



January 1984

Creeping Asset Acquisitions after TEFRA: On Reconciling the Irreconcilable

Jerred G. Blanchard Jr.

Recommended Citation

Jerred G. Blanchard, *Creeping Asset Acquisitions after TEFRA: On Reconciling the Irreconcilable*, 38 Sw L.J. 1053 (1984)

<https://scholar.smu.edu/smulr/vol38/iss6/2>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

CREEPING ASSET ACQUISITIONS AFTER TEFRA: ON RECONCILING THE IRRECONCILABLE

by

*Jerred G. Blanchard, Jr.**

THE manner in which the step-transaction doctrine applies to a “creeping” asset acquisition, that is, an acquisition of target stock followed by the acquisition of the assets of the target, and the federal income tax consequences incident to such application have long been troublesome to both tax counselors and administrators. Substantial confusion and uncertainty result from the apparent paradox that, for purposes of the reorganization provisions of the Code,¹ the courts appear to have applied a fairly loose formulation of the step-transaction doctrine in determining whether a creeping asset acquisition should be tested as a stock or asset reorganization;² for purposes of the complete liquidation provisions of the Code,³ however, courts have applied either a very strict construction of the step-transaction doctrine⁴ or have found the step-transaction doctrine wholly inapplicable.⁵ The confusion and uncertainty is compounded by doubt regarding the question of whether the complete liquidation and reorganization provisions can have concurrent application to a given transaction or whether one set of provisions preempts the other.⁶ The problem

* B.A., Yale University; J.D., Vanderbilt University; LL.M. (Taxation), New York University. Partner, Johnson & Swanson, Dallas, Texas.

1. See I.R.C. §§ 354, 356, 357, 358, 361, 362, 368 (1982).

2. See *King Enterprises, Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969).

3. See I.R.C. §§ 331-338 (1982).

4. Under the Code the only formulation of the step-transaction doctrine that could apply in the complete liquidation context would appear to be either the “binding commitment” test, as illustrated by *Commissioner v. Gordon*, 391 U.S. 83, 96 (1968), or the “mutual interdependence” test, as illustrated by *American Bantam Car Co. v. Commissioner*, 11 T.C. 397, 405 (1948), *aff’d per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

5. The question of whether the repeal of *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, *aff’d per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951), has completely eliminated the application of the step-transaction doctrine for purposes of the complete liquidation provisions is discussed *infra* notes 14-26 and accompanying text.

6. See *General Housewares Corp. v. United States*, 615 F.2d 1056, 1063 (5th Cir. 1980); *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75, 77-78 (2d Cir.), *cert. denied*, 361 U.S. 835 (1959); *Performance Sys., Inc. v. United States*, 382 F. Supp. 525, 534 (M.D. Tenn. 1973), *aff’d per curiam*, 501 F.2d 1338 (6th Cir. 1974); *FEC Liquidating Corp. v. United States*, 548 F.2d 924, 926-27 (Ct. Cl. 1977); *Kass v. Commissioner (May B. Kass)*, 60 T.C. 218, 222-23 (1973), *aff’d*, 491 F.2d 749 (3d Cir. 1974); *Treas. Reg. § 1.1332-2(d)* (1955).

is further complicated by the fact that, even if a creeping asset acquisition is tested as an asset acquisition for purposes of the reorganization provisions, the manner in which the continuity of proprietary interest test is applied to the transaction is not always clear.⁷

The succeeding analysis does not purport to resolve all of the problems surrounding creeping asset acquisitions under current law. Rather, by carefully focusing upon the issues and pertinent authorities, a few conclusions may be drawn that will perhaps aid others in their search for the principles that should be applied in determining the tax consequences of creeping asset acquisitions.

I. THE STEP-TRANSACTION DOCTRINE

The so-called "step-transaction doctrine" is a specific application of the broad proposition that the substance of a transaction governs its tax consequences. The general question addressed by the doctrine is "[w]hether to accord the separate steps of a complex transaction independent significance, or to treat them as related steps in a unified transaction."⁸ The courts generally have recognized three standards for determining whether separate steps must be treated as a single transaction for tax purposes: (1) the "end result" test, which combines two steps if the second step was intended at the time the first step was taken;⁹ (2) the "mutual interdependence" test, which combines two steps if, but for the second step, the first step would have been fruitless;¹⁰ and (3) the "binding commitment" test, which combines two steps if a binding commitment to take the second step was present at the time the first step was taken.¹¹ Each time a court is asked by the taxpayer or the government to treat a series of transactions as a single transaction, the court must decide which formulation, if any, of the step-transaction doctrine should be applied in light of the policy underlying the taxing statute being scrutinized.¹²

7. The confusion regarding continuity of interest involves the case in which the acquiring corporation owns a substantial block of "old and cold" stock of the target corporation. The law is unclear as to whether continuity is tested solely by reference to the outsiders' target stock, or if continuity is tested by reference to all of the stock of the target, whether the acquiring corporation's "old and cold" target stock will be deemed to have been exchanged for qualifying consideration. *Cf. Kass v. Commissioner* (May B. Kass), 60 T.C. 218, 222, 223 (1973) (acquiring corporation's "old and cold" stock contributes to continuity of interest), *aff'd*, 491 F.2d 749 (3d Cir. 1974); *Warner Co. v. Commissioner*, 26 B.T.A. 1225, 1227 (1932) (reference to outsiders' target stock).

8. *King Enterprises, Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969).

9. *See id.*

10. *See American Bantam Car Co. v. Commissioner*, 11 T.C. 397, 405 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

11. *See Commissioner v. Gordon*, 391 U.S. 83, 96 (1968).

12. In *King Enterprises, Inc. v. United States*, 418 F.2d 511, 518 (Ct. Cl. 1969), the Court of Claims expressly adopted the end result test for purposes of deciding whether a stock acquisition followed by an upstream merger should be "collapsed" and treated as a type A reorganization. In *McDonald's v. Commissioner*, 76 T.C. 972, 997-98 (1981), *rev'd sub nom. McDonald's Restaurants of Ill., Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982), the Tax Court expressly adopted the mutual interdependence test for purposes of determin-

A. *In the Context of the Complete Liquidation Provisions*

Prior to the enactment of the 1954 Internal Revenue Code, the most significant case applying the step-transaction doctrine to complete liquidations was *Kimbell-Diamond Milling Co. v. Commissioner*.¹³ In *Kimbell-Diamond* P purchased all of the stock of T¹⁴ for the sole purpose of acquiring T's milling plant to replace P's plant, which had been destroyed by fire. Shortly after the stock purchase, T was completely liquidated. P took the position that the adjusted basis of the T assets that P received in the liquidation constituted a carryover basis under the complete liquidation provisions of the 1939 Code. The Tax Court, agreeing with the government, concluded that "[t]he purchase of [T's] stock and its subsequent liquidation must be considered as one transaction, namely, the purchase of . . . assets which was [P's] sole intention."¹⁵ Thus, the Tax Court held that the proper basis for T's assets in the hands of P was a cost basis, which was considerably lower than the carryover basis reported by P.¹⁶

While the Tax Court apparently did not make a conscious decision to apply any particular formulation of the step-transaction doctrine to the facts of *Kimbell-Diamond*, the end result test was probably applied. The language quoted above indicates that the Tax Court viewed the stock purchase and liquidation as a single transaction because P's sole intention in acquiring the T stock was the acquisition of T's assets.¹⁷ The end result test, therefore, was applied by the courts for purposes of determining the tax consequences of a creeping asset acquisition under the liquidation provisions of the 1939 Code.¹⁸

ing whether a merger followed by a cash sale of the acquiring company stock issued in the merger should be "collapsed" and treated as a cash merger.

13. 14 T.C. 74, *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

14. For ease of reference, the purchasing or parent corporation generally will be called "P," the target corporation generally will be called "T," and, occasionally, "S" will play the role of a wholly owned subsidiary of P.

15. 14 T.C. at 80.

16. *Id.* at 80-81.

17. An argument could be made that under the circumstances the acquisition of the T stock would have been "fruitless" but for the subsequent acquisition of the T assets, given P's overwhelming need for a new milling plant following the destruction of its own plant. Thus, the creeping acquisition in *Kimbell-Diamond* may have satisfied the mutual interdependence test. In *United States v. M.O.J. Corp.*, 274 F.2d 713, 717 (5th Cir. 1960), the court applied the *Kimbell-Diamond* rule to an acquisition in which a going business was acquired under less dire circumstances because P acquired the T stock for the sole purpose of acquiring the business. *Accord* *North American Serv. Co. v. Commissioner*, 33 T.C. 677, 691 (1960) (*Kimbell-Diamond* applicable to going business reorganized). Accordingly, the courts clearly have construed *Kimbell-Diamond* as an end result case.

18. Although the *Kimbell-Diamond* decision may be a dead letter in creeping acquisitions by corporations under current law, it may have continuing vitality for purposes of applying § 331 in the context of creeping acquisitions by individuals. Thus, if an individual, or group of individuals, acquires the stock of a corporation for the sole purpose of acquiring its assets, the transaction may be treated as an asset purchase. The purchaser recognizes no gain or loss on the liquidation and acquires a basis in T's assets equal to the cost of the stock. *See Snively v. Commissioner*, 219 F.2d 266, 267-68 (5th Cir. 1955); *E.T. Griswold v. Commissioner*, 45 T.C. 463, 472 (1966), *aff'd*, 400 F.2d 427 (5th Cir. 1968); *Estate of Suter v. Commissioner*, 29 T.C. 244, 258-59 (1957).

The enactment of TEFRA¹⁹ in 1982 conclusively answered the question of the vitality of *Kimbell-Diamond* under current law. Prior to TEFRA, the government and all courts considering the question, with the exception of the Court of Claims,²⁰ held the subjective end result test overruled by the enactment of section 334(b)(2) in 1954.²¹ Congress eliminated any doubt as to the vitality of *Kimbell-Diamond* by adding to the Code section 338, which, according to the Senate Finance Committee Report,²² was intended to overrule *Kimbell-Diamond*. The enactment of TEFRA, therefore, clearly made the *Kimbell-Diamond* doctrine a dead letter in the context of creeping acquisitions to which section 332, by its terms, applies.²³

The repeal of *Kimbell-Diamond* arguably does not prevent the application of the end result test for purposes of sections 331, 336, and 337 in the case of corporate creeping acquisitions to which section 332 of the Code cannot apply. For example, suppose P purchases for cash 75% of the stock of T for the sole purpose of acquiring T's operating assets. Shortly thereafter, T adopts a plan of complete liquidation and distributes, in complete

19. The Tax Equity and Fiscal Responsibility Act of 1982 [hereinafter cited as TEFRA], Pub. L. No. 97-248, 96 Stat. 324 (codified as amended at 26 U.S.C. (1982)).

