The Ghost of *Kimbell-Diamond*: Application of the Step-Transaction Doctrine to Multistep Corporate Transactions*

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*Any views expressed in this presentation are exclusively those of the presenters and not of the organizations with which they are associated.*
“Ghosts don’t haunt us. That’s not how it works. They’re present among us because we won’t let go of them.”

Sue Grafton, “M” is for Malice
Agenda:

1. Paradigm *Kimbell-Diamond* Transaction
2. Examples of *Kimbell-Diamond* Transactions
   a. Two-Step Acquisitive “D”
   b. Two-Step Nonqualifying “D”
   c. Stock Acquisition Followed By Drop and Asset Reorganization
   d. Acquisition of Less Than 80% Followed by Asset Reorganization
   e. Stock Acquisition Followed By Merger into a Partnership
3. Paradigm Reverse *Kimbell-Diamond* Transaction
4. Reverse *Kimbell-Diamond* Transaction Involving a Partnership

Unless otherwise stated, any “§” reference is to the Internal Revenue Code of 1986, as amended (the “IRC”), or to the Treasury regulations (“Reg.”) issued pursuant to the IRC.
1. Paradigm *Kimbell-Diamond* Transaction

Paradigm Facts

P purchases all the stock of T for cash and then, pursuant to P’s unilateral intent to acquire T’s assets in existence prior to P’s purchase of the T stock, T is completely liquidated into P or a P subsidiary (S).
1. Paradigm *Kimbell-Diamond* Transaction Cont’d

**Fundamentals of *Kimbell-Diamond* Transactions**

1. *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951), is one of a string of pre-1954 cases holding that if P buys the stock of T for the purpose of liquidating T and acquiring T’s assets, P’s transitory ownership of the T stock is disregarded, and P is treated as buying the T assets.

   a. All that was required to apply the step-transaction doctrine in this context is P’s pre-existing, unilateral intent to acquire T’s assets (including an acquisition by S, a subsidiary controlled by P) (the “end-result test”).

   b. Prior to 1982 (*compare In re Chrome Plate v. Commissioner*, 614 F.2d 990 (5th Cir. 1980), *with American Potash & Chemical Corp. v. United States*, 399 F.2d 194 (Ct. Cl. 1968)), reaching different answers on whether *Kimbell-Diamond* survived the enactment of the 1954 IRC, the doctrine applied solely for purposes of determining the basis of T’s assets in the hands of P (or S). T’s shareholders generally were respected as selling T stock to P, and T respected as transferring its assets to P via a complete liquidation. *Dallas Downtown Development Co. v. Commissioner*, 12 T.C. 114 (1949), *acq. 1950-1 CB 2*. [This is similar to the current state of the law regarding sales of partnership interests resulting in a termination of the partnership because all the interests become owned by buyer -- the seller is respected as selling a partnership interest, whereas the buyer is treated as buying the seller's proportionate share of the partnership's assets. *See Rev. Rul. 99-6, 1999-1 C.B. 432.*]

   c. Thus, prior to enactment of §338 in 1982, the recast generally determined only the tax consequences to P (or S), and it was unclear whether the recast survived the 1954 enactment of former §334(b)(2).
2. Today the step-transaction recast applies *solely* for purposes of determining whether the overall transaction qualifies as a reorganization under §368(a).

   a. If the recast as a T asset acquisition results in a good reorganization, the recast applies for purposes of determining the tax consequences to *all parties*. Rev. Rul. 2001-46, 2001-2 CB 321. Compare this to the whipsaw in *King Enterprises, Inc. v. U.S.*, 418 F.2d 511 (Ct. Cl. 1969) (T shareholders taxed under §§354 and 356; P received stepped-up basis under former §334(b)(2) per a PLR obtained by P).

   b. If the recast results in a failed reorganization, then the form is respected and that form governs the tax consequences to *all parties*, whether or not the first step *per se* is a good reorganization or a QSP. Rev. Rul. 2008-25, 2008-1 CB 986; Rev. Rul. 77-427, 1977-2 CB 100, *revoking* Rev. Rul. 58-79, 1958-1 CB 177; *Campbell v. Commissioner*, 15 T.C. 312 (1950), *acq.* 1951-1 CB 1.

   c. Even if the first step *per se* is a good reorganization, if the recast results in a failed reorganization, the first step cannot qualify as a reorganization and can be a QSP. Rev. Rul. 2008-25, 2008-1 CB 986. Thus, the anti-*Yoc Heating* rule of Reg. §1.338-3(d) plays a very limited role today.
3. Integration is subject to exceptions such as those found in:
   a. the expanded application of §368(a)(2)(C) by Reg. §1.368-2(k);
   b. the "F" reorganization "bubble" rule of Reg. §1.368-2(m)(3)(ii); and
   c. the "cascading §351" rulings.

