

Uniroyal (and Other) Buyouts: Revisiting the Step-Transaction Doctrine

by Robert W. Wood • San Francisco

The repurchase of shares appears to be in vogue. Buybacks are common, perhaps fueled by modest economic growth. For example, Mattel, Inc. reportedly plans to buy back ten million shares during the next four years. The trend has been significant, given that companies have found that they do not need cash for expansion. According to the *Wall Street Journal*, the volume of announced buyback programs has averaged \$9.53 billion per quarter since the surge began, up from \$5.36 million in earlier quarters. (See “Many Concerns Use Excess Cash To Repurchase Their Shares,” *Wall St. J.*, 7/2/93, p. C1.)

Buybacks are generally straightforward from a tax viewpoint, with redemption treatment to shareholders (assuming that the buyback is either substantially disproportionate, or not essentially equivalent to a dividend). Where subsidiaries are involved, companies frequently prefer dividend treatment to redemption treatment because of the dividends-received deduction.

Dividend vs. Sale

That was the case in *Uniroyal Inc.*, TCM 1993-214. There, the question was whether a \$16.5 million cash transfer to Uniroyal by a 50% subsidiary was a dividend to Uniroyal or part of the sale price of Uniroyal's stock in the subsidiary. The stock was sold after the dividend distribution, and the IRS sought to integrate the transactions.

In fact, the subsidiary paid \$16.5 million to each of the 50% parents, in cash to Uniroyal and in a note to the other parent. Shortly thereafter, the other parent purchased Uniroyal's stock in the subsidiary for \$14.5 million. Uniroyal treated the distribution as a dividend, and the stock sale as a separate transaction, but the IRS disagreed.

Step-Transaction Doctrine

Since the first transaction was structured as a dividend, the question was whether the dividend could

be disregarded as a separate transaction under the step-transaction doctrine. The Tax Court went through the more current step-transaction authorities, such as *Esmark, Inc.*, 90 TC 171 (1988), *aff'd*, 886 F.2d 1318 (CA-7, 1989), and *Walt Disney Inc.*, 97 TC 221 (1991). Much of the current authority suggests that the doctrine will be invoked successfully by the IRS only where there is a binding commitment to take the subsequent “steps.”

Indeed, the Tax Court in *Uniroyal* notes that the step-transaction doctrine is another rule of substance over form. Much of the recent case law has confused—or at least intertwined—the two notions. In any case, the step-transaction doctrine may now be easier for taxpayers to overcome than at any time in the past. The Supreme Court noted in *Gordon*, 391 US 83 (1967), that the step-transaction doctrine ought not to be applied (at least for purposes of determining control under Section 355) unless there was a binding commitment to take the subsequent steps. Later courts looked beyond this rigid binding commitment test, and the Tax Court, in *Penrod*, 88 TC 1415 (1987), citing *King Enterprises, Inc.*, 418 F.2d 511 (Ct. Cls., 1969), even stated that adherence to the binding commitment test would render the step-transaction doctrine a dead letter.

There have been many significant taxpayer victories on the step-transaction doctrine in recent years, including, in addition to *Esmark* and *Disney*, such notable cases as *Tandy Corp.*, 92 TC 1165 (1989), *Cal-Maine Foods, Inc.*, 93 TC 181 (1989), and *Anderson*, 92 TC 138 (1989). These victories suggest that the IRS should be limited in its invocation of the step-transaction doctrine. Nonetheless, there have been a few more aggressive applications of the step-transaction doctrine in classic reorganization situations, such as in *Associated Wholesale Grocers, Inc.*, 720 F.Supp. 887 (DC Kan., 1989). There, the court used the interdependence test to find that a cash merger was really a Section 332 liquidation.

The court in *Uniroyal* asked whether the transfer of the cash prior to the sale was merely a meaningless step in a step-transaction situation. This tautological statement seems to be similar to the independent significance notion, *i.e.*, that separate steps will be respected as long as each step has

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independent significance. In any event, the court in *Uniroyal* concluded that the cash dividend prior to the stock purchase had independent significance and therefore, the step-transaction doctrine should not be applied.

Today, the focus on the form of transaction surely eases the climate for taxpayers, as long as the various ramifications of the form of the transactions are truly followed. Given the anxiety long associated with these concepts, and their admitted lack of precision, the lesser concern with the step-transaction doctrine is a positive development. ■

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