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District of Columbia Bar
Taxation Section – Corporate Tax Committee*
Request for Guidance Concerning the Continued Application of the
Kimbell-Diamond Doctrine

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Summary

Since the enactment of Section 338¹ in 1982,² the Internal Revenue Service (the “Service”) has issued guidance in the form of revenue rulings and regulations addressing the continued vitality of the Kimbell-Diamond doctrine. Although such guidance has resolved many issues in this area, even the most recent of such pronouncements³ leave room for further guidance. See the chart attached as Exhibit A illustrating how current authorities apply the Kimbell-Diamond doctrine to two step asset acquisitions, and where further guidance is necessary.

The members of the Corporation Tax Committee of the Taxation Section of the District of Columbia Bar (the “Committee”) and other practitioners continually encounter transactions not addressed by current authorities. The Committee believes that further clarity in this area is essential for purposes of sound tax administration. This report recommends the adoption in published guidance of the following four principles that both incorporate current guidance and resolve many of the remaining issues dealing with the continued vitality of the Kimbell-Diamond doctrine:

1. The step transaction doctrine is not applied to integrate a stock acquisition and subsequent liquidation, dissolution, merger, or other elimination of the Target corporation (i.e., a combination of the Target corporation into the Acquiring Corporation or its affiliate) as an asset acquisition that results in Section 1012 basis, regardless of whether the stock acquisition is a qualified stock purchase within the meaning of Section 338(d)(3) (a “QSP”) if viewed independently.
2. Where integration of related steps would result in a Section 362(b) transferred basis for the assets of the Target corporation, apply the step transaction doctrine to integrate the related steps as a reorganization.
3. If the step transaction doctrine would result in a Section 362(b) transferred basis transaction under the Second Principle, then a Section 338 election is unavailable unless the election under Temp. Treas. Reg. Section 1.338(h)(10)-1T is available. This election should be made available for Section 338(g) elections as well, with appropriate rules to prevent whipsaw.
4. If the step transaction doctrine is not applied under the First Principle, then the stock acquisition should be respected as a separate step for all federal income tax purposes. A Section 338 election should be available only if the stock acquisition is a QSP, viewed independently. For purposes of testing whether a second-step

¹ Unless otherwise indicated, all Section references herein are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

² P.L. 97-248, §224(a)-(b).

³ See Rev. Rul. 2001-46, 2001-2 C.B. 321, and Temp. Treas. Reg. Section 1.338(h)(10)-1T, discussed below.

potential asset reorganization satisfies the continuity of interest, control, and solely for voting stock requirements, the anti-Yoc Heating regulation (Treas. Reg. Section 1.338-3(d)) should be expanded to apply regardless of whether the first step stock acquisition is a QSP.

Introduction

The applicability of the step transaction doctrine in the context of a two step asset acquisition has long been a vexing question in corporate taxation. The authorities often seem inconsistent,⁴ and it is difficult to discern a consistent theme.

One area of particular importance involves the continued applicability of the Kimbell-Diamond doctrine.⁵ At stake is whether an acquisition of the stock of a “Target corporation” followed by the elimination of the Target corporation (for example, via liquidation into the “Acquiring corporation”) can be converted into an asset acquisition. Given the repeal of the General Utilities doctrine in 1986,⁶ such an integration could result in two levels of taxation, instead of one.

In Rev. Rul. 90-95,⁷ the Service concluded that a QSP followed by a liquidation of the Target corporation is not recast into a direct asset purchase by the Acquiring corporation but, rather, the form of the acquisition as a purchase of stock and a Section 332 liquidation is respected regardless of whether an election under Section 338(g) or an election under Section 338(h)(10) is made. Five years later, the Service promulgated the predecessor to Treas. Reg. Section 1.338-3(d) that codified Rev. Rul. 90-95 and also applied the same

⁴ For example, in Rev. Rul. 2004-83, 2004-32 I.R.B. 157, P corporation owns all of the stock of S and T corporations. Pursuant to an integrated plan, P sells all of the T stock to S in exchange for cash, and T liquidates into S. Applying the step transaction doctrine, the transaction is treated as an asset acquisition by S qualifying under Section 368(a)(1)(D). Although the ruling states that the authorities that reject the application of the step transaction doctrine are not relevant because the related party stock acquisition cannot qualify as a QSP, this was not necessary for the conclusion. See, e.g., Rev. Rul. 67-274, 1967-2 C.B. 141. Nonetheless, this statement might be interpreted as a Service pronouncement on the application of the step transaction doctrine when a stock acquisition does not qualify as a QSP (when viewed independently) even where application of the doctrine would result in a Section 1012 assets basis. Cf. Rev. Rul. 77-427, 1977-2 C.B. 100 (in a similar situation where a related party stock purchase is followed by the liquidation of the Target corporation, the step transaction doctrine is not applied).

⁵ The doctrine takes its name from the 1950 Tax Court case Kimbell-Diamond Milling Co. v. Comm’r, 14 T.C. 74 (1950), aff’d per curiam, 187 F.2d 718 (5th Cir. 1951) (holding that the purchase of the stock of Target corporation for the purpose of obtaining its assets through a prompt liquidation should be treated by the Acquiring corporation as purchase of Target corporation’s assets).

⁶ See General Utilities & Operating Company v. Helvering, 296 U.S. 200 (1935) (holding that the distributing corporation does not recognize gain or loss on the distribution of property with respect to its stock). The Tax Reform Act of 1986 repealed the General Utilities doctrine by amending Sections 336, 337, and 311 (in addition to others) to ensure that gain will be recognized by the distributing corporation when appreciated assets are distributed to its shareholders (except for distributions that qualify under Section 355 and complete liquidations that qualify under Section 332).