4. If integration of the first of several steps with subsequent steps results in a failed reorganization or is prevented by an exception, integration may still apply to later steps if the recast of those steps results in a good asset reorganization.
   a. See Rev. Rul. 2015-10, 2015-21 IRB 973 (P transfers all the T stock to its wholly owned subsidiary, S1; S1 transfers all the T stock to its wholly owned subsidiary, S2; S2 transfers all the T stock to its wholly owned subsidiary, N; T liquidates into N: the first and second transactions are respected as unrelated §351 exchanges, and the third and fourth transactions are integrated and treated as a reorganization).

**Steps**

A, B, and C sell all their T stock to P for cash

T liquidates into P

**After**

A, B, and C sell all their T stock to P for cash

T liquidates into P

**Facts**

A, B, and C are unrelated individuals. A owns 50% of the stock of P; B owns 30% of the stock of P; and C owns 20% of the stock of P. A, B, and C also own all the stock of T in the same proportions (i.e., A owns 50%, B 30%, and C 20%). Each of A, B, and C sells all her T stock to P for cash. Pursuant to a pre-existing plan, T later liquidates into P.

- **Application of Kimbell-Diamond.** Step 1 is combined with Step 2 because the 2 steps together qualify as an acquisitive “D” reorganization – (i) T’s shareholders control P after the exchange within the meaning of §368(a)(2)(H)(i); (ii) P acquires substantially all the assets of T; (iii) COBE is satisfied; and (iv) the stock distribution requirement of §354(b)(1)(B) is satisfied under Reg. §1.368-2(l)(2) (P and T are owned by substantially the same shareholders in substantially the same proportions). Rev. Rul. 2004-83, 2004-2 CB 157.

- **Tax Consequences.** As a result the tax consequences are:
  - T recognizes no gain or loss and takes a carryover basis in T’s assets. §§361 & 362(b).
  - Each T shareholder recognizes gain under §356(a)(1) equal to the lesser of her realized gain and the cash received. *But see Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966).
  - Because no T shareholder reduces her proportionate shareholder’s interest, each shareholder’s recognized gain is taxable as a dividend under §356(a)(2) to the extent of the shareholder’s proportionate share of E&P. *Commissioner v. Clark*, 489 U.S. 726 (1989). The authorities are split on whether the amount of the dividend is measured solely by the E&P of T or by the E&P of both P and T. *Compare* Rev. Rul. 70-240, 1970-1 CB 81, and *Davant* (dividend measured by the E&P of both) *with Am. Mfg. Co., Inc. v. Commissioner*, 55 T.C. 204 (1970); *James Armour, Inc. v. Commissioner*, 43 T.C. 295 (1964); *Estate of Bell v. Commissioner*, 30 T.C.M. (CCH) 1221 (1971); *Atlas Tool Co. v. Commissioner*, 614 F.2d 860 (3d Cir. 1980) (boot dividend amount measured solely by E&P of T).

**Facts**

A, B, and C are unrelated individuals. A owns 40% of the stock of P; B owns 30% of the stock of P; and C owns 30% of the stock of P. A, B, and C also own all the stock of T, but not in the same proportions (A owns 50%, B 30%, and C 20%). Each of A, B, and C sells all her T stock to P for cash. Pursuant to a pre-existing plan, T later liquidates into P.

