-1(c)(7)(ii); S. REP. No. 1707, 89th Cong., 2d Sess. (1966), *reprinted in*, 1966-2 CUM. BULL. 1059, 1101.

110. S. REP. No. 1622, *supra* note 60, at 258.

111. INT. REV. CODE OF 1954, §334(b)(3). For a more exhaustive analysis of the purchase area, *see* O'Hara, *Liquidation of Subsidiaries-Basis-Sec. 334(b)(2)*, BNA TAX MGMT. PORTFOLIO No. 16-4th at A-6 to -10 (1973). *See also* Bijou Park Properties, Inc., 47 T.C. 207 (1966), *acquiesced in*, 1968-2 CUM. BULL. 1.

112. *E.g.*, INT. REV. CODE OF 1954, §§362, 1015.

113. *Id.* §1014.

114. *Id.* §351. *See* Rev. Rul. 57-296, 1957-2 CUM. BULL. 234 (a §351 transfer to a controlled corporation does not constitute a purchase for purposes of §334(b)(2)(B) due to the application of §334(b)(3)(B)).

115. INT. REV. CODE OF 1954, §318(a). Section 334(b)(3) was amended in 1966 (Act of Nov. 1966, Pub. L. 89-809, Title II, §202(a), 80 Stat. 1576) "to cure the timing problem created by §334(b)(3)(C) where a chain of subsidiaries was acquired and liquidated into the parent in the wrong order . . . ." B. BITTKER & J. EUSTICE, *supra* note 42, at 11-37. The amendment expanded the definition of "purchase" for purposes of §334(b)(2) to include "an acquisition of [S-2] stock from a corporation [S-2] when ownership of such [S-1] stock would be attributed under section 318(a) to the person [P] acquiring such [S-1] stock, if the stock of such [S-1] corporation . . . was acquired by purchase (within the meaning of the preceding sentence)." INT. REV. CODE OF 1954, §334(b)(3) (last sentence). The committee report's explanation of the change appears in S. REP. No. 1707, *supra* note 109.

116. Madison Square Garden, 58 T.C. 619, 625 n.6 (1972), *aff'd in part and rev'd in part*, 500 F.2d 611, 74-2 U.S.T.C. ¶9618 (2d Cir. 1974).

117. S. REP. No. 1707, *supra* note 109.

Once control has been achieved by purchase during a twelve-month period, a plan of liquidation must be adopted[118] within two years from the date on which the controlling interest was acquired.[119] It is not necessary for the liquidating distribution to occur during this two-year period if good business reasons cause the delay.[120] Section 334(b)(2), however, applies only to the stock owned by the parent corporation immediately before the liquidation,[121] and only property received with respect to such stock is given special treatment under the statute.[122]

Finally, Congress has authorized the Commissioner to make proper adjustment in the cost basis that the distributed property assumes in the hands of the distributee corporation.[123] These computations can become quite complex,[124] and the area abounds with unanswered questions.[125] As a

118. The date of adoption of the liquidation plan is determined under §332(b)(2). Treas. Reg. §1.334-1(c)(2). *See* notes 72-73 *supra.*

119. Where a controlling interest is obtained in a single purchase, the two-year period will begin on the day following such purchase. Whenever control is acquired through a series of purchases, the two-year period commences on the day following the earliest date (which is the end of a twelve-month period or less) on which the requisite 80% stock interest was acquired. For example, if 20% of the subsidiary's stock is purchased on each of the following dates, April 1, 1973, June 30, 1973, September 30, 1973, December 31, 1973, and June 1, 1974, the two-year period shall begin on January 1, 1974, because this is the earliest date ending a twelve-month period or less (here, nine months) on which the requisite 80% stock interest was acquired. If, however, 20% of the subsidiary's stock is purchased on each of the following dates, November 1, 1972, June 30, 1973, September 30, 1973, December 31, 1973, and June 1, 1974, then the two-year period shall begin on June 2, 1974, because this is the earliest date ending a twelve-month period or less (here, eleven months) on which the requisite 80% stock interest was acquired. *See* Treas. Reg. §1.334-1(c)(2).

