Tax-Free Liquidation of a Subsidiary Resurrection of the Kimbell-Diamond Doctrine

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TAX-FREE LIQUIDATION OF A SUBSIDIARY: 
RESURRECTION OF THE KIMBELL-
DIAMOND DOCTRINE

If corporation X purchases the assets of corporation Y, the basis of those assets to X is their cost. If Y's shareholders, however, may prefer a sale of their stock to a sale of Y's assets. If X buys Y's stock and later liquidates Y, the basis of the assets X acquires depends upon whether the liquidation is taxable. If it is, the basis is the fair market value of the assets. But if the liquidation of Y is tax-free, Y's basis will normally be carried over to the parent corporation, X. The only exceptions to this carryover basis for property received in a tax-free liquidation of a corporation are the statutory exception of section 334(b)(2), which

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1 INT. REV. CODE OF 1954, § 1012 [hereinafter cited as CODE].
2 Under the 1939 Code, the sale of Y's assets would result in double taxation: Y would pay a tax on any gain and Y's shareholders would pay tax on their dividends. A liquidation of Y followed by a sale of the assets by the shareholders might still have been doubly taxed. See Commissioner v. Court Holding Co., 324 U.S. 331 (1945). Despite the enactment of CODE § 337, intended to overrule the Court Holding case, it may still be advantageous for the shareholders to sell their stock rather than having Y sell its assets. See Levin, Purchase and Sale of Corporate Businesses: Tax Opportunities and Pitfalls, 35 TAXES 942, 943 (1957).
3 The 1954 Code states that, as a general rule, "Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock." CODE § 331(a)(1). It also provides a rule for determination of the amount of gain or loss to the distributee. Id. § 1001.
4 Id. § 334(a).
5 Id. §§ 332, 333. This note is concerned with § 332 liquidations only.
6 Id. § 334(b)(1).
7 CODE § 334(b) provides as follows:
(1) IN GENERAL.—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), 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. If property is received by a corporation in a transfer to which section 332(c) applies, and if paragraph (2) of this subsection does not apply, then the basis of the property in the hands of the transferee 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 (within the meaning of section 332(b)), 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) (or, in the case of a series of transactions, the date of the last such transaction); 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 (except non-voting stock which is limited and preferred as to dividends),
provides for a cost-of-stock basis if its conditions are met, and the Kimbell-Diamond doctrine. This case law doctrine, developed before the enactment of section 334(b)(2), required a cost basis if the parent’s intent in purchasing a subsidiary was to acquire its assets. The recent decision of the Court of Claims in American Potash & Chemical Corp. v. United States, holding that the Kimbell-Diamond doctrine is still applicable to corporate purchasers who have not complied with section 334(b)(2), restores some of the uncertainty which existed prior to the enactment of that section and suggests a possible problem with carryover of tax attributes under section 381.

I

THE Kimbell-Diamond DOCTRINE

In Kimbell-Diamond Milling Co. the taxpayer corporation purchased all the stock of the Whaley Mill & Elevator Company and liquidated Whaley. Whaley’s adjusted basis was greater than the cost of the stock to Kimbell-Diamond. The Tax Court rejected the taxpayer’s contention that the 1939 Code required a carryover basis and held

was acquired by the distributee by purchase (as defined in paragraph (5)) during a 12-month period beginning with the earlier of,

(i) the date of the first acquisition by purchase of such stock, or
(ii) if any of such stock was acquired in an acquisition which is a purchase within the meaning of the second sentence of paragraph (8), the date on which the distributee is first considered under section 318(a) as owning stock owned by the corporation from which such acquisition was made,

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. For purposes of the preceding sentence, under regulations prescribed by the Secretary or his delegate, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to the distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

The doctrine is derived from Kimbell-Diamond Milling Co., 14 T.C. 74 (1950), aff’d per curiam, 187 F.2d 718 (5th Cir.), cert. denied, 342 U.S. 827 (1951), although it was first stated in Commissioner v. Ashland Oil & Ref. Co., 99 F.2d 588 (6th Cir. 1939), cert. denied, 306 U.S. 661 (1939).

