

RETHINKING THE ROLE OF THE JUDICIAL STEP TRANSACTION PRINCIPLE AND A PROPOSAL FOR CODIFICATION

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Since *Gregory v. Helvering*,¹ courts have been applying various “common law” doctrines, such as substance over form, step transaction, business purpose, sham transaction, and economic substance to challenge tax motivated transactions.² These doctrines have played an important role in numerous court decisions³ and in the recent

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1. 293 U.S. 465 (1935).

2. See generally, Yoram Keinan, *The Many Faces of the Economic Substance’s Two-Prong Test: Time for Reconciliation?* 1 N.Y.U. J. BUS. & LAW 372 (2005).

3. *Killingsworth v. Comm’r*, 864 F.2d 1214, 1216 (5th Cir. 1989) (“Since *Gregory* was decided, courts have consistently held that although a transaction may, on its face, satisfy applicable Internal Revenue Code criteria, it will nevertheless remain unrecognized for tax purposes if it is lacking in economic substance”); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (dealing with economic substance or reality of sale and leaseback transactions); *Knetsch v. United States*, 364 U.S. 361 (1960) (discussing interest expense deductions disallowed because only thing of substance to be realized from transaction was tax deduction); *Comm’r v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (recognizing the step transaction doctrine, whereby courts must consider all steps of transaction in light of entire transaction, so that substance of transaction will control over form of each step); *ACM P’ship v. Comm’r*, 157 F.3d 231, 233-43 (3d Cir. 1998), *aff’g in part and rev’g in part* 73 T.C.M. (CCH) 2189 (1997). (holding that the sophisticated investment partnership was formed solely to generate a capital loss to shelter some of Colgate-Palmolive’s capital gains); *N. Ind. Pub. Serv. Co. v. Comm’r*, 115 F.3d 506 (7th Cir. 1997) (affirming the tax court’s determination that a program designed to increase leverage by obtaining funds from a Netherlands corporation was not a sham and the tax benefits claimed were appropriate); *Kirchman v. Comm’r*, 862 F.2d 1486, 1491-95 (11th Cir. 1989); (holding that option straddles were entered into to produce deductions with little risk of real loss); *Karr v. Comm’r*, 924 F.2d 1018, 1021-25 (11th Cir. 1991) (holding that energy enterprise were developed solely to produce deductible losses for investors); *Rice’s Toyota World, Inc. v. Comm’r*, 752 F.2d 89 (4th Cir. 1985) (holding that sale-

government's proposals to fight corporate tax shelters.⁴ An important feature of the common law doctrines is that they overlap each other in many cases, and it is not uncommon for a court to decide to deny or not to deny benefits on the grounds of more than one doctrine.⁵

In many cases, taxpayers have adopted transaction forms that differ from the true substance of the underlying transactions.⁶ This situation is

leaseback of a computer by a car dealership was entered into solely to generate depreciation deductions); *Goldstein v. Comm'r*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance). See generally Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000); Boris I. Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 HOW. L.J. 693, 707 (1978); Department of the Treasury, General Explanations of the Administration's Revenue Proposals, Corporate Tax Shelters (Feb. 1999), available at <http://www.ustreas.gov/press/releases/docs/grnbk99.pdf> (last visited Jan. 23, 2007).

4. STAFF OF THE JOINT COMMITTEE ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-2-05 (2005), available at <http://www.house.gov/jct/s-2-05.pdf>. ("courts have applied the [common law] doctrines to deny tax benefits arising from certain transactions.") In a subsequent summary, the JCT elaborated:

Recent tax avoidance transactions have relied upon the interaction of highly technical tax law provisions to produce tax consequences not contemplated by Congress. A strictly rule based tax system cannot prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences. Thus, many courts have long recognized the need to supplement tax rules with anti-avoidance standards, such as the "economic substance" doctrine, in order to assure the Congressional purpose is achieved. Under present law, there is a lack of uniformity among the courts regarding the application of the economic substance doctrine.

The proposal provides a uniform standard for applying the economic substance doctrine to transactions having any of six characteristics present in many tax shelters. Under the uniform standard, for a transaction to have economic substance, a taxpayer must demonstrate that the transaction had a substantial non-tax purpose and changed the taxpayer's economic position in a meaningful way (apart from Federal tax consequences). The fact that financial accounting benefits would result from the desired tax treatment is not itself an allowable non-tax purpose. For transactions other than those with any of the six characteristics, the proposal retains present law.

Joint Committee on Taxation, *Summary of Joint Committee Staff "Options to Improve Tax Compliance and Reform Tax Expenditures"*, Tax Notes Today, April 12, 2005, LEXIS, 2005 TNT 72-32.

5. See STAFF OF THE JOINT COMMITTEE ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-2-05 (2005), available at <http://www.house.gov/jct/s-2-05.pdf>. ("The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS"); *Long-Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 171 (D. Conn. 2004), *aff'd per curiam*, 150 Fed. Appx. 40 (2d Cir. 2005) ("The terminology used, whether sham, profit motivation, or economic substance, is not critical, rather the analysis evaluates both the subjective business purpose of the taxpayer for engaging in the transaction and the transaction's objective economic substance").

6. See *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252, 255 (1939) ("In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding").

commonly referred to as the “substance-over-form” principle, pursuant to which a court can reclassify a transaction in accordance with its form.⁷ In 1945, in *Comm’r v. Court Holding Co.*, the Supreme Court held that:

The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. . . . To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.⁸

The IRS has generally invoked the substance-over-form principle in cases where the form of the transaction differed from its substance and disallowed the associated tax benefits.⁹

Nevertheless, where substance and form differ by the taxpayer’s own choice, taxpayers may be required to suffer the tax consequences of their form.¹⁰ Generally, the IRS can prevent taxpayers from disavowing the form of their transactions, absent “strong proof” in some courts,¹¹ and an even stricter standard referred to as the “Danielson” rule in other courts.¹² In other words, the courts over the years have supported the government’s efforts both to assert substance over form but also to require taxpayers to suffer the consequences of the form they have selected.¹³

The general doctrine of substance-over-form, however, has taken various directions, with the creation of other related common law doctrines. Generally, the doctrines that have emerged can be divided

7. *United States v. Scott*, 37 F.3d 1564, 1572 (10th Cir. 1994) (“[T]he income tax consequences under the Internal Revenue Code depend upon the substance of the situation, not the form.”). *See also Newman v. Comm’r*, 902 F.2d 159, 162 (2d Cir. 1990) (“[I]n reviewing a transaction for tax consequences, the substance of the agreement takes precedence over its form”).

8. *Court Holding Co.*, 324 U.S. at 334.

9. *Id.* *See also* Diane K. Klopsch, *What are the Real Requirements for Interest Deductibility? An Analysis of Revenue Procedure 94-27*, 21 U. DAYTON L. REV. 145, 148-53 (1995) (discussing the courts’ and the IRS’s use of the substance-over-form doctrine in income tax law).

10. *Comm’r v. Nat’l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974); *Comm’r v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967).

11. *Schultz v. Comm’r*, 294 F.2d 52, 55 (9th Cir. 1961) *aff’g* 34 T.C. 235 (1960) (quoting *Ullman v. Comm’r*, 264 F.2d 305, 307-08 (2d Cir. 1959)); *Kreider v. Comm’r*, 762 F.2d 580, 586-87 (7th Cir. 1985); *Major v. Comm’r*, 76 T.C. 239, 249 (1981).

12. *Danielson*, 378 F.2d at 775 (3d Cir. 1967).

13. *Id.*

into two subtests under the substance-over-form doctrine:¹⁴ (i) the economic substance/sham transaction doctrines (with the business purpose doctrine included as the subjective prong), and (ii) the step transaction doctrine.¹⁵ The latter one is the subject of this article.

The step transaction doctrine has played an important role in challenging tax shelters.¹⁶ As early as 1938, the United States Supreme Court has indicated that “a given result at the end of a straight path is not made a different result because reached by following a devious path.”¹⁷ Courts apply the step transaction doctrine in cases where taxing the individual steps of a transaction rather than the transaction as a whole would eviscerate the substance of the transaction resulting in improper tax treatment of the whole transaction.¹⁸ If the court finds that applying the doctrine is appropriate it can either: (i) disregard transactions or steps in a transaction that it believes are unnecessary,¹⁹ or (ii) change the order of such transaction or steps.²⁰ Nevertheless, the IRS may not “generate

14. See Edward A. Morse, *Reflections on the Rule of Law and 'Clear Reflection of Income': What Constrains Discretion?* 8 CORNELL J.L. & PUB. POL'Y 445, 471 (1999) (“Substance over form and its variations, including ‘step transaction’ and ‘business purpose’ doctrines, are prominent examples of judicially-developed interpretive doctrines that courts use to avoid textual constraints, particularly when the text produces a result unfavorable to the Government”).

15. See *True v. United States*, 190 F.3d 1165, 1174 (10th Cir. 1999) (referring to the step transaction doctrine as an “incarnation of the basic substance over form principle”); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244 (5th Cir. 1983) (“The step transaction doctrine is a corollary of the general tax principle that the incidence of taxation depends upon the substance of a transaction rather than its form”); *Brown v. United States*, 782 F.2d 559, 563 (6th Cir. 1986).

16. Jay A. Soled, *Use of Judicial Doctrines in Resolving Transfer Tax Controversies*, 42 B.C. L. REV. 587, 597-98 (2001).

Just as was the case with the substance over form doctrine and the business purpose doctrine, the step transaction doctrine has become a central feature in income tax adjudication. Its use is particularly pronounced in the corporate income tax area of the law. [footnote omitted] Courts skillfully apply this doctrine to see the forest rather than taxpayers’ deliberately planted trees that would otherwise camouflage their carefully laid tax avoidance schemes.

Id.

17. *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938). See also *Comm’r v. Clark*, 489 U.S. 726, 738 (1989).

18. *Del Commercial Props., Inc. v. Comm’r*, 251 F.3d 210, 213-14 (D.C. Cir. 2001) *aff’g* 78 T.C.M. (CCH) 1183 (1999). (“[A] particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes.”); *Grove v. Comm’r*, 490 F.2d 241, 246 (2d Cir. 1973) (noting that the step transaction doctrine applies to “meaningless intervening steps in a single, integrated transaction designed to avoid tax liability by the use of mere formalisms”).