⁷ 1990-2 C.B. 67.

reasoning to other transfers by the Target corporation to members of the Acquiring corporation's affiliated group.⁸ Because the QSP is treated as a separate transaction for purposes of certain reorganization requirements (i.e., the continuity of interest, control, and solely for voting stock requirements), the Acquiring corporation is not treated as acquiring the Target corporation's assets with a Section 1012 tax basis (in the absence of a Section 338 election).

In Rev. Rul. 90-95,⁹ a QSP appeared to preclude application of the step transaction doctrine. In Rev. Rul. 2001-46,¹⁰ however, the Service concluded that a QSP followed by a merger of the Target corporation into the Acquiring corporation is treated as a direct merger of the Target corporation into the Acquiring corporation and a reorganization under Section 368(a)(1)(A).¹¹ In other words, the fact that a stock acquisition qualifies as a QSP when viewed independently does not necessarily preclude application of the step transaction doctrine. In light of this development, should the holding of Rev Rul. 90-95 be expanded to a situation where the acquisition of the Target corporation stock is not a QSP when viewed independently from a subsequent liquidation, and integration of the steps would result in Section 1012 basis for Target's assets? The First Principle recommended by the Committee addresses this question. If the Kimbell-Diamond doctrine does not apply here, what are the tax consequences to the parties to the transaction? This question is addressed by the Fourth Principle.

The members of the Committee believe that this is an excellent time to build on Rev. Rul. 2001-46 and resolve the question of the continued vitality of the Kimbell-Diamond

⁸ The predecessor to Treas. Reg. Section 1.338-3(d) was intended to reverse the result of Yoc Heating Corp. v. Comm'r, 61 T.C. 168 (1973) (a stock purchase followed by Target's transfer of its assets to a newly formed wholly owned subsidiary of Acquiring recast as a taxable asset purchase).

⁹ 1990-2 C.B. 67.

¹⁰ 2001-2 C.B. 321.

¹¹ Rev. Rul. 2001-46 favorably cites King Enterprises, Inc. v. U.S., 418 F.2d 511 (Ct. Cl. 1969) (acquisition by Acquiring corporation of all of the stock of Target corporation for consideration consisting of 51 percent stock of Acquiring corporation and 49 percent cash and notes, followed by the pre-arranged merger of Target corporation into Acquiring corporation; second step merger converted the acquisition into an "A" reorganization) and Rev. Rul. 67-274, 1967-2 C.B. 141 (acquisition of all the stock of Target corporation in a transaction meeting the requirements of a "B" reorganization, if viewed independently, followed by the liquidation of Target corporation into Acquiring corporation, not respected as a stock acquisition and liquidation but recast as a "C" reorganization of Target corporation directly into Acquiring corporation). See also Rev. Rul. 72-405, 1972-2 C.B. 217 (forward triangular merger followed by the liquidation of controlled subsidiary that served as the acquirer in the merger tested as a "C" reorganization); Rev. Rul. 67-202, 1967-1 C.B. 73 (Section 351 transfer of the stock of Target corporation to Acquiring corporation, followed by the liquidation of Target corporation, tested as an asset reorganization); and Rev. Rul. 78-130, 1978-1 C.B. 114 (transfer of all the stock of Target corporation to Parent corporation for voting stock of Parent corporation, followed by the merger of Target corporation into Newco, a wholly-owned direct subsidiary of Parent, recast as a triangular "C" reorganization).

doctrine in the context of a corporate Acquiring corporation.¹² We have examined this question, and the larger question of the appropriate circumstances for applying the step transaction doctrine to a series of transactions, using the examples attached as Exhibit B. The Committee recommends adoption (through published guidance) of the four principles set forth in this report. The principles, with accompanying explanations set forth immediately below, are intended to both incorporate current guidance and resolve many of the remaining issues dealing with the continued vitality of the Kimbell-Diamond doctrine.¹³

First Principle: The step transaction doctrine is not applied to integrate a stock acquisition and subsequent liquidation, dissolution, merger, or other elimination of the Target corporation (i.e., a combination of the Target corporation into the Acquiring Corporation or its affiliate) as an asset acquisition that results in Section 1012 basis, regardless of whether the stock acquisition is a QSP (viewed independently).

In one form or another, this has generally been the government's position since the enactment of former Section 334(b)(2).¹⁴ In 1982, Section 338 replaced former Section 334(b)(2).¹⁵ Prior to the enactment of current Section 338, Section 334(b)(2) had provided that if (i) an Acquiring corporation acquired at least 80 percent of the stock of the Target corporation by purchase within a 12-month period, (ii) the Target corporation adopted a plan of liquidation within two years after the acquisition (or the last acquisition in a series of acquisitions), and (iii) the Target corporation liquidated within a certain period, then the Acquiring corporation determined its basis in the Target corporation's assets by the cost of the Target corporation's stock and its liabilities, and the Target corporation's attributes did not carry over to the Acquiring corporation. In other words, where Section 334(b)(2) applied, it replaced the Kimbell-Diamond doctrine with an objective standard for determining when a stock purchase followed by a liquidation would be treated as an asset purchase.

Where the provisions of former Section 334(b)(2) were not satisfied, the continued vitality of the Kimbell-Diamond doctrine was unclear. The government consistently argued that Section 334(b)(2) had pre-empted any application of Kimbell-Diamond and was generally

¹² The Committee has not considered, and this report does not make recommendations with respect to, the continued vitality of the Kimbell-Diamond doctrine in the context of two step asset acquisitions by individuals.