20. *American Potash & Chem. Corp. v. United States*, 399 F.2d 94, 198 (Ct. Cl. 1968). Several commentators agreed with the Court of Claims' view that § 334(b)(2) did not preempt *Kimbell-Diamond* on the theory that § 334(b)(2) was enacted as a safe haven for taxpayers desiring a cost basis rather than as the sole method of obtaining a cost basis. See Levin & Bowen, *Taxable and Tax-Free Two-Step Acquisitions and Minority Squeeze-Outs*, 33 TAX L. REV. 425, 460 (1978); Mopsick, *Yoc Heating Corp. and Two-Step Asset Acquisitions*, 1 J. CORP. TAX'N 235, 240-41 (1974); Pugh, *Combining Acquired and Acquiring Corporations and Their Subsidiaries Following a Purchase of Stock: Some Anomalies of Form and Substance*, 35 TAX L. REV. 359, 362-71 (1980). In the post-TEFRA world, the merits of this argument are of purely academic interest.

21. See *Chrome Plate, Inc. v. District Director*, 614 F.2d 990, 999 (5th Cir. 1980); *International State Bank v. Commissioner*, 70 T.C. 173, 181 (1978); *Kansas Sand & Concrete, Inc. v. Commissioner*, 56 T.C. 522, 529 (1971), *aff'd*, 462 F.2d 805 (10th Cir. 1972). The theory underlying the decisions that § 334(b)(2) preempts *Kimbell-Diamond* is that Congress must have intended form to control given the highly technical, or formal, requirements of § 334(b)(2). In this regard, these decisions parallel those cases holding that § 332, by virtue of its highly technical requirements, is "elective," in the sense that a taxpayer may avoid or invoke § 332 by either complying with, or failing to comply with, its provisions. See *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956); *Commissioner v. Day & Zimmerman, Inc.*, 151 F.2d 517 (3d Cir. 1945); Rev. Rul. 60-262, 1960-2 C.B. 114.

22. S. REP. NO. 494, 97th Cong., 2d Sess. 192, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 281.

23. One might argue that the enactment of § 338 "killed" *Kimbell-Diamond* only for purposes of determining the adjusted basis of T's assets in the hands of P and that, for other purposes, *Kimbell-Diamond* still lives. For example, assume: (1) P owns, on an "old and cold" basis, 21% of the stock of T; (2) P purchases for cash the remaining 79% of T's stock; and (3) P dissolves T in accordance with preexisting intent. One could argue that, for purposes of § 332, P must be treated as having purchased 79% of T's assets for cash and as having acquired the balance in exchange for 21% of T's stock. Under this analysis P would recognize gain or loss under § 331 with respect to the 21% of T's stock owned by P on an "old and cold" basis, but, due to the repeal of *Kimbell-Diamond* for basis purposes, would acquire a carryover basis in 100% of T's assets. Such an analysis is rebutted by the express language of § 334(b), which conditions the carryover basis provision on the application of § 332. Thus, the repeal of *Kimbell-Diamond* clearly entails the nonapplication of at least the end result formulation of the step-transaction doctrine in the context of a complete liquidation to which § 332, by its terms, applies.

liquidation, 75% of its assets, solely operating assets, to P and 25% of its assets, unneeded cash, to the minority shareholders of T. If the repeal of *Kimbell-Diamond* does not mean that, for purposes of the complete liquidation provisions of the Code, the transactions must be respected as a stock purchase by P followed by the complete liquidation of T, P might be viewed as having purchased T's operating assets rather than 75% of T's stock. Because T did not adopt a plan of complete liquidation until after P parted with its cash, the government might succeed in contending that section 337 cannot apply to the deemed sale of T's operating assets to P.²⁴ Thus, if *Kimbell-Diamond* still lives in the context of creeping acquisitions to which section 332 cannot apply, T might be treated as having made a taxable sale of 75% of its assets to P.

For at least two reasons, most experienced tax practitioners will conclude that T should not be deemed to have made a taxable sale of 75% of its assets to P under the facts described above. First, the sale of 75% of the T stock was by the stockholders of T and not by T. In all likelihood the 75% stockholders of T negotiated the sale of their shares to P for their own benefit, not on behalf of T. In addition, the T stock owned by T's shareholders is not, and never has been, an asset of T or an asset that could be sold by T. Pursuant to the Supreme Court's reasoning in *United States v. Cumberland Public Service Co.*,²⁵ therefore, an asset sale should not be imputed to T.

The most convincing reason for not treating T as having made a taxable sale of 75% of its assets, however, lies in the repeal of *Kimbell-Diamond*. If P had purchased for cash 80% of the stock of T, solely for the acquisition of T's operating assets, and had then completely liquidated T, the repeal of *Kimbell-Diamond* would mandate that P receive a carryover basis in the assets of T pursuant to section 334(b)(1). This result obtains only if, as expressly required by section 334(b)(1), the transfer of T's assets to P constitutes a complete liquidation to which section 332(a) applies. Once the government concedes that section 332 applies to the liquidation of T, the government would be hard put to deny section 336's jurisdiction over the distribution of T's assets to P. Thus, section 336 clearly applies to the case in which P purchases 80% of the T stock. Conditioning tax consequences to T solely upon the number of shares of T's stock P is able to purchase serves no tax policy.²⁶ Accordingly, the repeal of *Kimbell-Diamond* should entail the elimination of the end result test for purposes of applying sections 331 through 338 to creeping asset acquisitions by corporations, regardless of the percentage of T stock acquired by P.

24. Similarly, § 337 would not apply if T is a collapsible corporation or if the liquidation of T is completed more than one year after T adopts the plan of complete liquidation. See I.R.C. § 337(a), (c)(1) (1982).

25. 338 U.S. 451, 454-55 (1950). Of course, *Cumberland Public Service* should be compared to the case in which T negotiates the sale of its assets. See *Commissioner v. Court Holding Co.*, 324 U.S. 331, 333-34 (1945).

26. See *Rose Ann Coates Trust v. Commissioner*, 480 F.2d 468, 472-73 (9th Cir.), cert. denied, 414 U.S. 1045 (1973), for similar considerations in solving the §§ 351/304 overlap under pre-TEFRA law.

Labelling *Kimbell-Diamond* a dead letter does not mean that no formulation of the step-transaction doctrine applies in the context of the liquidation provisions. As noted above, the court in *Kimbell-Diamond* seems to have applied the end result formulation of the step-transaction doctrine. By repealing *Kimbell-Diamond* with the enactment of section 338, Congress apparently left open the question of whether the mutual interdependence or binding commitment formulation of the step-transaction doctrine applies in the context of the liquidation provisions. If, at the time that P purchases all of T's stock, P is under a binding obligation to completely liquidate T, a court quite conceivably would treat the transaction as a purchase of T's assets. As a general proposition, however, after the enactment of TEFRA, P's transitory ownership of T stock clearly will be recognized for purposes of the liquidation provisions of the Code, notwithstanding P's acquisition of the T stock for the sole purpose of obtaining T's assets.

B. In the Context of the Reorganization Provisions

In stark contrast to the recent authorities addressing the application of the step-transaction doctrine in the context of the complete liquidation provisions, the weight of authority seems to indicate that the end result test applies for purposes of determining whether a creeping asset acquisition should be tested as an asset or stock reorganization.²⁷ Holding that a stock acquisition followed by an upstream merger must be collapsed and treated as an "A" reorganization described in section 368(a)(1)(A), the Court of Claims in *King Enterprises* stated: "Purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."²⁸ Thus, if P intends to acquire the assets of T simultaneously with the acquisition of the stock of T, for purposes of the reorganization provisions of the Code, P may be treated as having acquired the T assets in exchange for the consideration P transferred in exchange for the stock of T. If such consideration

27. The most frequently cited example of the treatment of a creeping asset acquisition as an asset reorganization, or a statutory merger, is *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969). *King Enterprises* held that an upstream merger following a stock acquisition, in which more than 50% of the consideration was P stock, qualified as a type A reorganization because the upstream merger was intended at the time that the stock was acquired. *Id.* at 519. Other cases have applied the end result test in similar circumstances for purposes of determining whether an acquisition qualified as a reorganization. See *Helvering v. Bashford*, 302 U.S. 454, 457 (1938); *Anheuser-Busch, Inc. v. Helvering*, 115 F.2d 662, 666 (8th Cir. 1940), cert. denied, 312 U.S. 699 (1941); *Commissioner v. Dana*, 103 F.2d 359, 362 (3d Cir. 1939); *Avco Mfg. Corp. v. Commissioner*, 25 T.C. 975, 985-86 (1956); *Robert Campbell v. Commissioner*, 15 T.C. 312, 320-21 (1950); Rev. Rul. 76-123, 1976-1 C.B. 95; Rev. Rul. 67-274, 1967-2 C.B. 141.

28. 418 F.2d at 516; see also *Security Indus. Ins. Co. v. United States*, 83-1 U.S.T.C. (CCH) ¶ 9320, at 86,825 (5th Cir. 1983) (court stated that both end result and mutual interdependence tests apply in this context); Rev. Rul. 79-250, 1979-2 C.B. 156 (government apparently adopted hybrid end result and mutual interdependence test in reorganization context).

satisfies the continuity of proprietary interest test, and P acquires the assets of T in a state law merger, then the transaction would qualify as an A reorganization.

Three decisions seem to hold the end result formulation inapplicable in the context of the reorganization provisions. In *Commissioner v. Gordon*²⁹ the Supreme Court held that a series of two or more distributions of stock of a subsidiary could be treated as a single distribution for purposes of section 355 only if a binding commitment to make the second distribution exists at the time that the first distribution is made.³⁰ The Court of Claims, in *American Potash & Chemical Corp. v. United States*,³¹ refused to apply the step-transaction doctrine to treat a series of stock acquisitions followed by a complete liquidation of the target company as a "C" reorganization described in section 368(a)(1)(C).³² In *McDonald's v. Commissioner*³³ the Tax Court held that the mutual interdependence test applied for purposes of determining whether post-reorganization sales of acquiring company stock must be taken into account in determining whether the continuity of proprietary interest test is satisfied.³⁴

The *Gordon* court addressed the issue of whether section 355(a)(1)(D) permits a spin-off to occur in more than one distribution. Section 355(a)(1)(D) requires the distributing corporation to distribute, at a bare minimum, stock constituting "control" of the distributed corporation.³⁵ Congress apparently enacted this very precise requirement to prevent a parent corporation from making periodic distributions of small amounts of a subsidiary's stock in lieu of ordinary dividends.³⁶ As such, the Court was probably correct in holding that only the strictest formulation of the step-transaction doctrine can tie two or more distributions together for purposes of section 355(a)(1)(D); any other holding would tend to undermine the intent of Congress.³⁷

In *American Potash* P initially acquired, solely in exchange for P voting stock, 48% of the stock of T in September and November of 1954. More than one year after P's initial tender offer expired, P acquired, again solely in exchange for P voting stock, the remaining 52% of T. P then completely liquidated T. The first tender offer priced the T stock at \$60 per share, and

29. 391 U.S. 83 (1968).

