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THE STEP TRANSACTION DOCTRINE

PRIMER

Introduction

The Step Transaction Doctrine (Step Doctrine) determines whether the court should treat a series of transactions as a single taxable event for federal tax purposes.

A series of interrelated transactions may attract different tax consequences depending on whether the transactions are considered individually or whether they are viewed together as component parts of an overall transaction. Courts apply the Step Doctrine to ensure that federal tax liability is based on a realistic view of the substance of the entire transaction instead of viewing steps of a transaction in isolation.[1]

The application of the Step Doctrine results in an amalgamation of a series of purportedly distinct single-step transactions into one multi-step transaction.[2] The effect of this integration is that the series of transactions are treated as a single taxable event.[3] As stated by the U.S. Supreme Court, "federal tax liability may be based on a more realistic view of the entire transaction" by "linking together all interdependent steps with legal or business significance, rather than taking them in isolation".[4]

This primer explains the Step Doctrine and its purpose, as well as the three legal tests used by courts to apply the Step Doctrine: (1) the end result test; (2) the mutual interdependence test; and (3) the binding commitment test.[5]

Purpose and Invocation of the Step Doctrine

The Step Doctrine is a part of a series of judicial *substance over form* doctrines designed to combat tax sheltering activities.[6] These judicial doctrines all seek to invalidate transactions that would achieve a result that undermines the Code's intent, particularly when the form of a transaction allows an entity to complete that transaction in an indirect manner to avoid the tax consequences of a more direct approach.

The Step Doctrine is a common-law concept and is not codified in the *Internal Revenue Code* ("IRC"). Courts most frequently invoke the Step Doctrine in cases involving complex corporate transactions, which often reference §301 – 391 of the IRC: 'Corporate Distributions and Adjustments'.[7]

The purpose of the Step Doctrine is to prevent transactional practices that enable abusive tax practices while formalistically complying with statutory provisions.[8] Because the IRC contains numerous provisions which stipulate the tax treatment of a specific type of discrete transaction, the form of a series of transactions can conceal the overall substance of the totality of transactions. The Step Doctrine seeks to prevent transactional maneuvers that undermine the intention behind statutory tax provisions.

Tax authorities typically raise the Step Doctrine to integrate a series of allegedly discrete and single-step transactions into one multi-step transaction, and subsequently treat that integrated transaction as a single event for tax purposes. Although less common, taxpayers can also raise the Step Doctrine to characterize their transaction(s) for a more favorable tax consequence.

The Legal Test(s)

Courts often, but not always, employ at least one of the following three tests when they apply the Step Doctrine: (1) the end result test; (2) the mutual interdependence test; and (3) the binding commitment test.[9]

Courts most frequently apply the end result test, periodically apply the mutual interdependence test, and rarely apply the binding commitment test.[10]The nature of the transaction under scrutiny will determine which test, if any, the court will apply.

These tests are widely applicable to any type of taxable transaction, and can be raised by any party to a dispute. Whether taxes owed would increase or decrease according to the application of the Step Doctrine is immaterial to its application. More than one test may be applicable in a scenario, but a scenario need only satisfy one of the tests for the Step Doctrine to apply.[11]

The End Result Test

The end result test asks whether "a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result."[12] Under the end result test, "purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."[13]

Although tax minimization is permissible, the end result test focuses on whether a taxpayer designed a series of transactions specifically to achieve some premeditated result.

The end result test focuses on the cumulative result of related single-step transactions and is the easiest test to satisfy under the Step Doctrine. If a court determines that the single-step transactions were components of a previously-contemplated multi-step transaction intended towards the same end result, and each of those transactions was executed solely to achieve the intended final result, a court will likely apply the Step Doctrine to amalgamate those steps.[14]

Courts take a subjective approach when they apply the end result test and examine whether a taxpayer intended to achieve some premeditated end result by structuring a series of transactions in a particular way.[15] It is immaterial whether a taxpayer intended to avoid or reduce taxes. Courts will likely apply the end result test when there is evidence of a taxpayer's intention to achieve some desired goal.

The Mutual Interdependence Test

The mutual interdependence test asks whether apparently discrete single-step transactions are interdependent to the extent that "the legal relations created by one transaction would have been fruitless without a completion of the series [of related transactions]."[16] Under the mutual interdependence test, a court will integrate purportedly discrete transactions if "it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts..."[17]

The mutual interdependence test focuses on the relationships between the steps in an allegedly multi-step transaction. If discrete single-step transactions would lack economic or business significance without other steps in the purported multi-step transaction, the court will likely apply the Step Doctrine.[18] Courts take an objective approach when they apply the mutual interdependence test, and examine the relationship between each of the steps involved in an allegedly multi-step transaction, regardless of a taxpayer's intended result for each step.[19]

The Binding Commitment Test

The binding commitment test integrates a series of allegedly single-step transactions into one multi-step transaction "if, at the time the first step is entered into, there was a binding commitment to undertake [a] later step."[20]

The binding commitment test is the strictest of the Step Doctrine's tests and focuses on the existence of a binding commitment between parties to an allegedly multiple-step transaction.[21] The binding commitment test relies heavily on documentary evidence. Courts will usually apply the binding commitment test if there is concrete evidence of a binding commitment to take additional steps (after the execution of a first step) to achieve a premeditated result, or if the steps of an allegedly multi-step transaction are executed over many years. [22]

An Example of the Step Doctrine's Application

The case of *McDonald's Restaurants of Illinois, Inc. v. Commissioner of Internal Revenue* exemplifies the application of the Step Doctrine's three tests.[23] McDonald's Restaurants of Illinois ("**McDonalds**") and The Garb-Stern Group ("**GSG**") were corporations which owned numerous subsidiaries, all of which operated as restaurants. GSG merged all of its subsidiaries into McDonalds in exchange for unregistered McDonalds stock. Part of the McDonalds-GSG agreement provided that GSG may participate in any McDonalds stock registration

in the next six years or enforce a McDonalds stock registration in the next year. GSG participated in a McDonalds-planned stock registration shortly after the GSG-McDonalds agreement and GSG sold GSG's McDonalds stock immediately.