19. *Andantech L.L.C. v. Comm’r*, 83 T.C.M. (CCH) 1476, *97 (2002). See also *Andantech L.L.C. v. Comm’r*, 331 F.3d 972, 981-82 (D.C. Cir. 2003).

20. *Comm’r v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (“To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress”).

events which never took place just so an additional tax liability might be asserted.”²¹

The courts have articulated three different threshold tests for determining when it is appropriate to apply the step transaction doctrine: (1) the “binding commitment” test; (2) the “end result test;” and (3) the “mutual interdependence” test.²² Nevertheless, as discussed in this article, the first test is rarely used, and the other two are generally not different from each other as a practical matter.

The step transaction doctrine was rarely discussed by commentators as opposed to the economic substance doctrine, which has drawn the attention of many commentators.²³ In my view, this is probably due to the fact that while the economic substance doctrine has been applied very inconsistently among Circuit Courts,²⁴ there is less confusion in regards to the application of the step transaction doctrine. In general, the main controversy pertaining to the application of the step transaction principle is whether the court can apply the doctrine if each step by itself or the whole transaction has economic substance/business purpose. As this article will show, courts are generally divided with respect to this issue.

While in the past, in many cases (such as *True v. U.S.*²⁵ and

21. *Grove*, 490 F.2d at 247 (“[u]seful as the step transaction doctrine may be . . . it cannot generate events which never took place just so an additional tax liability might be asserted”) (quoting *Sheppard v. United States*, 361 F.2d 972, 978 (1966)). See also *Esmark, Inc. v. Comm’r*, 90 T.C. 171, 196-97 (1988) (same); *Greene v. United States*, 13 F.3d 577, 583 (2d Cir. 1994) (“Of course, the [step transaction] doctrine cannot manufacture facts that never occurred to create an otherwise non-existent tax liability”).

22. *True v. United States*, 190 F.3d 1165, 1174-75 (10th Cir. 1999) (“Courts have developed three tests for determining when the step transaction doctrine should operate to collapse the individual steps of a complex transaction into a single integrated transaction for tax purposes: (1) end result, (2) interdependence, and (3) binding commitment”); *Redding v. Comm’r*, 630 F.2d 1169, 1175 (7th Cir. 1980) (“The commentators have attempted to synthesize from judicial decisions several tests to determine whether the step transaction doctrine is applicable to a particular set of circumstances in order to combine a series of steps into one transaction for tax purposes”); *McDonald’s Rests. of Ill. v. Comm’r*, 688 F.2d 520, 524 (7th Cir. 1982) (citing *Redding*, 630 F.2d at 1177.); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244-45 (5th Cir. 1983); *Kornfeld v. Comm’r*, 137 F.3d 1231, 1235 (10th Cir. 1998) *aff’g* 72 T.C.M. (CCH) 1062 (1996); *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 191 (D. Conn. 2004) (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1522 (10th Cir. 1991)); *Andantech L.L.C.*, 83 T.C.M. (CCH) at *99 (citing *Penrod v. Comm’r*, 88 T.C. 1415, 1428-30 (1987)).

23. For an early discussion, see Marvin A. Chirelstein & Benjamin B. Lopata, *Recent Developments in the Step-Transaction Doctrine*, 60 TAXES 970, 970-75 (1982). See also Oliver C. Murray, Jr., Note, *Step Transactions*, 24 U. MIAMI L. REV. 60 (1969); Richard D. Hobbet, *The Step Transaction Doctrine and Its Effect on Corporate Transactions*, 19 TUL. TAX INST. 102 (1970).

24. See generally, Yoram Keinan, *The Many Faces of the Economic Substance’s Two-Prong Test: Time for Reconciliation?* 1 N.Y.U. J. BUS. & LAW, 372 (2005).

25. 190 F.3d 1165 (10th Cir. 1999).

*Associated Wholesale Grocers v. U.S.*²⁶), the step transaction principle had served as the IRS's primary weapon against the taxpayer,²⁷ in recent years, the principle has become the IRS's secondary (or alternative) argument to the more general economic substance doctrine.²⁸ The main reason for this trend, in my view, is that it is harder for the IRS to prevail on the step transaction argument as opposed to the more general economic substance/business purpose test. As I conclude below, in cases where the transaction can be challenged on both grounds, it is very unlikely that the IRS will use the step transaction principle as the primary weapon.

Thus, as this article will conclude, the role of the step transaction doctrine has been diminishing over the years from a primary weapon against tax shelters into an alternative test. In order to revive its role, the step transaction principle could be codified. As opposed to the controversial proposed codification of the economic substance doctrine, in my view, the codification of the step transaction principle will be more acceptable. The last part of this article sets forth a basic proposal for such codification.

This article will continue as follows. The first part discusses the fundamentals of the general principle of substance-over-form from which the step transaction doctrine (as well as other common law anti-abuse rules) has emerged. The second part sets forth the building blocks of the step transaction doctrine and its application in practice. Part III

26. 927 F.2d 1517 (10th Cir. 1991).

27. See, e.g., *Del Commer. Props., Inc. v. Comm'r*, 78 T.C.M. (CCH) 1183 (1999), *aff'd*, 251 F.3d 210, 213. (D.C. Cir. 2001); see also *Associated Wholesale Grocers*, 927 F.2d at 1521, where the Court, characterizing the IRS's position, stated:

The government urges this court to disregard Elder, Inc.'s transitory ownership of Weston by applying the step transaction doctrine in holding that the merger and reorganization 'should be collapsed and viewed as a single transaction for tax purposes.' The district court agreed and 'viewed the execution of the two integrated agreements as one transaction which did not effect a bona fide sale of stock and concluded, as a matter of law, that Super Market Developers, at all relevant times, owned more than 80 percent of the outstanding shares of Weston. . . .

Id.

28. See, e.g., *Transcapital Leasing Assocs. 1990-II, L.P. v. United States*, 2006 U.S. Dist. LEXIS 16238, at ¶ 38 (W.D. Tex. 2006)).

The Government's second alternative theory applies the "step transaction doctrine" to collapse each discrete step of the 1991 Mainframe Investment and reallocate the "\$11,518,795 of rental income reported by TransCapital Leasing Associates 1990-II in its year ended August 31, 1991 . . . [to] Bancor . . . because the transactions that produced the rental income were an interrelated series of transactions designed to shift income to a tax neutral entity while allowing Bancor . . . to claim the related deductions."

Id.

elaborates on the three alternative threshold tests that courts have developed over the years pertaining to the step transaction doctrine. Part IV discusses another important element in determining whether the doctrine should apply to a given transaction—the lapse of time between each step. The fifth part discusses the main controversial element of the step transaction doctrine, which is whether the IRS can prevail in a step transaction case where each step in the disputed transaction has economic substance and business purpose. Three recent cases in which the step transaction doctrine was only used by the IRS as an alternative weapon are discussed in Part VI to emphasize my point that the doctrine’s role has diminished over the years. Part VII sets forth a proposal to codify the step transaction doctrine in accordance with existing case law. Finally, Part VII contains my conclusions.

I. SUBSTANCE-OVER-FORM

The substance over form doctrine originated in *Gregory v. Helvering*,²⁹ and the Supreme Court soon thereafter articulated that: “The incident of taxation depends on the substance rather than form of the transaction.”³⁰ Thus, the Supreme Court established that the substance rather than the form of a transaction ought to govern in determining the tax consequences of the transaction.³¹ In *Saviano v. Comm’r*, the Seventh Circuit elaborated that:

[t]he freedom to arrange one’s affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are empowered, are in fact duty-bound,

29. 293 U.S. 465 (1935), *aff’g* 69 F.2d 809 (2d Cir. 1934).

30. *Comm’r v. Court Holding Co.*, 324 U.S. 331, 334 (1945). *See also* *True v. United States*, 190 F.3d 1165, 1174 (10th Cir. 1999) (noting that substance over form is a “fundamental tax principle,” and applies to “look beyond the taxpayers’ characterization” of the challenged business transactions); *Kornfeld v. Comm’r*, 137 F.3d 1231, 1234 (10th Cir. 1998) (“the taxation scheme set out in the Internal Revenue Code is complicated and the tax consequences of many transactions depend on form, how the transaction is structured,” but at the same time, the “incidence of taxation depends on the substance of a transaction”) (quoting *Court Holding Co.*, 324 U.S. at 334); *Kuper v. Comm’r*, 533 F.2d 152, 155 (5th Cir. 1976); *Derr v. Comm’r*, 77 T.C. 708, 722 (1981) (“It is now well established that the incidence of taxation depends upon the substance of the transaction and not the mere form, where the form is not imbued with economic reality”); *Leahy v. Comm’r*, 87 T.C. 56, 71 (1986) (“[I]t is well established that the economic substance of a transaction, rather than its form, controls for Federal income tax purposes . . . [W]e must be concerned with the economic realities and not the form employed by the parties”); Rev. Rul. 2002-69, 2002-2 C.B. 760 (“The substance of a transaction, not its form, governs its tax treatment”).

31. *See generally* Joseph Isenbergh, *Musing on Form and Substance in Taxation*, 49 CHI. L. REV. 859 (1982).

to look behind the contrived forms of transactions to their economic substance and to apply the tax laws accordingly.³²

Courts have applied the substance-over-form doctrine since *Gregory v. Helvering* to disallow tax benefits arising out of transactions the forms of which have differed from their substance.³³ The substance-over-form doctrine is triggered, therefore, only when the transaction's substance actually differs from its form.³⁴

The substance-over-form doctrine is viewed as the most general common law doctrine from which the other four doctrines have emerged.³⁵ As the Tax Court indicated in *Andantech L.L.C. v. Comm'r*. (See discussion *infra*): "Substance over form and related judicial doctrines all require a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened."³⁶

Under the substance-over-form doctrine, a court has the power to re-characterize a transaction in accordance with its true substance if such substance is demonstrably contrary to its outward form.³⁷ The effect of such a determination is generally to produce a different tax result than the result that the form of the transaction would produce.³⁸

As the Fifth Circuit stated in *Crenshaw v. U.S.*:

[Taxpayers] cannot compel a court to characterize the transaction

32. *Saviano v. Comm'r*, 765 F.2d 643, 654 (7th Cir. 1985), *aff'g* 80 T.C. 955 (1983).

