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Not Your Father's Step Transaction Doctrine

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

With economic substance on the radar in Congress, and some likelihood that legislation on this perennial topic could actually pass, one of our other erstwhile nonstatutory favorites may also be ripe for review. Like prevailing political parties, concern over the step transaction doctrine ebbs and flows. Yet, it never entirely goes away. Broadly stated, the step transaction doctrine requires all steps in a single transaction to be integrated.

We seek to determine the true nature of the transaction as a whole, not adhering to (or respecting) the arguably artificial parts. The tax consequences attending the transaction must be applied to the whole, not to the ostensible parts. Primarily applied in corporate reorganizations, the step transaction doctrine has also been used in other contexts. [*See American Bantam Car Co.*, CA-3, 49-2 USTC ¶9471, 177 F2d 513 (1949), *cert denied*, 339 US 920 (1950).]

With near wizardry, the step transaction doctrine allows the IRS either to create a reorganization where one was not intended, or to deny tax-free reorganization treatment where one was intended. The IRS and the courts have developed a variety of factors to be used in assessing whether this imposing, inflexible doctrine should be applied. The major factors follow.

Are the Steps Interdependent?

The interdependence of various steps (the degree to which each one depends on the others), has long been considered relevant. Seemingly separate steps may be integrated if one step would have been fruitless without the others. A lack of mutual interdependence may result in the steps being treated as distinct.

Is There a Binding Commitment?

Historically, the most important factor has been whether there is a binding commitment to take each step in the series. In fact, the

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Supreme Court once suggested that the step transaction doctrine could not be applied *unless* there was a binding commitment to take all of the steps. [*See I. Gordon*, SCt, 68-1 USTC ¶9383, 391 US 83 (1967).] The IRS views such rigid adherence to binding contracts as preposterous, and most courts have also considered such an application as far too rigid. The Tax Court has even stated that adherence to a binding commitment test would render the step transaction doctrine a dead letter. [*See R.A. Penrod*, 88 TC 1415, Dec. 43,941 (1987), quoting *King Enterprises, Inc.*, CtCls, 69-2 USTC ¶9720, 418 F2d 511 (1969).]

Nevertheless, binding commitment analysis serves as a kind of outer limit to the doctrine, bracketing the range of authority. A good example of binding commitment analysis is *McDonald's of Illinois*, CA-7, 82-2 USTC ¶9581, 688 F2d 520 (1982), where there were merely pre-reorganization sale negotiations, and a sale occurred shortly after the reorganization. Mere negotiations have often not been enough.

For example, the *McDonald's of Illinois* analysis was distinguished in *E. Christian Est.*, 57 TCM 1231, Dec. 45,926(M), TC Memo. 1989-413 (1989). The Tax Court in *Christian* distinguished *McDonald's of Illinois*, noting the lack of express or implied intent to sell stock after the reorganization (although, in fact, it was sold). Moreover, the court found little probative value in the taxpayer's insistence on registered shares, which made a disposition of the shares easier.

How Much Time Elapsed?

The IRS and the courts have long considered the period of elapsed time between the various steps as relevant. The greater the time elapsing between the steps, the more difficult it is to integrate them. Conversely, the shorter the elapsed time, the easier it is to integrate them.

Notwithstanding the desirable simplicity of this factor, much of the case law has undercut its importance. Some cases have upheld the interdependence of steps occurring only hours apart. [*See Bruce v. Helvering*, CA-DC, 35-1 USTC ¶9166, 76 F2d 442 (1935); and *Henricksen v. Braicks*, CA-9, 43-2 USTC ¶9582, 137 F2d 632 (1943).] Conversely, some courts have applied the step transaction doctrine notwithstanding a lapse as long as several years between steps. [*See May Broadcasting Co.*, CA-8, 53-1 USTC ¶66,048, 200 F2d 852 (1953).] Appropriately, the focus in modern times is more on intent and less on timing.

What Is the Intention of the Parties?

This test generally focuses on the end result the parties have in mind, so it is variously described as the intent of the parties, or the "end result test." Few would argue that the intention of the parties in completing a transaction is irrelevant. Of course, such an intent must be gleaned from written documents, testimony or something else.

Sometimes there is a clear indication of the parties' intention. Sometimes it is clear that they need and want an ultimate result

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to be achieved after the entire series of transactions. In such a case, this intent will certainly bear on integration. [*See E. Vest*, 57 TC 128, Dec. 31,045 (1971), *aff'd* in part and *rev'd* in part on other grounds, CA-5, 73-2 USTC ¶9530, 481 F2d 238 (1973), *cert. denied*, 414 US 1092 (1973).] Under the end result or ultimate result test, a transaction is examined to determine whether it would be carried out in any event.

