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TAXATION—KIMBELL-DIAMOND STILL AVAILABLE AS AN ADJUNCT TO SECTION 334(b)(2).

Between September, 1954 and November, 1955, a period exceeding twelve months, taxpayer, American Potash and Chemical Cooporation (Potash) acquired 100 percent of the outstanding stock of Western Electro Chemical Company (Wecco) in exchange for shares of the taxpayer's voting stock plus cash in lieu of fractional shares. The purpose of the acquisition was to obtain Wecco's assets.[1] Potash operated Wecco until June 30, 1956 at which time Wecco was completely liquidated and all its assets distributed to Potash. Taxpayer computed its depreciation deduction for the depreciable assets received from Wecco on a "cost" basis.[2] The Internal Revenue Service contended that the correct basis of these assets was the basis of the assets in the hands of Wecco prior to the liquidation. The Service argued that the assets received in the liquidation were subject to a "carryover" basis under section 332[3] and section 334(b)(1)[4] of the

1. "For the purpose of this motion, both plaintiff and defendant agree that the stock acquisition of Wecco and its liquidation were undertaken for the purpose of obtaining the the Wecco assets, *i.e.*, plaintiff purchased the stock to reach the assets . . . ." American Potash and Chemical Corp. v. United States, 399 F.2d 194, 198 (Ct. Cl. 1968).

2. INT. REV. CODE of 1954, § 1012 reads in part:

SEC. 1012. BASIS OF PROPERTY—COST

The basis of property shall be the cost of such property, except as otherwise provided. . . .

Cost is the amount paid for such property, (a) ". . . in cash . . . .", Treas. Reg. § 1.1012-1(a); (b) in other property, the valuation of such property to be determined by its fair market value at the time it is surrendered, Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954); (c) in the amount of debts assumed by the purchaser, United States v. Hendler, 303 U.S. 564 (1938), *reh. den.* 304 U.S. 588 (1938); and, (d) in shares of stock valued at the fair market value at the time of issuance, Pierce Oil Corp., 32 B.T.A. 403 (1935).

3. INT. REV. CODE of 1954, § 332 reads in part:

SEC. 332. COMPLETE LIQUIDATIONS OF SUBSIDIARIES

(a) General Rule.—No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

4. *Id.* § 334 reads in part:

SEC. 334. BASIS OF PROPERTY RECEIVED IN LIQUIDATIONS

(a) General Rule.—If property is received in a distribution in partial or complete liquidation . . . and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution.

(b) Liquidation of Subsidiary.—

(1) In general.—If property is received by a corporation in a distribution in complete liquidation of another corporation . . . then, except as provided in paragraph (2), the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor. . . .

(2) Exception.—If property is received by a corporation in a distribution in complete liquidation of another corporation . . . , and if—

(A) the distribution is pursuant to a plan of liquidation adopted—

(i) on or after June 22, 1954, and

(ii) not more than 2 years after the date of the transaction described in subparagraph (B) . . . and

(B) stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock . . . was acquired by the distributee by purchase . . . during a 12-month period . . . .

Internal Revenue Code as assets received by a parent in the process of liquidating its wholly owned subsidiary.[5] Potash, on the other hand, proposed that the liquidation was excepted from the application of sections 332 and 334(b)(1) by the doctrine enunciated in *Kimbell-Diamond Milling Co. v. Commissioner.*[6] This doctrine, according to the taxpayer, remains viable, not being pre-empted by the enactment of section 334(b)(2),[7] the legislative exception to the general rule of section 334(b)(1).[8] *Held,* that a corporation which purchases all of the stock of another corporation and subsequently liquidates the subsidiary, upon a showing of the requisite intent, may still use a cost basis for the assets received upon liquidation although the stock purchase fails to comply with the specific requirements of section 334(b)(2). *American Potash and Chemical Corp. v. United States,* 399 F.2d 194 (Ct. Cl. 1968).

Under the Internal Revenue Code of 1939,[9] a corporation intending to acquire the assets of another corporation was faced with a unique tax problem when such assets had appreciated in value and the shareholders of the latter corporation were willing to sell the stock but not the assets. Where an outright purchases of assets was made, section 113(a) [currently section 1012][10] required the application of a "cost" basis for the determination of the depreciation

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then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made.