33. *See, e.g.*, *Comm'r v. CM Holdings*, 301 F.3d 96, 102 (3d Cir. 2002) (noting that the rationale behind *Gregory* and its progeny is that "courts should not elevate form over substance by rewarding taxpayers who have engaged in transactions that lack any purpose save that of tax savings. The taxpayer has the burden of showing that the form of the transaction accurately reflects its substance, and the deductions are permissible.")

34. *See, e.g.*, *Tracinda Corp. v. Comm'r*, 111 T.C. 315, 326 (1998) ("... in order to apply either the substance-over-form doctrine or the step-transaction doctrine, we must determine that the substance of the transaction differs from its form")

35. *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1521 (10th Cir. 1991) ("The step-transaction doctrine developed as part of the broader tax concept that substance should prevail over form."); *see also* *Bail Bonds by Marvin Nelson, Inc. v. Comm'r*, 820 F.2d 1543, 1549 (9th Cir. 1987) ("The economic substance factor involves a broader examination of whether the substance of a transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax deduction")

36. *Andantech L.L.C. v. Comm'r*, 83 T.C.M. (CCH) 1476, *89 (2002) (quoting *Harris v. Comm'r*, 61 T.C. 770, 783 (1974)).

37. *United States v. Ingalls*, 399 F.2d 143, 145 (5th Cir. 1968) ("This court has... repeatedly looked to the substance of transactions rather than to their form")

38. *Id.* Notable examples are all debt versus equity cases, where a court may re-characterize debt as equity for tax purposes, and, accordingly, deny deductions for "interest" payable on the debt. *See Laidlaw Transp., Inc. v. Comm'r*, 75 T.C.M. (CCH) 2598, *57-58 (1998) (discussing several nonexclusive factors used to determine whether advances should be characterized as debt or equity).

solely upon the basis of a concentration on one facet of it when the totality of circumstances determines its tax status. The most obvious answer to Taxpayer's argument that the parties' characterization is conclusive is that such a result would completely thwart the Congressional policy to tax transactional realities rather than verbal labels Otherwise, form, rather than substance, would invariably prevail.³⁹

Substance over form is generally raised *by the Commissioner* when the taxpayer chooses a form that not only differs from the substance of the transaction, but also a form that provides the taxpayer with a tax benefit, to which the taxpayer would normally not be eligible if the form is consistent with the substance.⁴⁰ In its report on tax shelters in 1999, the U.S. Department of the Treasury indicated:

Generally, the tax results arising from a transaction (or series of transactions) are obvious, uncontroverted, and based on the 'form' of the transactions the taxpayer has chosen. In some rare (but important) cases, however, the "substance" of a particular transaction produces tax results that are inconsistent with its "form" as embodied in its underlying documentation Under the substance-over-form doctrine, the IRS and the courts may recharacterize a transaction in accordance with its substance, if the substance of the transaction is demonstrably contrary to the form.⁴¹

The transaction's form, however, may not be easily ignored.⁴² Applying the standard of *Frank Lyon v. U.S.*,⁴³ the Second Circuit indicated in *Newman v. Comm'r* that relevant criteria in determining whether a transaction's form ought to be respected include: (i) the existence of a business purpose; (ii) whether the transaction has changed the parties' economic interests; (iii) whether the transaction's terms were arm's-length terms; and (iv) did the parties respect their own form.⁴⁴

39. 450 F.2d 472, 477-78 (5th Cir. 1971).

40. *Keeler v. Comm'r*, 243 F.3d 1212, 1217 (10th Cir. 2001) ("In inquiring whether taxpayer's deductions were properly disallowed, we look past the form of the transactions at issue and examine their substance.").

41. DEPARTMENT OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION ANALYSIS, AND LEGISLATIVE PROBLEMS 46-47 (1999), <http://www.ustreas.gov/offices/tax-policy/library/ctswwhite.pdf>).

42. *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978) ("In applying the doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed").

43. *Id.* at 561-62 (1978) (creating the two prong test). See generally, Yoram Keinan, *The Many Faces of the Economic Substance's Two-Prong Test: Time for Reconciliation?* 1 N.Y.U. J. BUS. & LAW, 372 (2005).

44. *Newman v. Comm'r*, 902 F.2d 159, 163-64 (2d Cir. 1990).

Thus, the Second Circuit indicated that the form will not be disregarded simply because the substance may differ from the transaction's form.⁴⁵

Nevertheless, taxpayers have found it very difficult to successfully invoke common law anti-abuse doctrines to challenge *their own* transaction form.⁴⁶ In only a few cases, taxpayers have succeeded in challenging their own form;⁴⁷ a court will not easily allow the taxpayer to disavow his or her own form, even if it is evident that the form differs from the transaction's substance.⁴⁸

Courts are divided, however, over the required standard for the taxpayer to be eligible to disavow its own form.⁴⁹ While several circuits as well as the Tax Court allow a taxpayer to disavow its own form if the taxpayer shows "strong proof" to support its alternative form,⁵⁰ the Third Circuit set forth a stricter standard in *Comm'r. v. Danielson*.⁵¹ Under what has become known as the "Danielson" standard, a taxpayer is permitted to disavow its own form only by proving that the contract between the parties should be disregarded on the grounds of mistake, fraud, undue influence or similar grounds.⁵² The latter standard has been adopted by the Fifth, Sixth, Eleventh and Federal Circuits.⁵³ Finally, the

45. *Id.* at 163 ("While we exalt substance over form, we do not ignore the form.")

46. *Estate of Rogers v. Comm'r*, 29 T.C.M. (CCH) 869, *13-15 (1970) *aff'd per curiam*, 445 F.2d 1020 (2d Cir. 1971); *Halstead v. Comm'r*, 296 F.2d 61, 62 (2d Cir. 1961); *Spector v. Comm'r*, 641 F.2d 376, 381 (5th Cir. 1981); *Bradley v. United States*, 730 F.2d 718, 720 (11th Cir. 1984); *Maletis v. United States* 200 F.2d 97 (9th Cir. 1952); *MAS One L.P. v. United States*, 390 F.3d 427 (6th Cir. 2004). *Cf. Comdisco v. United States*, 756 F.2d 569, 578 (7th Cir. 1985).

47. *See, e.g.*, *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939); *Estate of Weinert v. Comm'r*, 294 F.2d 750, 755 (5th Cir. 1961); *Ill. Power Com. v. Comm'r*, 87 T.C. 1417 (1986); *Pacific Gamble Robinson v. Comm'r*, 54 T.C.M. (CCH) 915, *27 (1987).

48. *Stokely-Van Camp v. United States*, 974 F.2d 1319, 1325 (Fed. Cir. 1992) ("[G]enerally, a taxpayer may not disregard the terms of a contract allocating the payment thereunder and adopt a different allocation having more favorable tax consequences.")

49. *Schatten v. United States*, 746 F.2d 319, 322 (6th Cir. 1984) ("Although recognizing that the Tax Court has rejected the *Danielson* rule, *see, e.g.*, *Weiner v. Comm'r*, 61 T.C. 155, 159-60 (1973), we conclude that the *Danielson* approach is sounder.")

50. *Schultz*, 294 F.2d at 55 (quoting *Ullman v. Comm'r*, 264 F.2d 305, 308 (2d Cir. 1959)). *See also Kreider v. Comm'r*, 762 F.2d 580, 586-87 (7th Cir. 1985); *Major v. Comm'r*, 76 T.C. 239, 249 (1981).

51. *Comm'r v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967). For an in-depth discussion on the "Danielson" doctrine, *see generally* Christian A. Johnson, *The Danielson Rule: An Anodyne for the Pain of Reasoning*, 89 COLUM. L. REV. 1320 (1989).

52. *Danielson*, 378 F.2d at 775 ("a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.")

53. *See, e.g.*, *Bradley v. United States*, 730 F.2d 718, 720 (11th Cir. 1984) ("Taxpayers have failed to submit any evidence to prove the existence of a mistake, undue influence, fraud, or duress so as to merit release from the transaction form that they employed"); *Schatten*, 746 F.2d at 322

First Circuit has tended to avoid the *Danielson* standard but also has not adopted the “strong proof” standard.⁵⁴ Although the Tax Court generally follows the “strong proof” standard,⁵⁵ a Tax Court might be obligated to follow the stricter *Danielson* standard if an appeal from the court would be made to a Circuit that applies *Danielson*.⁵⁶

II. OVERVIEW OF THE STEP TRANSACTION PRINCIPLE

The step transaction principle is a variation on the substance-over-form doctrine, the purpose of which is to ensure that transactions are taxed according to their substance and not their outward form.⁵⁷

(“For three reasons, we agree with the Third and Fifth Circuits that a party may not challenge the tax consequences of a settlement agreement absent ‘proof which in an action between the parties to the agreement would be admissible to alter the construction or to show its unenforceability because of mistake, undue influence, fraud or duress.’”); *Spector v. Comm’r*, 641 F.2d 376, 384-85 (5th Cir. 1981) (“At the outset, we note that several policy considerations argue for application of the *Danielson* rule [to this case]”).

54. *Leslie S. Ray Ins. Agency, Inc. v. United States*, 463 F.2d 210, 211-12 (1st Cir. 1972) (“We need not, however, choose between *Danielson* and the view of the circuits which do not follow it.”); *Harvey Radio Laboratories, Inc. v. Comm’r*, 470 F.2d 118, 120 (1st Cir. 1972) (“While at its core *Danielson*, like *Leslie Ray*, is a rule of intent, we presently see no reason for pushing to the extreme of that rule, or indeed, in determining the degree of difference. Perhaps if a taxpayer can show an ancillary agreement to support his tax treatment, then the sales agreement should not be binding. At any rate, we are not faced with that situation.”).

