Revisiting The Step Transaction Doctrine

By Robert W. Wood[1]

I. INTRODUCTION

There is perhaps no corporate tax doctrine more revered — or feared — than the step transaction doctrine. Although concern over the step transaction doctrine ebbs and flows, it never entirely goes away. Broadly stated, the step transaction doctrine requires all steps in a single transaction to be integrated in order to determine the true nature of the transaction. The tax consequences attending the transaction are then applied to the whole, rather than to the artificially separate parts. Primarily applied in corporate reorganizations, the step transaction doctrine has also been used in other contexts as well.[2]

II. HISTORICAL LOOK AT THE DOCTRINE

The step transaction doctrine allows the IRS either to create 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:

A. Interdependent Steps.

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.

B. Binding Commitment.

The most important factor historically has been whether there is a binding commitment to take each step in the series. The 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.[3] Most courts have considered this far too rigid, the Tax Court stating that adherence to a binding commitment test would render the step transaction doctrine a dead letter.[4]

A good example of binding commitment analysis is contained in *McDonald's of Illinois*,[5] where there were merely pre-reorganization sale negotiations, and a sale occurred shortly after the reorganization. However, mere negotiations have often not been enough. For example, the *McDonald's of Illinois* analysis was distinguished in *Estate of Elizabeth Christian*.[6] The Tax Court in *Christian* distinguished *McDonald's of Illinois*, *supra*, noting the lack of express or implied intent to sell stock after the reorganization (although, in fact, it was sold), and the lack of probative value presented by the taxpayer's insistence on registered shares (which, of course, made a disposition of the shares easier.

C. Elapsed Time.

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.[7] Conversely, some courts have applied the step transaction doctrine notwithstanding a lapse of several years between steps.[8] Understandably, the focus in modern times is more on intent and less on timing.

D. End Result/Intention of the Parties.

Few would argue that the intention of the parties in completing the transactions is irrelevant. Of course, its probative value must be gleaned from written documents, testimony, or something else. If there is a clear indication of the parties' intention, such as an ultimate result to be achieved after the entire series of transactions, this intent will certainly bear on integration.[9]

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.[10] 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).

III. APPLICATION OF THE DOCTRINE

The four factors identified above have done little to sharpen the focus of a step transaction inquiry, and certainly are 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 emerge as well as new tests altogether. For example, the presence or absence of a business purpose for each step is often mentioned. A business purpose for separate steps was viewed as significant in *Weikel*,[11] and the step transaction doctrine was not applied.

A widely watched and much celebrated case was *Esmark v. Commissioner*.[12] The 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 in the case, primarily focusing on whether Esmark would have to recognize $52 million in gain on the distribution of the 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 watch words, but 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. 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) which have not been as favorable to taxpayers.[13]

IV. IRS ISSUES GUIDANCE

Anyone who views the step transaction doctrine as a dead letter should look at several recent rulings. Revenue Ruling 2001-26,[14] addresses two situations involving two-step stock acquisitions. The first step involved a tender offer for 51% 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.

Revenue Ruling 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 Section 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 Section 368(a)(2)(E). Despite this conclusion, a number of practitioners have scratched their heads wondering how 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 Service 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.

Another recent ruling, Revenue Ruling 2001-46,[15] 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% stock and 30% 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 Section 338, given that the acquirer takes a carryover basis rather than a cost basis.

V. CONCLUSION

There is a tendency to view the step transaction doctrine as an ineffective tool in the hands of the government, not unlike the tax avoidance doctrine contained in Section 269 (which has largely been ineffective for the government), and the nonstatutory substance over form concept. Nevertheless, especially as an administrative matter — and in court as well — the step transaction doctrine is far from dead.

ENDNOTES

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2. For example, the step transaction doctrine has been employed under Section 351. See *American Bantam Car Company*, 177 F.2d 513 (3d Cir. 1949), *cert denied*, 339 U.S. 920 (1950).

3. See *Gordon*, 391 U.S. 83 (1967).

4. See *Penrod v. Commissioner*, 88 T.C. 1415 (1987), quoting *King Enterprises, Inc. v. U.S.*, 418 F.2d 511 (Ct. Cl. 1969).

5. 688 F.2d 520 (2d Cir. 1982).

6. T.C. Memo 1989-418 (1989).

7. See *Bruce v. Helvering*, 76 F.2d 442 (DC Cir. 1935) and *Henricksen v. Braicks*, 137 F.2d 637 (9th Cir. 1943).

8. See *May Broadcasting Co. v. U.S.*, 200 F.2d 852 (8th Cir. 1953).

9. For example, see *Vest*, 57 T.C. 128 (1971), *aff'd in part and rev'd in part on other grounds*, 481 F.2d 238 (5th Cir. 1973), *cert. denied*, 414 U.S. 1092 (1973).

10. Regarding the end result test, see *Weikel v. Commissioner*, T.C. Memo 1986-58 (1986).

11. T.C. Memo 1986-58 (1986).

12. 90 T.C. 171 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989).

13. See *Schneider Estate* 855 F.2d 435 (7th Cir. 1988).

14. 2001-23 I.R.B. 1297.

15. 2001-42 I.R.B. 1.