5. The Service advanced two arguments to support its position that a carryover basis was required. The Commissioner's first contention was that the acquisition of Wecco and the subsequent liquidation was a reorganization under section 368 (a)(1)(C) of the Code. Thus, being a section 368(a)(1) reorganization, a carryover basis was mandated under section 362(b) of the Code which provides in part:

> (b) Transfers to Corporations.—If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

The court found that a reorganization had not occurred and thus concluded that the carryover provision of section 362(b) was not applicable.

The Commissioner's alternative argument was that involving section 334. This note will restrict itself to a discussion of this second contention.

6. Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), *aff'd per curiam,* 187 F.2d 718 (5th Cir. 1951), *cert. denied,* 342 U.S. 827 (1951). In this case the taxpayer, Kimbell-Diamond Milling Co. was engaged in the business of milling, processing and selling grain products. In 1942, the taxpayer sustained a fire casualty which completely destroyed one of its physical plants. Finding it impractical to construct a new structure, the taxpayer acquired all the stock of another corporation which owned a milling plant substantially comparable to the taxpayer's destroyed property. The taxpayer paid $210,000 for the stock of the new corporation. The taxpayer's adjusted basis in the assets destroyed was $18,922. The insurance proceeds amounted to $118,200. Under the non-recognition provision of section 112(f) [currently section 1033(a)], the taxpayer's cost basis in the newly acquired company was therefore $110,772 ($18,922 basis in the property destroyed plus $91,800 additional cash paid). The basis of the assets in the hands of the subsidiary was $139,522. A few days subsequent to the acquisition, the taxpayer liquidated the acquired company and caused the subsidiary's assets to be distributed to the parent. The Tax Court sustained the Commissioner's proposition that because the transaction was substantially a purchase of assets, a cost basis of $100,722 had to be used, notwithstanding the carryover requirements of section 113(a)(15) of the 1939 Code, *see infra* note 11.

7. *See supra* note 4.

8. *Id.*

9. H. R. REP. No. 2762, 76th Cong., 1st Sess. (1939).

10. *See supra* note 2.

deductions. But if the corporation acquired the assets indirectly by purchasing the stock of the selling corporation and immediately thereafter liquidating it, section 113(a)(15) [currently section 334(b)(1)][11] would have mandated the application of a "carryover" basis. The practical result of this was that a corporation interested in acquiring assets but unable to do so because of the reluctance of the selling corporation, was precluded from using a "cost" basis for the acquired assets notwithstanding that the price paid by the parent was based on the fair market value of the assets at the time of the stock acquisition. Thus, the literal application of the carryover provisions created a dichotomy between two acquisitions which were identical in substance, differing only in form.

This dichotomy, however, also ran in favor of the taxpayer. Thus where a corporation wished to acquire the assets of another corporation in whose hands the assets had a basis in excess of their fair market value, the acquiring corporation, by taking the stock purchase route, was able to get a stepped-up basis.[12] Indeed, this is similar to what occurred in the *Kimbell-Diamond* case where the taxpayer acquired the stock of another corporation at a "cost"[13] which was less than the basis of the assets in the hands of the acquired company. Applying the strict statutory interpretation of section 113(a)(15) [currently section 334(b)(1)], the parent assumed a carryover basis and computed its depreciation deductions on this higher amount.[14]

In an effort to minimize the apparent inconsistency in the treatment of such transactions, the courts developed an exception to the strict application of section 113(a)(15)[15] [currently section 334(b)(1)]. Where it was determined that the parent had purchased the stock of the subsidiary for the purpose of acquiring its assets, and promptly after the acquisition the parent liquidated the subsidiary,[16] it was generally held that a "purchase" of assets had occurred.[17] This

11. INT. REV. CODE of 1939, § 113(a)(15) provided in part:

(15) Property Received by a Corporation on Complete Liquidation of Another. If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112(b)(6), then the basis shall be the same as it would be in the hands of the transferor. . . .

12. For example, *see* Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d 685 (5th Cir. 1954); Texas Bank and Trust Co. of Dallas, 12 T.C.M. 588 (1953).

It has generally been held that if the entire transaction was in fact essentially the purchase of assets, the different steps will not be separately treated, at the instance of either the government or the taxpayer, regardless of whether the result imposes a tax or relieves from taxes. Commissioner v. Ashland Oil & Refining Co., 99 F.2d 588, 591 (6th Cir. 1938); Tulsa Tribune v. Commissioner, 58 F.2d 937, 940 (10th Cir. 1932). Although these cases were decided prior to *Kimbell-Diamond*, a Memorandum Decision, *Texas Bank & Trust Co. of Dallas*, *supra*, relying fully on *Kimbell-Diamond*, allowed a corporate taxpayer the higher cost basis, rejecting the Commissioner's contention that a carryover basis was required. *See also*, Mansfield, *The Kimbell-Diamond Situation; Basis to the Purchaser in Connection With Liquidation*, 13 N.Y.U. 13TH INST. ON FED. TAX. 623, 624 (1953).