55. *See, e.g., Elrod v. Comm’r*, 87 T.C. 1046, 1066 (1986) (noting that the Tax Court has not adopted the *Danielson* rule set forth by the Third Circuit, and that “Inasmuch as this case would be appealable to the Court of Appeals for the Fourth Circuit, we are not bound to apply this rule in the instant case. . . . The strong proof rule is a standard applied by this Court.”).

56. *See, e.g., Deve. Corp. of America v. Comm’r*, 55 T.C.M. (CCH) 455, *85 (1988) (“[W]hile we still adhere to our ‘strong proof’ standard, we are bound to apply the *Danielson* rule in the instant case.”).

57. *Comm’r v. Clark*, 489 U.S. 726, 738 (1989). (“Under [the step transaction] doctrine, interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction.”); *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1521 (10th Cir. 1991) (quoting *American Potash & Chem. Corp. v. United States*, 399 F.2d 194, 207, 185 Ct. Cl. 161 (1968)) (“The [step transaction] doctrine is part of the broader tax concept that substance should prevail over form.”); *Kanawha Gas & Util’s Co. v. Comm’r*, 214 F.2d 685, 691 (5th Cir. 1954) (“[substance-over-form] is particularly pertinent to cases involving a series of transactions designed and executed as parts of a unitary plan to achieve an intended result. Such plans will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation. The series of closely related steps in such a plan are merely the means by which to carry out the plan and will not be separated”); *Associated Wholesale Grocers, Inc.*, 927 F.2d at 1521 (“The step- transaction doctrine developed as part of the broader tax concept that substance should prevail over form.”); *True v. United States*, 190 F.3d 1165, 1174 (10th Cir. 1999) (noting that the step transaction doctrine is an “incarnation of the basic substance over form principle”); *Sec. Indus. Ins. Co.*, 702 F.2d at 1244 (“The step transaction doctrine is a corollary of the general tax principle that the incidence of taxation depends upon the substance of a transaction rather than its form”); *Greene v. United States*, 13 F.3d 577, 583 (2d Cir. 1994) (“By emphasizing substance over form, the step transaction doctrine prevents a taxpayer from escaping taxation. The doctrine

Accordingly, a court will not apply the step transaction doctrine if the substance of the transaction does not differ from its form.⁵⁸

In *Minn. Tea Co. v. Helvering*, a corporation was organized and its stock was immediately distributed to its shareholders.⁵⁹ Immediately thereafter, the corporation acquired stock of another company and cash.⁶⁰ The cash was immediately distributed to the corporation's shareholders pursuant to a plan of reorganization that required the shareholders to assume the corporation's debts.⁶¹ The United States Supreme Court established the step transaction principle and held that:

In pursuance of the resolution, the stockholders received the money from petitioner to the extent of \$106,471.73, not as a distribution for their benefit but as a fund the equivalent of which they were bound to pass on, and did pass on, to the creditors. The conclusion is inescapable, as the court below very clearly pointed out, that by this roundabout process petitioner received the same benefit "as though it had retained that amount from distribution and applied it to the payment of such indebtedness." Payment of indebtedness, and not distribution of dividends, was, from the beginning, the aim of the understanding with the stockholders and was the end accomplished by carrying that understanding into effect. A given result at the end of a straight path is not made a different result because reached by following a devious path. The preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands, so transparently artificial that further discussion would be a needless waste of time. The relation of the stockholders to the matter was that of a mere conduit. The controlling principle will be found in *Gregory v. Helvering*, 293 U.S. 465, 469-470; and applying that

treats the 'steps' in a series of formally separate but related transactions involving the transfer of property as a single transaction, if all the steps are substantially linked"); *Penrod v. Comm'r*, 88 T.C. 1415, 1428-29 (1987) ("The step transaction doctrine is in effect another rule of substance over form; it treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result"); *Teong-Chan Gaw v. Comm'r*, 70 T.C.M. (CCH) 1196, *124 (1995) ("The step transaction doctrine developed from the substance over form doctrine") (citing *Associated Wholesale Grocers, Inc.*, 927 F.2d at 1521).

58. *MAS One L.P. v. United States*, 271 F. Supp. 2d 1061, 1067 (S.D. Ohio 2003), *aff'd*, *MAS One L.P. v. United States*, 390 F.3d 427 (6th Cir. 2004) ("The step transaction doctrine is inapplicable in this case because the substance and the form of the transactions in question do not differ in any meaningful way"); *Turner Broadcasting System, Inc. v. Comm'r*, 111 T.C. 315, 326 (1998) ("... in order to apply either the substance-over-form doctrine or the step-transaction doctrine, we must determine that the substance of the transaction differs from its form.").

59. *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 610 (1938).

60. *Id.*

61. *Id.*

principle here, the judgment of the court below is *Affirmed*.⁶²

Under the step transaction doctrine, separate transactions or steps may be treated as a single, unified transaction for tax purposes.⁶³ Courts apply the step transaction doctrine in cases where taxing the individual steps of a transaction rather than the transaction as a whole would eviscerate the substance of the transaction resulting in improper tax treatment of the whole transaction.⁶⁴ As a result, such individual steps would be disregarded for tax purposes, and the transaction will be taxed as a single unified transaction as opposed to separate steps.⁶⁵

In *Smith v. Comm'r*,⁶⁶ the Tax Court illustrated the application of the doctrine:

The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged. [Citation omitted.]⁶⁷

The step transaction doctrine is frequently raised by the IRS in

62. *Id.* at 613-14.

63. *D'Angelo Assoc., Inc. v. Comm'r*, 70 T.C. 121, 129 (1978) ("Where a series of closely related steps are taken pursuant to a plan to achieve an intended result, the transaction must be viewed as an integrated whole for tax purposes."). *See also* *Andantech L.L.C. v. Comm'r*, 83 T.C.M. (CCH) 1476, *98 (2002).

64. *Del Commercial Props., Inc. v. Comm'r*, 251 F.3d 210, 213-14 (D.C. Cir. 2001) ("[A] particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes."); *Grove*, 490 F.2d at 246 (the step transaction doctrine applies to "meaningless intervening steps in a single, integrated transaction designed to avoid tax liability by the use of mere formalisms.").

65. *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652, 658 (5th Cir. 1968) ("[A] tax-free exchange cannot be transformed into two sales by the arbitrary separation of time and exchange of cash"). *See also* Donald L. Korb, *IRS Chief Counsel Offers Historical Overview of Shelters*, Tax Notes Today, Feb. 11, 2005, LEXIS, 2005 TNT 29-61.

A business transaction often does not have a sharply defined beginning or ending. One step in a transactional sequence often bears a strong relationship to that which came before it and that which follows it. For analytical purposes, however, it is often necessary to examine a transaction as an organic whole. To that end, the IRS and courts often fuse formally separate transactional steps to determine the tax consequences of the overall transaction.

Id.

66. 78 T.C. 350 (1982).

67. *Id.* at 389. *See also* *Andantech L.L.C.*, 83 T.C.M. (CCH) at *97 (quoting *Smith v. Comm'r*, 78 T.C. 350, 389 (1982)).

cases of transfers of property.⁶⁸ In *Greene v. U.S.*, the taxpayers formed a tax-exempt private foundation in the early 1970s.⁶⁹ From 1974 to 1980, the taxpayers donated futures contracts to the institute and reported on their tax returns charitable contributions equal to the fair market value of the contracts at the time when they were donated.⁷⁰

The effect of the 1981 enactment of I.R.C. §§1256⁷¹ and 170⁷² on the taxpayers was that if “they would continue donating their entire interest in futures contracts to the Institute, they would only be entitled to claim a charitable deduction for 60 percent of the contracts’ fair market value—the amount equal to the long-term gain portion.”⁷³ To avoid this result, the taxpayers changed the manner in which they made their contributions and conveyed only the “right, title and interest in the long term capital gain of the futures contracts” to the Institute, specifically retaining the short-term capital gain.⁷⁴ The contracts were then transferred to a special account held with Merrill Lynch over which and were sold the same day or shortly after each gift was made.⁷⁵ “The part of the proceeds representing the long-term capital gains was transferred to the Institute’s account, and the part representing the short-term capital gains was transferred to [taxpayer’s] personal account.”⁷⁶ The taxpayers’ reported and paid income taxes on the short-term capital gains and took a deduction for their charitable donation of the long-term capital.⁷⁷

The government argued that under the step transaction doctrine, the taxpayers’ donation of appreciated futures contracts should be disregarded, and the transaction should be treated as a sale by the taxpayers of the contracts followed by a gift of a portion of the cash proceeds to the tax-exempt foundation.⁷⁸ The Second Circuit applied the end result and interdependence test (two of the three alternative tests,

68. See, e.g., *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1520 (10th Cir. 1991).

69. *Greene v. United States*, 13 F.3d 577, 579 (2d Cir. 1994).

70. *Id.*

71. I.R.C. § 1256(a) (West 1988). Congress amended § 1256 in order “to combat perceived tax abuses by commodities traders . . .” *Greene*, 13 F.3d at 579.

72. § 170(e)(1). According to the *Greene* Court, “[s]ection 170 of the Code does not permit a charitable donation deduction for the value of donated property that would have been a short-term gain to the taxpayer had the taxpayer sold the property.” *Greene*, 13 F.3d at 579.

73. *Id.*

74. *Id.* at 579-80.

75. *Id.* at 580.

76. *Id.*

77. *Id.*

78. *Id.* at 583.

which are discussed in greater detail below), and disagreed with the Government.⁷⁹ The Second Circuit first indicated that:

[t]he doctrine treats the steps in a series of formally separate but related transactions involving the transfer of property as a single transaction, if all the steps are substantially linked. Rather than viewing each step as an isolated incident, the steps are viewed together as components of an overall plan.⁸⁰

Once a court determines that applying the step transaction to the particular case is appropriate, it can either: (i) disregard transactions or steps in a transaction that it believes are unnecessary,⁸¹ or (ii) change the order of such transaction or steps.⁸² In most cases, the former action is made, and several transactions or steps are integrated into a single transaction.⁸³

Nevertheless, as many courts have indicated, the IRS may not “generate events which never took place just so an additional tax liability might be asserted.”⁸⁴ In *Long Term Capital Holding* (See

79. *Id.* at 583-85. The Second Circuit, however, found that the end result test was inapplicable because it found no evidence that a prearranged plan to dispose of the futures contract existed at the time of donation. *Id.* at 583. In addition, the Second Circuit found that the two steps were independent from each other. *Id.* at 583-84. Thus, the Second Circuit held for the taxpayer. *Id.* at 584.