As a result of the transactions, (i) A’s interest in T’s earnings and assets decreases from 50% to 40%; (ii) B’s interest remains unchanged at 30%; and (iii) C’s interest increases from 20% to 30%.
2. Examples of *Kimbell-Diamond* Transactions: b. Two-Step Nonqualifying “D” Cont’d

- **Application of Kimbell-Diamond.** Step 1 is *not* combined with Step 2 because the 2 steps together do not qualify as a reorganization – (i) due to violation of the boot relaxation rule of §368(a)(2)(B), the combined transaction does not satisfy the solely for voting stock requirement of §368(a)(1)(C); and (ii) the transaction does not qualify as an acquisitive “D” reorganization because the stock distribution requirement of §354(b)(1)(B) is not satisfied under Reg. §1.368-2(l)(2) (while P and T are owned by substantially the same shareholders, they are not owned in substantially the same proportions). Therefore, the steps are respected as separate transactions. *Warsaw Photographic Assocs., Inc. v. Commissioner*, 84 T.C. 21 (1985); Rev. Rul. 77-427, 1977-2 CB 100; Rev. Rul. 2008-25, 2008-2 CB 986. *Compare* Reg. §1.368-2(l)(3), Example 4.

- **Tax Consequences.** As a result the tax consequences are:
  - T and P recognize no gain or loss on the liquidation of T under §§332(a) and 337(a). P takes the same basis as T in T’s assets. §334(b)(1).
  - Section 304 applies to each shareholder’s sale of T stock to P.
  - Because neither B nor C decreases her proportionate shareholder interest in T under §304(b)(1), each of B and C is treated as receiving a dividend as provided in §304(b)(2). The fact that T’s stock is eliminated when T is liquidated under §332 should not matter in applying §§304(b)(1) and 302(b). *Massell v. United States*, 412 F. Supp. 398 (N.D. Ga. 1976); Rev. Rul. 77-427, 1977-2 CB 100; PLR 8339081 (June 29, 1983).
  - Because A’s proportionate interest in the T stock is reduced from 50% to 40%, she should qualify for sale or exchange treatment under §§304(b)(1) and 302(b)(1). *Roebling v. Commissioner*, 77 T.C. 30 (1981); *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973); Rev. Rul. 75-502, 1975-2 CB 111.
2. Examples of *Kimbell-Diamond* Transactions: c. Stock Acquisition Followed By Drop and Asset Reorganization

**Facts: Steps 1 and 2**

Each of P and T is the publicly traded common parent of a consolidated group. The T stock is widely held (no one owns more than 5%) and worth $100, and the P stock is worth $40. P owns all the stock of S1, and S1 owns all the stock of S2. T is acquired by P as follows:

1) P transfers $60 cash and $40 in value of P stock to newly formed corporation N in exchange for all the N stock.

2) N merges into T with T surviving. The outstanding T stock is converted into $60 cash and $40 in value of P stock, and T becomes wholly owned by P. The $40 of P stock received by the T shareholders constitutes 50% of the outstanding P stock following the merger.
2. Examples of *Kimbell-Diamond* Transactions: c. Stock Acquisition Followed By Drop and Asset Reorganization Cont’d

Facts: Steps 3 and 4

Several days after T becomes wholly owned by P:
3) P contributes all the T stock to the capital of S1.
4) T merges into S2 with S2 surviving.
2. Examples of *Kimbell-Diamond* Transactions: c. Stock Acquisition Followed By Drop and Asset Reorganization

**Application of *Kimbell-Diamond* to the Overall Transaction**


- The first question is whether the overall transaction (steps 1-4) is a good asset reorganization of T into S2. If not, steps 1 and 2 are respected as a separate transaction constituting P’s acquisition of all the T stock for cash and P stock.
  - While the overall transaction would qualify as a good “A” reorganization under §368(a)(2)(D) if P had §368(c) control of S2, indirect ownership doesn’t count. Therefore, combining the steps doesn’t result in a good “A” reorganization.
  - While one or more T shareholders “control” P within the meaning of §368(a)(2)(H)(i) (as a group the T shareholders own at least 50% in voting power or value of the P stock as a result of the first merger of N into T), the distribution requirement of §354(b)(1)(B) is not satisfied because (i) no stock of the acquiring corporation (S2) is actually distributed to the T public shareholders and (ii) clearly the T public shareholders do not constructively own (applying §304(c)(3)) S2 stock in the same proportions in which they owned T stock. Thus, the overall transaction is not a good acquisitive “D” reorganization.
  - Accordingly, steps 1 and 2 must be respected as a single, separate transaction (in which P acquires all the T stock in exchange for 50% of the outstanding P stock, worth $40, and $60 cash). Rev. Rul. 77-427, 1977-2 CB 100; Rev. Rul. 2001-46, 2001-2 CB 321; Rev. Rul. 2008-25, 2008-1 CB 986. This transaction, standing alone, is not a good reorganization.
2. Examples of *Kimbell-Diamond* Transactions: c. Stock Acquisition Followed By Drop and Asset Reorganization