13. *See supra* note 6.

14. *Id.*

15. *See supra* note 11.

16. It is not clear how soon after the acquisition the acquired corporation would have to be liquidated in order to qualify under the *Kimbell-Diamond* rationale. In Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d 685 (5th Cir. 1954), an intervening period of six months did not preclude the application of a cost basis. But in Trianon Hotel Co. v. Com-

conclusion was based on the assumption that the two steps—the acquisition of stock and the subsequent liquidation of the subsidiary—were in fact a single transaction, namely, the purchase of assets. Since the transaction was merely a "purchase" of assets, a section 112(b)(6)[18] liquidation [currently section 332(a)] had not occurred and consequently the carryover provisions of section 113(a)(15) [currently section 334 (b)(1)] were not applicable. Thus being a purchase, a cost basis under section 113(a) [currently section 1012] had to be applied. From the leading case in this field, this principle became known as the *Kimbell-Diamond* rule.

Although the development of the *Kimbell-Diamond* rationale was premised on the notion of promoting equity in the tax consequences of certain economic transactions, the operation of that judicial concept was not satisfactory. Founded upon subjective intent, it failed to provide certainty and therefore led to a most difficult variety of litigation, that involving proof of the party's intent at the time of a stock acquisition. Each case had to be determined on the basis of its own factual situation with the result that a taxpayer was not able to predict with reasonable certainty the consequences of his activity.[19]

The revision of the 1939 Code and the resulting 1954 Code sought to put the taxpayer on notice that particular tax consequences will result from certain types of transactions.[20] Further, it was intended that where different taxpayers pursue different avenues to accomplish the same result, each taxpayer would thereby incur similar tax consequences.[21] Realizing that exclusive reliance on this judicial doctrine was inconsistent with the basic objectives of the 1954 Code, Congress set down certain quantitative guidelines in the enactment of section 334(b)(2).

missioner, 30 T.C. 156 (1958), a period of one year denied the taxpayer the use of a cost basis upon the liquidation of a subsidiary.

17. *See* Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), *aff'd per curiam* 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951); Commissioner v. Ashland Oil & Refining Co., 99 F.2d 588 (6th Cir. 1938), where the court pointed out at page 591 ". . . taxation is an intensely practical matter, and . . . the substance of the thing done and not the form it took must govern." *See also* Carter Publications, Inc. v. Commissioner, 28 B.T.A. 160 (1933).

18. INT. REV. CODE of 1939, § 112(b)(6) provided in part:

> (6) Property Received by a Corporation on Complete Liquidation of Another.—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation . . . .

19. Even where the corporate purchaser liquidated the subsidiary promptly after the stock acquisition, the *Kimbell-Diamond* rule was held inapplicable where the intent to dissolve was not present at the time of the stock purchase. Distributors Finance Corp. v. Commissioner., 20 T.C. 768, 784, *acq.* 1954-2 CUM. BULL. 4.

20. H. R. No. 1337, 83d Cong., 2d Sess., (1954).

21.
> Your committee has revised existing law in conformity with its objective of making it sufficiently definite to permit taxpayers to ascertain in advance the tax consequences of their actions. Your committee's bill is designed to insure that the same tax consequences result from the different types of transactions which are available to accomplish substantially the same result. This correlation is important not only because it promotes clarity and certainty in the law but also because it insures that taxpayers cannot, by choosing the type of transaction, in effect choose the type of tax for which they are liable.

Id. at 39.

Section 334(b)(1) of the Internal Revenue Code of 1954, incorporating the law as it existed in section 113(a)(15) of the 1939 Code, sets forth the general rule that whenever a parent corporation completely liquidates its subsidiary in a nontaxable liquidation, a carryover basis shall be used.[22] The exception to this general rule is embodied in section 334(b)(2).[23] Under this section, where the conditions of section 334(b)(1) are met, and:

(i) the plan of liquidation was adopted within two years after the parent acquired 80 percent of the subsidiary's stock, and
(ii) the parent acquired its 80 percent stock interest within a period of 12 months, and
(iii) it acquired such interest by a taxable purchase or exchange and not from a related party,

then the parent corporation shall have a basis in the property received on the liquidation determined by reference to its cost in the subsidiary's stock. Unlike the judicially formulated *Kimbell-Diamond* doctrine,[24] section 334(b)(2)[25] is applicable without regard to the acquiring corporation's intent or purpose at the time of the stock acquisition. The formal steps will be controlling.[26]