Although the price received by Whaley’s shareholders for their stock was greater than the adjusted basis of Whaley’s assets, part of the purchase price was insurance money received by Kimbell-Diamond for property destroyed by fire. The cost of the stock was computed as the basis of Kimbell-Diamond’s lost assets plus the amount paid in excess of the insurance, and thus the adjusted basis was larger than the cost basis. Id. at 80.

12 14 T.C. at 80. Section 112(b)(6) of the 1939 Code provided for non-recognition of gain or loss for assets received by a corporation in a distribution pursuant to a complete
that "the purchase of Whaley's stock and its subsequent liquidation must be considered as one transaction, namely, the purchase of Whaley's assets . . ." The basis of the assets acquired by Kimbell-Diamond was, therefore, the cost of the Whaley stock.

The Kimbell-Diamond doctrine has been described as "an exception to the general rule that a carryover basis is required when a corporation is completely liquidated." The rationale of the decisions under the 1939 Code finding a cost basis applicable was that substance should prevail over form, and that what "really happened" was a purchase of assets. The Kimbell-Diamond doctrine was thus a particular application of the step-transaction doctrine, which has been described as follows:

It has been said too often to warrant citation that taxation is an intensely practical matter, and that the substance of the thing done and not the form it took must govern . . . 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.

Although the Kimbell-Diamond doctrine seemed correct in principle, its application proved troublesome. In order to achieve a cost basis it was necessary to show that the "intent" of the purchasing corporation was at all times to acquire assets. In Kimbell-Diamond the intent was clear; Whaley was liquidated within a week after its purchase and Kimbell-Diamond's corporate minutes reflected a desire to acquire
TAX-FREE LIQUIDATIONS

Whaley's mill to replace one of its own.23 Related factors, such as an attempt to purchase assets directly or the "stripping down" of the acquired corporation, may also demonstrate the requisite intent.24 But because the doctrine was based upon the subjective foundation of intent, in many cases the tax consequences of a liquidation could be determined only by litigation.

II

THE STATUTORY EXCEPTION TO THE CARRYOVER BASIS—SECTION 334(b)(2)

Unlike its predecessor, the 1954 Code contains rules which provide for a cost basis in certain corporate purchase and liquidation situations.25 If a liquidation is tax-free under section 332,26 the general rule is that a carryover basis is required.27 However, if the detailed requirements of section 334(b)(2)28 are met, the basis is the cost of the acquired stock, subject to adjustments required by the regulations.29 For this section to apply to a liquidation, the subsidiary must be completely liquidated, the parent must have purchased eighty percent or more of the subsidiary's stock within a twelve-month period,30 and the liquidation must be pursuant to a plan adopted within two years of the stock purchase.31 If a purchaser complies with section 334(b)(2), intent is irrelevant.32

Because there has been almost no litigation involving the section, 334(b)(2) has been considered an improvement over the Kimbell-

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23 14 T.C. at 75-76.
24 For a discussion of the factors which may be important in determining corporate intent in a Kimbell-Diamond situation, see Lewis, Cost-Of-Stock Basis For Assets Received from Acquired Corporation, 19 U. Miam. L. Rev. 159, 163-69 (1964).
26 Section 332(a) provides that "[n]o gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation." Section 332(b) sets forth detailed requirements which must be met if the section is to apply. Section 332(c) provides a special rule concerning indebtedness of a subsidiary to its parent.
27 Cod. § 334(b)(1).
28 The text of § 334(b) is set out in note 7 supra. For a guide to the problems of complying with § 334(b)(2), see O'Malley, The Pitfalls of a Section 334(b)(2) Liquidation and How to Avoid Them, 24 J. Taxation 138 (1968).
30 Except for non-voting preferred stock.
31 Treas. Reg. § 1.334-1(c)(3) (1955) gives detailed provisions for determining the date on which the specified two-year period begins.
Diamond doctrine. The section has been criticized, however, on the "form over substance" ground that careful tax planning may allow the parent corporation to choose whatever basis is highest.