- **Application of *Kimbell-Diamond to the Later Steps***. While steps 1 and 2 are required to be treated as an independent acquisition by P of all the T stock in exchange for $60 cash and $40 of P stock, the step-transaction doctrine can apply to integrate steps 3 and 4. The triangular recast of Rev. Rul. 78-130, 1978-1 CB 114, was revoked by Rev. Rul. 2015-9, 2015-21 IRB 972, so steps 3 and 4 cannot be recast as a triangular reorganization of T into S2 in which P receives stock of S1. Does this mean step 3 **must** be respected as a transfer of T stock to S1 under §351(a), and step 4 respected as an “A”/acquisitive “D” reorganization of T into S2?

  o Not that we care, but if S1 has only voting stock outstanding, couldn’t step 3 (if respected as independent of step 4) also qualify as a “B” reorganization?

  o Should Rev. Rul. 2015-9 apply if the treatment of T as merging into S2 in exchange for S1 stock qualifies as a good reorganization (e.g., under §368(a)(2)(D))?
2. Examples of *Kimbell-Diamond* Transactions: c. Stock Acquisition Followed By Drop and Asset Reorganization

- **QSP Status.** Suppose P wishes to make a §338(g) election for T. Due to the application of §304 to the cash portion (60%) of the consideration paid by P for the T stock (the T shareholders acquire §304(c)(1) “control” of P [at least 50% vote or value] in the first merger, and that P stock counts in measuring “control” under §304(c)(2)(A)), the basis of 60% of the T stock is determined under Reg. §1.304-2(a) by reference to the basis of the stock in the hands of the T shareholders and, hence, is not acquired by “purchase” under §338(h)(3)(A)(i). Thus, 80% of the T stock is not acquired by purchase, as required by §338(d)(3), so P hasn’t made a QSP of T.

- **Sections 304 and 1001.** Except for overlapping P/T shareholders, each T shareholder suffers a 50 percentage-point reduction in interest under §304(b)(1), qualifying for sale or exchange treatment on the receipt of cash under §302(b)(2). Section 1001 applies to the receipt of P stock.
2. Examples of *Kimbell-Diamond* Transactions: d. Acquisition of Less Than 80% Followed by Asset Reorganization

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**Steps**

(1) cash for all the Newco stock

\[ \begin{align*}
& (1) \text{ cash for all the Newco stock} \\
& (2) 3\% \text{ of } P \\
& \text{ common stock for } \\
& 75\% \text{ of the } T \\
& \text{ stock}
\end{align*} \]

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**After**

\[ \begin{align*}
& 97\% \\
& \text{P Public} \\
& 3\% \\
& \text{T Public} \\
& 25\% \\
& \text{P} \\
& 75\% \\
& \text{T} \\
& \text{cash} \\
& \text{Newco}
\end{align*} \]

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**Facts: Step 1 and 2**

1) P transfers cash to a newly formed domestic corporation (Newco) in exchange for all the stock of Newco.

2) Pursuant to a tender offer, P transfers 3% of its common stock to the shareholders of T in exchange for 75% of the outstanding T stock.

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One of two alternative transactions (*Alternative A* and *Alternative B*), described on the next 2 slides, is undertaken to complete the two-step acquisition of T’s assets. All transactions occur pursuant to a single plan.
2. Examples of *Kimbell-Diamond* Transactions: d. Acquisition of Less Than 80% Followed by Asset Reorganization Cont’d

**Steps**

(3) T merges into Newco with Newco surviving.

(3) T distributes cash to the T public shareholders and 75% of Newco’s stock to P pursuant to the merger.

**After**

(P) P Public

(T) T Public

(P) P Public

(T) T Public

(97%)

(3%)

(25%)

(75%)

(3%) T Public to cash

(75%) Newco to P Public

Facts: Alternative A (Step 3)

3) T merges into Newco with Newco surviving. Pursuant to the merger, the T stock held by public shareholders (25%) is converted into cash, and P’s T stock (75%) is converted into Newco stock.
2. Examples of *Kimbell-Diamond* Transactions: d. Acquisition of Less Than 80% Followed by Asset Reorganization Cont’d

**Steps**

1. **T** transfers all its assets to **Newco** for cash plus 75% of **Newco**’s stock.
2. **T** dissolves under state law, distributing cash to **T**’s public shareholders in complete redemption of their **T** stock and 75% of the **Newco** stock to **P** in complete redemption of **T**’s **T** stock.