The question of whether section 334(b)(2) is the sole mechanism for obtaining a "cost" basis, to the exclusion of the *Kimbell-Diamond* principle, has heretofore been unresolved. The tax commentators have been divided on this issue. Some authorities felt that "the more reasonable interpretation would seem to be that, at least where a corporate buyer is involved, the statutory rule is meant to be a complete substitute for the *Kimbell-Diamond* rule, and the stock basis will not carry over to the parent unless the specific rules of section 334(b)(2) are satisfied."[27] Indeed, the commentators continue, "any other construction would reestablish the same imprecision which the statute was designed to negate."[28] However, other noted authorities have expressed the contrary view that:

> . . . an automatic application of §334(b)(2) whenever the statutory conditions are satisfied . . . does not necessarily mean that *Kimbell-Diamond* has no continuing vitality when these statutory conditions are not satisfied. Thus, a deliberate avoidance of the time limits for acquiring the stock or liquidating the acquired corporation might, on a finding of an intent to acquire assets, produce the same result as under pre-1954 law. . . .[29]

22. *See supra* note 11.
23. *See supra* note 4.
24. *See supra* note 6.
25. *See supra* note 4.
26. REV. RUL. 60-262, 1960-2 CUM. BULL. 114.
27. Schwart, *Acquisition of Stock of Another Corporation In Order to Acquire Assets*, 1957 S. CAL. TAX INST. 45, 65-66.
28. Freling, *What Is New In Subchapter C: The Service's Current Ruling Policy*, 23rd INST. ON FED. TAX. 421, 438 (1965).
29. BITTKER AND EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 378 (2d ed. 1966).

Certain authorities, on the other hand, have remained neutral on the subject of the vitality of *Kimbell-Diamond* admitting that a court determination was required.[30]

The court in the instant case observed that the legislative history of section 334(b)(2) in no instance expressly provided that the newly enacted statute was to be the exclusive exception to the carryover rule of section 334(b)(1). Nor did Congress state that the doctrine enunciated in *Kimbell-Diamond* was still viable. The original House Report on the 1954 Code,[31] the court continued, extended the application of section 334(b)(2) to any shareholder, corporate or individual.[32] The Senate report, however, limited the application of this section to corporate taxpayers and stated that:

> Paragraph (2) of subsection (b) incorporates into your committee's bill rules effectuating principles *derived* from Kimbell-Diamond Milling Co., supra. (Emphasis supplied.)[33]

The court recognized that the legislative history of the section reflected a Congressional intent to inject some degree of certainty into an area of tax law previously occupied by problems of proving that a taxpayer had the requisite intent. However, 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 the taxpayer from further resort to proof of a subjective intent to obtain the assets in situations where the objective tests of section 334(b)(2) had not been fulfilled. Further, the court stated that there is no indication that a taxpayer, by virtue of the precise rule of section 334(b)(2), is to be afforded an opportunity to choose between a carryover and a cost basis. If the statute is the only route for avoiding a carryover basis, a taxpayer can elect, with relative ease, either to comply with the statute or not to comply. There is no indication that the basis of the assets acquired in these transactions is to be an elective matter. Indeed the court continued, it would seem preferable from the government's point of view, to retain the basic step-transaction approach to achieve substance over form in a situation where a taxpayer, possessed of the requisite subjective intent, deliberately avoids the statute. Thus, where a corporate tax-

30. "Whether the courts . . . will . . . apply the intent test of *Kimbell-Diamond* and restrict the basis of the assets to the cost of the stock even though the specific requirements of section 334(b)(2) are not satisfied, has not yet been answered." CHIELSTEIN AND SURREY, WORLD TAX SERIES—TAXATION IN THE UNITED STATES 757-58 (1963). *See also* Cohen, Gelberg, Surrey, Tarleau and Warren, *Corporate Liquidations Under the Internal Revenue Code of 1954*, 55 COLUM. L. REV. 37, 43-44 (1955).

> It is somewhat disquieting to contemplate the coexistence of a precise statutory rule based on objective criteria and a more nebulous judicial rule based on subjective intent. Yet such a possibility cannot be ruled out summarily. The courts may be puzzled by a statute which purports to prescribe a definite rule without the right of election, yet states the rule in such a way that an election is actually permitted . . . .