120. The liquidation of a subsidiary into its parent where for good business reasons the single liquidating distribution was delayed until three years after the plan was adopted qualifies under §332, and the basis of the transferred assets is determined under §334(b)(2). Rev. Rul. 71-326, 1971-2 CUM. BULL. 177.

121. Treas. Reg. §1.334-1(c)(1). Sales during the liquidation period are permitted so long as the parent maintains an 80% interest in the subsidiary's stock. *See* note 74 *supra.*

122. Treas. Reg. §1.334-1(c)(1). For this purpose, the basis of the stock used to determine the basis of the assets is the total basis of all stock held by the parent whether or not such stock was acquired by purchase and whether or not it was acquired during the twelve-month acquisition period specified in §334(b)(2)(A). *Id.*

123. INT. REV. CODE OF 1954, §334(b)(2) (last sentence). The term "distributee" is specially defined in §334(b)(4) to mean only the corporation that meets the specified 80% stock ownership requirements specified in §332(b).

124. *See, e.g.,* Treas. Reg. §1.334-1(c); B. BITTKER & J. EUSTICE, *supra* note 42, at 11-38 to -45; Bonovitz, *Current Liquidation Problems Under Section 334(b)(2) and Section 337 Distributions and Reserves,* N.Y.U. 30TH INST. ON FED. TAX. 1095, 1135-42 (1972); O'Hara, *supra* note 111, at A-10 to -30.

125. Most conspicuous are the problems arising from a delayed liquidation, reorganization overlap, and numerous valuation problems including cash or its equivalent, *Burnet v. Logan* "open" liquidations, and goodwill. *See* B. BITTKER & J. EUSTICE, *supra* note 42, at 11-38 to -45; O'Hara, *supra* note 111, at A-10 to -30. It is interesting to note one commentator's general observations: "In spite of the fact that Section 334(b)(2) has been in the law since 1954 and certainly is a provision that has been used many times, there is almost a complete absence of litigation on it, and very little in the way of published articles. It would appear that controversies which have arisen have been settled at the Service level and probably without much uniformity. . . . Certainly the section and its regulations need

general rule, however, it may be said that the final adjusted basis of the assets received equals the parent's total basis in the subsidiary's stock,[126] increased by the amount of any unsecured liabilities assumed by the parent[127] and by its undistributed share of the subsidiary's earnings and profits since acquisition.[128] This in turn is reduced by pre-liquidation distributions to the parent,[129] its share of the subsidiary's deficit in earnings and profits since acquisition,[130] and by any cash or its equivalent received in the liquidation.[131] The parent's basis as adjusted is then allocated among all the various tangible and intangible assets received, except for cash and its equivalent.[132] Normally, this allocation of basis is made in proportion to the net fair market values[133] of the assets on the date distributed in liquidation to the parent. The intended thrust of these provisions, therefore, is to assign a basis to the distributed assets as if they had been purchased directly from the acquired corporation, rather than through the circuitous route of first purchasing stock and then immediately liquidating the subsidiary corporation.[134] This is entirely consistent with the underlying philosophy of *Kimbell-Diamond*, which forms the cornerstone for the statutory exception. But does this mean that section 334(b)(2) has completely preempted application of the judicial doctrine?

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clarification." O'Malley, *The Pitfalls of a Section 334(b)(2) Liquidation and How To Avoid Them*, 24 J. TAXATION 138, 142 (1966).

126. Treas. Reg. §1.334-1(c)(4). The adjusted basis of the subsidiary's stock in the hands of the parent includes all stock held by the parent whether or not acquired by purchase or during the twelve-month acquisition period specified in §334(b)(2)(A). *Id.* §1.334-1(c)(1).

127. *Id.* §1.334-1(c)(4)(v)(a)(1).

128. *Id.* §1.334-1(c)(4)(v)(a)(2).

129. *Id.* §1.334-1(c)(4)(i). This reduction shall not be made to the extent that the distributions reduced the parent's basis under §301(c)(2), or to the extent that the distributions were made out of earnings and profits accumulated since the stock was purchased. *Id.* §1.334-1(c)(4)(iv).

130. *Id.* §1.334-1(c)(4)(v)(b)(2).

131. *Id.* §1.334-1(c)(4)(v)(b)(1).