80. *Id.* at 583 (internal citation omitted).

81. *Andantech L.L.C. v. Comm’r*, 83 T.C.M. (CCH) 1476, *97 (2002).

82. *Comm’r v. Court Holding Co.*, 324 U.S. 331, 334 (1945). (“To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.”).

83. See, e.g., *Andantech L.L.C.*, 83 T.C.M. (CCH) at *99. See also Memorandum of Law in Support of Defendants’ Motion to Strike Allegations in Counts One Through Forty of the Indictment, Pursuant to Rule 7(D) of the Federal Rules of Criminal Procedure, *United States v. Jeffrey Stein*, No. S1 O5 Cr. 888, 2005 U.S. Dist. LEXIS 28166 (S.D.N.Y. Nov. 15, 2005), available at 2006 WL 1868180.

Under the “step transaction” doctrine, the government may try to telescope various steps of a transaction, combining them into one so as to achieve tax consequences that are more favorable to the government. It must be able to reach the same result as the original transaction, however, and, in so doing, may not posit even the *same number* of, but different, “steps” to reach the same result via a different means from that of the taxpayer; the government must reach that result in fewer steps.

Id. (emphasis in original).

84. *Grove v. Comm’r*, 490 F.2d 241, 247 (2d Cir. 1973) (“[u]seful as the step transaction doctrine may be . . . it cannot generate events which never took place just so an additional tax liability might be asserted”) (quoting *Sheppard v. United States*, 361 F.2d 972, 978 (1966)). See also *Esmark, Inc. v. Comm’r*, 90 T.C. 171, 196-97 (1988) (same); *Greene v. United States*, 13 F.3d 577, 583 (2d Cir. 1994) (“Of course, the [step transaction] doctrine cannot manufacture facts that never occurred to create an otherwise non-existent tax liability”); 11 JACOB MERTENS, JR., THE LAW OF FEDERAL INCOME TAXATION § 43:226, at 361 (2005) (“While a recharacterization may combine steps [in a transaction], it may not reach a different result or invent new steps”).

discussion in greater detail *infra*), the court explained that:

Grove and Greene stand for the unstartling proposition that, absent clear error in a trial court's finding that the transacting parties did not informally agree to or prearrange various steps of an overall plan, or where it determines on summary judgment that there is no evidence that the transacting parties did so, an appellate court will not overturn that finding/determination in favor of rejected findings of fact or a position for which there is no evidence. In such cases, the Government's re-characterization is unsubstantiated fiction and does not reflect the substance of what the evidence fairly shows occurred.⁸⁵

Thus, as the Government recently indicated in a Coordinated Issue Paper, "as a general rule, courts have held that in order to collapse a transaction, the Government must have a logically plausible alternative explanation that accounts for all the results of the transaction."⁸⁶

Because the step transaction doctrine is a variation of the substance-over-form doctrine, courts have generally held that the taxpayer's ability to invoke the step transaction doctrine by challenging its own transaction steps is limited, in accordance with the *Danielson* or "strong proof" standards discussed above.⁸⁷ Nevertheless, although in most cases the Government raises the step transaction doctrine to disallow tax benefits, several courts have held that the taxpayer is allowed to use the doctrine as well.⁸⁸ In *MAS One Limited Partnership v. U.S.* (See discussion in greater detail below), the court held that, "the step transaction doctrine is not merely a method preventing tax avoidance, but can also be used for a taxpayer's benefit."⁸⁹

85. *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 194-95 (D. Conn. 2004). See also *Transcapital Leasing Assocs. 1990-II, L.P. v. United States*, 2006 U.S. Dist. LEXIS 16238, at ¶ 42 (W.D. Tex. 2006)).

The Government's theory would require the Court to disregard TCLA 1990-II's pre-August 31, 1991 form and find Bancor, a non-partner at that time, to be a putative partner, by collapsing each of the 1991 Mainframe Investment's transactions in a single transaction. The Court's jurisdiction does not extend so far. The Court cannot "fictionally," for tax purposes only, make Bancor a partner in a partnership in which it was not a partner. As of August 31, 1991, Bancor had no interest in TCLA 1990-II.

Id.

86. Internal Revenue Service, *Coordinated Issue Paper Addresses Partnership Straddle Tax Shelters*, Tax Notes Today, May 9, 2005, LEXIS, 2005 TNT 91-27 (citing *Del Commercial Props., Inc. v. Comm'r*, 251 F.3d 210, 213-14 (D.C. Cir. 2001)); *Penrod v. Comm'r*, 88 T.C. 1415, 1428-30 (1987); *Tracinda Corp. v. Comm'r*, 111 T.C. 315, 327 (1998).

87. *Estate of Durkin v. Comm'r*, 99 T.C. 561, 571-73 (1992).

88. *South Bay Corp. v. Comm'r*, 345 F.2d 698, 703 (2d Cir. 1965) ("The 'step analysis' of transactions does not operate in terms of an estoppel of taxpayers to deny the forms of their transactions but in terms of the reality of the transactions").

89. *MAS One L.P. v. United States*, 271 F. Supp. 2d 1061, 1067 (S.D. Ohio 2003), *aff'd*,

In conclusion, there are two prerequisites for applying the step transaction doctrine: (i) the substance of the transaction must differ from the form; and (ii) such a difference has to be viewed as abusive for tax purposes. For this reason, and as discussed in greater detail below, the IRS has found it harder to challenge transactions under the step transaction doctrine and has been using this route only as an alternative argument in several recent cases.

III. THE THREE ALTERNATIVE THRESHOLD TESTS

Applying the step transaction principle to a set of steps or transactions is not an easy task.⁹⁰ Thus, as the Tax Court indicated, “The step-transaction doctrine remains a somewhat elusive principle. However, there have been attempts to establish some sort of coherence as to the manner in which it is applied.”⁹¹ In attempts to bring some uniformity, the courts have articulated three different threshold tests (each of which is discussed in greater detail below) for determining when it is appropriate to apply the step transaction doctrine:

- the “binding commitment” test;
- the “end result test;” and
- the “mutual interdependence” test.⁹²

Nevertheless, because the step transaction principle is a common law creature, its application still remains open to various

MAS One L.P. v. United States, 390 F.3d 427 (6th Cir. 2004) (citing *Comm’r v. Clark*, 489 U.S. 726, 738 (1989)) (“applying the step transaction doctrine to reject the ‘counterintuitive conclusion urged by the Commissioner.’”).

90. *King Enters. Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969) (“[W]hether to accord the separate steps of a complex transaction independent significance, or to treat them as related steps in a unified transaction, is a recurring problem in the field of tax law”). See generally Seymour S. Mintz & William T. Plumb, Jr., *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. INST. ON FED. TAX’N 247 (1954).

91. *Weikel v. Comm’r*, 51 T.C.M. (CCH) 432, *26 (1986).

92. *True v. United States*, 190 F.3d 1165, 1174-75 (10th Cir. 1999) (“Courts have developed three tests for determining when the step transaction doctrine should operate to collapse the individual steps of a complex transaction into a single integrated transaction for tax purposes: (1) end result, (2) interdependence, and (3) binding commitment”); *Redding v. Comm’r*, 630 F.2d 1169, 1175 (7th Cir. 1980) (“The commentators have attempted to synthesize from judicial decisions several tests to determine whether the step transaction doctrine is applicable to a particular set of circumstances in order to combine a series of steps into one transaction for tax purposes”); *McDonald’s Rests. of Ill. v. Comm’r*, 688 F.2d 520, 524 (7th Cir. 1982) (citing *Redding*, 688 F.2d at 1175); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244-45 (5th Cir. 1983); *Kornfeld v. Comm’r*, 137 F.3d 1231, 1235 (10th Cir. 1998); *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 191 (D. Conn. 2004) (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1522 (10th Cir. 1991)); *Andantech L.L.C. v. Comm’r*, 83 T.C.M. (CCH) 1476, *99-100 (2002) (citing *Penrod v. Comm’r*, 88 T.C. 1415, 1428-30 (1987)).

interpretations.⁹³ Frequently, courts applying the step transaction doctrine have applied more than one of these three tests.⁹⁴ Some courts have determined that the Government can satisfy *any* of the above standards tests in order for the step transaction doctrine to operate.⁹⁵ As I conclude below, the step transaction test as a practical matter is a two-prong test.

In *Associated Wholesale Grocers, Inc. v. United States*, between 1976 and 1980, Super Market Developers, Inc. acquired approximately 99.97 percent of the stock of Weston Investment Co. (“Weston”), a publicly traded holding company.⁹⁶ The management of Super Market Developer’s parent corporation, Associated Wholesale Grocers, Inc., subsequently decided it was not in their best interests to own and operate grocery stores through subsidiary corporations.⁹⁷ “One of Weston’s subsidiaries was Weston Market, Inc., a grocery managed by Thomas Elder.”⁹⁸ “In 1980, Mr. Elder expressed to taxpayer his interest in buying Weston Market.”⁹⁹ The parties structured a disposition of Weston’s stock in the form of two agreements between Super Market

93. See, e.g., *Redding*, 630 F.2d at 1175 (“Unfortunately, these tests are notably abstruse—even for such an abstruse field as tax law. And we must bear in mind, in applying the ‘tests’ that ‘(t)he step transaction doctrine is only a judicial device expressing the familiar principle that in applying the income tax laws, the substance rather than the form of the transaction is controlling’”) (quoting *Taxation of Stock Rights*, 51 CALIF. L. REV. 146, 157 (1963)). See also 11 JACOB MERTENS, JR., *THE LAW OF FEDERAL INCOME TAXATION* § 43:226, at 359-60 (2005) (“tests used in applying the step transaction doctrine vary depending on the circumstances and have been described as ‘notably abstruse.’”) (citing *Redding*, 630 F.2d at 1175).