**Facts: Alternative B (Steps 3 and 4)**

3) **T** transfers all its assets to **Newco** in exchange for cash, 75% of **Newco**’s outstanding stock, and **Newco**’s assumption of **T**’s liabilities.

4) **T** dissolves under state law, distributing cash to **T**’s public shareholders in complete redemption of their **T** stock and 75% of the **Newco** stock to **P** in complete redemption of **T**’s **T** stock.
2. Examples of *Kimbell-Diamond* Transactions: d. Acquisition of Less Than 80% Followed by Asset Reorganization Cont’d

**Application of *Kimbell-Diamond***

- **Alternative A.** Even though P acquires only 75% of the T stock in step 2, in Alternative A (T merges into Newco with Newco surviving), application of *Kimbell-Diamond* to integrate steps 2 and 3 results in a good direct triangular merger under §368(a)(1)(A) and (a)(2)(D).
  - P controls Newco within the meaning of §368(c). Newco acquires substantially all the T assets by operation of law. COBE is satisfied and COI is satisfied because 75% of the T stock is exchanged in step 1 for qualifying consideration (P common stock, P being a party to the reorganization). See *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995) (discussion of “plan of reorganization” and holding the concept is broad enough to integrate a tender offer, in which P issued its voting stock in exchange for T stock, with a later merger, both of which were required by the transaction documents).
  - The “F bubble” rule doesn’t apply because Reg. §1.368-2(m)(3)(iv)(A) provides that triangular reorganization treatment trumps “F” reorganization treatment. Therefore, the transaction is treated under *Kimbell-Diamond* as a direct triangular “A” reorganization of T into Newco, a §368(c)-controlled subsidiary of P.
  - P’s transitory ownership of 75% of the T stock should be disregarded for tax purposes, and the tax consequences to Newco, T, and T’s public shareholders should be governed by §§361, 354, and 356 and Reg. §1.1032-2(b).
Application of *Kimbell-Diamond* Cont’d

**Alternative B.** In steps 3 and 4 of Alternative B, Newco doesn’t acquire T’s assets, and T’s existence doesn’t terminate, by operation of law as required by Reg. §1.368-2(b)(1). Consequently, the integration of steps 2, 3, and 4 in Alternative B can’t qualify as a good direct triangular merger under §368(a)(1)(A) and (a)(2)(D). It also can’t qualify as a good triangular reorganization under §368(a)(1)(C) because more than 20% in gross value of T’s assets are acquired by Newco in exchange for cash and debt assumption and, hence, the boot relaxation rule is violated. Therefore, the integration of steps 2, 3, and 4 doesn’t result in a good reorganization, meaning (i) *Kimbell-Diamond* doesn’t integrate the steps and (ii) P’s acquisition of 75% of the T stock in step 2 can’t qualify as a reorganization.

- The 2nd step is a taxable transfer of 75% of the T stock to P for P stock. Thus, the T shareholders recognize gain or loss on the exchange, and P takes a cost basis in 75% of the T stock.
- The 3rd step should qualify under §351 because P is a co-transferor with T to Newco and under §351(c) T’s distribution of 75% of the Newco stock to P in step 4 doesn’t violate the “control immediately after” requirement. Therefore, provided the total of T’s liabilities assumed by Newco doesn’t exceed the aggregate adjusted basis of T’s assets, T should recognize gain only to the extent the cash received by T is allocated to BIG assets of T under Rev. Rul. 68-55, 1968-1 C.B. 140.
- The complete liquidation of T is taxed under §§331 and 336. Thus, (i) T recognizes gain on the distribution of Newco stock to P to the extent the value of the Newco stock exceeds T’s basis in the Newco stock (determined under §358(a)(1) in the step 3 exchange), and (ii) T’s shareholders recognize gain or loss on the liquidation of T.
- **Question:** Is there a QSP by P of T as a result of T’s distribution of cash to historic T shareholders in complete redemption of their T stock under §331 in step 4, or is this prevented by the simultaneous termination of T’s existence?
2. Examples of *Kimbell-Diamond* Transactions: e. Stock Acquisition Followed By Merger into a Partnership

**Facts**
Each of P and T is the publicly traded common parent of a consolidated group. The T stock is worth $100, and the P stock is worth $270. P owns all the stock of S. P and S own all of the interests in a partnership (PRS), with P owning 20% and S 80% of the PRS interests. T is acquired by P as follows:

1) P transfers $10 cash and $90 in value of P voting common stock to newly formed corporation N in exchange for all the N stock.