132. *Id.* §1.334-1(c)(4)(viii). Although neither the Code nor regulations define "cash or its equivalent," the Service in Rev. Rul. 66-290, 1966-2 CUM. BULL. 112, stated that the phrase includes cash, currency, bank deposits, time deposits, share accounts in savings and loan associations, checks, drafts, money orders, and "any other item of similar nature." This does not, however, include accounts receivable, inventories, marketable securities, and other similar current assets, even if highly liquid in nature. *Id.* In essence, cash or its equivalent encompasses those items that have no value other than face value and hence "could not logically be given a basis." Boise Cascade Corp. v. United States, 288 F. Supp. 770, 773, 68-2 U.S.T.C. ¶9509, at 87,754 (D. Idaho 1968), *aff'd per curiam*, 429 F.2d 426, 70-2 U.S.T.C. ¶9595 (9th Cir. 1970).

133. Treas. Reg. §1.334-1(c)(4)(viii). "Net fair market value" is defined as fair market value less any specific mortgage or pledge to which the asset is subject. Once the allocation of basis has been made, the amount of the lien is then added to the basis of the property against which the lien exists. *Id.*

134. Boise Cascade Corp. v. United States, 288 F. Supp. 770, 771, 68-2 U.S.T.C. ¶9509, at 87,753 (D. Idaho 1968), *aff'd per curiam*, 429 F.2d 426, 70-2 U.S.T.C. ¶9595 (9th Cir. 1970).

CURRENT PROBLEMS

Current Vitality of Kimbell-Diamond

When Congress added section 334(b)(2) to the 1954 Code, it sought to incorporate "rules effectuating principles derived from *Kimbell-Diamond Milling Co.*"[135] Thus, it was generally assumed that the *Kimbell-Diamond* rule,[136] which looks to the purchaser's subjective intent, was completely codified by the enactment of section 334(b)(2). This view is reflected in the Treasury's contention that section 334(b)(2) is the exclusive exception to the general carryover basis rule of section 334(b) (1).[137] But a parent corporation failing to meet the rigid statutory requirements of section 334(b)(2) will sometimes assert that *Kimbell-Diamond* is not "dead." According to this argument, the parent's intent to purchase assets entitles it to a cost basis in the distributed assets because of the application of the judicial doctrine.[138]

Litigation arising from section 334(b)(2) is surprisingly scarce, and the reported decisions that discuss this problem are indeed few in number.[139] Yet the increasing frequency with which this issue is being raised, undoubtedly at the conference level, prompted the Service to list it as a "prime issue"[140] in 1973–one that the Commissioner will litigate, rather than settle or concede.

In one of the few reported cases that have met this question directly, the Court of Claims in *American Potash & Chemical Corp. v. United States*[141] held that "[i]n the absence of some specific direction that *Kimbell-Diamond* is no longer viable, we find that it has not been pre-empted by section 334(b)(2)."[142] In *American Potash,* the taxpayer corporation (Potash) ac-

135. S. REP. No. 1622, *supra* note 60.

136. *See* text accompanying notes 53-59 *supra.*

137. *See, e.g.,* American Potash & Chem. Corp. v. United States, 399 F.2d 194, 68-2 U.S.T.C. ¶9472 (Ct. Cl. 1968); Yoc Heating Corp., 61 T.C. 168 (1973). *But see* Rev. Rul. 74-35, 1974 INT. REV. BULL. No. 2, at 6.

138. *E.g.,* American Potash & Chem. Corp. v. United States, 399 F.2d 194, 68-2 U.S.T.C. ¶9472 (Ct. Cl. 1968).