III

The Resurrection of Kimbell-Diamond

Application of the Kimbell-Diamond doctrine to a transaction which did not meet the requirements of section 334(b)(2) has been sanctioned by American Potash & Chemical Corp. v. United States. Potash had exchanged, in two separate transactions, a portion of its stock for all the stock of Wecco, which it then liquidated. Because Potash did not acquire eighty percent of Wecco's stock within any twelve-month period, the requirements of section 334(b)(2)(B) were not met. Nevertheless, Potash used a cost basis in computing its depreciation deduction on the assets obtained from Wecco. The court denied the government's motion for summary judgment and held that section 334(b)(2) had not totally vitiates the Kimbell-Diamond doctrine.

The decision was based upon an interpretation of the legislative history of section 334. Since the Senate Finance Committee extensively changed the House proposals, its report would seem to be the key document. The report states, with regard to section 334:

Under the House bill, a shareholder would in all cases be permitted to receive the purchase price for his stock as his basis for the assets distributed to him regardless of the assets' cost to the corporation. In this respect the principle of Kimbell-Diamond Milling

See Lewis, supra note 24, at 185.

"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 in not one, but many ways." Cohen, Gelbert, Surrey, Tarfeau & Warren, Corporate Liquidations Under the Internal Revenue Code of 1954, 55 Colum. L. Rev. 37, 43-44 (1955) (footnote omitted).

68-2 U.S. Tax Cas. ¶ 9472, modified, 68-2 U.S. Tax Cas. ¶ 9650 (Ct. Cl. 1968). It has been reported that the Government will appeal the decision. 68-18 BNA Tax Mot. Mem. 13 (1968).

The court did not reach the question whether the Kimbell-Diamond doctrine would apply where an exchange of stock rather than a purchase of stock preceded the liquidation. The court also declined to rule on the effect of Potash having operated Wecco as a subsidiary for 7 months. It simply said that the doctrine could apply even in light of § 334(b)(2) and remanded the case. 68-2 U.S. Tax Cas. at 87,634.

Id. The court also held that the transaction was not a "creeping B" reorganization under Code § 368(a)(1)(B). On petition for rehearing, however, it ruled that the issue could be relitigated on remand. 68-2 U.S. Tax Cas. ¶ 9650.


Company . . . was effectuated. Since the application of the rule of this case is primarily in the area of liquidations by a parent corporation of its subsidiary, the rule has been limited by your committee to liquidations of this type.\textsuperscript{40}

The court reasoned that because Congress showed no intent to make the basis-of-assets choice elective,\textsuperscript{41} because \textit{Kimbell-Diamond} remains viable for individual purchasers,\textsuperscript{42} and because Congress would not have attempted to modify existing case law without clearly stating that purpose, nothing in the legislative history indicated that \textit{Kimbell-Diamond} was "dead."\textsuperscript{43} The absence of a more definite statement of purpose, however, may indicate that the Senate was not clearly aware of the problem and therefore had no specific legislative intent. Thus, a more appropriate approach would have been to stress the relative desirability of the \textit{Kimbell-Diamond} doctrine as opposed to an exclusively statutory test.

The juxtaposition of a clear statutory rule in which intent plays no part\textsuperscript{44} and a judge-made doctrine in which intent is controlling is disturbing. If a corporate purchaser desires a cost basis, it can achieve that goal by compliance with section 334(b)(2). If, however, it is unable to comply, or if a carryover basis is desired, the purchaser must face the difficult problem of proving or disproving an intent to acquire assets.