30. *Id.* at 96.

31. 399 F.2d 194 (Ct. Cl.), *modified*, 402 F.2d 1000 (Ct. Cl. 1968).

32. 399 F.2d at 201-05.

33. 76 T.C. 972 (1981), *rev'd sub nom.* McDonald's Restaurants of Ill., Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

34. 76 T.C. at 998.

35. I.R.C. § 355(a)(1)(D) (1982). The distributing corporation must either distribute all of its stock in the distributed corporation or at least "control" of the distributed corporation, as defined in § 368(c). If any stock in the distributed corporation is retained, the distributing corporation must establish that the retention is not pursuant to a plan of tax avoidance. *Id.*

36. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS ¶ 13.07, at 13-43, -44 (4th ed. 1979).

37. Section 355 is in essence "elective" in the same sense as § 332, because the precise requirements must be satisfied in order for § 355 to apply to a distribution. For cases discussing the electivity of § 332, *see supra* note 21.

the second priced the stock at \$90 per share. After concluding that a series of stock acquisitions involving two separate offers could not qualify as a "B" reorganization described in section 368(a)(1)(B),³⁸ the court refused to hold that a disqualified B reorganization could qualify as a C reorganization by virtue of a subsequent complete liquidation of T.³⁹ In a second opinion the court remanded the question of whether the transaction constituted a B reorganization.⁴⁰ The facts of *American Potash* indicate that, absent the planned complete liquidation of T, the second acquisition of 52% of the stock of T probably qualified as a B reorganization. At the time that P acquired the first 48% of the stock of T, however, P was clearly not assured of acquiring the control of T that section 368(a)(1)(B) requires. The initial acquisition of 48% of the T stock probably was, therefore, a taxable transaction to the exchanging T shareholders, because at least a significant possibility remained that P would not have acquired control of T immediately after the transaction.⁴¹ Given the reasonable conclusion that P's initial acquisition of 48% of the stock of T should not qualify for nonrecognition treatment under section 368(a)(1)(B), P reasonably could be treated as owning 48% of the T stock on an "old and cold" basis at the time that T was completely liquidated. By applying the end result test to treat the subsequent acquisition of 52% of the stock of T, followed by the complete liquidation of T, as an asset acquisition, the acquisition should not have qualified as a C reorganization because 48% of the consideration transferred by P in exchange for T assets, the stock of T, was "boot property" in violation of the boot relaxation rule of section 368(a)(2)(B).⁴²

In *McDonald's* T merged into P under state law, pursuant to which the shareholders of T received only common stock of P in exchange for their T stock. Pursuant to registration rights granted to the T shareholders before the merger, however, the former T shareholders sold substantially all of their P stock in a secondary public offering shortly after the merger occurred. The Tax Court held that, for purposes of determining whether the continuity of proprietary interest test was satisfied by the merger, the merger and the post-merger sale of P stock should be treated as a single transaction only if the mutual interdependence test is satisfied.⁴³ The Tax

38. 399 F.2d at 200.

39. *Id.* at 201.

40. 402 F.2d at 1002.

41. Section 368(a)(1)(B) mandates that P be in control of T "immediately after" the exchange. This "control immediately after" requirement is identical to the "control immediately after" requirement of § 351(a), to which the courts have applied the mutual interdependence formulation of the step-transaction doctrine. See *American Bantam Car Co. v. Commissioner*, 11 T.C. 397, 405 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950). In *American Potash* P took over 12 months to acquire control of T. Given the substantial possibility that P would not acquire control of T at the time that P acquired the initial 48% of T in 1954, the mutual interdependence formulation of the step-transaction doctrine probably was not satisfied. Accordingly, the initial acquisition of 48% of T probably should have been treated as a taxable acquisition.

42. *Cf. Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75, 77 (2d Cir. 1959) (P's surrendering of its T stock deemed additional consideration), *cert. denied*, 361 U.S. 835 (1959).

43. 76 T.C. at 997-98. In this regard the Tax Court's decision seems to conflict with

Court reasoned:

The crux of the continuity-of-interest test lies in the continuation of the acquired shareholders' proprietary interest. . . . In other words, having entered the merger as shareholders of the acquired corporation, they must exit as shareholders in the acquiring corporation. However, once they have acquired a sufficient proprietary interest in the ongoing enterprise, the acquired shareholders should subsequently be free to do what they may with that interest without affecting the reorganization status of the transaction. Just as they were free to dispose of their shares in the premerger enterprise, so should they be free to dispose of those shares in the postmerger enterprise. . . .

With this in mind, we believe that the "mutual interdependence test" . . . is best suited to provide a frame of reference against which to measure the "stepability" of the present transactions.⁴⁴

The Tax Court apparently advocates a stricter formulation of the step-transaction doctrine than the end result test in evaluating continuity of interest. This view is based on the absence of a requirement that the former T shareholders continue to hold their P stock for any period of time after the reorganization, because the crux of the continuity-of-interest doctrine is simply that the T shareholders *receive* P stock in exchange for their T stock.

To summarize, *Gordon* is distinguishable from the authorities applying the end result test to creeping asset reorganizations on the ground that *Gordon* involved a tax avoidance provision of section 355 that permits no variance. *American Potash* can be harmonized with the authorities applying the end result test to creeping asset reorganizations on the ground that the Court of Claims, in effect, applied the end result test to treat the subsequent acquisition of 52% of the stock of T, followed by the complete liquidation of T, as an asset acquisition that could not qualify as a C reorganization. Finally, the Tax Court's decision in *McDonald's* is distinguishable because it addressed an issue (namely, post-merger continuity of interest) that justifies a stricter test than the definitional issues addressed by *King Enterprises* and its kin. Accordingly, for purposes of determining whether a creeping asset reorganization must be tested as an asset or stock acquisition under the reorganization provisions, all courts considering the issue have apparently applied the end result test.

II. OVERLAP OF THE LIQUIDATION AND REORGANIZATION PROVISIONS

The differing step-transaction tests applicable in the complete liquidation and reorganization contexts do not, *per se*, create problems. For example, if P acquires all of the stock of T solely in exchange for P voting

Heintz v. Commissioner, 25 T.C. 132 (1955), wherein the Tax Court appears to have applied the end result test under strikingly similar facts. Perhaps for this reason the Seventh Circuit Court of Appeals, in reversing the Tax Court's decision in *McDonald's*, refrained from adopting the Tax Court's position that the mutual interdependence test applies for continuity of interest purposes.

44. 76 T.C. at 997-98.

stock, after which T is merged upstream into P, no difficulty results from the treatment of the two transactions as both an A reorganization and as a complete liquidation described in sections 332 and 334(b)(1). Under either characterization, P acquires a carryover basis in T's assets and the T shareholders recognize no gain or loss. In those cases with substantially the same results under both the reorganization and complete liquidation provisions, regardless of whether the steps are collapsed or treated as independent transactions, clearly no harm results to either the government or the taxpayer from the application of differing step-transaction tests.

Problems may arise, however, in those cases in which one or more tax consequences under the complete liquidation provisions conflict with one or more tax consequences under the reorganization provisions. A determination may then be necessary as to whether one set of provisions preempts the other, or, if both sets apply, which of the conflicting tax consequences prevails. For example, suppose P acquires all of the stock of T, an unrelated corporation, in exchange for 90% P common stock and 10% cash. The acquisition of 10% of the T stock for cash disqualifies the transaction as a B reorganization.⁴⁵ Assume, however, that as in *Kimbell-Diamond* and *King Enterprises* P intends to acquire the assets of T at the time that P acquires the T stock, and, shortly after the stock acquisition, T is merged upstream into P under state law. P also files a timely election under section 338(g) to treat T as having purchased and sold its assets pursuant to section 338(a). These facts set the stage for a discussion of what at one time appeared to be the most difficult liquidation/reorganization overlap problem in the post-TEFRA tax universe: which set of rules governs the basis of T's assets in the hands of P and the tax consequences to the selling T stockholders in a creeping asset acquisition.

Absent the section 338(g) election, the government could hardly object to the treatment of the stock purchase/upstream merger as a good A reorganization under the end result test of *King Enterprises*. Whether determined under section 334(b) or section 362(b), the tax basis of the T assets in the hands of P will be the same as the tax basis of the T assets in the hands of T prior to the upstream merger.⁴⁶ Unlike the situation in *King Enterprises*,⁴⁷ symmetry prevails: the T stockholders recognize gain only to the extent of the cash received under section 356(a), and the gain inherent in the T assets is preserved.

45. See Rev. Rul. 75-123, 1975-1 C.B. 115; see also *Heverly v. Commissioner*, 621 F.2d 1227, 1246 (3d Cir. 1980) (previous cash purchase of T stock disqualifies transaction as B reorganization); *Chapman v. Commissioner*, 618 F.2d 856 (1st Cir. 1980) (acquisition of 8% of T stock for cash prior to exchange for 80% of T stock disqualifies transaction as B reorganization).

46. See I.R.C. §§ 334(b)(1), 362(b) (1982).

47. In *King Enterprises*, 418 F.2d at 511, P obtained a ruling from the Internal Revenue Service to the effect that the basis of the assets P received from T in the upstream merger was stepped up under old § 334(b)(2) to reflect P's "cost basis" in the T stock. The cost basis consisted of the cash and fair market value of P stock paid for the T stock. Thus, *King Enterprises* represents a classic "whipsaw" in which the government failed to collect tax at both the corporate and shareholder levels.

If P were entitled to make a valid section 338(g) election,⁴⁸ however, then the treatment of the stock acquisition/upstream merger as a good A reorganization would “whipsaw” the government. Pursuant to sections 338(a) and 338(b), P would acquire a fair market value basis in T’s assets,⁴⁹ while T would obtain the benefit of nonrecognition under section 337 on the deemed sale of its assets to “new T.”⁵⁰ The T stockholders would avoid gain recognition under section 354(a) to the extent that they receive P stock in exchange for their T stock.⁵¹ By virtue of the differing step-transaction tests applied in the contexts of the liquidation and reorganization provisions, a creeping asset acquisition arguably could have been structured to permit the taxpayers to achieve the best of two worlds: corporate-level basis step-up without gain recognition, and shareholder-level gain deferral, or perhaps avoidance if the P stock were held until death.