2) N merges into T with T surviving. The outstanding T stock is converted into $10 cash and $90 in value of P voting common stock, and T becomes wholly owned by P.

3) T merges into PRS with PRS surviving. After the merger, P owns 90% and S 10% of the PRS interest.
2. Examples of *Kimbell-Diamond* Transactions: e. Stock Acquisition Followed By Merger into a Partnership Cont’d

**Kimbell-Diamond Recast**

- **Application of *Kimbell-Diamond***. If the first merger and second merger are integrated under step-transaction principles, then:
  - T is treated as transferring all its assets to PRS in exchange for $10 cash and $90 of P voting common stock. Because a partnership cannot be a “party to the reorganization” within the meaning of §368(b), presumably this would be a **fully taxable sale in which T recognizes all gain and loss inherent in its assets**. See Reg. §1.368-2(b)(1)(iii), Example 5, and (k)(2), Example 5. **PRS would take a stepped-up cost basis in the T assets.**
  - T then distributes the cash and P voting stock to T’s shareholders in complete liquidation. T’s liquidation would be fully taxable to T under §336 and to the T shareholders under §331.
  - Presumably PRS acquires the $10 cash and $90 of P voting stock from P by issuing an additional 70% PRS interest to P in exchange for the cash and P stock. P should recognize no gain or loss on this hypothetical transaction under §§721(a) and 1032, and PRS would recognize no gain or loss under Reg. §1.1032-3(b) when it transfers the P stock to T in exchange for T assets.
2. Examples of *Kimbell-Diamond* Transactions: e. Stock Acquisition Followed By Merger into a Partnership Cont’d

**Kimbell-Diamond Recast**

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<th>S</th>
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<td>P</td>
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<td>T</td>
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<tr>
<td>PRS</td>
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(1) $10 cash and $90 of P voting common stock for 70% PRS interest

(2) Transfer of all the T assets to PRS for $10 cash and $90 of P voting common stock

(3) $10 cash and $90 (25%) of P voting common in liquidation of T

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**Can *Kimbell-Diamond* Apply?** There is no authority applying the step-transaction doctrine to integrate P’s acquisition of T stock with a subsequent acquisition of T’s assets by a partnership directly or indirectly controlled by P. But Reg. §1.368-2(k)(1) is the critical turn-off switch here, and:

- In order for Reg. §1.368-2(k)(1) to prevent PRS’s acquisition of T assets from being collapsed with P’s T stock acquisition, (1) the first step, standing alone, must qualify as a reorganization; (2) the COBE requirement must remain satisfied; (3) the transfer must not be to former shareholders of T; and (4) the transferor (*i.e.*, the target corporation, surviving corporation, or acquiring corporation, as the case may be) must not terminate its existence in connection with the transfer.

- Unfortunately, T’s existence terminates so Reg. §1.368-2(k)(1) apparently is not applicable.

**Conclusion.** *Kimbell-Diamond* does and then doesn’t apply. That is, the steps are respected as separate, but the merger of N into T cannot qualify as a reorganization. Rev. Rul. 2008-25, 2008-1 CB 986. Therefore, the first 2 steps are a QSP of T by P, and the third step (under Rev. Rul. 69-6, 1969-2 CB 104) is a §721(a) transfer by T of all its assets to PRS in exchange for a 70% PRS interest, followed by a §332 liquidation of T into P. If that’s right, this is a surviving vestige of the “indirect continuity” doctrine (see *Groman v. Commissioner*, 302 U.S. 82 (1937), and *Helvering v. Bashford*, 302 U.S. 454 (1938)) in which a unilateral act by P can blow away the tax treatment expected by T and its shareholders.
2. Examples of *Kimbell-Diamond* Transactions: **e. Stock Acquisition Followed By Merger into a Partnership Cont’d**