McDonalds recorded the acquisition of the restaurant assets as a "pooling of interests" in their financial statements for that fiscal year, but recorded the acquisition as a "purchase" in their tax returns for that same fiscal year. As a result, McDonalds gave itself a stepped-up basis in the assets acquired from GSG, and the value of that stepped-up basis was based on the profit GSG realized when GSG liquidated GSG's McDonalds stock. McDonalds allocated the cost basis among various assets, then distributed those assets to its subsidiaries. McDonalds' subsidiaries used that basis to compute depreciation costs in their tax returns.

The tax authorities took the position that McDonalds' subsidiaries must use GSG's original cost basis in the assets and assessed a deficiency in McDonalds' subsidiaries tax returns for that year. However, the court decided to apply the Step Doctrine because this situation satisfies all three tests; the court renders the merger and subsequent stock sale as one multi-step transaction. The Court ruled:

- the end result test was satisfied because the parties intended to allow GSG to cash out of the transaction in a way that allowed McDonalds to use creative accounting methods;

- the mutual interdependence test was satisfied because the court determined GSG would not have agreed to the merger without a virtual guarantee in the merger agreement that the McDonalds stock received by GSG would or could be highly liquid; and

- the binding commitment test was satisfied because GSG sold the McDonalds stock within 6 months of acquiring the stock, the McDonalds stock would almost certainly not have been transferable without the registration contemplated in the McDonalds-GSG contract, and GSG could enforce a registration to guarantee the salability of the McDonalds stock if GSG wished.

Blue J Legal Products

The Step Doctrine is not always mentioned, nor is the possibility of its application always obvious, in cases involving complex transactions. Blue J Legal's U.S. Tax Foresight offers a series of products that explore the "Step Transaction Doctrine." The product can help you determine whether a series of transactions in which a taxpayer engaged are likely to be treated as mere steps of a multi-step transaction for U.S. tax law purposes. By completing a questionnaire based on the factors which inform the three legal tests detailed above, Blue J Legal's Tax Foresight will compute the applicability of the Step Doctrine to your specific scenario, and compare your scenario to relevant previously-decided cases..

Endnotes

1 See e.g. *King Enterprises, Inc. v. United States*, 418 F.2d 511, 517, 189 Ct.Cl. 466 (Fed. Cl., 1969) [*hereinafter King*].
2 *Crenshaw v. United States*, 450 F.2d 472, 475 (5th Cir. 1971).
3 See e.g. *King, supra* note 1 at 516.
4 *Commissioner of Internal Revenue v. Clark* 489 U.S. 726, 738, 109 S.Ct. 1455, (1989).
5 See e.g. *Penrod v. Commissioner of Internal Revenue*, 88 T.C. 1415, 1429 – 1433, 1987 WL 49335, (1987) [hereinafter *Penrod*].
6 See e.g. Office of Chief Counsel Internal Revenue Service, *Opinion – Substance Over Form – Preferred Stock Acquisition*, https://www.irs.gov/pub/irs-wd/r_10012.pdf at 2.
7 26 U.S.C. §301 – 391; The following IRC sections are most frequently mentioned in corporate transaction cases involving the Step Doctrine: §332, §338, §351, §354, §355, §362, and §368.
8 See e.g. *King, supra* note 1 at 516 – 517.
9 See e.g. *Penrod, supra* note 5 at 1429, 1433; for an instance of the Doctrine's application where the court does not employ the Step Doctrine's tests, see e.g. *Broz v. Commissioner of Internal Revenue*, 137 T.C. 46, 63, (2011);
10 *Penrod, supra* note 5 at 1429.
11 See *McMillin-BCED/Miramar Ranch North v. County of San Diego*, 31 Cal.App.4th 545, 556, 37 Cal.Rptr.2d 472, (1995).
12 *Penrod, supra* note 5 at 1429.
13 See e.g. *King, supra* note 1 at 516.
14 Office of Chief Counsel Internal Revenue Service, *Step Transaction Doctrine Memorandum*, (February 26, 2008) https://www.irs.gov/pub/irs-wd/0826004.pdf at 2; see also e.g. *Penrod, supra* note 1 at 1429.
15 See e.g. *Brown v. U.S.*, 782 F.2d 559 (6th Cir., 1986), 563.
16 *American Bantam Car Co. v. Commissioner of Internal Revenue*, 11 T.C. 397, 405 (1948); see also *Redding v. C. I. R.*, 630 F.2d 1169, 1177, (7th Cir., 1980).
17 *Kuper v. Commissioner of Internal Revenue*, 533 F.2d 152 (5th Cir., 1976) at 156.
18 *Cal-Maine Foods, Inc. v. Commissioner of Internal Revenue*, 93 T.C. 181, 199, 1989 WL 87697 (1989).
19 *Kornfeld v. Commissioner of Internal Revenue*, 137 F.3d 1231, 1235, (10th Cir., 1998).
20 Penrod, *supra* note 5 at 1429.
21 *Gordon Bann v. Commissioner of Internal Revenue*, 391 U.S. 83, 96, 88 S.Ct. 1517, 20 L.Ed.2d 448 (1968); see also *Penrod*, *supra* note 5 at 1429.
22 *McDonald's Restaurants of Illinois, Inc. v. Commissioner of Internal Revenue*, 688 F.2d 520 (7th Cir., 1982) [hereinafter McDonald's Restaurants].
23 This example is based on McDonald's Restaurants.