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Don't Forget the Step Transaction Doctrine

By Robert W. Wood • Wood & Porter • San Francisco

If you're like me, you've been obsessing about the newly codified economic substance requirement and its strict liability penalties. For prior coverage, *see* Robert W. Wood, *Health Care Reform and Economic Substance*, M&A TAX REP., May 2010, and Steven E. Hollingworth, *The "Codified" Economic Substance Doctrine,"* M&A TAX REP., May 2010. It's too soon to say how important that newly minted statutory provision—but decidedly not new concept—will prove to be.

Yet it's clear there is a coterie of other nonstatutory (and still *truly* not statutory) doctrines. Our old friend the step transaction doctrine is one of them. If you need proof that the step transaction doctrine needs to be considered across a veritable panoply of corporate and not-so-corporate transactions, take the recent Tax Court decision in *Klauer Manufacturing*, 99 TCM 1254, Dec. 58,172(M), TC Memo. 2010-65.

Klauer was an S corporation—an honest-to-goodness family business—operating a hardware and tin shop. This family company ventured into real estate, acquiring land in New Mexico that included approximately 2,581 acres known as the Taos Valley Overlook. From it, one could view the Rio Grande Gorge and the Rio Grande River.

Prior to 2001, Klauer had leased 700 acres of this land to the U.S. Department of the Interior's Bureau of Land Management (BLM) for a nominal $1 annual rental. The BLM used its adjacent government property along with this property as part of the Orilla Verde Recreation Area. The BLM approached Klauer a few times about buying the 700 acres outright, but the parties couldn't agree.

White Knight?

In 1999, the Trust for Public Land (a 501(c)(3) organization) contacted Klauer about the prime real estate in question. The Trust was clearly interested in the land, but was not in the financial position to acquire it.

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The Trust indicated that it was trying to acquire the land but it could make no commitments.

Instead, the Trust insisted that Klauer grant it an option to purchase annually a portion of the Taos Valley Overlook if and when (during each year) the Trust had the funds available to purchase such a portion. The family S corporation was willing to do this, but insisted that any portion of the Taos Valley Overlook (for which it granted the Trust a purchase option during the initial year) would have to border an exterior boundary of the Taos Valley Overlook.

Run for the Border

The idea was to ensure that if the Trust decided *not* to exercise its option to purchase any of the remaining property, Klauer would own the interior of the Taos Valley Overlook. That turned out to be a critical provision, as we'll see. The Trust did end up acquiring all of the Taos Valley Overlook, but the provision was later quite important for tax reasons.

On January 23, 2001, the Trust and Klauer Manufacturing entered into an option agreement. It provided that the Trust would purchase the Taos Valley Overlook property in a number of phases through the exercise of the options. For its 2001, 2002 and 2003 tax years, Klauer Manufacturing claimed a charitable contribution deduction based on a series of bargain sales. In each case, the bargain sale deduction flowed through to the S corporation's shareholders.

The IRS challenged the deductions, arguing that none of the sales in 2001 through 2003 constituted a bargain sale. Applying the step transaction doctrine, the IRS asserted, Klauer Manufacturing should be treated as having sold the 2,581 acres of the Taos Valley Overlook to the Trust in a single transaction on January 23, 2001. That was the effective date of the option agreement.

At that time, the property had a fair market value of $15 million, which was the total amount the Trust paid to Klauer in 2001, 2002 and 2003 to acquire all of the Taos Overlook Property. In contrast, Klauer Manufacturing contended that its respective sales to the Trust in 2001, 2002 and 2003 under the various options were bargain sales, in each case for a price that was less than the property's fair market value on the date of the respective sale.

The Tax Court agreed. Not only should that spark renewed use of bargain sales, but it might embolden other transactions that traditionally faced the step transaction gauntlet.

A bargain sale isn't always a bargain—it's more of a charity discount. If a taxpayer donates a $10 million building to charity, one values the building and the taxpayer claims a charitable contribution deduction. Of course, there may be percentage limits and restrictions on using the deduction. If the taxpayer sells the $10 million building to charity at that price, the taxpayer reports the sale exactly as if the buyer was an ordinary taxpayer rather than a charity.