¹³ We are not attempting to resolve, nor do we suggest, that the government publish guidance on the general question of when it is appropriate for two or more steps to be integrated under the step transaction doctrine. Rather, it is assumed that, under the appropriate iteration of the step transaction doctrine, the steps described in the examples in this report would be treated as a single integrated acquisition by the Acquiring corporation of the assets of the Target corporation.

¹⁴ See generally S. REP. NO. 1662, 83d Cong., 2d Sess. 257 (1954).

¹⁵ P.L. 97-248, §224(a)-(b).

(though not always) successful in this argument.¹⁶ The legislative history of Section 334(b)(2), which stated only that the provision incorporated rules “effectuating the principles derived from Kimbell-Diamond,”¹⁷ was not clear enough on this point.

In American Potash, the Court of Claims held that Section 334(b)(2) was not available to the Acquiring corporation, because the requisite stock acquisition took more than 12 months, and was therefore not a “purchase.” The court held, however, that Section 334(b)(2) was merely a safe harbor, and that the Kimbell-Diamond doctrine was still available to treat the multiple steps as an integrated asset purchase. In so holding, the court noted Congress’s failure to state that Section 334(b)(2) was the exclusive means of achieving an asset basis step-up, or that Kimbell-Diamond was superseded.¹⁸ In effect, the court ruled that, in the absence of a clear statement in the legislative history that Kimbell-Diamond was overridden, it would allow a taxpayer to use the case to obtain a basis step-up in acquired assets when the requirements of Section 334(b)(2) were not met.

The Committee believes that the enactment of Section 338 resolved the uncertainty regarding the continued vitality of the Kimbell-Diamond doctrine. Legislative history reflects Congressional intent that Section 338 “replace[s] any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine.”¹⁹ Given the direct challenge to the government in the American Potash decision, it would appear that the quoted language means that Kimbell-Diamond has no continuing vitality to achieve a Section 1012 asset basis, whether or not the stock acquisition is a QSP. We believe this conclusion finds support in the fact that, when Section 338 was enacted, only the situation with no QSP was even debated.²⁰ Also, any other conclusion would fail to make Section 338 the exclusive means by which a stock purchase can be treated as an asset purchase,

¹⁶ Boise Cascade Corp v. U.S., 429 F.2d 770 (9th Cir. 1968) (Section 334(b)(2) was passed by Congress to eliminate the subjective intent test enunciated in Kimbell-Diamond); Broadview Lumber Inc. v. U.S., 561 F.2d 698 (7th Cir 1977) (Kimbell-Diamond inapplicable and basis step-up in assets can only be obtained via Section 334(b)(2)); Supreme Inv. Corp. v. U.S., 468 F.2d 370, 377 (5th Cir. 1972) (stating in dictum that Section 334(b)(2) was a codification of the Kimbell-Diamond doctrine and that with Section 334(b)(2) Congress changed the subjective tests of Kimbell-Diamond (i.e., intent) into the objective tests outlined in Section 334(b)(2)); Kansas Sand & Concrete Inc. v. Comm’r, 462 F.2d 805 (10th Cir. 1972) (purchase of all of the stock of Target for cash followed by a merger of Target into Parent meets the requirements of Section 334(b)(2)); Chrome Plate Inc. v. U.S., 614 F.2d 990 (Ct. Cl. 1980) (taxpayer was precluded from applying the principles of Kimbell-Diamond to obtain a basis step up in the Target assets because the court held that Section 334(b)(2) was the exclusive means to obtain a basis step up in assets after a stock acquisition). But see American Potash v. U.S., 402 F.2d 1000 (Ct. Cl. 1968) (Kimbell-Diamond viable despite enactment of Section 334(b)(2) because the legislative history of Section 334(b)(2) contained no affirmative statement of legislative intent to modify or abrogate Kimbell-Diamond).

¹⁷ S. REP. NO. 1662, 83d Cong., 2d Sess. 257 (1954).

¹⁸ American Potash, 399 F.2d at 206-209.

¹⁹ H.R. CONF. REP. NO. 97-76, at 529 (1982).

²⁰ The legislative history specifically uses the phrase “stock purchase” when discussing the continued vitality of the Kimbell-Diamond doctrine and not the phrase “QSP,” which is used throughout the balance of the committee report. H.R. CONF. REP. NO. 97-76, at 529 (1982).

thus vitiating the exclusive elective regime of Section 338 that was at the core of Rev. Rul. 90-95 and Treas. Reg. Section 1.338-3(d). Because Congress apparently sought to allow a basis step-up only in cases where the parties are eligible to make a Section 338 election and make such election, it would seem anomalous to conclude that Congress chose to allow taxpayers to continue to assert the step transaction doctrine to obtain a cost basis under Section 1012 in cases where they do not even satisfy the requirements for making the election.

Finally, at least two well established revenue rulings support the conclusion that the Kimbell-Diamond doctrine does not apply even if a stock acquisition, viewed independently, is not a QSP.

In Rev. Rul. 75-521,²¹ the Acquiring corporation owned 50 percent of the stock of the Target corporation, with the balance of the stock held by unrelated individuals. As part of an integrated plan, the Acquiring corporation acquired the remaining stock for cash and then caused the Target corporation to liquidate.²² The Service refused to integrate the two steps into a taxable acquisition of Target's assets but, instead, respected the form of the transaction.

In Rev. Rul. 77-427,²³ the shareholders of X sold all their X stock to related Y corporation, solely for cash, followed by the immediate liquidation of X into Y. Again, the Service did not integrate the steps into a taxable asset purchase by Y. Instead, the X stock acquisition was treated as a separate Section 304(a)(1) transaction, whereby the transfer of the X stock was treated as a contribution to the capital of Y and Y received a transferred basis in the X stock. The ruling concludes that the acquisition of the X stock was not a QSP for Section 334(b)(2) purposes. Accordingly, the liquidation of X was treated as a complete liquidation under Section 332, and Y received a transferred basis in the X assets under Section 334(b)(1).