94. See, e.g., *True*, 190 F.3d at 1175 (“More than one test might be appropriate under any given set of circumstances”). See also *Greene v. United States*, 13 F.3d 577, 583-85 (2d Cir. 1994) (applying the end result and interdependence tests and holding that under both tests, the step transaction should not apply); see also *Andantech L.L.C.*, 83 T.C.M. (CCH) at *112 (applying the end result and interdependence tests and holding that under either test, the steps should be collapsed into a single transaction).

95. See *Andantech L.L.C.*, 83 T.C.M. (CCH) at *99-100 (citing *Associated Wholesale Grocers, Inc.*, 927 F.2d at 1527-28). See also *Long Term Capital Holding*, 330 F. Supp 2d at 191, where the government contended that under either the end result test or the interdependence test, a taxpayer’s contributions of preferred stock to a partnership in exchange for a partnership interest and the taxpayer’s subsequent sale of that partnership interest to a third party must be stepped together into a single sale transaction with the result that the third party acquired the preferred stock, rather than the partnership interest, for a cost basis pursuant to I.R.C. § 1012.) The Court agreed that this result followed from application of the end result test and therefore did not undertake an application of the interdependence test. *Id.* Cf. *Redding*, 630 F.2d at 1178 (“[T]he lack of ‘binding commitment’ is simply one factor to which we give appropriate consideration here. Certainly, it is not necessary for us to rely on this factor to reach our result”).

96. *Associated Wholesale Grocers, Inc.*, 927 F.2d at 1518.

97. *Id.*

98. *Id.*

99. *Id.*

Developers and Elder Food Mart, Inc. (“Elder, Inc.”), “a corporation organized by Mr. Elder to facilitate the purchase of Weston Market.”¹⁰⁰ “Both agreements were signed on December 11, 1980, and consummated on December 23, 1980.”¹⁰¹

“Under the ‘Agreement and Plan of Merger,’ Weston was merged into Elder, Inc., with Elder, Inc. as the surviving corporation.”¹⁰² “Under the ‘Agreement and Plan of Reorganization,’ which took effect ‘immediately following the time of effectiveness of the merger’, Super Market Developers bought back all the assets acquired by Elder, Inc. under the merger agreement except for the stock of Weston Market.”¹⁰³ The taxpayer treated the transaction as a taxable sale of Weston’s assets and declared a tax loss under I.R.C. § 1001(a)¹⁰⁴ in its 1980 consolidated federal income tax return and sought to carry back portions of the loss to each of the three prior years.¹⁰⁵ “The IRS denied the loss, concluding the transaction was not a sale but rather a complete liquidation of taxpayer’s subsidiary, Weston.”¹⁰⁶ “As such, the IRS concluded, recognition of the loss was barred by section 332.”¹⁰⁷

100. *Id.*

101. *Id.*

102. *Id.* “Elder, Inc. exchanged \$300,000 in cash and a non-interest bearing demand promissory note, with a face value of \$9,049,703, for the Weston stock.” *Id.* “The minority shareholders were entitled to receive \$28.50 per share, or more, depending on their pro rata share of the cash and note exchanged for Weston stock.” *Id.*

103. *Id.* at 1518-1519. “In exchange for those assets, Super Market Developers paid ‘an amount equal to the principal amount of the promissory note . . . plus an amount equal to the cash received by the [minority] shareholders.’” *Id.* at 1519.

104. I.R.C. § 1001 (West 1989). Determination of amount of and recognition of gain or loss

(a) Computation of gain or loss

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

.....

(c) Recognition of gain or loss

Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

Id.

105. *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1519 (10th Cir. 1991).

106. *Id.*

107. *Id.* § 332, entitled “Complete liquidation of subsidiaries,” provides:

(a) General rule

No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

(b) Liquidations to which section applies

For purposes of subsection (a), a distribution shall be considered to be in complete liquidation only if –

The lower court refused to apply the end result test.¹⁰⁸ The Tenth Circuit indicated that more than one test might be appropriate under any given set of facts but that the circumstances need satisfy only one of the tests in order for the step transaction doctrine to operate.¹⁰⁹ Thus, the Tenth Circuit followed the lower court, focused on the interdependence test, and held for the Government.¹¹⁰

Other courts have articulated that satisfying only one of the alternative tests may not be enough for the government.¹¹¹ Frequently, courts conclude that more than one of the alternative tests should be satisfied in determining whether the steps ought to be collapsed under the step transaction doctrine.¹¹²

A. *The Binding-Commitment Test*

The “binding commitment” test was introduced by the Supreme Court in *Comm’r v. Gordon*.¹¹³ The transaction in *Gordon* took place in

(1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends); and either

(2) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or

(3) such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within 3 years from the close of the taxable year during which is made the first of the series of distributions under the plan, except that if such transfer is not completed within such period, or if the taxpayer does not continue qualified under paragraph (1) until the completion of such transfer, no distribution under the plan shall be considered a distribution in complete liquidation.

Id. (2007).

108. *Associated Wholesale Grocers, Inc.*, 927 F.2d at 1519.

109. *Id.* at 1527-28 (finding end result test inappropriate under the particular circumstances of case, but applying the step transaction doctrine using the interdependence test).

110. *Id.* at 1527-30.

111. *See, e.g., Redding v. Comm’r*, 630 F.2d 1169, 1178 (1980) (“[T]he lack of ‘binding commitment’ is simply one factor to which we give appropriate consideration here. Certainly, it is not necessary for us to rely on this factor to reach our result.”).

112. *See Andantech L.L.C.*, 83 T.C.M. (CCH) at *112 (applying both the end result and interdependence tests).

113. *Comm’r v. Gordon*, 391 U.S. 83, 97 (1968). In *Gordon*, the Supreme Court “refused to apply step transaction analysis to a multi-year series of stock transfers in the absence of a ‘binding

two steps. In 1961, in pursuance of a plan to divide a subsidiary of American Telephone and Telegraph Company into two entities, shareholders of the subsidiary received the right to purchase at a price below the fair market value common stock in the new subsidiary. When the rights were granted, the stock of the new subsidiary was owned by the first subsidiary.¹¹⁴

The total rights transferred in 1961 equaled 57 percent of the stock in the new subsidiary.¹¹⁵ In 1963, the remaining rights in the new subsidiary (*i.e.*, 43 percent of the stock) were offered to the shareholders.¹¹⁶ The dispute was over the question whether the difference between the amount paid by the shareholders when they exercised their rights and the fair market value of the new subsidiary's stock they received was taxable to the shareholder as ordinary income, or whether the stock distribution was tax-free or constituted a "spin-off" under I.R.C. § 355.¹¹⁷

The Supreme Court held that separate steps will be collapsed into a single transaction only if, at the time the first step takes place, the taxpayer was under a *commitment* to complete the remaining steps.¹¹⁸ Stated differently, "[i]f there were a moment in the series of the transactions during which the parties were not under a binding obligation, the steps cannot be collapsed under this test."¹¹⁹ Applying this principle, the Supreme Court held that the shareholders that exercised their rights to purchase the new subsidiary's stock should have recognized ordinary income equal to the difference between the amount paid for the stock and the stock's fair market value, and that the amount received on the sale of the rights was also taxable as ordinary income.¹²⁰

As the Tax Court indicated in *Andantech L.L.C. v. Comm'r*

commitment' to take the later steps." *Associated Wholesale Grocers*, 927 F.2d at 1523 n.6 (citing *Gordon*, 391 U.S. at 96).

114. *Gordon*, 391 U.S. 83.

115. *Id.*

116. *Id.*

117. *Id.* See I.R.C. § 355 (2007).

118. *Gordon*, 391 U.S. at 96 (noting that "if one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps."); *Penrod v. Comm'r*, 88 T.C. 1415, 1428-30 (1987); *Redding v. Comm'r*, 630 F.2d 1169, 1178 (7th Cir. 1980); *McDonald's Rests. of Ill. v. Comm'r*, 688 F.2d 520, 524-25 (7th Cir. 1982); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244-45 (5th Cir. 1983) ("Thus the 'binding commitment' test requires telescoping several steps into one transaction only if a binding commitment existed as to the second step at the time the first step was taken"); *Merrill Lynch & Co. v. Comm'r*, 120 T.C. 12, 95-100 (2003).

119. Internal Revenue Service, *Coordinated Issue Paper Addresses Partnership Straddle Tax Shelters*, Tax Notes Today, May 9, 2005, LEXIS, 2005 TNT 91-27 (citing *Long Term Capital Holding v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004)).

120. *Gordon*, 391 U.S. at 98.

(discussed *infra*), the binding commitment standard is the most rigorous standard of the three:

The purpose of the binding commitment test is to promote certainty in tax planning; it is the most rigorous limitation of the step transaction doctrine. It is seldom used and is applicable only where a substantial period of time has passed between the steps that are subject to scrutiny.¹²¹

Thus, when the steps are more closely related in time, courts may refuse to apply the binding commitment test.¹²² As indicated by the Tax Court in *Penrod v. Comm'r*, “there have been objections to [the binding commitment] test on the ground that the result is easily manipulable by taxpayers.”¹²³ The Fifth Circuit elaborated in *Security Industrial Ins. Co. v. U.S.* that:

Subsequent decisions, however, have tended to confine *Gordon* [391 U.S. 83 (1961)] to its facts. The Seventh Circuit, for example, has concluded that lack of a “binding commitment” should be determinative only in cases involving multiyear transactions; in other situations, the presence or absence of a “binding commitment” is simply one factor to be considered.¹²⁴

As a result, the binding commitment test is seldom used.¹²⁵ By

121. See *Andantech L.L.C. v. Comm'r*, 83 T.C.M. (CCH) 1476, *100 (2002); *Penrod*, 88 T.C. at 1429 (“The narrowest alternative is the ‘binding commitment’ test, under which a series of transactions are collapsed if, at the time the first step is entered into, there was a binding commitment to undertake the later step”); *Sec. Indus. Ins. Co.*, 702 F.2d at 1245 (“The third and most restrictive test permitting invocation of the step transaction doctrine is the binding commitment’ test”); *McDonald’s Rests. of Ill.*, 688 F.2d at 525.