No Code provision states that, in the case of a transaction described in both the reorganization and liquidation provisions, one set of rules governs to the exclusion of the other. The courts do not agree as to whether one set of rules preempts the other. The Fifth Circuit Court of Appeals finds no incompatibility between the liquidation rules and the reorganization rules and applies both sets of rules to the same transaction.⁵² The Court of Claims evidently is of the opinion that the reorganization provisions completely preempt the liquidation provisions.⁵³ The regulations under section 332 assume that both sets of rules may apply to the same transaction, but indicate that the liquidation provisions govern to the extent that they mandate tax consequences different from those mandated by the reorganization provisions.⁵⁴

A long line of “liquidation/reincorporation” cases support the argument

48. Prior to the enactment of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, an argument could be made that P’s acquisition of the T stock in the hypothetical qualified as a purchase within the meaning of § 338(h)(3)(A). Because the end result test is not applied for purposes of § 338, P arguably had made a qualified stock purchase within the meaning of section 338(d)(3), provided no T stockholder owned either before or after the transaction more than 50% in value of the stock of P and the cash was not taxed under § 304(a)(1). Thus, a § 338(g) election arguably would have been valid under the facts described above. Fortunately, as discussed in the succeeding text, the Tax Reform Act of 1984 has amended the definition of “purchase” to exclude any transaction in which the transferring T shareholders are entitled to nonrecognition of gain or loss under § 354. As such, P clearly will not be entitled to step up the basis of T’s assets under the hypothetical. *See infra* notes 65-72 and accompanying text.

49. Tax Reform Act of 1984, Pub. L. No. 98-369, § 712(k), 98 Stat. 494, 948 (to be codified at I.R.C. § 338).

50. I.R.C. § 338(a)(1) (1982).

51. *Id.* § 354(a).

52. *General Housewares Corp. v. United States*, 615 F.2d 1056, 1063 (5th Cir. 1980).

53. *See, e.g., FEC Liquidating Corp. v. United States*, 548 F.2d 924, 928 (Ct. Cl. 1977) (reorganization occurring during liquidation controls tax consequences); *see also Abegg v. Commissioner*, 429 F.2d 1209, 1214 (2d Cir. 1970) (reorganization-liquidation in personal holding company area), *cert. denied*, 400 U.S. 1008 (1971); *American Mfg. Co. v. Commissioner*, 55 T.C. 204, 224 (1970) (continued business operations indicative of reorganization).

54. Treas. Reg. § 1.332-2(d) (1955). The view of the regulation appears consistent with the *General Housewares* view of the overlap issue.

that the reorganization provisions preempt the complete liquidation provisions. In the typical "liquidation/reincorporation" case, sound tax policy mandates that either the reorganization provisions preempt the liquidation provisions or the transaction fails to qualify as a complete liquidation.⁵⁵ Such a case involves a purported liquidation of T either followed or preceded by a cash sale of the T assets to a corporation controlled by the shareholders of T. If such a transaction were allowed to qualify as a complete liquidation of T, followed or preceded by a sale of T's assets to P, then the T shareholders would succeed in (1) withdrawing cash from a controlled corporation, which will continue operations as a corporation after the withdrawal, at long-term capital gain rates, and (2) stepping up the basis of T's assets, at little or no tax cost to T, without losing control over those assets. Clearly, section 301(c)(1) would be repealed if such treatment were allowed.⁵⁶ Complete liquidation treatment should not be available, therefore, if P is controlled by the T shareholders.

If the purchasing corporation is not controlled by the shareholders of T, however, generally no reason mandates not affording T and its shareholders complete liquidation or sale treatment. Relinquishing control over an asset is an intrinsic characteristic of a sale. In essence, the T shareholders are not withdrawing cash from a controlled and continuing corporation at long-term capital gain rates, or stepping up the basis of T's assets to fair market value without relinquishing control over those assets. Permitting these kinds of transactions to qualify as complete liquidations or sales poses no threat of repeal of section 301(c)(1).⁵⁷ Thus, if P is not controlled by the shareholders of T, complete liquidation treatment, from a policy standpoint, generally should be available.

Returning to the hypothetical, section 338 is arguably inconsistent with the reorganization provisions, which require P to take a carryover basis in

55. In *Telephone Answering Serv. Co. v. Commissioner (TASCO)*, 63 T.C. 423 (1974), *aff'd per curiam*, 39 A.F.T.R.2d (P-H) 77-786 (4th Cir. 1976), *cert. denied*, 431 U.S. 914 (1977), the Tax Court considered an alleged complete liquidation in which T's operating assets ended up in a new corporation controlled by T's stockholders. Judge Tannenwald held that the term "complete liquidation" requires a distribution of all of the assets of T; that the new corporation holding T's operating assets, owned by substantially the same shareholders as T, was a "mere continuation" of T; and accordingly, no complete liquidation occurred because T did not distribute all of its assets. 63 T.C. at 435. Thus, the *TASCO* case presented no question of whether the reorganization provisions preempt the liquidation provisions. The typical liquidation/reincorporation case, however, involves a finding of reorganization in lieu of complete liquidation, with the implicit understanding that the reorganization provisions preempt the complete liquidation provisions. *Cf. Reef Corp. v. Commissioner*, 66-2 U.S.T.C. (CCH) ¶ 9716, at 87,326 (5th Cir. 1966) (finding clear reorganization); *American Mfg. Co. v. Commissioner*, 55 T.C. 204, 221 (1970) (liquidating steps merely integral parts of reorganization).

56. In addition, for the cost of obtaining a new corporate charter, T could step up the basis of its assets to current fair market value. This aspect of the "liquidation/reincorporation" transaction seems as repugnant as the repeal of § 301(c)(1).

57. Section 304, which applies to a stock sale only if the selling T shareholders actually or constructively own 50% or more in vote or value of the stock of P before or after the transaction, confirms this proposition. I.R.C. § 304(c)(1) (1982). If a stock transfer in which the T shareholders own less than 50% of P qualifies for sale treatment, then an asset transfer in which the T shareholders own less than 50% of P should qualify for sale treatment.

the assets of T⁵⁸ and, therefore, should not apply if the transaction also constitutes a good A reorganization. Some merit for this analysis possibly prevailed in the pre-TEFRA tax world as old section 334(b)(2) allowed the step-up in basis of T's assets only if P acquired T's assets in liquidation. Because the basis-determining event under both section 362(b) and old section 334(b)(2) was P's acquisition of T's *assets*, clearly section 362(b) and old section 334(b)(2) conflicted with each other.⁵⁹

In the post-TEFRA tax world, however, the basis-determining event under section 338 is P's acquisition of T's *stock*. Of course, for purposes of determining the application of the reorganization provisions to the hypothetical, the transaction is treated as an asset acquisition. The basis-determining event, therefore, is P's acquisition of T's *assets*. Section 334(b) in the post-TEFRA Code, along with section 362(b), requires P to take a carryover basis in the assets of T upon the complete liquidation of T.⁶⁰ Thus, after TEFRA, the complete liquidation provisions governing the basis of T's assets generally will not directly conflict with the reorganization provisions governing the basis of T's assets.

The strongest argument against applying section 338 to the hypothetical is that allowing P to step up the basis in T's assets is inconsistent with the nonrecognition treatment afforded T's shareholders under the reorganization provisions⁶¹ and may result in a permanent avoidance of taxation of the gain inherent in T. First, because section 338(a)(1) provides that section 337 applies to the "deemed sale" of T's assets to "new T,"⁶² no corporate level tax, other than tax on recapture, is triggered by the step-up.⁶³ Second, if the former T shareholders retain their P stock until death, their heirs will obtain a basis step-up to fair market value pursuant to section 1014(a).⁶⁴ As the Code would not allow such tax avoidance if T had directly merged into P in exchange for 90% P stock and 10% cash, clearly such tax avoidance should not be allowed to exist in the case of the creeping merger described in the hypothetical. Accordingly, under the prior Code, which permitted a creeping asset acquisition to qualify as a stock purchase described in section 338, a court might have held, applying "substance over form" principles, either that P is not permitted an election under section 338(g) or that the transaction does not qualify as a good A reorganization.

Fortunately, the enactment of section 712(k)(5) of the Tax Reform Act of 1984 (the "Act")⁶⁵ relieves courts of the obligation of confronting the

58. See I.R.C. § 362(b) (1982).

59. In a dictum the Tax Court had indicated that perhaps the reorganization provisions and old § 334(b)(2) might apply to the same transaction. *Kass v. Commissioner* (May B. Kass), 60 T.C. 218, 222 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974).

60. See I.R.C. §§ 334(b), 362(b) (1982).

61. See *id.* §§ 354, 356. Section 354 provides general nonrecognition treatment, while § 356 requires gain to be recognized to the extent boot is received.

62. *Id.* § 338(a)(1).

63. *Id.*

64. See *id.* § 1014(a).

65. Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

issue. Paragraph (D) of section 712(k)(5) of the Act amended the definition of "purchase" set forth in section 338(h)(3)(A) to provide that a transaction does not qualify as a purchase if the target stock is acquired in an exchange to which section 351, 354, 355, or 356 applies or if the transferor of the target stock otherwise does not recognize the entire amount of the gain or loss realized in the transaction.⁶⁶ Since section 338(a) may apply only if at least 80% of the T stock is acquired by purchase, this amendment removes the creeping asset acquisition described in the hypothetical from the jurisdiction of section 338.⁶⁷ If under the end result test of *King Enterprises*, the shareholders of T are entitled to nonrecognition treatment under section 354,⁶⁸ then P has not acquired 80% of the T stock by "purchase," as defined in section 338(h)(3)(A) after the amendment.⁶⁹ Thus, P will not be allowed to step up the basis of T's assets under section 338(g).⁷⁰

With enactment of the Act, Congress resolved one of the principal problems inherent in the dual application of the liquidation and reorganization provisions to creeping asset acquisitions: the inconsistency of asset basis step-up at the corporate level and nonrecognition of gain at the shareholder level. The treatment of a creeping asset acquisition as a reorganization will now remove the stock acquisition from the jurisdiction of section 338. P may no longer accomplish via a creeping acquisition a result that could not be accomplished via a direct merger of T into P.