In neither Rev. Rul. 75-521 nor Rev. Rul. 77-427 was the acquisition of Target corporation stock a QSP under Section 334(b)(2), and yet the Service did not apply the step transaction doctrine to convert the stock acquisition and the liquidation of the Target corporation into a taxable purchase of Target assets. Although both Rev. Rul. 75-521 and Rev. Rul. 77-427 predate Section 338, the rejection of the Kimbell-Diamond doctrine was consistent with the Service's litigating position where the taxpayer attempted to integrate steps to effect asset purchase treatment when the stock acquisition was not a QSP.²⁴

²¹ 1975-2 C.B. 120.

²² Presumably, Parent's acquisition of the remaining 50 percent of Target stock did not occur within a 12-month period of its original acquisition.

²³ 1977-2 C.B. 100.

²⁴ See e.g., Boise Cascade, 429 F.2d 770; Broadview Lumber, 561 F.2d 698; Supreme Inv., 468 F.2d 370; and Kansas Sand & Concrete, 462 F.2d 805; Chrome Plate, 614 F.2d 990, discussed supra in note 16.

Second Principle: Where integration of related steps would result in a Section 362(b) transferred basis for the assets of the Target corporation, apply the step transaction doctrine to integrate the related steps as a reorganization.

If application of the step transaction doctrine would result in a reorganization under Section 368(a), and not a taxable asset acquisition, the First Principle does not apply, but the Second Principle does. The Second Principle simply reiterates current law, as set forth in Rev. Rul. 67-274, Rev. Rul. 2001-46, King Enterprises, and other authorities.²⁵ Where the integration of a series of steps would result in a reorganization, application of the step transaction doctrine is appropriate, whether or not the acquisition of Target stock satisfies the definition of a QSP. In applying this Second Principle, all steps of a related transaction are combined to determine whether the integrated transaction qualifies as a reorganization.

The basis for the Second Principle is that Section 338 precludes integration of a series of steps only where integration would result in a taxable asset acquisition. Where a reorganization would result from integrating the steps, nothing in the legislative history of Section 338 indicates an intent to preclude integration.

As recommended by the Committee, the Second Principle would apply only in the context of a transferred basis transaction under Section 362(b). A more difficult case is the one in which the basis of assets is determined under Section 362(a) because of a Section 351 transaction. Example 1 of Exhibit B sets forth the case. In that example, individual A owns all the stock of corporation X, and individual B (unrelated to individual A) owns all the stock of corporation Y. A and B form Newco, with A transferring all the stock of X to Newco for non-voting Newco stock (representing 40 percent of the total value of all the Newco stock) and B transferring all the stock of Y to Newco for voting Newco stock (representing 60 percent of the total value of all the Newco stock) plus cash. Then, as part of an integrated plan, X liquidates into Newco.

Example 1 is similar to the transaction described in Rev. Rul. 76-123,²⁶ except that, in Example 1, if the steps are integrated into an asset acquisition, the acquisition could not qualify as a “C” reorganization, because the consideration paid to A is non-voting Newco stock. Application of the step transaction doctrine, however, could result in the transfer of X stock and liquidation of X being integrated and treated as a Section 351 transfer by X of its assets in exchange for nonvoting Newco stock, followed by a Section 331 liquidation of X in which the non-voting Newco stock is distributed to A.²⁷

²⁵ Rev. Rul. 67-274, 1967-2 C.B. 141; Rev. Rul. 2001-46, 2001-2 C.B. 321; King Enterprises, 418 F.2d 511.

²⁶ 1976-1 C.B. 94.

²⁷ See Section 351(c), providing that, in determining “control” for Section 351 purposes, the fact that any corporate transferor distributes part or all of the stock of the transferee corporation to its shareholders is not taken into account. Accordingly, X corporation and the shareholders of Y corporation are treated as “transferors” that together own 100 percent of the Newco stock for purposes of satisfying the “control” requirement.

The Committee does not believe that integration of the steps is appropriate in this case for three reasons. First, integration of the steps would convert the Section 351 transfer of X stock by A into a taxable disposition of X stock (the liquidation of X). Second, and more important, integration would result in a disconnect between the location of the assets of X and its attributes, because Section 381 would not apply to the Section 351 exchange.²⁸ Finally, Newco could end up with a full step-up in the basis of the X assets under Section 362(a) if A receives sufficient boot in addition to the non-voting stock in the transfer.²⁹

Although our recommendation is result oriented, the Committee believes that the results of integration are inappropriate as a matter of policy.³⁰ Thus, under the Second Principle, the steps in Example 1 of Exhibit B would not be integrated on those facts. Instead, Newco's acquisition of X stock would be respected as an exchange of X stock for Newco stock under Section 351, followed by a complete liquidation of X under Section 332.

Third Principle: If the step transaction doctrine would result in a Section 362(b) transferred basis transaction under the Second Principle, then a Section 338 election is unavailable, unless the election under Temp. Treas. Reg. Section 1.338(h)(10)-1T is available. This election should be made available for Section 338(g) elections as well, with appropriate rules to prevent whipsaw.

The legislative history of Section 338 does not differentiate between Section 338(g) and 338(h)(10) elections with respect to the application of the step transaction doctrine. Therefore, where the step transaction doctrine (as reflected in Rev. Rul. 2001-46 and King Enterprises) can be modified to permit a Section 338(h)(10) election for the stock acquisition that precedes a liquidation of Target, it should also be modified to permit a Section 338(g) election.