**If Steps 1 and 2 Are Respected as Separate**

- **Qualification of Steps 1 and 2 as a Reorganization.** Generally, if the merger of N into T is respected as separate from the merger of T into PRS, it will qualify as a good reorganization thanks to §368(a)(2)(E).
  - T acquires the N assets in a “statutory merger or consolidation” within the meaning of Reg. §1.368-2(b)(1)(ii).
  - T stock representing §368(c) “control” of T is exchanged solely for voting stock of the corporation (P) having §368(c) “control” of N.
  - T retains substantially all its assets and acquires substantially all the assets of N not transferred to T’s shareholders or used to pay reorganization costs. See Reg. §1.368-2(j)(3)(iii); Rev. Rul. 88-48, 1988-1 CB 117.
  - COBE is satisfied and remains satisfied following the transfer of T’s assets to PRS. See Reg. §1.368-1(d)(4)(iii).
  - COI is satisfied because 90% of the consideration for the T stock is stock of a party to the reorganization (P).

- **Qualification of Step 3 under §§721(a) and 332.** Also assuming *Kimbell-Diamond* doesn’t apply, step 3 is treated as T’s transfer of all its assets to PRS in exchange for a 70% PRS interest followed by the complete liquidation of T under §332. Rev. Rul. 69-6, 1969-2 CB 104.
2. Examples of *Kimbell-Diamond* Transactions: e. Stock Acquisition Followed By Merger into a Partnership Cont’d

**Moral of the Story:** “There’s no subchapter C problem that cannot be solved by one or more additional steps and/or entities.” For example, after P acquires all the stock of T in the reverse subsidiary merger, T could merge into a newly formed DRE of P, with the DRE surviving, after which P contributes all the membership interests in DRE to PRS in exchange for an additional 70% interest in PRS.

**Steps**

- **(1)** $10 cash and $90 of P voting common stock for all of N’s stock
- **(2)** $10 cash and $90 (25%) of P voting common stock pursuant to merger
- **(3)** merger of T into DRE with DRE surviving
- **(4)** transfer of DRE to PRS for an additional 70% PRS interest

**After**

- P Public
- T Public
- PRS

- P Public: 25%
- T Public: 75%
- PRS: 90%
- S: 10%

- DRE: T assets

- Steps (1), (2), and (3) are integrated under Rev. Rul. 2001-46 and qualify as a good reorganization under §368(a)(1)(A) and Reg. §1.368-2(b)(1)(ii) (a direct transfer by operation of law of all of T’s assets to P in exchange for 90% P stock and 10% boot coupled with the termination of T’s existence and distribution of the cash and P stock to T’s shareholders).

- Because P’s later contribution of the T assets to PRS satisfies COBE (Reg. §1.368-1(d)), step (4) is treated as an independent transaction under Reg. §1.368-2(k)(1) that doesn’t disqualify the reorganization.
3. Paradigm Reverse *Kimbell-Diamond* Transactions

**Paradigm Facts**

The T shareholders transfer appreciated property to T (which may or may not be newly formed) in exchange for stock of T - a transaction intended to qualify under §351(a). The T shareholders then transfer all the T stock to P (an existing and often publicly traded corporation) in exchange for P stock in what is intended to be a reorganization under §368(a). In *West Coast Marketing*, T’s existence was transitory.

*If T isn’t liquidated into P, could the T shareholders be viewed as transferring property to T in exchange for P stock (a fully taxable triangular transaction)?*
3. Paradigm Reverse *Kimbell-Diamond* Transactions Cont’d

**Fundamentals of Reverse *Kimbell-Diamond* Transactions**

Here the taxpayer generally does not want the step-transaction doctrine to apply because she wants the first step to be respected as a good nonrecognition exchange under §351(a) and the second step to be respected as a good reorganization in which she recognizes no gain or loss under §354(a).