To summarize, from a technical standpoint the better conclusion with respect to a creeping asset acquisition in which P and T are unrelated is that the complete liquidation and reorganization provisions have concurrent jurisdiction over the transactions⁷¹ and that the complete liquidation provisions govern the tax consequences to P and T.⁷² From a tax policy

66. *Id.* § 712(k)(5)(D), 98 Stat. 494, 950 (codified at I.R.C. § 338(h)(3)(A)).

67. *See* I.R.C. § 338(a) (1982).

68. T shareholders recognize no gain in a reorganization to the extent target stock is exchanged for stock of the acquiring corporation. *Id.* § 354(a)(1).

69. *See* Tax Reform Act of 1984, Pub. L. No. 98-369, § 712(k)(5)(D), 98 Stat. 494, 950 (to be codified at I.R.C. § 338(h)(3)(A)).

70. The election to step up the basis of the assets received from T must be made by a "purchasing corporation." I.R.C. § 338(g)(2) (1982). P's failure to make a qualified stock "purchase," pursuant to § 338(a), removes P from the statutory definition of purchasing corporation. *Id.* § 338(d)(1).

71. *See* Rogan v. Starr Piano Co., 139 F.2d 671 (9th Cir.), *cert. denied*, 322 U.S. 728 (1943); *see also* Bruce, *Liquidations and Reorganizations: Madison Square Gardens and Kass*, 30 TAX L. REV. 303, 351 (1973). In other areas the courts and the government have ruled that other provisions of the Code may also apply to transactions described in the reorganization provisions. For decisions holding that the principles of §§ 351 and 368 have concurrent application, *see* Helvering v. Cement Investors, Inc., 316 U.S. 527, 533 (1942); Leckie v. Commissioner, 37 B.T.A. 252, 257 (1938); Handbird Holding Corp. v. Commissioner, 32 B.T.A. 238, 247 (1935), *appeal dismissed*, (2d Cir. 1936); Royal Marcher v. Commissioner, 32 B.T.A. 76, 79-80 (1935), *appeal dismissed*, (2d Cir. 1936); Rev. Rul. 84-71, 1984-19 I.R.B. 6; Rev. Rul. 79-274, 1979-2 C.B. 131; Rev. Rul. 76-188, 1976-1 C.B. 99; Rev. Rul. 76-123, 1976-1 C.B. 94. Other decisions state that the concepts of §§ 332 and 368 have concurrent jurisdiction. *See* Performance Sys., Inc. v. United States, 73-2 U.S.T.C. (CCH) ¶ 9743, at 82,426 (M.D. Tenn. 1973), *aff'd per curiam*, 501 F.2d 1338 (6th Cir. 1974); Movielab, Inc. v. United States, 494 F.2d 693, 701 (Ct. Cl. 1974); Eastern Color Printing Co. v. Commissioner, 63 T.C. 27, 35 (1974).

72. Treas. Reg. § 1.332-2(d) (1955). Cases such as *Performing Sys., Inc. v. United*

standpoint, given the Act's elimination of the possibility of making a section 338 election in a *King Enterprises* "creeping merger," this result is sound in all cases in which P is not controlled by the shareholders who control T.

III. CONTINUITY OF INTEREST

The following hypothetical illustrates the principal difficulty in applying the continuity of proprietary interest test to creeping asset reorganizations: P owns 89% of the outstanding stock of T; the remaining 11% is owned by Mr. A, an individual who owns no stock of P. P acquired its 89% interest in the stock of T fifteen years ago. T merges upstream into P under state law, with P surviving. Pursuant to the merger, Mr. A exchanges all of his T stock solely for P voting stock. P's initial acquisition of 89% of T fifteen years ago is "old and cold" and clearly not part of a single transaction that includes the present upstream merger of T into P.

The courts initially developed the continuity of proprietary interest test to distinguish reorganizations from sales.⁷³ The theory underlying the test is that Congress designed the reorganization provisions to defer tax on transactions involving "only a change in the corporate form in which business was conducted without an actual realization of any gain from an exchange of properties."⁷⁴ In order to constitute a "mere change in form" of conducting the business, a substantial portion of the consideration received by the T shareholders must be P stock.⁷⁵ Thus, the continuity of proprietary interest doctrine mandates that, in order to qualify as a corporate reorganization, a significant percentage of the total consideration issued in exchange for the acquired company's stock or assets must be stock of the acquiring company.

The courts have never delineated a clear minimum ratio of stock to total consideration. The Supreme Court, however, has approved a merger in which approximately 38% of the consideration consisted of stock,⁷⁶ and the Tax Court has disqualified transactions in which 16% of the consideration was acquiring company stock.⁷⁷ As a general rule, therefore, a merger of T into P, pursuant to which only 11% of the consideration is P stock, fails to satisfy the continuity of proprietary interest test. The hypothetical given

States, 73-2 U.S.T.C. (CCH) ¶ 9743, at 82,426 (M.D. Tenn. 1973), *aff'd per curiam*, 501 F.2d 1338 (6th Cir. 1974), afforded P and T reorganization treatment when such treatment was more favorable to the taxpayer than liquidation treatment.

73. See *LeTulle v. Scofield*, 308 U.S. 415, 418 (1940); *Cortland Speciality Co. v. Commissioner*, 60 F.2d 937, 939 (2d Cir. 1932).

74. *Cortland Speciality Co. v. Commissioner*, 60 F.2d 937, 940 (2d Cir. 1932).

75. See *Kass v. Commissioner* (May B. Kass), 60 T.C. 218, 222 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974) (percentage of consideration comprised of P stock (16%) was not substantial enough to satisfy the test).

76. See *John A. Nelson Co. v. Helvering*, 296 U.S. 374, 377 (1935); see also *Miller v. Commissioner*, 84 F.2d 415, 418 (6th Cir. 1936) (indicating 25% continuity sufficient).

77. See *Kass v. Commissioner* (May B. Kass), 60 T.C. 218, 227 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974); see also *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168, 177 (15% insufficient).

above poses the issue of whether 11% of the consideration may be P stock when the balance of the consideration is T stock owned on an "old and cold" basis by P.⁷⁸

In *Frelmont Realty Corp. v. Commissioner*⁷⁹ an 80% subsidiary merged upstream into its parent under state law. The parent argued for reorganization treatment. The Board of Tax Appeals disagreed, however, holding that the transaction was in substance a liquidation.⁸⁰ A later decision, *Warner Co. v. Commissioner*,⁸¹ involved a parent corporation's acquisition of 100% control of a previously 33% owned subsidiary. As part of an integrated plan, the parent subsequently liquidated the subsidiary. The government argued that the transaction amounted to a reorganization, giving P a carryover basis in the subsidiary's assets. Once again, however, the Board of Tax Appeals disagreed, holding that the transaction was a liquidation.⁸² The *Warner Co.* case is important because it was based on the theory that the continuity of proprietary interest test was not satisfied. The court reasoned, "it can hardly be said that the stockholders of the dissolved [subsidiary] became the stockholders of the taxpayer, as the taxpayer itself was the sole stockholder of [the subsidiary]."⁸³ These two early decisions indicate that the Tax Court at one time viewed an upstream merger as incapable of qualifying as a reorganization.

In *Warner*, however, no P stock was issued to the minority shareholders. By contrast, General Counsel's Memorandum 7472⁸⁴ involved P's acquisition of all of the assets of T, a 60% owned subsidiary of P, in exchange for P stock, after which T was completely liquidated. Thus, the minority shareholders of T received only P stock in exchange for their T stock. The government conceded that the transaction qualified as a reorganization and permitted the minority shareholders of T nonrecognition treatment. In a subsequent decision, the Board of Tax Appeals agreed with the government.⁸⁵

Finally, in 1943 the Ninth Circuit Court of Appeals espoused a proposi-

78. In reality P acquires the assets of T in exchange for: (1) P stock issued to Mr. A; (2) 89% of the T stock that P is, in effect, giving back to T in exchange for T's assets; and (3) the assumption of T's liabilities. Unless T is so thinly capitalized, or insolvent, that its creditors are deemed to be its stockholders, however, the assumption of T's liabilities generally is not treated as consideration for purposes of the continuity of proprietary interest test. *Cf. Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 183 (1941) (continuity of interest test satisfied when bankruptcy creditors stepped into shoes of old stockholders).

79. 29 B.T.A. 181 (1933).

80. *Id.* at 189.

81. 26 B.T.A. 1225 (1932).

82. *Id.* at 1228.

83. *Id.* at 1227.

84. G.C.M. 7472, IX-1 C.B. 184 (1930), declared obsolete by Rev. Rul. 69-44, 1969-1 C.B. 312.

85. *See Winston Bros. Co. v. Commissioner*, 29 B.T.A. 905, 909 (1934), *aff'd*, 76 F.2d 381 (8th Cir. 1935); *see also* *Gutbro Holding Co. v. Commissioner*, 138 F.2d 16, 20 (2d Cir. 1943) (nonrecognition treatment accorded in absence of complete liquidation). *But see* *Rogan v. Starr Piano Co.*, 139 F.2d 671, 673 (9th Cir.) (nonrecognition treatment denied in absence of stock-for-stock exchange), *cert. denied*, 322 U.S. 728 (1943).

tion that is reasonable and probably represents the law today.⁸⁶ The court rejected the argument that a transaction cannot be both a liquidation and a reorganization, holding that it can in fact be both.⁸⁷ In addition, the court held that qualifying as a reorganization does not automatically afford P nonrecognition treatment on the receipt of T's assets.⁸⁸ Finding no provision in the reorganization context that provided P with nonrecognition treatment on the receipt of T assets in exchange for T stock, the court held that P recognized gain on the transaction.⁸⁹

The pre-1954 Code case law and rulings failed to define clearly the role played by P's "old and cold" T stock for purposes of the continuity of proprietary interest test. However, the better view concluded that the assets received by P in respect of "old and cold" T stock were deemed received in exchange for qualifying consideration for purposes of the continuity of proprietary interest test. This view was based on the ground that such assets remain in corporate solution and continue to be owned by the same interests, the P shareholders, that owned them prior to the transaction.

The modern cases and rulings uniformly indicate that P's "old and cold" T stock, in one manner or another, counts for purposes of the continuity of proprietary interest test. In *May B. Kass*⁹⁰ the Tax Court stated that: reorganization treatment is appropriate when the parent's stock ownership in the subsidiary was not acquired as a step in a plan to acquire assets of the subsidiary. The parent's stockholdings can be counted as contributing to continuity-of-interest, so that since such holding represented more than 80 percent of the stock of the subsidiary, the continuity-of-interest test would be met.⁹¹ Although a dictum in the *Kass* case because P's T stock clearly was not "old and cold," the foregoing reasoning remains undeniably strong.