²⁸ The X attributes would disappear on the deemed liquidating distribution to A. This disconnect between the assets of X and its attributes is even more pronounced if X has a corporate shareholder and, therefore, Section 332 applies to the deemed liquidation of X. In that case the X attributes would carryover to the corporate shareholder under Section 334(b), while the former X assets reside in Y.

²⁹ Assume also in Example 1 that X has one asset with a fair market value of \$100, with a tax basis of \$50. If A receives \$50 cash in addition to Y nonvoting stock, integration of the steps would result in \$50 of boot to X under Section 351(b). As a result, Y would receive a fair market value basis in the X asset under Section 362(a) outside of the Section 338 regime (\$50 starting basis, plus the \$50 gain recognized by the transferor).

³⁰ Our recommendation for Example 1 is consistent with the Committee's underlying principle in this report that the step transaction doctrine generally should apply to aggregate steps of an integrated transaction, except when there is a countervailing policy reason. For example, in Rev. Rul. 2003-51, 2003-21 I.R.B. 938, the Service did not integrate a series of steps to disqualify an asset transfer as a Section 351 exchange notwithstanding the transferor's disposition of all of the transferee's stock pursuant to a binding agreement in place before the asset transfer. Under the facts of the ruling, the Service did not apply the step transaction doctrine and concluded that the "control" requirement under Section 351(a) was satisfied because the nontaxable disposition of the transferee's stock was not inconsistent with the purposes of Section 351. Although the transaction described in Rev. Rul. 2003-51 does not involve a two step asset acquisition, it does illustrate the Service's willingness to follow form in the Section 351 context when policy reasons dictate. See also Rev. Rul. 77-449, 1977-2 C.B. 110, amplified by Rev. Rul. 83-34, 1983-1 C.B. 79, and Rev. Rul. 83-156, 1983-2 C.B. 66; cf. Rev. Rul. 70-140, 1970-1 C.B. 73.

In a Section 338(g) or Section 338(h)(10) transaction, the purchaser and the selling shareholders should treat the transaction consistently to prevent whipsaw to the government. In the context of a Section 338(g) election, the Section 338 regulations will need to be modified to require some form of notice to the selling shareholders because they do not participate in an election under Section 338(g) (similar to the rules of Treas. Reg. Section 1.338-2(e)(4) in the case of a Section 338(g) election for a controlled foreign corporation, where notice must be given to the U.S. shareholders of the foreign Target corporation for a Section 338(g) election to be valid). This notice should also be sent to the Service to help ensure consistent treatment.

This notice, however, would not be binding on the selling shareholders without a modification of the regulations under Sections 332, 351, 354, 361, 362, 367, 368, and 1012. The modification would make it clear that a transaction for which a valid Section 338 election is made cannot qualify as reorganization or a Section 351 transaction to the selling shareholders when an election is made under Section 338(g) or Section 338(h)(10). The Committee recommends the adoption of such a modification, making it mandatory for all parties to the transaction.³¹

Fourth Principle: If the step transaction doctrine is not applied under the First Principle, then the stock acquisition should be respected as a separate step for all federal income tax purposes. A Section 338 election should be available only if the stock acquisition is a QSP, viewed independently. For purposes of testing whether a second-step potential asset reorganization satisfies the continuity of interest, control and solely for voting stock requirements, the anti-Yoc Heating regulation (Treas. Reg. Section 1.338-3(d)) should be expanded to apply regardless of whether the first step stock acquisition is a QSP.

The true import of this principle is set forth in Examples 1 and 2 of Exhibit B. Example 1 has been described earlier in this report. Under the First Principle, the step transaction doctrine is not applied to convert the transaction into a Section 351 transfer of X assets to Newco, because such a deemed direct asset acquisition would not qualify as a reorganization. As a result, under this Fourth Principle, A's transfer of X stock to Newco would be respected as a separate transaction for all federal income tax purposes. Accordingly, A's exchange of X stock solely for Newco nonvoting stock would qualify as a tax-free Section 351 exchange (in which B is a co-transferor), and the liquidation of X would qualify as tax-free under Sections 332 and 337. A Section 338 election would not be available to Newco with respect to the X stock acquisition because, viewed independently, the stock acquisition does not qualify as a "purchase" under Section 338(h)(3)(A), and is therefore not a QSP.

³¹ The Committee understands that, if adopted, our recommendation would require the selling shareholders to seek contractual protection from the buyer if they prefer tax-free treatment. We do not believe this is unusual in a reorganization transaction, however, because contractual protection is often necessary to help ensure that an Acquiring corporation will not do anything to violate various reorganization requirements (e.g., the continuity of business enterprise requirement).

In Example 2, B is an individual who owns all the stock of T corporation. A is an individual (unrelated to T or B) who owns all the stock of X corporation. As part of an integrated plan, (i) T distributes 50 percent of its operating assets to B, (ii) B exchanges all his T stock solely for X voting stock (representing less than 50 percent of the vote or value of X stock), and (iii) T is liquidated into X. If all three steps are integrated, T would be treated as transferring all its remaining assets to X in exchange for X stock and X's assumption of T's liabilities, followed by T's distribution of the X stock to B in liquidation of T. The direct asset acquisition would not qualify as an asset reorganization under Section 368(a), because X would not acquire substantially all of T's assets or acquire such assets pursuant to a statutory merger or consolidation, and because B would not "control" X after the transaction.³² Accordingly, if the steps are integrated, (i) T would recognize gain or loss on the transfer of assets to X; (ii) X would acquire a Section 1012 basis in the T assets without having made a Section 338 election; (iii) T would recognize gain (and perhaps loss) on the distribution of the X stock and its other assets to B in complete liquidation under Section 336; and (iv) B would recognize gain or loss on the exchange of T stock for X stock under Section 331.

