Step Transaction Missteps

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The step-transaction doctrine requires all steps in a single transaction to be integrated.

It seeks to determine the true nature of an entire transaction, without regard for the tax treatment of arguably artificial parts. It is primarily applied in corporate reorganizations, but the step-transaction doctrine has also been used in a variety of other contexts. [*See American Bantam Car Co.,* CA-3, 49-2 USTC ¶9471, 177 F2d 513 (1949), *cert denied*, 339 US 920 (1950).]

Perhaps because it is nonstatutory and nonformulaic in nature, tax practitioners sometimes fear it. Some should. After all, it allows the IRS either to create a reorganization where one was not intended, or to deny tax-free reorganization treatment where one was intended.

That makes it potent. Yet it is not without form. The IRS and the courts have developed factors to be used in assessing when the doctrine should be applied. The major factors follow.

Binding Commitment

Historically, the most important factor used in applying the step-transaction doctrine has been whether there is a binding commitment to take each step in the series. In fact, 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. [*See I. Gordon*, SCt, 68-1 USTC ¶9383, 391 US 83 (1967).] Not surprisingly, of course, the IRS views such rigid adherence to binding contracts as preposterous.

Slightly more surprising is the fact that most courts have also considered such an application as far too rigid. The binding commitment test is too narrow. You should not assume that you are out of the woods merely because there is no binding commitment. 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).]

Binding-commitment analysis serves as a kind of outer limits to the doctrine, bracketing the range of authority. A good example of binding-commitment analysis appears in *McDonald's of Illinois*, CA-2, 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.

Interdependent Steps

The degree to which each step depends on the others has long been considered relevant in applying the step-transaction doctrine. Separate steps may be integrated if one step would have been fruitless without the others. Conversely, a lack of mutual interdependence may result in the steps being treated as distinct.

Elapsed Time

The IRS and the courts have long considered the elapsed time between the steps to be relevant. The greater the time between the steps, the more difficult it is to integrate them. Conversely, the shorter the elapsed time, the easier it is to integrate them. This is awfully general but it is also awfully obvious.

Yet much of the case law has undercut the importance of this elapsed time factor. Some cases have upheld the interdependence of steps occurring only hours apart. [*See E. Bruce*, 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 ¶66048, 200 F2d 852 (1953).]

This can lead to understandable frustration. Clients and advisors are both unhappy when it is impossible to say how long (of a wait) is long enough. Fortunately, the current trend is to focus more on intent and less on timing.

Intention of the Parties/End Result

Plainly, the intention of the parties in completing a transaction is relevant to assessing its tax consequences. Documents and correspondence can be telling and even damning. After all,

that intent must be gleaned from written documents, testimony, *etc.*

The end result the parties have in mind for the transaction is variously described as the intent of the parties or the end result test, and both terms are used. Sometimes there is a clear indication of the parties' intention. Sometimes it is clear that they want an ultimate result after the entire series of transactions.

In such a case, this intent will certainly bear on integration. [*See 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 ¶9513, 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).

Applying the Tests

These tests have generally been unhelpful to taxpayers and advisors. They are not even exclusive. Hybrids emerge and sometimes new tests altogether are enunciated. For example, the presence or absence of a business purpose for each step is sometimes mentioned. Other times it is not.

Some practitioners may feel that as long as there was no binding commitment to carry out all the steps, the step-transaction doctrine is largely toothless. Yet that has not proven to be true. 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, a section that has largely been ineffective for the government. More controversially, there is also the nonstatutory substance-over-form concept. Then of course we have economic substance concepts in both their nonstatutory and more recent statutory guises.

As with all of these glosses on taxpayer behavior, the step-transaction doctrine should not be overlooked.

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