In Revenue Ruling 58-93⁹² the government considered a case in which P owned, on an "old and cold" basis, 79% of the stock of T, with the balance being owned by minority shareholders. After transferring all of its assets to a new subsidiary, T merged upstream into P. Pursuant to the merger, the minority shareholders of T received P stock in exchange for their T stock. The government ruled that the upstream merger qualified as a good A reorganization.⁹³ Unless the government found the 21% continuity sufficient to satisfy the continuity of proprietary interest test, a highly unlikely interpretation of the ruling, the ruling indicates that the government accounted for the "old and cold" T stock owned by P in applying the test.

86. *Rogan v. Starr Piano Co.*, 139 F.2d 671 (9th Cir.), *cert. denied*, 322 U.S. 728 (1943).

87. 139 F.2d at 674.

88. *Id.* at 673.

89. *Id.*

90. *Kass v. Commissioner (May B. Kass)*, 60 T.C. 218 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974).

91. 60 T.C. at 223.

92. Rev. Rul. 58-93, 1958-1 C.B. 188.

93. *Id.* at 189.

Thus, under the view of both the Tax Court and the government, the hypothetical described above apparently qualifies as a good A reorganization. The views of the government and the Tax Court seem to diverge, however, as to how P's "old and cold" T stock is taken into account. The *Kass* dictum above indicates that P should be deemed to have received the T assets, distributed in respect of P's "old and cold" T stock, in exchange for qualifying consideration consisting of P stock. If Mr. A received consideration consisting of \$10 worth of P stock and \$90 cash for his 11% interest in T, the transaction would nonetheless qualify as a good A reorganization under the Tax Court's view. By contrast, the government's view apparently excludes P's "old and cold" T stock from both the numerator and denominator of the continuity of proprietary interest test; the test is limited to the consideration paid to Mr. A in exchange for his T stock.⁹⁴ Thus, if 16% or less of the consideration issued to Mr. A in the merger is in P stock, the transaction clearly fails to qualify as a good A reorganization under the government's view.

The better view, assuming the continuity of proprietary interest test has merit, seems to be that of the government. Under the hypothetical described above, P already owns 89% of the capital and profits interest in T's assets and, in substance, is acquiring Mr. A's additional 11% interest in T's assets. Thus, examining only the mix of consideration being paid to Mr. A for his T stock for purposes of applying the continuity of proprietary interest test seems appropriate.

In any event, applying either the Tax Court's view, taking P's "old and cold" T stock into account by including it in both the numerator and denominator of the continuity test, or the government's view, taking P's "old and cold" T stock into account by excluding it from both the numerator and denominator of the continuity test, the hypothetical described above clearly satisfies the test because the only consideration received by Mr. A is P stock. On the other hand, if P's ownership of the T stock had not been "old and cold," then the test would examine not only the consideration given to Mr. A, but also the consideration paid by P for its 89% interest.⁹⁵ If, counting the P stock issued in the merger to Mr. A as well as any P stock issued in the transaction in which P acquired its 89% interest in T, sufficient P stock has been issued to satisfy the continuity of proprietary interest test, then the transaction should qualify as a good A reorganiza-

94. See *Krane, Current Problems in Acquisitive Reorganizations*, 51 TAXES 737, 749-50 (1973); Levin & Bowen, *supra* note 20, at 448; McGaffey & Hunt, *Continuity of Shareholder Interest in Acquisitive Corporate Reorganizations*, 59 TAXES 659, 670-72 (1981); Private Letter Ruling 8237016 (June 11, 1982); Private Letter Ruling 7905053 (Oct. 31, 1978). In Private Letter Ruling 8311103 (Dec. 16, 1982), however, the Service stated that P's "old and cold" ownership of T stock will be included in the continuity of interest fraction (presumably in both the numerator and the denominator). The Service, therefore, may be moving away from the position that "old and cold" T stock is excluded from both the numerator and denominator of the continuity of interest fraction.

95. See *Security Indus. Ins. Co. v. United States*, 83-1 U.S.T.C. (CCH) ¶ 9320, at 86,824 (5th Cir. 1983); *Superior Coach of Florida, Inc. v. Commissioner*, 80 T.C. 895, 905-06 (1983); *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168, 177 (1973); *Kass v. Commissioner* (May B. Kass), 60 T.C. 218, 223 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974).

tion. Each T shareholder receiving P stock, including both Mr. A and those participating in the first transaction, should be entitled to nonrecognition treatment to the extent of the P stock received.⁹⁶

IV. THE *BAUSCH & LOMB* "DOCTRINE"

Besides potential continuity of interest problems, P's ownership of "old and cold" T stock raises additional questions. These issues include whether such T stock will be treated as boot in the reorganization and whether P will recognize gain or loss on the receipt of T assets in exchange for such T stock. Consideration of the following three examples facilitates an understanding of these issues.

Example A. T owns assets worth \$100 and has no liabilities. P acquires all of T's assets solely in exchange for \$80 worth of P stock and real estate worth \$20. The real estate has an adjusted basis in P's hands of \$10. T completely liquidates, distributing the P stock and land to its shareholders.

Example A clearly constitutes a good C reorganization. As required by the "boot relaxation rule" of section 368(a)(2)(B),⁹⁷ P acquired 80% in value of the assets of T solely in exchange for P voting stock. P, however, also transferred \$20 worth of appreciated real estate in exchange for \$20 worth of T's assets. Unless section 1031 covers this exchange, clearly P will recognize \$10 of gain on the exchange, because no rule in the reorganization provisions prevents the acquiring corporation from recognizing gain on an exchange of appreciated boot property for assets in an otherwise qualifying reorganization.⁹⁸ If the real estate were worth \$25 and the P stock worth \$75, then, the transaction would also fail to qualify as a good C reorganization due to the failure to satisfy the boot relaxation rule.⁹⁹

Example B. In lieu of owning real estate, P owns 20% of the stock of T, which is worth \$20 and has an adjusted basis of \$10 in P's hands. P acquires all of T's assets in exchange for \$80 worth of P stock and P's T stock. T then completely liquidates, distributing the P stock to the outside shareholders of T. As P is not a T shareholder at the time of liquidation, P receives none of this distribution.

Like the real estate transferred by P in Example A, the T stock owned by P and transferred to T in exchange for T assets in Example B constitutes boot for purposes of the reorganization provisions.¹⁰⁰ Although the transaction satisfies the boot relaxation rule and thus qualifies as a good C reor-

96. See *King Enterprises, Inc. v. United States*, 418 F.2d 511, 520-21 (Ct. Cl. 1969).

97. The transaction qualifies as a C reorganization as the P stock received by T equalled 80% of the value of the T assets acquired by P. I.R.C. § 368(a)(2)(B)(iii) (1982).

98. See Rev. Rul. 72-327, 1972-2 C.B. 197. Section 361(b)(1) prevents the acquired corporation from recognizing gain on the receipt of boot property, provided the boot is distributed in the transaction. I.R.C. § 361(b)(1) (1982).

99. *Id.* § 368(a)(2)(B); see *supra* note 97 and accompanying text. Section 1032 prevents P from recognizing gain on the exchange of P stock for T assets notwithstanding the fact that the transaction fails to qualify as a good C reorganization. I.R.C. § 1032(a) (1982).

100. See *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75, 77 (2d Cir.), *cert. denied*, 361 U.S. 835 (1959); *Grede Foundries, Inc. v. United States*, 202 F. Supp. 263, 265 (E.D. Wis. 1962).

ganization, it nonetheless results in \$10 of gain recognition to P.¹⁰¹

Example C. P owns 25% of the stock of T, which is worth \$25 and has an adjusted basis of \$15. T transfers all of its assets to P solely in exchange for \$100 of P voting common stock. Subsequently, T completely liquidates, distributing \$25 worth of P stock to P and \$75 worth of P stock to the remaining T shareholders.

The only differences between Example B and Example C are: (1) P owns 25% of the stock of T in Example C; and (2) P does not exchange its T stock directly for assets of T; rather, P first acquires all of T's assets solely for P stock and gets back 25% of the P stock in exchange for P's T stock. In *Bausch & Lomb Optical Co. v. Commissioner*¹⁰² the Second Circuit Court of Appeals, under similar facts, held that the "circular" flow of P stock to T and back to P should be ignored and that P should be treated as acquiring the assets of T in exchange for 25% T stock and 75% P stock.¹⁰³ Under this characterization, P recognizes gain on the exchange of its 25% interest in the T stock for T assets, and the boot relaxation rule is violated.¹⁰⁴ Thus, under the facts of Example C, the transaction is not a good reorganization, and P recognizes \$10 of gain.

At least five methods are available by which P, or a wholly owned P subsidiary, may be combined with T under the facts of Example C such that the transaction qualifies as a reorganization. The most obvious method involves an upstream merger of T into P under state law. Revenue Ruling 58-93 holds that such an upstream merger qualifies as an A reorganization, provided that a substantial portion of the consideration paid to the 75% T shareholders for their T stock is P stock.¹⁰⁵ Of course, as noted above, P would still recognize \$10 of gain on the swap of its T stock for 25% of the T assets. A second method is to merge P downstream into T. The weight of authority holds that such a transaction qualifies as an A reorganization, provided that a substantial portion of the consideration paid to the P shareholders for their P stock is T stock.¹⁰⁶

101. I.R.C. § 1001(a) (1982). For a different resolution, however, see Rev. Rul. 58-93, 1958-1 C.B. 188. Revenue Ruling 58-93 is contrary to the conclusion that P recognizes gain or loss on a transfer of T stock in exchange for T assets pursuant to an otherwise good reorganization. In that ruling the government held that P recognized no gain or loss on an upstream merger of a 79%-owned subsidiary. *Id.* Revenue Ruling 58-93 appears irreconcilable with the result described in Rev. Rul. 72-327, 1972-2 C.B. 197, wherein accounts receivable, rather than T stock, were used by P to acquire T assets. Thus, Revenue Ruling 72-327 apparently modifies Revenue Ruling 58-93 on the issue of gain recognition by P.

102. 267 F.2d 75 (2d Cir.), *cert. denied*, 361 U.S. 835 (1959).

103. 267 F.2d at 77.