139. *See* Pacific Transp. Co. v. Commissioner, 483 F.2d 209, 73-2 U.S.T.C. ¶9615 (9th Cir. 1973), *cert. denied,* U.S. , 94 S. Ct. 1469 (1974); Griswold v. Commissioner, 400 F.2d 427, 68-2 U.S.T.C. ¶9559 (5th Cir. 1968); Boise Cascade Corp. v. United States, 288 F. Supp. 770, 68-2 U.S.T.C. ¶9509 (D. Idaho 1968), *aff'd per curiam,* 429 F.2d 426, 70-2 U.S.T.C. ¶9595 (9th Cir. 1970); American Potash & Chem. Corp. v. United States, 399 F.2d 194, 68-2 U.S.T.C. ¶9472 (Ct. Cl. 1968). The current vitality of the *Kimbell-Diamond* rule, however, is a favorite topic among tax commentators. *See, e.g.,* authorities cited in American Potash & Chem. Corp. v. United States, 399 F.2d 194, 208, 68-2 U.S.T.C. ¶9472, at 87,633 (Ct. Cl. 1968); O'Hara, *supra* note 111, at A-27; Note, *Federal Income Tax–*Kimbell-Diamond, *Section 334(b)(2) and the "Indirect Purchaser,"* 23 Sw. L. J. 393 (1969); Note, *Taxation–Basis for Assets in Liquidations–Viability of* Kimbell-Diamond *Doctrine in Light of Section 334(b)(2) of the Internal Revenue Code of 1954,* 15 WAYNE L. REV. 920 (1969).

140. 9 CCH 1974 STAND. FED. TAX REP. ¶6632, at 71,416; 7 CCH 1973 STAND. FED. TAX REP. ¶8213, at 74,397. This issue was released by the Service under the Freedom of Information Act, 5 U.S.C. §552 (1970).

141. 399 F.2d 194, 68-2 U.S.T.C. ¶9472 (Ct. Cl. 1968).

142. *Id.* at 208-09, 68-2 U.S.T.C. ¶9472, at 87,633.

quired all of the stock of Western Electrochemical Company (Wecco) in block purchases of forty-eight and fifty-two per cent over a period of fourteen months. Potash exchanged its own voting stock plus an insignificant amount of cash in each of the two transactions. At no time during any twelve-month period did Potash attain the eighty per cent ownership level required by section 334(b) (2), and upon achieving complete control, it operated Wecco as a subsidiary for seven months.[143]

The only issue for the Court of Claims to determine was the proper basis for the depreciable assets distributed to Potash. In rejecting the Government's contention that a carryover basis was required under the tax-free reorganization provisions of section 368(a)(1)(C),[144] the court found that "the basic transaction was a stock-for-stock exchange (B reorganization) rather than a stock-for-asset exchange (C reorganization)."[145] Because Potash had not obtained control of Wecco within a twelve-month period,[146] the majority held that a B reorganization[147] had not in fact occurred.[148] Moreover, because the stock-for-stock exchange failed to qualify as a valid B reorganization, the court refused to apply the step transaction doctrine, as the Government urged,[149] to look through the form of the transaction (two exchanges followed by a liquidation and distribution of Wecco's assets) and transform its individual steps into a qualifying stock-for-asset exchange under section 368(a)(1) (C).[150]

In the alternative, the Government argued that the liquidation of Wecco was governed by section 332, and therefore, a carryover basis under section 334(b)(1) was required.[151] Because Potash had not purchased the requisite eighty per cent controlling interest within a twelve-month period, it conceded the inapplicability of section 334(b) (2). Potash asserted, however, that the basic doctrine of *Kimbell-Diamond* should apply because its sole purpose throughout the entire fourteen-month period was to acquire the assets of Wecco.[152]

The court accepted the taxpayer's contention, holding that the judicial doctrine had not been preempted by the enactment of section 334(b)(2). In

143. *Id.* at 197, 68-2 U.S.T.C. ¶9472, at 87,624.

144. INT. REV. CODE OF 1954, §§368(a)(1)(C), 361(a).

145. 399 F.2d at 200, 68-2 U.S.T.C. ¶9472, at 87,626.

146. See Treas. Reg. §1.368-2(c), which echoes S. REP. No. 1622, *supra* note 60, at 273. Although the twelve-month period appears to be merely a guideline in determining whether a B reorganization has occurred, the *Potash* court chose to apply this language quite literally. It should not be confused with the twelve-month purchase period contained in §334(b)(2), which is mandatory. *See* text following note 151 *infra*.

147. INT. REV. CODE OF 1954, §368(a)(1)(B).

148. 399 F.2d at 201, 68-2 U.S.T.C. ¶9472, at 87,627.