1. Generally the courts have applied the “mutual interdependence” and “binding commitment” tests for purposes of integrating these transactions; that is, they will not be integrated if (i) the first exchange serves an independent business purpose, the achievement of which does not depend on the completion of the second transaction, and (ii) the transferor in the first exchange is not subject to a binding commitment to complete the second step at the time the first step is completed. *Weikel v. Commissioner*, 51 T.C.M. (CCH) 432 (1986) (respecting the form); *Vest v. Commissioner*, 57 T.C. 128 (1971) (respecting the form), *aff’d in part, rev’d in part on other grounds*, 481 F.2d 238 (5th Cir. 1973); *West Coast Marketing Corp. v. Commissioner*, 46 T.C. 32 (1966) (treating T as a mere conduit through which the T shareholder transferred the incorporated assets to P in a taxable sale; T was liquidated by P, and the transfer of the assets to T served no business purpose but was done solely to facilitate the second step as a tax-free “C” reorganization). See also Rev. Rul. 70-140, 1970-1 CB 73 (following *West Coast Marketing* and recasting as taxable sale of assets to P for P stock followed by P’s drop to T where P did not liquidate T after the second step).
2. Relying on the “cascading §351” rulings (Rev. Rul. 77-449, 1977-2 CB 110, amplified by Rev. Rul. 83-156, 1983-2 CB 66; Rev. Rul. 83-34, 1983-1 CB 79) and the fact that the taxpayer did not “cash in” on its investment in the property transferred to T, the IRS has concluded that it will respect the form of a reverse Kimbell-Diamond transaction as a good §351(a) exchange in the first step and a tax-free exchange in the second step if (i) the overall transaction is undertaken for business reasons, and (ii) recasting the steps as was done in Rev. Rul. 70-140 would result in a good “cascading §351” exchange. This favorable treatment was available even though the taxpayer was under a binding commitment to complete the second step at the time the first was undertaken. Rev. Rul. 2003-51, 2003-1 CB 938.

3. Of interest is that recasting the transaction as a triangular exchange (e.g., as was done in Rev. Rul. 78-130, 1978-1 CB 114, revoked by Rev. Rul. 2015-9, 2015-21 IRB 972) was not discussed in Rev. Rul. 2003-51. For example, the T shareholders arguably could be viewed as transferring property to T in exchange for P stock, a fully taxable exchange. While the Rev. Rul. 70-140 recast was used as a litmus test, no mention is made of the triangular recast.
4. Reverse *Kimbell-Diamond* Transaction Involving a Partnership

- **Facts.** T is engaged in various businesses, including Business A. P, the common parent of a consolidated group having significant consolidated net operating losses (CNOLs), owns all the stock of S (a member of the P group). S is engaged in various businesses, including Business A. X, unrelated to either T or P, likewise is engaged in various businesses, including Business A.

- T, P, and X wish to combine their Businesses A under the roof of a single entity, with (i) T exchanging its unlimited upside and downside in its Business A in exchange for a fixed return; (ii) the corporation owning the P group’s interest in the combined Businesses A remaining in the P consolidated group; (iii) X receiving pass-thru treatment with respect to its interest in the combined Businesses A; and (iv) P funding through a cash contribution one year’s worth of Business A operating costs. The parties enter into a written binding contract to execute the following integrated transactions:

1. T forms a new US corporation (N) and transfers all the assets of T’s Business A to N in exchange for all the stock of N.

2. T transfers all the N stock to S in exchange for S nonvoting preferred stock structured to satisfy all the requirements of §1504(a)(4) and to not constitute “nonqualified preferred stock” within the meaning of §351(g)(2) (the stock is required to be redeemed after 21 years and accrues annual dividends at a fixed rate). At the same time, P contributes cash to the capital of S in an amount in excess of 10% of the FMV of the S stock owned by P prior to the contribution.

3. S transfers all its Business A assets to N after N becomes wholly owned by S.

4. N transfers all the S and T Business A assets and cash to a newly formed partnership (XN) in exchange for a 50% interest in XN. At the same time, X transfers all its Business A assets to XN in exchange for a 50% interest in XN.
### 4. Reverse *Kimbell-Diamond* Transaction Involving a Partnership Cont’d

**Steps**

1. **Transfer of all the assets of Business A to N for all the N stock**
2. **Capital contribution of cash to S in an amount equal to >10% of the FMV of the S stock owned by**
   P
3. **Capital contribution of all the assets of S’s Business A plus cash to N**
4. **Transfer of all the assets of S’s Business A, T’s Business A plus cash to XN for a 50% XN interest**

**After**

- **100% of S’s nonvoting preferred stock**
- **100% of S’s common stock**

- **Note the limitation in §1503(f) on the use of CNOLs of other members**

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