Under the First Principle, the step transaction doctrine would not apply to integrate the steps, because if the transactions were so integrated, X would be treated as purchasing the T assets resulting in Section 1012 asset basis, rather than acquiring such assets in a reorganization. Accordingly, the acquisition of the T stock should be considered separate from the subsequent liquidation of T. As described above, treating the liquidation of T as a complete liquidation under Section 332 ensures that X receives a transferred basis in the T assets, thereby protecting the elective regime of Section 338. Viewed independently, the stock acquisition will also impact the tax consequences of B, the T shareholder who receives solely X voting stock in exchange for his T stock. Because that transaction would qualify as a "B" reorganization, B would not recognize gain or loss on the exchange, and, of course, a Section 338 election would not be available.

The First Principle prohibits application of the step transaction doctrine only insofar as necessary to protect the Section 338 regime (i.e., it does not allow a Section 1012 asset basis outside of the Section 338 regime). Accordingly, it may be argued that X, in Examples 2, should be entitled to a Section 1012 asset basis by making a Section 338 election. In this case, in order to provide consistent treatment and prevent whipsaw to the government, the Target stock transferor, B, would not receive tax-free treatment on the exchange under Section 354.

The Committee believes, however, that when the First Principle applies, it is more appropriate to treat the stock acquisition as a separate transaction for all federal income tax purposes. As such, the X stock acquisition in Example 1 and the T stock acquisition in

³² Accordingly, the transaction would not qualify as an "A" reorganization, a "C" reorganization, or a "D" reorganization. The transaction also would not qualify as a Section 351 exchange. Therefore, the integrated transaction would be fully taxable.

Example 2 cannot qualify as QSPs. Arguably, the Service has already determined that a Section 338 election is unavailable when a stock acquisition, viewed independently, does not qualify as a QSP. In Temp. Treas. Reg. Section 1.338(h)(10)-1T(e), Example 14, P owns all of the stock of Y, a newly formed subsidiary, and S owns all of the stock of T. P, Y, S, and T are domestic corporations. Y merges into T with T surviving, and P acquires all of the stock of T from S solely for P voting stock. After the acquisition by P and as part of the plan, T is merged into P. The example concludes that no Section 338(h)(10) election can be made with respect to P's acquisition of the T stock, because, viewed independently of T's merger into P, the acquisition of T stock is a B reorganization and not a QSP, despite the fact that T does not survive the transaction. Thus, the Fourth Principle adopts the rationale and the conclusion of Example 14 of Temp. Treas. Reg. Section 1.338(h)(10)-1T(e).

Moreover, under the second sentence of the Fourth Principle, a Section 338 election would be unavailable for a stock acquisition that does not qualify as a QSP for any reason. Thus, the stock acquisitions described in Examples 1 and 2 do not qualify as a "purchase" under Section 338(h)(3)(A) when viewed independently because, in each case, the Acquiring corporation acquired the Target corporation stock in a transferred basis transaction. Similarly, a Section 338 election would not be available for a stock acquisition that does not qualify as a QSP, either because the stock was acquired from a related person (Section 338(h)(3)(C)), or because the Acquiring corporation does not acquire Section 1504(a)(2) ownership within the requisite 12-month acquisition period (e.g., Rev. Rul. 75-521,³³ described above).

It is important to note that the Committee's recommendation that the stock acquisition be treated as a separate step for all federal income tax purposes does not mean that the stock acquisition should automatically be treated as *unrelated* to the subsequent liquidation or other elimination transaction. Rather, we simply recommend that a *recast* of the transaction as a direct asset acquisition should not apply in circumstances described in the Fourth Principle.

Thus, for example, the Fourth Principle does not in all circumstances mandate that the continuity of interest requirement is satisfied in the case that the second step is a potential asset reorganization. Under Treas. Reg. Section 1.368-1(e)(2), certain acquisitions of target stock occurring in connection with a potential reorganization may cause the continuity of interest requirement to be violated. An exception to this rule is provided in the "anti-Yoc Heating" rule of Treas. Reg. Section 1.338-3(d), but only for purposes of determining the treatment of the purchasing corporation and other members of the same affiliated group as the purchasing corporation. The existing rules are demonstrated in the Example to Treas. Reg. Section 1.338-3(d). In that example, P owns all of the stock of X, and unrelated T is owned 85 and 15 percent by individuals A and K, respectively. P purchases all of A's T stock for cash in a QSP but does not make a Section 338 election. As part of an integrated transaction, T merges into X under state law in a transaction that

³³ 1975-2 C.B. 120.

qualifies under Section 368(a)(1)(A), but for the question of continuity of interest. In the merger, P and K receive solely X stock in exchange for their T stock. The example concludes that, by virtue of Section 338, and pursuant to the rules provided by Treas. Reg. Section 1.338-3(d), the merger qualifies as a reorganization with respect to P, X, and T, but not with respect to K. Under general principles of tax law applicable to reorganizations, the continuity of interest requirement is not deemed satisfied because the T stock acquisition and merger were pursuant to an integrated transaction in which A (an 85% owner) receives solely cash in exchange for A's T stock. Accordingly, the example concludes that Section 354 does not apply to K's exchange of T stock for X stock.