149. Because the Government was arguing for the applicability of the step transaction doctrine to the asserted B reorganization, at first blush it would appear inconsistent that the Government alternatively asserted that *Kimbell-Diamond* was no longer viable. It should be remembered, however, that the *Kimbell-Diamond* doctrine is merely a factual application of the broader step transaction doctrine to the indirect purchase situation.

150. 399 F.2d at 201-05, 68-2 U.S.T.C. ¶9472, at 87,627-31.

151. *Id.* at 206, 68-2 U.S.T.C. ¶9472, at 87,631.

152. *Id.* at 206-07, 68-2 U.S.T.C. ¶9472, at 87,632.

reviewing the relevant legislative history, the court observed that neither the House nor the Senate committee reports expressly stated that section 334(b)(2) was the exclusive exception to the general carryover rule, or that *Kimbell-Diamond* was preempted by its enactment. On the other hand, neither report stated that the doctrine was still viable.[153] Turning to the legislative history of other Code sections within these same 1954 committee reports, the court emphasized that whenever Congress intended to modify or change an existing judicial doctrine by enacting a particular statute, it generally made a statement to that effect in the report. Finding no comparable language in the legislative history of section 334(b)(2), the court refused to infer that Congress had intended to preempt *Kimbell-Diamond*.[154] Moreover, the majority found "without question" that the doctrine remained viable for *individual* taxpayers, who purchased stock in order to obtain corporate assets through a prompt liquidation,[155] because section 334(b)(2) applies only to corporate taxpayers.[156] Therefore, the court concluded that Congress had not "intended to differentiate between corporate and individual taxpayers and permit the use of the judicial *Kimbell-Diamond* doctrine by an individual who has acquired stock during a period in excess of twelve months, and to deny its application to a corporate taxpayer under the same circumstances."[157]

Although this case has evoked considerable response from tax commentators,[158] the decision has yet to be adopted by another court.[159] It is nevertheless submitted that the *Kimbell-Diamond* doctrine maintains current vitality in the revenue laws, as correctly decided by the *Potash* court.

In this context "[i]t is firmly established that in applying the revenue laws, we must look to the substance of a transaction rather than to its form unless from an examination of the statute and its purpose form was intended to be determinative."[160] Finding no clear-cut directive from the congressional

153. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 38 (1954); S. REP. No. 1622, *supra* note 60.

154. 399 F.2d at 209, 68-2 U.S.T.C. ¶9472, at 87,633-34.

155. *Id.* at 208, 68-2 U.S.T.C. ¶9472, at 87,633. *See* Estate of James F. Suter, 29 T.C. 244 (1957), *acquiesced in*, 1958-2 CUM. BULL. 8; H.B. Snively, 19 T.C. 850 (1953), *aff'd*, 219 F.2d 266, 55-1 U.S.T.C. ¶9221 (5th Cir. 1955); *acquiesced in*, 1956-2 CUM. BULL. 8; Ruth M. Cullen, 14 T.C. 368 (1950), *acquiesced in*, 1950-2 CUM. BULL. 1; Rev. Rul. 69-242, 1969-1 CUM. BULL. 200.

156. *See* note 103 *supra*.

157. 399 F.2d at 208, 68-2 U.S.T.C. ¶9472, at 87,633.

158. *See, e.g.*, O'Hara, *supra* note 111, at A.27; Note, 23 SW. L.J., *supra* note 139; Note, 14 WAYNE L. REV., *supra* note 139.

159. *See, e.g.*, Yoc Heating Corp., 61 T.C. No. 168 (1973), where the Tax Court was urged to consider the current vitality of the *Kimbell-Diamond* doctrine but declined to do so. Relying on its decision in Boise Cascade Corp. v. United States, 429 F.2d 426, 70-2 U.S.T.C. ¶9595 (9th Cir. 1970), *aff'g per curiam* 288 F. Supp. 770, 68-2 U.S.T.C. ¶9509 (D. Idaho 1968), the Ninth Circuit has recently reaffirmed its position that "the *Kimbell-Diamond* philosophy is no longer controlling . . . ." Pacific Transp. Co. v. Commissioner, 483 F.2d 209, 213, 73-2 U.S.T.C. ¶9615, at 81,984 (9th Cir. 1973), *cert. denied*, U.S. , 94 S. Ct. 1469 (1974). The Fifth Circuit seemingly holds to the contrary. Griswold v. Commissioner, 400 F.2d 427, 68-2 U.S.T.C. ¶9559 (5th Cir. 1968).