122. *McDonald’s Rests. of Ill.*, 688 F.2d at 525 (noting that the binding commitment test is the most rigorous of the three step transaction tests “because it was formulated to deal with the characterization of a transaction that in fact spanned several tax years and could have remained ‘not only indeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen.’”) (quoting *Gordon*, 391 U.S. at 96). Cf. *Redding*, 630 F.2d at 1178 (reasoning that the Supreme Court did not intend the failure to satisfy the binding commitment test in circumstances involving much shorter time periods than were at issue in *Gordon* to automatically preclude application of the step transaction doctrine, and concluding that the binding commitment test is, thus, “simply one factor to which we give appropriate consideration here. Certainly, it is not necessary for us to rely on this factor to reach our result”).

123. *Penrod*, 88 T.C. at 1429 (quoting *King Enters. Inc. v. United States*, 418 F.2d 511, 518 (Ct. Cl. 1969) (“the step transaction doctrine would be a dead letter if restricted to situations where the parties were *bound* to take certain steps.”) (emphasis in original)).

124. *Sec. Indus. Ins. Co.*, 702 F.2d at 1245, citing *McDonald’s Rests. of Ill.*, 688 F.2d at 525; *Redding*, 630 F.2d at 1178; *King Enters. Inc.*, 418 F.2d at 517-18.

125. *True v. United States*, 190 F.3d 1165, 1175 n.8 (10th Cir. 1999) (“The binding commitment test is seldom utilized, and only applies to situations ‘where the taxpayer is subject to an obligation or binding commitment, at the time the first step is entered into, to pursue the

definition, a court applying the binding commitment test will normally search for a formal commitment, typically in the form of an agreement between the parties to complete the remaining steps.¹²⁶ Nevertheless, the existence of a formal agreement is not a prerequisite; the Tax Court has held in *Merrill Lynch & Co. v. Comm’r* that “[a] binding commitment or even an agreement in principle that each step of a plan will occur is not a prerequisite for finding that a firm and fixed plan existed, although uncertainty regarding one or more steps of the plan is a factor we must consider.”¹²⁷

In my view, the binding commitment test should be treated as supporting evidence rather than one of the three primary tests. In other words, if a binding commitment is found, this could be a strong indication that the steps should be collapsed, but the lack of binding commitment should not preclude the application of the step transaction doctrine. This view is reflected in my proposed codification of the doctrine discussed below.

B. *The End-Result Test*

In 1954, the Fifth Circuit held in *Kanawha Gas & Utils. Co. v. Comm’r* that the “end result” test:

is particularly pertinent to cases involving a series of transactions designed and executed as parts of a unitary plan to achieve an intended result. Such plans will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation. The series of closely related steps in such a plan are merely the means by which to carry out the plan and will not be separated.¹²⁸

Under this standard, separate steps will be integrated if they are a part of a single scheme designed to achieve a single result.¹²⁹ Thus, the

successive steps in a series of transactions,’ usually spanning several years.”) (citing JACOB MERTENS, JR., *THE LAW OF FEDERAL INCOME TAXATION*, § 43:256 (1997)). See also *Kornfeld v. Comm’r*, 137 F.3d 1231, 1235 (10th Cir. 1998) (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1522 n.6 (10th Cir. 1991)).

126. *Penrod*, 88 T.C. at 1429.

127. *Merrill Lynch & Co. v. Comm’r*, 120 T.C. 12, 100 (2003). See also *Roebing v. Comm’r*, 77 T.C. 30, 55 (1981) (“We do not believe the requirement of a firm and fixed plan for redemptions need be as rigid under the circumstances here involved.”); *McDonald’s Rests. of Ill.*, 688 F.2d at 525 (“The Tax Court found the test unsatisfied because the Garb-Stern group was not legally obliged to sell its McDonald’s stock. We think it misconceived the purpose of the test and misapplied it to the facts of this case.”).

128. *Kanawha Gas & Util’s Co. v. Comm’r*, 214 F.2d 685, 691 (1954).

129. *Kornfeld*, 137 F.3d at 1235; *McDonald’s Rests. of Ill.*, 688 F.2d at 524; *King Enters. Inc.*, 418 F.2d at 516-17. See generally Stephen Bowen, *The End Result Test*, 72 TAXES 722 (1994).

end result test focuses on the taxpayer's *intent* at the time of the first step.¹³⁰ As the Court of Claims indicated in *King Enterprises Inc. v. U.S.*, the step transaction doctrine should apply to "purportedly separate transactions . . . [that] were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."¹³¹ The end result test combines separate steps or events that appear to be components of an action undertaken to reach a particular result into a single transaction.¹³² Accordingly, under the end result test, if a court finds that a series of closely related steps or events is merely the means to achieve a particular end result, it would treat the steps as a single transaction.¹³³

The end result test is the test most often invoked in connection with the step transaction doctrine.¹³⁴ As the Tax Court indicated in *Andantech L.L.C. v. Comm'r.*:

Under the end result test, there is no independent tax recognition of the individual steps unless the taxpayer shows that at the time the parties engaged in the individual step, its result was the intended end result in and of itself. . . If this is not what was intended, then we collapse the series of steps and give tax consideration only to the intended end result. The doctrine derives vitality, rather, from its application where the form of a transaction does not require a particular further step be taken; but, once taken, the substance of the transaction reveals that the ultimate result was intended from the outset.¹³⁵

130. *Greene v. United States.*, 13 F.3d 577, 583 (2d Cir. 1994) ("Under the end result test, the step transaction doctrine will be invoked if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result").

131. *King Enters. Inc.*, 418 F.2d 511, 515 (Ct. Cl. 1969). See also *McDonald's Rests. of Ill.*, 688 F.2d at 524 (citing *King Enters. Inc.*, 418 F.2d at 516); *Redding v. Comm'r.*, 630 F.2d 1169, 1175 (1980) ("the parties ask us to consider. . . the 'end result' test, whereby purportedly separate transactions will be amalgamated into a single transaction when it appears that the successive steps were made 'in furtherance of, and for the purpose of executing and putting into effect, the plan of reorganization."); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244 (5th Cir. 1983) (citing *King Enters. Inc.*, 418 F.2d at 516).

132. *Greene*, 13 F.3d at 583 ("Under the end result test, the step transaction doctrine will be invoked if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result"). See *Kornfeld*, 137 F.3d at 1235 ("The 'end result' test amalgamates into a single transaction separate events which appear to be component parts of something undertaken to reach a particular result") (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1523 (10th Cir. 1991)).

133. *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613-614 (1938).

134. *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244 (5th Cir. 1983). See also *Penrod v. Comm'r.*, 88 T.C. 1415, 1429 (1987) ("At the other extreme [of the binding commitment test], the most far-reaching alternative is the 'end result' test").

135. See *Andantech L.L.C. v. Comm'r.*, 83 T.C.M. (CCH) 1476, *102-03 (2002) (quoting in

True v. U.S. emphasized the application of the end result test.¹³⁶ This case involved two transactions:¹³⁷

Ranchland Transactions: During the 1980s, the True family purchased five ranch properties;¹³⁸ each purchase took place through the same series of steps.¹³⁹ First, the taxpayers arranged for Smokey Oil Company to purchase the properties, “while True Ranches acquired the operating assets of each ranch.”¹⁴⁰ Smokey Oil Company then transferred the ranchlands to True Oil Company in a like-kind exchange (under I.R.C. § 1031)¹⁴¹ for productive oil and gas leases.¹⁴² “True Oil Company immediately distributed the newly acquired ranchlands to the [] family-member partners of True Oil Company as tenants in common.”¹⁴³ The partners then contributed their interests in the lands to True Ranches by a general warranty deed.¹⁴⁴

This transaction resulted in the following tax consequences: I.R.C. § 1031(d) provides that the “basis of property received in a tax-free exchange is the same as the basis of the property transferred.”¹⁴⁵ Thus, “Smokey Oil Company received depletable oil and gas leases with the same cost basis it had in the non-depreciable ranchland it transferred.”¹⁴⁶ “This allowed Smokey Oil Company to claim cost depletion deductions for the leases on its tax returns for 1989 and 1990 under section 612, resulting in substantial tax savings for the True family.”¹⁴⁷

“True Oil Company, on the other hand, received the non-depreciable ranchland with a zero basis because the oil and gas leases it exchanged pursuant to section 1031 were fully cost depleted.”¹⁴⁸ Through the subsequent transfers, True Ranches acquired the ranchland with the same zero basis as True Oil Company’s oil and gas leases.”¹⁴⁹

part *King Enters. Inc.*, 418 F.2d at 518).

136. *True v. United States*, 190 F.3d 1165, 1175 (10th Cir. 1999).

137. *Id.* at 1168.

138. *Id.*

139. *Id.*

140. *Id.*

141. I.R.C. § 1031 (2007).

142. *True v. United States*, 190 F.3d 1165, 1168 (10th Cir. 1999).

143. *Id.* at 1168-69.

144. *Id.* at 1169. “Internal Revenue Code Sections 721 and 731 allowed the Trues to treat these distributions as non-recognition transactions.” *Id.*

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.* As the court summarized:

Ultimately, the Trues reaped the tax benefits of turning non-depreciable assets (ranchlands) into cost-depletable assets (oil and gas leases) in the hands of Smokey Oil

Oil and Gas Lease Transactions: Similarly, the Trues utilized Bear Lodge Mountain Corporation and True Land and Royalty Company to acquire and then assign oil and gas leases.¹⁵⁰ Bear Lodge Mountain Corporation and True Land and Royalty Company acquired the oil and gas leases, and shortly thereafter, assigned a 100 percent interest in the leases to either True Oil Company or Smokey Oil Company.¹⁵¹ “In exchange, Bear Lodge Mountain Corporation or True Land and Royalty Company retained an overriding royalty of five percent, against which True Oil Company and Smokey Oil Company made annual advance royalty payments . . . over the life of the lease.”¹⁵²

“As a result of these transactions, True Oil Company and Smokey Oil Company deducted the guaranteed minimum overriding royalties paid to Bear Lodge Mountain Corporation and True Land and Royalty Company on their tax returns for 1989 and 1990 under Treas. Reg. 1.612-3(b)(3).”¹⁵³ This allowed True Oil Company and Smokey Oil Company to immediately expense the royalty payments instead of capitalizing the purchase of the leases as required for direct purchases of those assets.¹⁵⁴ On the other side of the transaction, Bear Lodge Mountain Corporation and True Land and Royalty Company reported the royalty payments as income but claimed an offsetting cost depletion deduction under Treas. Reg. 1.612-3(b)(1).¹⁵⁵

The Tenth Circuit applied only the end result and independence test.¹⁵⁶ In discussing the end result test, the court elaborated that “[t]he intent we focus on under the end result test is not whether the taxpayer intended to avoid taxes. . . . Instead, the end result test focuses on whether the taxpayer intended to reach a particular result by structuring a series of transactions in a certain way.”¹⁵⁷

Company, with the residual effect of ridding True Oil Company of fully cost-depleted assets (oil and gas leases) and leaving True Ranches with a zero basis in otherwise non-depreciable assets (ranchlands).

