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The Step Transaction Doctrine – Sword or Shield

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Similar to the complicated storylines in *Game of Thrones*, business transactions can also be very complicated. Decisions made by a character in the show (or novels) may be perceived one way when viewed in a vacuum, but differently in the grand scheme of things. Just as Tyrion Lannister uses words as a sword or shield to navigate the Seven Kingdoms, so too can the step transaction doctrine be used to navigate U.S. tax laws.

What is the Step Transaction Doctrine?

The step transaction doctrine is a common law judicial doctrine that seeks to address potential taxpayer abuse by generally providing for various transaction steps to be recast as a single transaction for U.S. federal income tax purposes.

When is the Step Transaction Doctrine Applicable?

The application of this doctrine should be considered when a company engages in a series of transactions that generally involve distributions, redemptions, sales, or mergers and acquisitions. A series of related transaction steps may be subject to the step transaction doctrine if they meet one of three tests: (1) the binding commitment test, (2) the end result test, or (3) the interdependence test.[1]

The binding commitment test inquires as to whether there was a legally binding commitment to undertake the later step in a series of transactions.[2] The end result test analyzes whether the series of separate steps were really part of a single scheme designed to achieve the ultimate result.[3] Under this test, if a "series of closely related steps in a transaction are merely the means to reach a particular result" the steps will be treated as a single transaction.[4] The end result test focuses on the subjective intent of the taxpayer to allow the court to determine whether a taxpayer "directed a series of transactions to an intended purpose."[5] The interdependence test inquires as to 'whether under a reasonably objective view the steps were so interdependent that the legal relations created by one of the transactions seem fruitless without completion of the series.'"[6]

There have been numerous cases and guidance issued by the Internal Revenue Service (the "Service") where the step transaction doctrine has been applied as a sword or shield.

As a Sword

In *Uniroyal Inc. and Consolidated Subsidiaries v. Commissioner,* Uniroyal Inc. ("Uniroyal") and ICI Americas, Inc. ("ICI") each held 50 percent of the outstanding stock of Rubicon Chemicals, Inc. ("Rubicon").[7] As part of a broader restructuring to separate Rubicon's businesses, Rubicon distributed a dividend to Uniroyal in the form of a promissory note prior to the sale of Rubicon to ICI. The Service argued that the step transaction doctrine should apply to integrate the dividend and sale together. The Tax Court concluded that the steps should be respected as two separate transactions even though the steps occurred only a few days apart because there was a business purpose for the structure and there was no binding agreement for the sale to take place before the dividend. The Tax Court distinguished the facts of two other cases¸ *Waterman Steamship*[8] and *Litton Industries*[9], based on certain facts and circumstances such as timing between the steps, the business purpose, costs, and the subsidiary's ability to make a dividend distribution.

Under the facts of Rev. Rul. 2008-28, the selling corporation and purchasing corporation intended to effectuate a tax-free reorganization. The purchasing corporation formed a new transitory merger subsidiary for the purpose of merging it with and into the selling corporation's subsidiary, the target corporation. In the merger, the purchasing corporation acquired all of the stock of the target corporation. Thereafter, pursuant to a plan, the target corporation completely liquidated into the purchasing corporation. The ruling concluded that even though each separate step qualified for tax-free treatment, the steps should be recast and treated as a taxable purchase of the target subsidiary's stock followed by a tax-free liquidation of the target subsidiary. A serious consequence since the selling corporation was expecting a favorable tax result.

As a Shield

Even though there is quite a bit of uncertainty in the treatment of a series of steps that occur close in proximity, the step transaction doctrine does not always apply to destroy steps like Frey daggers at the Red Wedding. There are authorities that allow a taxpayer to use the step transaction doctrine as a taxpayer-friendly planning tool. For example, a corporation could use it to collapse certain steps (out of a series of steps) into a reorganization under Section 368(a)(1)(F) of the Internal Revenue Code (i.e., F reorganization). This transaction is often referred to as an "F in a Bubble" since it generally turns off the step transaction doctrine with respect to other steps that occur before or after the F reorganization.[10]

Although the step transaction doctrine and its various tests are commonly used in tax law,[11] courts have also applied similar principles to bankruptcy cases as "collapsing transactions."[12]

Prepare for Winter

The application of the step transaction doctrine to recast a series of steps can significantly alter a company's intended business, legal, and tax consequences. A company should keep this doctrine at the top of mind when planning a transaction involving a series of other transactions close in time. This is especially true if the transaction steps take place during the same tax year. By considering the step transaction doctrine early in the process, a company is better positioned to determine whether its business objectives outweigh the possible tax consequences.

The facts and circumstances surrounding the various transaction steps, such as the timing, business purpose, and non-tax motives, are important factors to consider. Having a binding commitment to do X within a few months of Y could result in significant, unexpected tax consequences.

If your business attorney is not also your tax attorney, then it is important to ensure that the two practitioners discuss the transaction steps early when contemplated rather than when Winter (i.e., the Service) Comes...

[1] *McDonald's Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982).
[2] *See Commissioner v. Clark v. Gordon, 391 U.S. 83, 96 (1968)*; *Penrod v. Commissioner*, 88 T.C. 1415, 1429 (1987).
[3] *See Packard v. Commissioner* 85 T.C. 397, 420 (1985).
[4] *True v. U.S.*, 190 F.3d 1165, 1175 (10th Cir. 1999), citing *Kanawha Gas & Utils. Co. v. Commissioner*, 214 F.2d 685, 691 (5th Cir.1954).
[5] *See True v. U.S.*, 190 F.3d 1165, 1175 (10th Cir. 1999), citing *Brown v. U.S.*, 783 F.2d 559, 563 (6th Cir. 1986).
[6] *See Security Industrial Ins. Co. v. U.S.*, 702 F.2d 1234, 1247.
[7] T.C. Memo. 1993-214.
[8] 430 F.2d 1185 (5th Cir. 1970).
[9] 89 T.C. 1086 (1987).
[10] *See generally* Treas. Reg. § 1.368-2(m).
[11] See e.g., *Commissioner v. Clark*, 489 U.S. 726, 738 (1989).
[12] *See e.g., In re Old CarCo LLC,* 435 B.R. 169, 185 (Bankr. S.D.N.Y. 2010).

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