160. Herman Glazer, 44 T.C. 541, 545-46 (1965) (citing numerous cases).

language, particularly when compared to the definitive statements contained in other sections of the same report, the *Potash* court reasoned that Congress could have used language to preempt *Kimbell-Diamond*, yet apparently chose not to do so. Instead, the House committee report merely stated: "In this respect the principle of *Kimbell-Diamond Milling Co. . . .* is effectuated."[161] The Senate's version was almost identical, incorporating "rules effectuating principles derived from *Kimbell-Diamond Milling Co. . . . .*"[162] The key word in both reports is "effectuate," which means "to bring about; cause to happen; effect; accomplish."[163] Clearly, none of these synonyms even implies preemption. It therefore seems unwarranted to believe that Congress intended preemption when it could have so easily stated, as it did in other sections. Addressing this semantic problem the Court of Claims aptly observed:

> Obviously Congress intended to inject some degree of certainty into an area of the tax law previously occupied by problems of proving that a taxpayer had the requisite intent. It is not a necessary conclusion therefrom that Congress intended, by establishing an objective route for obtaining a cost basis without the need for proving an intent to acquire assets, to prohibit both the government and taxpayers from further resort to proof of a subjective intent to obtain the assets (without complying with the precise objective tests of section 334(b)(2)).[164]

Thus, the step transaction doctrine as developed in *Kimbell-Diamond* was a factual application of the broader tax principle that substance should prevail over form. By substituting a mechanical test for the court's subjective intent standard, certainly Congress did not intend to preempt this judicial doctrine in cases where the parent had the requisite intent to purchase assets, but failed to comply with the detailed statutory requirements.[165] Instead, Congress provided objective criteria to aid rather than restrict the courts in determining the proper basis under section 334(b). Admittedly, the *Kimbell-Diamond* rule involves problems of proof, "but the end result of consistent treatment of transactions for what they are more than compensates for the inconvenience of administering the doctrine."[166]

The "Backed Into" Purchase

In the recent case of *Madison Square Garden Corp.*,[167] the question arose concerning the appropriate tax basis for assets distributed to the taxpayer corporation on the liquidation of its subsidiary, the old Madison Square

161. H.R. REP. No. 1337, *supra* note 153.
162. S. REP. No. 1622, *supra* note 60.
163. WEBSTER'S NEW WORLD DICTIONARY 239 (1965).
164. 399 F.2d at 207-08, 68-2 U.S.T.C. ¶9472, at 87,633.
165. The Treasury's position is to the contrary, stating that "the formal steps themselves are significant under the 1954 Code and the element of purpose or intent is immaterial." Rev. Rul. 60-262, 1960-2 CUM. BULL. 114, 115.
166. Note, 15 WAYNE L. REV., *supra* note 139, at 927.
167. 58 T.C. 619 (1972), *aff'd in part and rev'd in part*, 500 F.2d 611, 74-2 U.S.T.C. ¶9618 (2d Cir. 1974).

Garden Corporation (Garden). During the period February 19, 1959, through January 31, 1960, the taxpayer purchased 288,351 shares of Garden's only authorized class of capital stock. When the initial purchase was made, Garden had 563,500 shares outstanding, but during the next eleven and one-half months, Garden purchased and retired 203,800 shares of its own stock. As a result of these transactions, on February 1, 1960, the taxpayer owned approximately 80.16 per cent of Garden's total shares outstanding as of that date. During the month of March the taxpayer purchased an additional 200 shares, boosting its ownership to 80.22 per cent of Garden's 359,700 outstanding shares.[168]

On April 20, 1960, Garden was formally merged into the taxpayer corporation. Pursuant to the merger-liquidation agreement, the owners of the other 71,149 shares of Garden stock received 160,085 shares of the taxpayer's $0.60 cumulative preferred stock in exchange for their Garden stock. Accordingly, the taxpayer received 100 per cent of Garden's assets on liquidation.[169]