Stated differently, the inquiry is whether the end result sought by the taxpayer can be achieved only after *all* the steps have been taken. [*See M.M. Weikel*, 51 TCM 432, Dec. 42,868(M), TC Memo. 1986-58.] The end result test is often applied where there is no binding commitment to carry out all of the steps, but the parties intend all along to reach one goal (for example, to receive cash rather than stock).

How Do You Test?

The four factors identified above have done little to sharpen the focus of a step transaction inquiry. Not only that, but these tests have been unhelpful in aiding practitioners in applying it. One factor is given primary importance in one case, while another may be given short shrift. Hybrids of these factors also emerge and sometimes new tests altogether are enunciated.

For example, the presence or absence of a business purpose for each step is sometimes mentioned. A business purpose for separate steps was viewed as significant in *Weikel*, and the step transaction doctrine was not applied.

One widely discussed case nearly 20 years ago was *Esmark, Inc.*, 90 TC 171, Dec. 44,548 (1988), *aff'd*, CA-7 (unpublished opinion), 886 F2d 1318 (1989). That case arose out of the disposition of Esmark's Vickers Energy division. Esmark invited Mobil Oil to make a tender offer for Esmark's shares. Assuming Mobil acquired sufficient shares in Esmark, Esmark would then redeem the shares with virtually all outstanding shares of Vickers.

The transaction proceeded and Esmark did not receive any of the cash paid by Mobil to Esmark's public shareholders. A variety of tax issues were raised by the IRS, primarily focusing on whether Esmark would have to recognize $52 million in gain on the distribution of its Vickers stock to Mobil in exchange for Esmark's stock. On the step transaction point, the Tax Court mentioned the binding commitment, interdependence, and end result.

However, the Court focused on whether there were meaningful or unnecessary steps that should be ignored. Viewing the alternatives for the transaction, the Tax Court opined that no route was more direct. The *Esmark* court therefore found it acceptable that the parties chose the route calling for the least amount of tax.

This may remind some M&A TAX REPORT readers of the famous Learned Hand remark that "there is nothing sinister in so arranging one's affairs as to keep one's taxes as low as possible." On another occasion, Judge Hand noted that, "Any one may so arrange his affairs that his taxes shall be as low as possible." In *Esmark*, in the face of steps that each had permanent economic consequences (despite Mobil Oil's admittedly transitory ownership of shares), the transaction was respected. Esmark was criticized by some other cases (even in the same circuit) that have not been as favorable to taxpayers. [*See A.J. Schneider Est.*, CA-7, 88-2 USTC ¶9484, 855 F2d 435 (1988).]

Nail in the Coffin?

A few years ago some practitioners suggested that the step transaction doctrine might be a dead letter. Not so. In fact, even before the latest tax shelter era, there were signs it was heating up. For example, Rev. Rul. 2001-26, 2001-1 CB 1297, addresses two situations involving two-step stock acquisitions. The first step involved a tender offer for 51 percent of the outstanding stock of the target in exchange for stock of the parent/acquiring corporation. The second step involved a newly-formed subsidiary of the acquirer merging into the target in exchange for two-thirds parent voting stock and one-third cash in a statutory merger.

Rev. Rul. 2001-26 assumes that the steps are integrated under a reorganization plan, and that the reorganization requirements of the Code are met, except the requirement in Code Sec. 368(a)(2)(E)(ii) that the parent acquire control of the target in exchange for its voting stock. Nevertheless, the ruling concludes that this integrated acquisitive transaction satisfies the reverse subsidiary merger requirements of Code Sec. 368(a)(2)(E).

It is interesting to question whether existing step transaction authority supports this. The facts in the ruling, after all, do not indicate that the first step of the transaction was conditioned on the second. The merger was a unilateral act of the acquiring entity, undertaken to squeeze out minority shareholders. The ruling, though, says we should assume that the step transaction doctrine applies.

These assumptions, it turns out, are pretty critical. The ruling appears to assume that the tender offer and merger must be integrated. Indeed, some from the IRS have said that this ruling is not intended to say anything about when the step transaction doctrine does or does not apply. If you are confused, you are not alone.

Furthermore, Rev. Rul. 2001-46, 2001-2 CB 321, also addressed two-step acquisitions, this time dealing with assets. In the first step, the acquiring corporation acquired all of the target stock for 70-percent stock and 30-percent cash in a reverse triangular merger. The second step was an upstream merger of the target into the acquiring entity. The ruling concludes that the two mergers do not violate the policy underlying Code Sec. 338, given that the acquirer takes a carryover basis rather than a cost basis.

P.S.

There is a tendency to view the step transaction doctrine as an ineffective tool in the hands of the government. To some, this makes it a little like the non-tax avoidance doctrine contained in Code Sec. 269 (which has largely been ineffective for the government). One also thinks, more controversially, about the non-statutory substance over form concept. In any event, in administrative matters and in court, the reports of the step transaction doctrine's demise have been exaggerated.