104. For discussion of the "boot relaxation" rule, see *supra* note 97 and accompanying text.

105. Rev. Rul. 58-93, 1958-1 C.B. 188.

106. See *Commissioner v. Webster's Estate*, 131 F.2d 426, 429 (5th Cir. 1942); *Commissioner v. Gilmore's Estate*, 130 F.2d 791, 793-94 (3d Cir. 1942); *Helvering v. Einhorn*, 100 F.2d 418, 418 (2d Cir. 1938); *H. Grady Manning Trust v. Commissioner*, 15 T.C. 930, 941 (1950). Similarly, Rev. Rul. 78-47, 1978-1 C.B. 148, holds that a transfer of a holding company's assets to a 5%-owned subsidiary amounts to a good C reorganization, even though the subsidiary's stock constituted 71% of the parent's assets. Assets other than subsidiary stock satisfied the "substantially all" test of § 368(a)(1)(C).

A third method of combination consists of P organizing a wholly owned subsidiary for the purpose of acquiring the remaining T stock and then merging the subsidiary into T, pursuant to which the outside T shareholders must either accept P voting, common stock or exercise their appraisal rights. This transaction cannot qualify as a "reverse triangular merger" pursuant to section 368(a)(2)(E) because P will not acquire "control," defined as at least 80%, of T in the merger.¹⁰⁷ Provided that T, not P, supplies the cash to pay off any dissenters,¹⁰⁸ however, the reverse merger should qualify as a good B reorganization.¹⁰⁹

Revenue Ruling 57-278¹¹⁰ describes the fourth, and perhaps most interesting, technique. In that ruling P formed a new, wholly owned subsidiary, S, by transferring to S \$100 worth of P voting common stock. T subsequently transferred all of its assets to S solely in exchange for P voting common stock. Thereafter, T completely liquidated, distributing 75% of the P stock to T's outside shareholders and 25% of the P stock back to P. The government ruled that the transaction constituted a good C reorganization, pursuant to which P, S, and T recognized no gain or loss.¹¹¹ In so ruling the government distinguished Revenue Ruling 54-396,¹¹² which stated the litigating position that ultimately prevailed in the *Bausch & Lomb* case, on the ground that S did not acquire any T assets in exchange for T stock.¹¹³ In contrast, in Revenue Ruling 54-396 as in *Bausch & Lomb*, clearly more than 20% of the assets of T was acquired in exchange for T stock. Thus, the government views the problems described above as avoided if P forms a new subsidiary to acquire the assets of T in exchange for P stock.¹¹⁴

107. See Rev. Rul. 74-564, 1974-2 C.B. 124; Rev. Rul. 74-565, 1974-2 C.B. 125; Ferguson & Ginsburg, *Triangular Reorganizations*, 28 TAX L. REV. 159 (1973).

108. Compare Rev. Rul. 68-285, 1968-1 C.B. 147 (good B reorganization when cash to pay dissenters comes from T, even though less than 80% of T stock acquired solely for P voting stock), with Rev. Rul. 75-360, 1975-2 C.B. 110 (bad B reorganization when P, directly or indirectly, provides the cash used to redeem T stock).

109. See Rev. Rul. 74-565, 1974-2 C.B. 125; Rev. Rul. 74-564, 1974-2 C.B. 124; Rev. Rul. 67-448, 1967-2 C.B. 144.

110. Rev. Rul. 57-278, 1957-1 C.B. 124. If P's T stock is not "old and cold," the technique will not work. Cf. Rev. Rul. 69-48, 1969-1 C.B. 106 (purchase as integral step in acquisition not "old and cold," and acquisition disqualified).

111. Rev. Rul. 75-278, 1957-1 C.B. 124.

112. Rev. Rul. 54-396, 1954-2 C.B. 147.

113. Rev. Rul. 57-278, 1957-1 C.B. 124. Query whether S should be deemed to have acquired 25% of T's assets in exchange for S stock.

114. An interesting question is whether a state law merger of T into S, pursuant to which the 75% T shareholders receive only P stock in exchange for their T stock, would qualify as a reorganization. Section 368(a)(2)(D) applies only if no S stock is issued in the merger. Arguably, S stock is constructively issued to P in exchange for P's T stock because no P stock is issued to P in the merger, whereas the fair market value of the S stock is increased by 25% of the fair market value of T, which is P's interest in the T stock. Perhaps Rev. Rul. 67-326, 1967-2 C.B. 143, which holds that a triangular merger that does not qualify as an A reorganization may nonetheless qualify as a C reorganization, resolves the dilemma. The government, therefore, may be charitable and rule that a triangular merger of T into S should be deemed to be a qualifying C reorganization in which S acquires all the assets of T solely in exchange for P voting common stock. This technique, however, should not be utilized without a ruling.

Of the foregoing four techniques for combining P, or a wholly owned P subsidiary, with T under the facts of Example C, clearly the first alternative, the upstream merger of T into P, is inferior to the second, third, and fourth alternatives. Alternative one is inferior for the simple reason that P recognizes \$10 of gain in the first alternative, but recognizes no gain or loss in the other three alternatives. Thus, as in most contexts in Subchapter C, form remains critical in many cases in which P owns stock of T prior to the acquisition of T's assets.¹¹⁵

A fifth technique for avoiding gain at the P level and combining the assets of P and T without gain recognition to the 75% T shareholders merits discussion. This technique is a variation on the reverse triangular merger of S into T, pursuant to which the 75% T shareholders exchange their T stock solely for voting, common stock of P. After completion of the reverse merger, T becomes a wholly owned subsidiary of P. T subsequently merges upstream into P. The reverse merger of S into T and the upstream merger of T into P will likely be treated as a single transaction for purposes of the reorganization provisions.¹¹⁶ As such, the transaction constitutes a good A reorganization in which the 75% shareholders of T recognize no gain or loss.¹¹⁷ As discussed above, however, the reverse merger of S into T followed by the upstream merger of T into P should not be combined for purposes of the post-TEFRA liquidation provisions.¹¹⁸ Treasury Regulation section 1.332-2(d) clearly mandates that the tax consequences to P of the upstream merger must be governed by sections 332 and 334(b), since P owns at least 80% of the T stock on the date of the upstream merger.¹¹⁹ Accordingly, P recognizes no gain or loss on the upstream merger of T into P pursuant to section 332.¹²⁰

115. The excellent work of the Staff of the Senate Finance Committee, entitled "The Reform and Simplification of the Income Taxation of Corporations" (Sept. 22, 1983), addressed, and argued forcefully for eliminating, virtually all forms of "transactional selectivity" in the reorganization context. Even if all of the reforms suggested by the Staff were enacted, the facts of Example C would still contain the transactional election of gain recognition by P (e.g., if T is merged upstream into P), versus gain avoidance by P (e.g., if P is merged downstream into T). Thus, in those cases in which P owns, on an "old and cold" basis, less than 80% of the stock of T, competent tax advice will be required if P is to navigate safely the hazardous waters of the so-called *Bausch & Lomb* doctrine.

116. Using the step-transaction doctrine, the transaction would likely be characterized as an upstream merger into P, pursuant to which the 75% T shareholders receive P stock in exchange for their T stock. See *King Enterprises, Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969).

117. If the two steps are not combined for purposes of the reorganization provisions, however, the first step will qualify as a good B reorganization. See I.R.C. § 368(a)(1)(B) (1982). The 75% T shareholders, therefore, have no downside.

118. S. REP. NO. 494, 97th Cong., 2d Sess. 192, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 781.

119. Treas. Reg. § 1.332-2(d) (1955).

120. Section 332(b)(1) provides that P must own 80% of T upon adoption of the plan of liquidation and upon consummation of the complete liquidation. I.R.C. § 332(b)(1) (1982). If P intends to merge T upstream at the time that P acquires 75% of T, the government might contend that T "adopted" a "plan" of liquidation before P owned 80% of T and, therefore, that § 332 cannot apply to the liquidation. Such contention is of doubtful merit even if P is a majority shareholder of T when P forms the intention to acquire all of T. See *Honigman v. Commissioner*, 55 T.C. 1067, 1079 (1971); *Alameda Realty Corp. v. Commissioner*, 42 T.C.

The principal conclusion to be drawn from the preceding discussion is that substantial dangers and planning opportunities exist in cases in which P owns a substantial block, but less than 80%, of the stock of T prior to the acquisition of T's assets. In those cases careful consideration must be paid to the form of the transaction.

V. TRIANGULAR ASSET ACQUISITIONS

An issue that may emerge in creeping asset acquisition cases in which all or a portion of T's assets are to be held by a subsidiary of P is whether the acquisition constitutes a complete liquidation of T, within the meaning of the liquidation provisions. The only definition of "complete liquidation" found in the liquidation provisions is as follows:

A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders. A liquidation may be completed prior to the actual dissolution of the liquidating corporation. However, legal dissolution of the corporation is not required. Nor will the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence disqualify the transaction.¹²¹

Generally, the foregoing definition presents no difficulty in application, particularly if the corporation ceases to exist via dissolution or merger under state law.¹²² The continued ownership of the corporation's assets by a corporation owned, in whole or in part, by the shareholders of the liquidated corporation, however, creates substantial difficulty.

A landmark case in the area is Judge Tannenwald's decision in *Telephone Answering Service Co. v. Commissioner (TASCO)*.¹²³ TASCO was primarily a holding company; however, approximately 15% of the assets of TASCO consisted of assets used by TASCO in conducting an answering service. TASCO adopted a plan of complete liquidation and sold stock of one of its two preexisting subsidiaries to an unrelated third party. TASCO also transferred all of its answering service assets to a newly organized, wholly owned corporation (New TASCO). TASCO then liquidated, distributing all of its assets to its shareholders in complete redemption of all of the issued and outstanding TASCO stock. These assets consisted of the stock of New TASCO, the stock of one of its preexisting subsidiaries, and cash received on the sale of the other subsidiary. TASCO asserted that, because the liquidating distribution occurred within twelve months after TASCO adopted its plan of complete liquidation, section 337 applied to

273, 281 (1964); Treas. Reg. § 1.332-2(b) (1955); Rev. Rul. 65-235, 1965-2 C.B. 88. If P is a minority shareholder of T at the time that P formulates the intention to acquire all of P, the contention is of no merit.

121. Treas. Reg. § 1.332-2(c) (1955).

122. See *id.* § 1.332-2(d); see also Rev. Rul. 69-6, 1969-1 C.B. 104; Rev. Rul. 67-326, 1967-2 C.B. 143 (both rulings holding that state law merger of T into P constitutes a "complete liquidation" of T for purposes of liquidation provisions).