Adoption of the Fourth Principle would not change the result in this Example. Under the First Principle, P's acquisition of T stock would be respected as a *separate* step from the merger of T into X for all federal income tax purposes. As such, and given the rules of Treas. Reg. Section 1.338-3(d), the merger of T into X would qualify as a reorganization with respect to P, X, and T. Section 354 would not apply to A who receives solely cash in exchange for A's T stock. Because the acquisition of T stock is a *related* step, however, and because K is not subject to the special rule of Treas. Reg. Section 1.338-3(d), Section 354 would not apply to K for the same reasons articulated in the Example (i.e., applying general principles of tax law, continuity of interest is not satisfied), even after applying the Fourth Principle to cause the stock acquisition to be respected as a separate step. *See* Treas. Reg. Section 1.368-1(e)(2).

Under the third sentence of the Fourth Principle, and for the reasons set forth throughout the text above, the Committee recommends that Treas. Reg. Section 1.338-3(d) and the results of the Example be expanded to apply also in cases where P's acquisition of T stock does not qualify as a QSP (for example, because P and T are related). By way of illustration, a cash acquisition of 85% of the stock of T by related P, followed by a merger of T into X, another wholly-owned subsidiary of P, should not result in X's obtaining a cost basis in the former T assets simply because the first-step stock acquisition did not qualify as a QSP. Thus, as in the above Example, the sideways merger should qualify as a tax-free reorganization with respect to P, T, and X, but should not afford Section 354 treatment to K, a small minority former T shareholder who also receives X stock in the merger.

Conclusion

Notwithstanding numerous pronouncements by the Service addressing the continued vitality of the Kimbell-Diamond doctrine in the context of a two step asset acquisition by an Acquiring corporation, uncertainty still exists. For example, published guidance arguably does not address whether the Kimbell-Diamond doctrine applies where the acquisition of the Target corporation stock is not a QSP when viewed independently from a subsequent liquidation and integration of the steps would result in Section 1012 basis for Target's assets. For this reason, it is also uncertain what the tax consequences are to the parties to the transaction, including the Target corporation shareholders. The members of the Committee and other practitioners continually encounter transactions not addressed by

current authorities and believe that further clarity in this area is essential for purposes of sound tax administration. The Committee recommends for adoption in published guidance the four principles set forth in this report that both incorporate current guidance and resolve many of the remaining issues dealing with the continued vitality of the Kimbell-Diamond doctrine. See the chart attached as Exhibit C illustrating how the Kimbell-Diamond doctrine would apply to two step asset acquisitions if the four principles are adopted by the Service.

Sincerely,

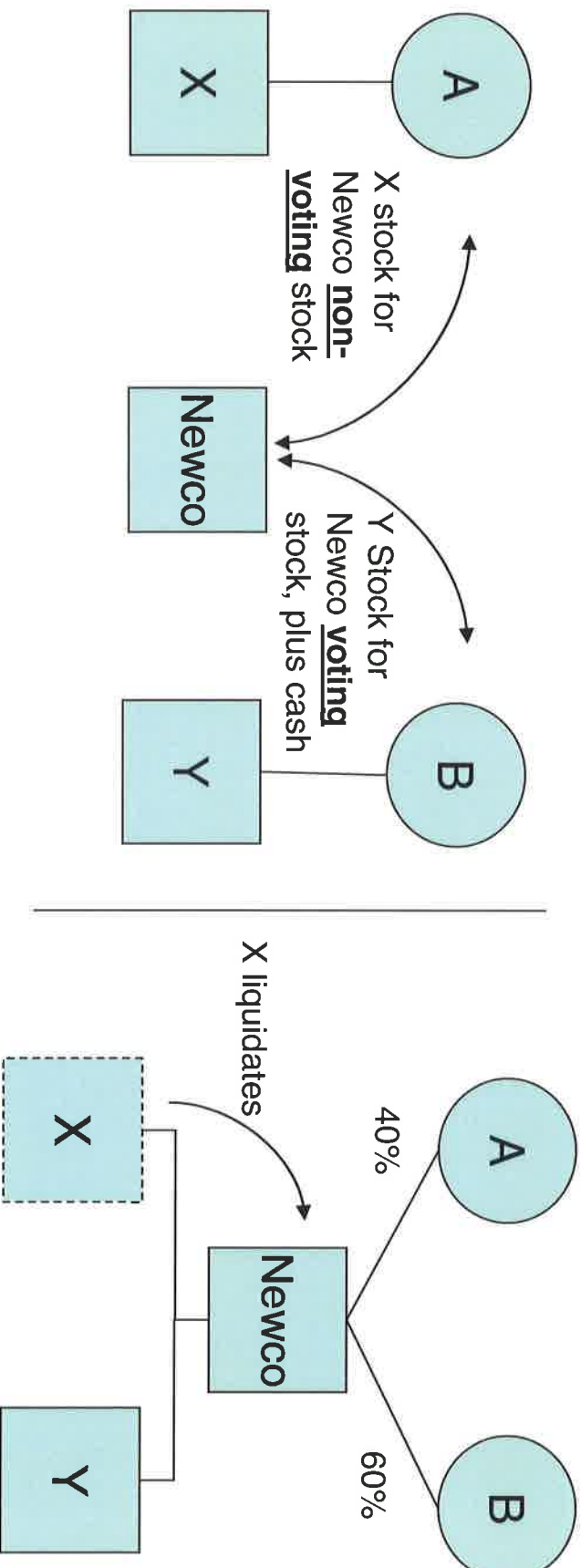


Suzanne Ross McDowell
Chair, Steering Committee of the
D.C. Bar Association, Section of Taxation