The Government conceded the applicability of section 332 to the merger-liquidation, which was treated as a liquidation for tax purposes.[170] Disagreement arose, however, in determining the proper basis for the distributed assets. The Government asserted that the taxpayer was limited to a substituted basis, because it had not acquired by purchase eighty per cent of the stock outstanding on the date when the first qualifying purchase was made. The taxpayer, on the other hand, argued that it had fully complied with the requirements of section 334(b)(2), therefore entitling it to a stepped-up basis for all assets received on liquidation.[171] The Tax Court granted the taxpayer a step-up in basis but limited this to 80.22 per cent of the assets received, because it controlled only that percentage of Garden at the time of the liquidation.[172]

Cross appeals were taken to the Second Circuit,[173] which affirmed the Tax Court's holding that section 334(b) (2) governed the determination of basis.[174]

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168. 58 T.C. at 620-21.

169. *Id.* at 621, 627.

170. *Id.* at 626-27.

171. *Id.* at 625-26.

172. *Id.* at 627.

173. Madison Square Garden Corp. v. Commissioner, 500 F.2d 611, 74-2 U.S.T.C. ¶9618 (2d Cir. 1974).

174. *Id.* In accepting the taxpayer's contention, the Tax Court observed that §334(b)(2) applied only to a liquidation that first met the requirements of §332(b). 58 T.C. at 626. Because it was merely a basis provision "having no significance independent of the operating liquidation provision. . . . [i]t was not necessary for the . . . basis section to identify *when* the requisite stock ownership was to be tested. Section 332(b) already stipulated that the appropriate time to measure was 'the date of the adoption of the plan of liquidation.' " Taxpayer's Reply Brief at 5, Madison Square Garden Corp. v. Commissioner, 500 F.2d 611, 74-2 U.S.T.C. ¶9618 (2d Cir. 1974). Noting that "section 334(b) does not expressly state *when* the number of shares on which the 80 percent acquired by purchase is to be determined," the court found that it would be incongruous, as the Commissioner urged, to measure the 80% purchase requirement by the number of shares outstanding on the date when the first qualifying purchase was made for purpose of §334(b)(2), but to measure the ownership requirement of §332 at the time the liquidation plan was adopted. According-

The appellate court found that the Commissioner's "rather mechanical interpretation of section 334(b)(2) without benefit of any direct authority" construed the word "purchase" too narrowly,[175] and held that the requisite controlling interest could be achieved through purchase and redemption. Thus, even though the taxpayer in fact had purchased only a 51 per cent interest, measured by the number of shares outstanding on the date when the first qualifying purchase was made, this majority interest ripened into a controlling 80.16 per cent interest due to Garden's redemption of 36 per cent of its stock during the acquisition period.[176]

Turning to the question of the proper basis for the assets distributed, the Second Circuit reversed the Tax Court's holding that the taxpayer's step-up in basis was limited to only 80.22 per cent of the assets received in liquidation. The appellate court found that "since . . . on the date of the merger-liquidation the taxpayer was obligated to the minority shareholders for 160,085 shares of the taxpayer's preferred stock, and that . . . [the taxpayer] thus acquired 100% of the Old Garden assets, the stepped-up basis should apply to that 100% rather than to the lesser percentage owned prior to the actual distribution."[177] Because this obligation to buy out the minority shareholders was "an integral part of the entire transaction,"[178] the taxpayer necessarily owned all of Garden's capital stock immediately prior to the liquidating distribution. How else could it have received *all* of Garden's assets on liquidation?

To buttress its decision, the Second Circuit found that the rationale of Revenue Ruling 59-412[179] applied to treat the minority interest as a liability assumed by the taxpayer, with a corresponding step-up in basis. In that ruling, one corporation purchased 99 per cent of the shares of another. Immediately thereafter, the acquired corporation was merged into the parent in a liquidation to which section 332 applied. Under the merger agreement, all of the subsidiary's assets were distributed to the parent subject to the interests of the minority shareholders, who were entitled to receive cash for their shares. Because the parent corporation purchased these minority shares *after* the

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ly, the court held that the same point in time measures the requisite controlling interest for both statutes, namely, the date on which the plan of liquidation was adopted. 58 T.C. at 626.