But what about a combination of these two? Suppose the taxpayer sells the building to charity for $5 million, intending that its $10 million property transfer for $5 million amounts to a charitable contribution of the other $5 million? A bargain sale is that simple. Of course, as you might expect, there are appraisal requirements and a few special rules.

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No Steps

The step transaction doctrine may not be economic substance, but it is decidedly a substance-over-form concept. Reduced to simplicity, the step transaction doctrine treats a series of formally separate steps as a single transaction. Of course, not every series is a whole. The doctrine is supposed to integrate putatively distinct steps if in substance the steps are integrated, interdependent and focused on a particular result.

The courts have generally used three approaches in deciding whether to apply the step transaction doctrine to a given set of facts.

Binding Commitment

The narrowest approach is the "binding commitment" test. As its name suggests, this test looks at collapsing a series of transactions if, when the first step is taken, there was a binding commitment to undertake the later step(s). That is a narrow approach, since there are obviously plenty of practical ways of making sure that something actually happens in a series, even though there is no binding contract or commitment to effect the later parts of the deal.

End Result

Perhaps for that reason, many courts have adopted an "end result" test. This approach applies the step transaction doctrine where it appears that a series of formally separate steps are really pre-arranged parts of a single transaction. The idea is to discern whether the arrangement is intended from the outset to reach the ultimate result. Obviously, many transactions can be swept within the end result test that would pass muster under the binding commitment test.

Interdependence

Finally, there's the "interdependence" test. It is arguably more sophisticated than the end result or binding commitment approaches. Under the interdependence test, the focus is on whether the steps are so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the entire series. That sounds inherently subjective, but it is meant to be objective.

In some ways, this interdependence test may seem most frightening, since there are often portions of transactions, arguably even entire transactions, that may not have a distinct legal and/or tax impact.

Stepping up for Charity

Most step transaction cases involve corporate acquisitions and distributions. Not here. But despite the charitable contribution context, the nomenclature should be familiar to M&A Tax Report readers.

The court considered the binding commitment and end result tests, and found that both were not a problem on these facts. The option agreement between Klauer and the Trust did not require the Trust to exercise any or all of its options. In fact, under the agreement, the Trust's exercise of its option to acquire one phase of the property did not obligate it to exercise its option to acquire any other phase. There was therefore no binding commitment.

In fact, there was a distinct possibility that the Trust might be unable to obtain the funds needed to purchase a portion of the Taos Valley Overlook specified in the option agreement. If that would have occurred, the Trust simply would not exercise its option to purchase that portion. That would mean Klauer would have retained that portion.

And there was proof of this. Indeed, the Tax Court said that Klauer and the Trust did not have either an express or even an implied agreement or understanding that the Trust would exercise all of its options under the option agreement. With neither an express nor an implied agreement or understanding that the Trust would buy all of the Taos Valley Overlook, neither the binding commitment nor the end result test dictated application of the step transaction doctrine.

Interdependent or Distinct?

The interdependence test analysis in the *Klauer* case is even more interesting. The court concluded that the interdependence test simply didn't apply. The individual steps in the transaction had independent significance. They did not have meaning only as a part of the larger transaction. The Trust's exercise of one or more (but not all) of the various options it had under the option agreement would clearly not have been fruitless without the Trust exercising all of the options.

Again, the Trust's exercise of one option was not linked in any way to the others. In fact, the court pointed out that the parties had clearly contemplated the possibility that not all of the options would be exercised. The fact that the agreement required the Trust to make purchases bordering an exterior boundary of the Taos Valley Overlook was expressly negotiated as part of the deal. It was designed in order that Klauer could preserve its right to property in the interior of the Taos Valley Overlook in case (as was certainly possible, if not likely) the Trust might end up failing to exercise all of its options to purchase the remaining property.

Conclusion

If you are a fan of bargain sale transactions as I am, you'll particularly find *Klauer* to be an important case. Even if you are not, however, with all of the hype over codified economic substance, don't forget your old friends. It pays to remember that the step transaction doctrine (at least in the eyes of the IRS) is alive and well.