31. *See supra* note 20.

32. *See supra* note 20 at 38.

33. S. REP. No. 1622, 83d Cong., 2d Sess., 257 (1954).

payer has demonstrated that its intention upon the acquisition of the subsidiary's stock was to acquire assets, the court determined that the taxpayer will be allowed to apply a cost basis, notwithstanding its failure to comply with section 334(b)(2).

It may well be argued that the holding in the instant case substantially undermines the congressional intent of injecting "some degree of certainty" in this area of tax law. The taxpayer who seeks to have a "cost" basis on the assets received upon liquidation, now has two alternative routes by which he can attain his expectancy. One is to comply with section 334(b)(2). This avenue will assure the taxpayer a "cost" basis. The alternative route is to qualify under the *Kimbell-Diamond* doctrine. The availability of this method will depend on the taxpayer's ability to demonstrate the requisite intent.

The taxpayer seeking a "carryover" basis, however, is not assured that such a "carryover" will be available. Under the holding in the instant case, such a taxpayer, although falling outside the provisions of section 334(b)(2), must be prepared to challenge a possible contention by the Commissioner that an intent to acquire assets existed. Since the burden of proof is on the taxpayer to rebut the Commissioner's allegation, the tax law, at least for this taxpayer, thus reverts back to the pre-1954 era of litigating a taxpayer's subjective intent.

Furthermore, it may be argued that the holding in the instant case can only lead to an extension of the applicability of the *Kimbell-Diamond* rationale. The Commissioner may indeed advance the following contention. The court in the instant case held that compliance with section 334(b)(2) is not mandatory to allow a "cost" basis where an intent to acquire assets is demonstrated. However, to limit such a showing for the purpose of establishing a "cost" basis is illogical. Thus, although a taxpayer has fulfilled the requirements of section 334(b)(2), the Commissioner should not be denied the opportunity to demonstrate that the intent at the time of the acquisition was *not* to acquire assets. Such an extension, the argument would continue, would reinstate the same imprecision inflicting the tax law prior to the enactment of section 334(b)(2).

These arguments, however, are untenable. Congress, in enacting section 334(b)(2), intended to inject *some* degree of certainty into this area of the tax law and not *absolute* certainty. Such absolute certainty would be available if section 334(b)(2) was construed to pre-empt *Kimbell-Diamond*. However, where absolute certainty is read into a section, an invitation to manipulate is created. It is axiomatic in the area of income taxation that the substance of the transaction prevails over its form. Thus to say that section 334(b)(2) is the exclusive vehicle for obtaining a cost basis would be to ignore the substance of the transaction and to give validity to its form. It is most doubtful that such was the congressional intent.

Further, the argument that the court's holding in the instant case creates greater uncertainty for a taxpayer seeking a carryover basis is not a valid rejection of the court's decision. Section 334(b)(2) was intended to offer relief

to a taxpayer seeking a cost basis. Indeed, the congressional history does not speak of a carryover basis taxpayer but confines its consideration to the taxpayer seeking a cost basis. Thus the conclusion that greater uncertainty is created for the taxpayers seeking a carryover basis is irrelevant in an analysis of the court's holding.

The final argument suggests that the Commissioner may offer evidence of a taxpayer's intention *not* to acquire assets and thus deny a cost basis notwithstanding compliance with section 334(b)(2). Unquestionably, this would reinstate the conditions existing prior to the enactment of the section. However, to support this contention would be to conclude that Congress, in enacting section 334(b)(2), intended that the section be construed out of existence. This is a most illogical presumption.

It would thus appear that the arguments supporting the pre-emption of *Kimbell-Diamond* are unfounded for two main reasons. First, as a matter of judicial construction, the legislative history fails to express an intent to pre-empt case law, and, second, as a practical matter, full pre-emption could only lead to full manipulation. It is doubtful that Congress enacted section 334(b)(2) for the purpose of facilitating the manipulation of the Internal Revenue Code.

Although it is clear that henceforth the rationale of the *Kimbell-Diamond* case will be available as an adjunct to section 334(b)(2), the court does not indicate the exact nature of the factual evidence required to establish the requisite intent. Furthermore, assuming that the requisite intent is established, the court fails to decide whether such intent could be negated by subsequent conduct of the corporation such as the operation of the subsidiary for several months after the initial acquisition. There are no clear guidelines provided as to whether subjective intent to acquire assets will of itself suffice to justify the exclusion from the requirements of section 334(b)(2).

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