The problem is compounded by the interaction of the doctrine and section 381 carryovers. That section provides for the carryover of certain tax attributes of a subsidiary liquidated under section 332.\textsuperscript{45} There is, however, an exception for distributions to which section 334(b)(2) applies.\textsuperscript{46} Since this exception refers only to the statutory means of determining basis as cost-of-stock,\textsuperscript{47} literal application of section 381 in a \textit{Kimbell-Diamond} case would result in the parent's having a cost basis for its acquired assets and a carryover of its subsidiary's tax attributes. The courts will presumably avoid any attempt to use the \textit{Potash} holding and section 381 to obtain a double tax benefit by reasoning that the application of the step-transaction doctrine makes the liquidation part of a purchase of assets, thus destroying liquidation

\begin{footnotes}
\item[40] Id. at 48.
\item[41] 68-2 U.S. Tax Cas. at 87,633.
\item[42] The court found no congressional intent to differentiate between individuals and corporations. Id.
\item[43] Id. at 87,633-34.
\item[45] The attributes which can be carried over are listed in \textit{Code} § 381(c). They include net operating loss, earnings and profits, and capital losses.
\item[46] Id. § 381(a)(1).
\item[47] Id. § 334(b)(2).
\end{footnotes}
attributes. If the transaction is viewed as a purchase, sections 332 and 381 would be inapplicable. The legislative history of section 381 supports such a result; the Senate report states that "whether or not the items carryover should be based upon economic realities rather than upon such artificialities as the legal form of the reorganization." In an appropriate case section 269 might also be used to disallow the carryover.

The Kimbell-Diamond doctrine can also be effectively used by the government. If a corporation has liquidated a recently-purchased subsidiary and carried over its tax attributes, the government could maintain that the carryover should be disallowed because the intent of the parent was to acquire assets. Thus, the resurrection of the Kimbell-Diamond doctrine may have given the IRS a new tool for disallowing section 381 carryovers. The difficulty of determining corporate intent and the fact that an intent to acquire a subsidiary and an intent to acquire its assets are by no means mutually exclusive make this area one of considerable uncertainty.

CONCLUSION

Although section 334(b)(2) provides at least one area of certainty not present under the 1939 Code, uncertainty remains when the requirements of that section are not met. Moreover, section 381 carryovers may now provoke litigation. Had Congress, in drafting section 334, fully considered its interaction with existing case law, these problems could have been avoided.

An exclusively statutory test based entirely upon the timing of the transactions would be both realistic and objective. A cost basis could be imposed if the liquidation takes place within six months of the acquisition of control of the liquidated company, with a carryover basis

48 Cf. United States v. M.O.J. Corp., 274 F.2d 713, 717 (5th Cir. 1960). Similar problems might arise under Code § 337(c)(2), which distinguishes for § 332 liquidation purposes between § 334(b)(1) and § 334(b)(2) basis determinations. In the former case, § 337, which provides for non-recognition of gain or loss on sales of property by certain corporations which have adopted a plan of liquidation, does not apply.


50 Code § 269 provides for disallowance of tax benefits obtained by a corporate acquisition if the principal purpose of that acquisition was tax avoidance or evasion.

51 See United States v. M.O.J. Corp., 274 F.2d 713, 716-17 (5th Cir. 1960).

52 Whatever the general merits of the House version of the 1954 Code, it would have eliminated the requirement of intent from this area. See H.R. 8300, 83d Cong., 2d Sess. §§ 331, 394 (1954).
required in all other cases. If greater flexibility were desired at the expense of some predictability, a statutory presumption that a purchase of assets was not intended if the liquidation takes place more than six months after the purchase might be substituted. Although such an approach may lack some of the "substance over form" appeal of the Kimbell-Diamond doctrine, it would provide a predictable and logical rule, "a consummation devoutly to be wished."

Alan M. Gunn

53 The Code permits the purchaser to avoid an "automatic" cost-of-stock basis by spreading the purchase of 80% of the subsidiary's stock over more than 12 months. Code § 334(b)(2)(B). Requiring a liquidation within 6 months of acquisition of a majority of the voting shares would make the section less elective, yet would provide for a cost basis in clear-cut cases such as Kimbell-Diamond. This would amount to legislative adoption of the "prompt liquidation" test. Cf. Lewis, supra note 24, at 165: "If the purchase was truly one of assets, it is natural to assume that the purchaser would wish to acquire the assets as soon as possible in order to utilize them as he had intended."

54 The Code adopts an analogous approach in taxing transfers made in contemplation of death. See Code § 2035(b).

55 W. SHAKESPEARE, HAMLET, Act III, scene 1.