Montana-Dakota Utilities Co. v. Commissioner, 25 T.C. 408 (1955)

When a series of steps are pre-planned and interdependent to achieve a single intended result, the step transaction doctrine allows courts to treat the steps as a single integrated transaction for tax purposes, rather than viewing each step in isolation.

Summary

Montana-Dakota Utilities Co. (MDU) sought to acquire the assets of two utility companies, Dakota Public Service Company (Dakota) and Sheridan County Electric Company (Sheridan County). To avoid becoming a holding company, MDU structured the acquisitions by purchasing all stock/securities of Dakota and stock of Sheridan County, and immediately liquidating them to obtain their assets. The Tax Court addressed whether these acquisitions qualified as tax-free liquidations under Section 112(b)(6) of the 1939 Internal Revenue Code, which would mandate using the predecessor companies' bases for the acquired assets under Section 113(a)(15). The court held that the step transaction doctrine applied, treating the acquisitions as a single purchase of assets, thus allowing MDU to use the cost basis of the stock and securities plus assumed liabilities for the acquired assets.

Facts

Montana-Dakota Utilities Co. (petitioner) aimed to expand its utility operations by acquiring Dakota Public Service Company and Sheridan County Electric Company.

To acquire Dakota, MDU purchased all outstanding stock, bonds, and notes from United Public Utilities Corporation, Dakota's parent company.

Similarly, to acquire Sheridan County, MDU bought all outstanding stock from Gerald L. Schlessman.

In both acquisitions, MDU's intent, communicated to regulatory agencies and sellers, was to immediately liquidate Dakota and Sheridan County after acquiring their stock to obtain their assets directly.

MDU obtained regulatory approvals contingent upon immediate liquidation of both companies.

Immediately after purchasing the stock/securities in each instance, MDU liquidated Dakota and Sheridan County and acquired all their assets, assuming their liabilities.

MDU sought to use the cost of the acquired stock/securities plus assumed liabilities as the basis for the assets, while the Commissioner argued for using the predecessor companies' bases under Sections 112(b)(6) and 113(a)(15), treating the stock purchase and liquidation as separate steps.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in income tax and excess profits tax against Montana-Dakota Utilities Co. for the years 1945, 1946, and 1947.

The sole issue before the Tax Court was the basis of the properties MDU acquired from Dakota and Sheridan County.

Issue(s)

1. Whether the acquisition of stock and securities of Dakota and stock of Sheridan County, followed by immediate liquidation of these companies, should be treated as a single, integrated transaction (purchase of assets) under the step transaction doctrine, or as separate transactions (stock/securities purchase and subsequent liquidation).

2. If the step transaction doctrine applies and Section 112(b)(6) is inapplicable, whether the basis of the assets acquired by MDU should be the cost of the stock and securities plus the liabilities assumed, or the transferor's basis under Section 113(a)(15) of the Internal Revenue Code of 1939.

Holding

1. No, Section 112(b)(6) of the Internal Revenue Code of 1939 does not apply to the liquidations of Dakota and Sheridan County because the transactions were properly viewed as a single, integrated acquisition of assets under the step transaction doctrine, not as separate, independent events.

2. Yes, because Section 112(b)(6) is inapplicable, Section 113(a)(15) is also inapplicable. Therefore, the basis of the assets acquired by MDU is the cost of the stock and securities purchased, plus the liabilities assumed upon liquidation of Dakota and Sheridan County.

Court's Reasoning

The court applied the step transaction doctrine, stating, "It is quite clear from the record that, whether petitioner negotiated specifically for the assets of the two corporations or not, its primary, in fact its sole purpose, was to acquire the corporate assets through the purchase of the stock and the immediate liquidation of the corporations, to the end that it might integrate the properties into its directly owned operating system."

The court emphasized that MDU's intent from the outset was to acquire the assets, and the stock purchases and liquidations were merely steps to achieve this single goal. The regulatory filings and agreements explicitly stated this intention of immediate liquidation.

Because the transactions were treated as a single purchase of assets, the requirements for a tax-free liquidation under Section 112(b)(6) were not met. Section 112(b)(6) requires a distribution in complete liquidation, but in this case, the court viewed the liquidation as an integral part of the asset purchase, not a separate liquidation in the context of a parent-subsidiary relationship as contemplated by the statute.

Since Section 112(b)(6) was inapplicable, Section 113(a)(15), which dictates the basis in a Section 112(b)(6) liquidation, was also inapplicable. The court reverted to the general rule of basis in Section 113(a), which states that "the basis of property shall be the cost of such property."

The court determined that MDU's cost for the assets included not only the cash paid for the stock and securities but also the liabilities assumed upon liquidation. Citing *Crane v. Commissioner*, 331 U.S. 1 (1947), the court affirmed that in a purchase, cost includes liabilities assumed.

The court distinguished *Kimbell-Diamond Milling Co.*, 14 T.C. 74, aff'd per curiam 187 F.2d 718, cert. denied 342 U.S. 827, noting that while *Kimbell-Diamond* also applied the step transaction doctrine, the issue of including assumed liabilities in the asset basis was not explicitly litigated or considered in that case.

Practical Implications

Montana-Dakota Utilities clarifies the application of the step transaction doctrine in corporate acquisitions, particularly when a taxpayer purchases stock solely to acquire the underlying assets through immediate liquidation.

This case demonstrates that the stated intent and pre-planned nature of steps are crucial in determining whether the step transaction doctrine will apply. Taxpayers cannot artificially separate steps to achieve a tax result inconsistent with the economic reality of an integrated transaction.

For tax practitioners, *Montana-Dakota Utilities* emphasizes the importance of documenting the intent behind acquisition steps and understanding that courts will look to the substance over the form of transactions.

It confirms that when the step transaction doctrine recharacterizes a stock purchase and liquidation as an asset purchase, the basis of the acquired assets is the cost, including liabilities assumed, consistent with general purchase principles, not carryover basis rules applicable to tax-free liquidations.

Later cases have cited *Montana-Dakota Utilities* for the principle that the step transaction doctrine can disregard intermediate steps to tax the ultimate intended transaction. This case remains a key precedent in analyzing corporate acquisitions involving liquidations and basis determination.