175 500 F.2d at 612, 74-2 U.S.T.C. ¶9618, at 85,005. See INT. REV. CODE OF 1954, §334(b)(3).

176. In rejecting the Commissioner's contention that the taxpayer could not "back into" the requisite 80% ownership interest by having the subsidiary redeem and retire some of its own shares, the court weakened the credibility of an earlier ruling. In Rev. Rul. 70-106, 1970-1 CUM. BULL. 70, the Service ruled: "The liquidation of a subsidiary fails to meet the 80 percent control requirement under section 332(b)(1) of the Code where a corporate shareholder owning 75 percent of the subsidiary's stock redeems the minority shareholders' 25 percent interest before adopting a liquidation plan." Hence, §331 governs the liquidation with respect to all shareholders. *Id.* at 71. Although the Commissioner conceded the applicability of §332 to the case *sub judice*, he nevertheless attempted to distinguish the similar facts in the ruling on the basis of distinguishable factual situations. *See* 58 T.C. at 624 n.4.

177. 500 F.2d at 613-14, 74-2 U.S.T.C. ¶9618, at 85,006.

178. 500 F.2d at 613, 74-2 U.S.T.C. ¶9618, at 85,006.

179. 1959-2 CUM. BULL. 108.

liquidating distribution, only the cost of the parent's 99 per cent stock interest, with respect to which the distribution was made, was included in determining the basis of the assets received under section 334(b)(2). The amounts paid to the minority shareholders pursuant to the merger agreement were treated, in effect, as if the parent had assumed and discharged an obligation of the subsidiary to its minority shareholders. Accordingly, the ruling held that the parent corporation was "entitled to have a basis attach to the assets to the extent the liability was assumed and paid."[180] In *Madison Square Garden,* the minority shareholders held 19.78 per cent rather than 1 per cent of the outstanding stock, and they were entitled to receive preferred stock instead of cash pursuant to the merger plan. Thus, the appellate court found that the ruling "controls just this case."[181]

The Second Circuit's decision appropriately clarified confusion created by the Tax Court with respect to determining the proper basis of the assets received on liquidation of Garden.[182] But by virtue of the fact that the Service raised this issue in direct opposition to Revenue Ruling 59-412, the same problem in the context of a slightly different factual situation may surface again.

CONCLUSION

Enacted during the Great Depression to simplify corporate structures, the precursor of section 332 granted nonrecognition treatment to the parent corporation on the liquidation of an eighty per cent owned subsidiary. The concomitant basis provision, which is currently found in section 334(b)(1), provided that the subsidiary's basis in its assets carried over to the parent on the liquidation. The inherent inequity of a carryover basis in situations where a corporation purchased the stock of another solely to obtain its assets through immediate liquidation, however, prompted the courts to apply the step transaction doctrine to these related events. Thus, the parent obtained a cost rather than a substituted basis in the distributed assets, which conformed to the realities and substance of the underlying transaction.

The problems in applying the subjective intent standard of the judicial *Kimbell-Diamond* doctrine, however, soon convinced Congress of the need for a statute that contained more objective criteria. The lawmakers responded in 1954 with section 334(b) (2), which generally incorporates the principles of *Kimbell-Diamond* and gives the parent a cost basis in the subsidiary's assets received on liquidation. Unfortunately, section 334(b)(2) has created problems where none previously existed. One such controversy involves the cur-

180. *Id.* at 110.

181. 500 F.2d at 614, 74-2 U.S.T.C. ¶9618, at 85,007.

182. In two subsequent cases involving the same type of transaction, the Tax Court recognized the rationale of Rev. Rul. 59-412, 1959-2 CUM. BULL. 108. Therefore, to avoid a charge of inconsistency, it distinguished its opinion in *Madison Square Garden* on procedural grounds. 500 F.2d at 615, 74-2 U.S.T.C. ¶9618, at 85,008. *See* May B. Kass, 60 T.C. 218, 223-25 (1973), *aff'd without opinion,* 491 F.2d 749 (3d Cir. 1974); Yoc Heating Corp., 61 T.C. 168, 179 n.17 (1973).