Exhibit A

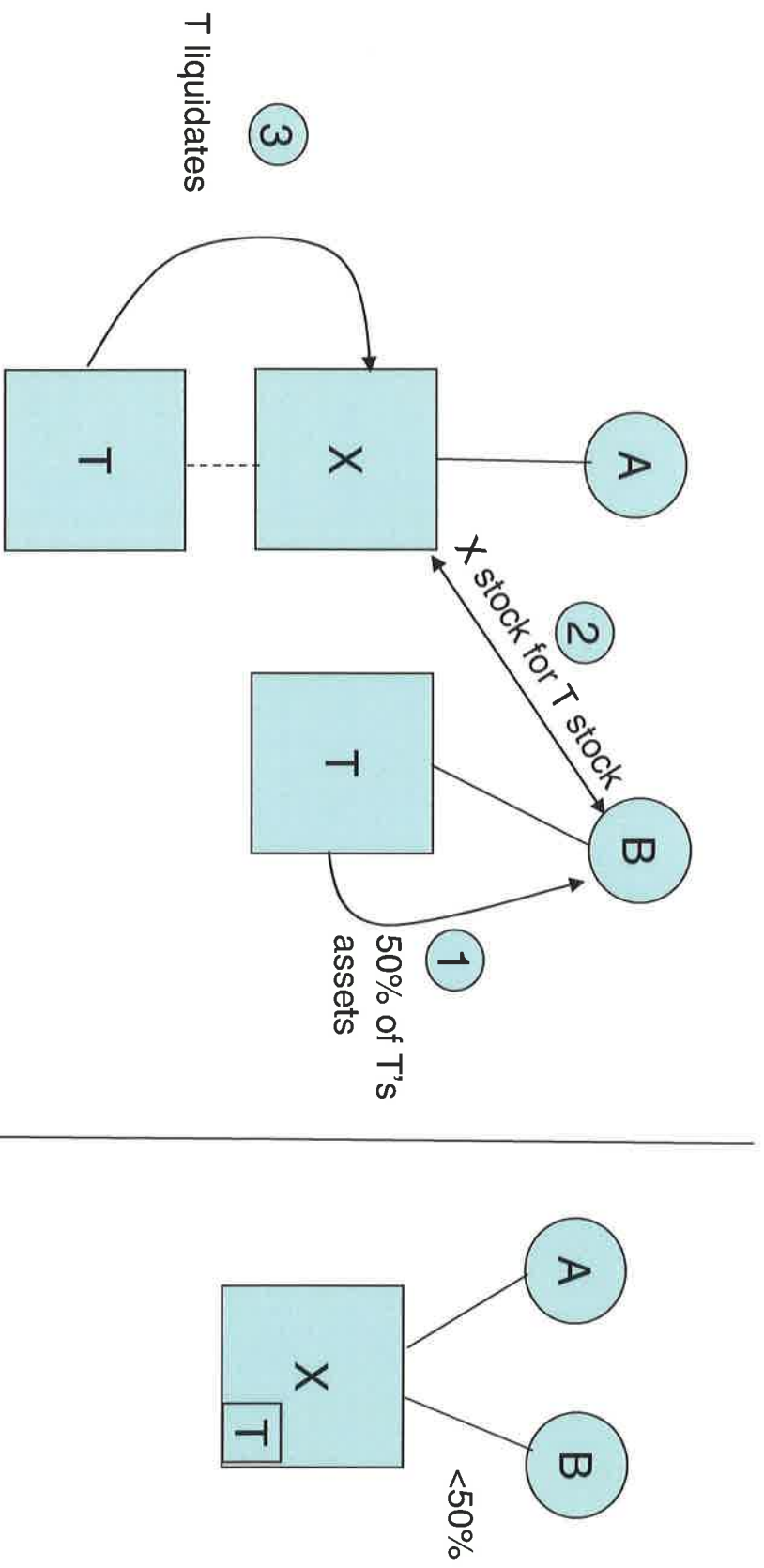
<u>RULING</u>	<u>STEP 1</u>	<u>STEP 2</u>	<u>STEP 1 + 2</u>	<u>Integrate?</u>	<u>Election?</u>
90-95	QSP	332	1001 (assets)	No	Yes
2001-46(1)	QSP	332	368(a) (assets)	Yes	No unless Reg. available
2001-46(2)	368(a) (stock)	332	368(a) (assets)	Yes	No
<i>Insufficient guidance</i>	351 (stock)	332	351 (assets)	?	?
<i>Insufficient guidance</i>	368(a) (stock)	332	1001 (assets)	?	?
<i>Insufficient guidance</i>	Other non- QSPs	332	1001 (assets)	?	?

Exhibit B--Example 1



- If steps integrated, X's transfer of assets to Newco does not qualify as a "C" (fails the "solely for voting stock" requirement) or a "D" reorganization (lack of "control"), but could qualify as a Section 351 exchange.

Exhibit B--Example 2



- Viewed independently, X's acquisition of T stock qualifies as a "B" reorganization.
- If steps integrated, X's acquisition of T's assets would not qualify as a "C" (fails the "sub all" requirement) or a "D" reorganization (lack of "control").

Exhibit C

<u>RULING</u>	<u>STEP 1</u>	<u>STEP 2</u>	<u>STEP 1 + 2</u>	<u>Integrate?</u>	<u>Election?</u>
90-95	QSP	332	1001 (assets)	No	Yes
2001-46(1)	QSP	332	368(a) (assets)	Yes	No unless Reg. available
2001-46(2)	368(a) (stock)	332	368(a) (assets)	Yes	No
<i>Per Report</i>	351 (stock)	332	351 (assets)	No	No
<i>Per Report</i>	368(a) (stock)	332	1001 (assets)	No	No
<i>Per Report</i>	Other non-QSPs	332	1001 (assets)	No	No