123. 63 T.C. 423 (1974), *aff'd per curiam*, 39 A.F.T.R.2d (P-H) 77-786 (4th Cir. 1976), *cert. denied*, 431 U.S. 914 (1977).

prevent TASC0 from recognizing gain on the sale of the preexisting subsidiary.¹²⁴ The majority of the Tax Court disagreed, holding that TASC0 had not been "completely liquidated."¹²⁵ According to Judge Tannenwald, the term "complete liquidation" requires:

A bona fide elimination of the corporate entity and does not include a transaction in which *substantially the same shareholders* continue to utilize a *substantial part of the directly owned assets* of the same enterprise in *uninterrupted corporate form* The transitory coexistence of TASC0 and New TASC0 does not support the conclusion that the subsequent but prearranged liquidation of the former effected a sufficient transmutation of the assets of petitioner out of corporate solution to satisfy the requirement of section 337 of "all of the assets of the corporation" be distributed. To hold for petitioner in the instant case would frustrate the congressional purpose to deny section 337 treatment in connection with distributions of ongoing corporations. We cannot give tax effect to the "mere shifting of charters" . . . masquerading as a complete liquidation.¹²⁶

Thus, in the view of a majority of the Tax Court,¹²⁷ a corporation is not completely liquidated if (1) a substantial part of the assets directly owned by the corporation (2) continue to be held by a corporation (3) that is owned by substantially the same shareholders.¹²⁸

The following hypothetical illustrates the potential of the foregoing analysis upon a creeping asset acquisition. P purchases for cash all of the issued and outstanding stock of T. Shortly thereafter T merges upstream into P. Soon after the upstream merger, P transfers 5% of T's assets to S, a newly created, wholly owned subsidiary of P. P treats the upstream merger as a complete liquidation of T because T possesses net operating loss carryovers that, if not inherited by P pursuant to section 381,¹²⁹ will be limited to the income of T or T's alter ego.¹³⁰

With respect to the foregoing hypothetical, the government will apparently adopt the position that T has not been completely liquidated. The

124. See I.R.C. § 337(a) (1982).

125. 63 T.C. at 433-35.

126. *Id.* (emphasis added); see also *Pridemark, Inc. v. Commissioner*, 345 F.2d 35, 41 (4th Cir. 1965) (if enterprise is continued in corporate form, old T shareholders must have disassociated themselves from enterprise for T to be deemed completely liquidated).

127. Chief Judge Dawson and Judges Sterrett and Drennen dissented.

128. In *Workman v. Commissioner*, 36 T.C.M. (CCH) 1534 (1977), Judge Raum proffered that the assets referred to in *TASC0* were the "historic" business assets directly owned by the corporation. *Id.* at 1540. If the corporation sells all of its historic assets for a note and distributes the note to its shareholder in complete liquidation, the subsequent transfer of the note to a second corporation wholly owned by the same shareholder does not disqualify the status of the first distribution as a complete liquidation. This analysis seems to overemphasize the character of the assets retained in corporation solution.

129. I.R.C. § 381 (1982). After TEFRA any complete liquidation to which § 332 applies qualifies as a transaction described in § 381(a). *Id.* § 381(a)(1). Note, however, that T's net operating loss carryovers are subject to disallowance under § 269(b) if the principal purpose of the complete liquidation is tax avoidance. *Id.* § 269(b).

130. *Cf.* Treas. Reg. § 1.1502-21(c) (1966), which would prevent P from using in a consolidated return any T loss carryovers arising in taxable years prior to the date on which T is affiliated with P within the meaning of § 1504.

government will treat S as a mere continuation of T, either under the *TASCO* definition of complete liquidation or under the theory that the transfer of 5% of T's assets to S constitutes a "reincorporation," an "F" reorganization, described in section 368(a)(1)(F).¹³¹ The government's position, however, ignores the fact that P is not an "historic" shareholder of T. The absence of historic shareholder continuity of proprietary interest should prevent the transaction from qualifying as an F reorganization¹³² and should also prevent the treatment of S as being a mere continuation of T.¹³³ The careful practitioner, if consulted in time, will, of course, structure the transaction such that S purchases 5% of T's stock and P purchases the balance. T would then adopt a plan of complete liquidation, distributing 5% of its assets to S and then merging upstream into P. Utilization of this form of transaction ensures P's inheritance of T's tax attributes pursuant to section 381, simply because the government has long acknowledged that this form of transaction can only be a complete liquidation of T.¹³⁴

An even greater tax disaster may result if S directly acquires substantially all of T's assets after P has purchased T stock. For example, suppose P purchases 90% of the T stock for cash. In order to eliminate the 10% minority shareholder, P causes T to merge into S, pursuant to which the minority shareholder receives cash and P stock. According to the Tax Court, the merger of T into S merits treatment as a taxable sale of all of T's assets, provided P planned the merger at the time that it acquired its 90% interest in the T stock.¹³⁵ On the other hand, if P did not intend to merge T into S at the time that P acquired its 90% interest in the T stock, the Tax Court will apparently treat a newly organized S as a mere continuation of T.¹³⁶ T recognizes no gain or loss and is treated as having redeemed the T stock held by the 10% minority shareholder. Needless to say, it is difficult to understand why the Tax Court believes that the end result test applies for purposes of determining whether the historic shareholders of T have sufficient continuity of interest, whereas the end result test does not apply for purposes of determining whether a post-merger sale of P stock must be considered for continuity of interest purposes.¹³⁷

To avoid with certainty the treatment of T as making a taxable sale of its assets to S under the hypothetical set forth in the preceding paragraph, the direction of the merger must merely be reversed. By merging S, a newly created corporation, into T, with T surviving, even the government agrees that the transaction merits treatment as a single purchase of the 10% mi-

131. See Rev. Rul. 76-429, 1976-2 C.B. 97; Rev. Rul. 69-617, 1969-2 C.B. 57; Technical Advice Memorandum 7836002 (Apr. 28, 1978).

132. See *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168, 177 (1973).

133. See *Pridemark, Inc. v. Commissioner*, 345 F.2d 35, 41 (4th Cir. 1965); *Workman v. Commissioner*, 36 T.C.M. (CCH) 1534, 1540 (1977).

134. See Rev. Rul. 60-262, 1960-2 C.B. 114.

135. *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168, 176 (1973).

136. See *Casco Prods. Corp. v. Commissioner*, 49 T.C. 32, 37 (1967). For an excellent comparison of *Yoc Heating* to *Casco Products*, see Levin & Bowen, *supra* note 20, at 477-80.

137. See *McDonald's v. Commissioner*, 76 T.C. 972, 997-98 (1981), *rev'd sub nom. McDonald's Restaurants of Ill., Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982).

nority shareholder's stock, not as a sale of T's assets.¹³⁸

The foregoing indicates that, in the case of a creeping asset acquisition in which all or a portion of T's assets are to be held by a subsidiary of P, form remains a paramount concern under current law. Given the size of the tax stakes usually involved, an overabundance of caution is required in structuring such triangular acquisitions.

VI. CONCLUSION

A web of confusion continues to surround transactions in which one corporation acquires the stock of a target corporation and thereafter acquires all or a portion of the target's assets. This confusion is due in large measure to the differing manners of application of the step-transaction doctrine in the context of the reorganization and liquidation provisions. A great deal of the confusion would be eliminated if the courts uniformly agreed that (1) the same step-transaction test applies in the case of a creeping asset acquisition, both for purposes of the liquidation provisions and for purposes of the reorganization provisions; and (2) the end result test no longer applies for purposes of determining whether a stock acquisition followed by an asset acquisition should be tested as an asset reorganization. Not only would such agreement end unnecessary ambiguity, the elimination of the end result test from this area of the law would represent a step toward a fairer and more easily administered tax system.

Unfortunately, the end result test will apparently continue to be applied by the courts in the context of the reorganization provisions. Congress's repair of the breach in the system, therefore, is fortunate. P now may not step up the basis of T's assets in those cases in which the T shareholders are entitled, in whole or in part, to nonrecognition treatment of the transfer of T stock to P. This change results from section 338(h)(3)(A), which removes a creeping asset acquisition that qualifies as a good reorganization under section 368(a) from the definition of a qualified stock purchase.

Since the amendment to section 338(h)(3)(A) by section 712(k)(5) of the Act, the most significant problem resulting from a dual application of the step-transaction doctrine is apparently solved. Other ambiguities in the taxation of creeping asset acquisitions, however, appear unsusceptible to legislative remedy. These include the manner in which the continuity of proprietary interest test is applied in the context of an upstream merger of an "old and cold" subsidiary having minority shareholders, the manner in which the *Bausch & Lomb* doctrine applies, and problems resulting from transfers of assets to one or more P subsidiaries after P acquires T's stock. Although, in each instance, a "better view of the law" can be derived, the absence of clear rules often either discourages transactions or forces taxpayers to seek "acceptable" forms that may or may not accord with their business goals.

138. See Rev. Rul. 73-427, 1973-2 C.B. 301.

In conclusion, under current law the following principles appear to govern the taxation of creeping asset acquisitions:

- (1) The end result test is not applied for purposes of determining the application of the complete liquidation provisions of the Code to a creeping asset acquisition. Thus, assuming the courts continue to apply the end result test in the context of the reorganization provisions, a creeping asset acquisition can qualify for both reorganization treatment and for nonrecognition treatment under sections 332 and 336.
- (2) With the possible exception of section 337, the reorganization and complete liquidation provisions have concurrent jurisdiction in most cases. Thus, for example, in the case of an upstream merger of T into P, P recognizes no gain or loss if section 332 applies, even though P would otherwise recognize gain under the reorganization provisions upon an exchange of P's T stock for T assets. An exception to this general rule of concurrent jurisdiction should be carved out for cases in which P and T are controlled by substantially the same shareholders. In those cases the reorganization provisions should preempt the liquidation provisions.
- (3) In a reorganization in which P owns T stock on an "old and cold" basis, the continuity of proprietary interest requirement should be applied by examining only the consideration flowing to T shareholders other than P.
- (4) For purposes of the reorganization provisions, T stock owned by P on an "old and cold" basis should be treated as any other boot property. Thus, if such T stock is exchanged by P for T assets and section 332 does not apply to the transaction, P should recognize any gain or loss realized by P on the exchange of its T stock for P assets, regardless of the form of the transaction.

Unfortunately, the foregoing principles do not address every problem that may result from a creeping asset acquisition. For example, the principles give no guidance as to the tax consequences to T upon a freeze-out merger of T into a wholly owned subsidiary of P, following a cash purchase by P of a majority of T's stock. Furthermore, even if the foregoing are, or become, generally accepted by the courts, the area will still be fraught with traps and planning potential. Perhaps the only general proposition that can be derived from the foregoing is: no matter how much "simplification" is visited upon the Code, subchapter C will remain a bastion of "transactional selectivity."