Id.

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.* at 1175, n.8. According to the Court:

As a general rule, ‘the binding-commitment test is only applicable where a substantial period of time has passed between the steps that are subject to scrutiny.’ Because the transactions in the present case do not span a long period of time or involve a binding commitment to pursue successive steps, we do not analyze them under this test.

Id. (quoting JACOB MERTENS, JR., *THE LAW OF FEDERAL INCOME TAXATION*, § 43:256 (1997)).

157. *Id.* at 1175.

The Tenth Circuit elaborated that:

[w]e emphasize that under the end result test, our focus is not on the legitimacy of the intended result, but instead on whether the taxpayer undertook multiple steps to achieve a particular result. Thus, if a taxpayer engages in a series of steps that achieve a particular result, he cannot request independent tax recognition of the individual steps unless he shows that at the time he engaged in the individual step, its result was the intended end result in and of itself. If this is not what the taxpayer intended, then we collapse the series of steps and only give tax consideration to the intended end result.¹⁵⁸

Thus, the parties' intent for each event is examined separately, and if the intent of the parties pertaining to a particular event is that such an event will merely serve as another step in achieving an end result, the court will disregard the event.¹⁵⁹

Similar to the binding commitment test, "a prerequisite to application of the end result test is proof of an agreement or understanding between the transacting parties to bring about the ultimate result."¹⁶⁰ As the Tax Court indicated in *Packard v. Comm'r.*, "[w]here an interrelated series of steps are taken pursuant to a *plan* to achieve an intended result, the tax consequences are to be determined not by viewing each step in isolation, but by considering all of them as an integrated whole."¹⁶¹

The difference between the two tests, however, is that while the binding commitment test is an objective test, the end result test is a subjective test because it focuses on the parties' actual intent at the time the transaction was entered into.¹⁶² Nevertheless, as opposed to the

158. *Id.* at 1175, n.9.

159. *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 191 (D. Conn. 2004) ("Relevant to this inquiry is the taxpayer's subjective intent to reach a particular result by directing a series of transactions to an intended purpose or structuring them in a certain way") (citing *True*, 190 F.3d at 1175).

160. *Id.* (citing *Blake v. Comm'r.*, 697 F.2d 473, 478-79 (2d Cir. 1982). *See also* *Greene v. United States*, 13 F.3d 577, 583 (2d Cir. 1994) ("For the government's characterization of the transaction to be accurate, the record facts would have to demonstrate that a prearranged plan for disposition of the futures contracts existed").

161. *Packard v. Comm'r.*, 85 T.C. 397, 420 (1985) (emphasis added).

162. *True*, 190 F.3d at 1175 ("The taxpayer's subjective intent is especially relevant under this test because it allows us to determine whether the taxpayer directed a series of transactions to an intended purpose."); *Brown v. United States*, 782 F.2d 559, 563 (6th Cir. 1986) (noting the "end result test" for determining when to apply "step transaction doctrine" makes intent a necessary element for application of doctrine); *Weikel v. Comm'r.*, 51 T.C.M. (CCH) 432, *25 (1986) ("The [end result] test involves an examination of the intention of the parties to determine what result the parties were seeking when the transaction was undertaken") (citing *Seymour S. Mintz & William T. Plumb, Jr., Step Transactions in Corporate Reorganizations*, 12 N.Y.U. INST. ON FED. TAX'N 247,

subjective business purpose test (which is a subjective analysis of the taxpayer's intent under the economic substance's two prong test), where the court focuses on the taxpayer's *intent to avoid taxes*, a court applying the end result focuses on a different intension, namely the *intent to reach the end result*.

In my view and as suggested in greater detail below, the end result test should become the subjective prong of the step transaction doctrine. In general, I think that the end result and business purpose tests share the same fundamental principle – examining the taxpayer's subjective motivation in connection with the transaction. Thus, similar to the business purpose test that has become the subjective prong of the economic substance test, the end result test would become the subjective prong of the step transaction principle.

C. The Mutual-Interdependence Test

Pursuant to the third alternative test, separate steps will be collapsed if, under a reasonable interpretation of the objectively stated facts, the steps are interdependent on one another.¹⁶³ Stated differently, under the mutual interdependence test, the step transaction doctrine applies if “the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.”¹⁶⁴

251 (1954)).

163. *Kass v. Comm’r*, 60 T.C. 218, 226 (1973). *See also* *Redding v. Comm’r*, 630 F.2d 1169, 1177 (7th Cir. 1980), where the Court characterized the interdependence test as requiring “an evaluation whether on a reasonable interpretation of objective facts the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.” (quoting Randolph E. Paul & Phillip Zimet, *Step Transaction*, in *SELECTED STUDIES IN FEDERAL TAXATION 200 & 204* (2d. Series 1938)); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244 (5th Cir. 1983). (same); *McDonald’s Rests. of Ill. v. Comm’r*, 688 F.2d 520, 524-25 (7th Cir. 1982); *Kornfeld v. Comm’r*, 137 F.3d 1231, 1235 (10th Cir. 1998) (“The ‘interdependence test’ focuses on the relationship between the steps, 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”) (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1523 (10th Cir. 1991); *King Enters. Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969) (“The ‘interdependence test’ requires an inquiry as to “whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series”) (quoting Randolph E. Paul & Phillip Zimet, *Step Transaction*, in *SELECTED STUDIES IN FEDERAL TAXATION 200 & 204* (2d. Series 1938)).

164. *Redding v. Comm’r*, 630 F.2d 1169, 1177 (7th Cir. 1980) (quoting Randolph E. Paul & Phillip Zimet, *Step Transaction*, in *SELECTED STUDIES IN FEDERAL TAXATION 200 & 204* (2d. Series 1938)); *True*, 190 F.3d at 1175 (“The interdependence test takes a slightly different approach. Under this test, we disregard the tax effects of individual transactional steps if ‘it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts’”)

Thus, as opposed to the end result test, the mutual interdependence test concentrates on the relationship between the steps, rather than on their “end result.”¹⁶⁵ The court must, therefore, examine whether the individual steps or events have independent significance or merely have meaning as part of the larger transaction.¹⁶⁶ Accordingly, if the steps have “reasoned economic justification standing alone,” then applying the mutual interdependence test is inappropriate.¹⁶⁷ By contrast, when “it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts . . . step transaction treatment may be deemed appropriate.”¹⁶⁸ In order to apply the mutual interdependence test objectively, courts may compare the disputed transaction with those usually expected to occur in otherwise bona fide business settings.¹⁶⁹

The interdependence test has been applied frequently in cases involving corporate transactions.¹⁷⁰ For example, in *Kuper v. Comm’r.*, shareholders of a realty-owning corporation contributed all of their shares to an automobile dealership corporation owned by the same shareholders, which, in turn, made a cash capital contribution on the same day to the realty corporation, and on the following day the automobile corporation exchanged the realty corporation’s shares for one stockholder’s one-third ownership of the automobile corporation.¹⁷¹

(quoting *Kuper v. Comm’r.*, 533 F.2d 152, 156 (5th Cir. 1976)).

165. *Sec. Indus. Ins. Co.*, 702 F.2d at 1245.

166. *Id.* See *Penrod v. Comm’r.*, 88 T.C. 1415, 1430 (1987)

167. *True*, 190 F.3d at 1178 (quoting *Sec. Indus. Ins. Co.*, 702 F.2d at 1247). See *Andantech L.L.C. v. Comm’r.*, 83 T.C.M. (CCH) 1476, *106 (2002).

168. *Sec. Indus. Ins. Co.*, 702 F.2d at 1245 (quoting *Kuper*, 533 F.2d at 156) (“[the step transaction] approach is especially proper where, as here, it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts, all of which when seen together substantively form a taxpayer level stock swap.”).

169. *Andantech L.L.C.*, 83 T.C.M. (CCH) at *106-07 (“In order to maintain this objectivity and ensure the steps have independent significance, it is useful to compare the transactions in question with those usually expected to occur in otherwise bona fide business settings.”) (citing *Merryman v. Comm’r.*, 873 F.2d 879, 881 (5th Cir. 1989) *aff’g* 55 T.C.M. (CCH) 191 (1988).

170. *Associated Wholesale Grocers, Inc.*, 927 F.2d 1517, 1529 (10th Cir. 1991) (merger and reorganization followed by transfer of subsidiary treated as complete liquidation). See also *Sec. Indus. Ins. Co.*, 702 F.2d 1234 (acquisitions and reorganizations followed by transfer treated as complete liquidations); *McDonald’s Rests. of Ill.*, 688 F.2d 520 (merger and stock transfer followed by sale of stock treated as liquidation); *South Bay Corp. v. Comm’r.*, 345 F.2d 698 (2d Cir. 1965) (purchase of controlling interest in corporations followed by merger into principal corporation treated as purchase by principal corporation of controlling interests); *King Enters.*, 418 F.2d at 514-19 (stock acquisition followed by merger treated as reorganization). See generally Seymour S. Mintz & William T. Plumb, Jr., *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. INST. ON FED. TAX’N 247 (1954).

171. *Kuper v. Comm’r.*, 533 F.2d 152, 153-55 (5th Cir. 1976).

The Fifth Circuit affirmed the Tax Court's finding that these steps were mere steps to disguise a stock-for-stock transaction at the shareholder level, and therefore it treated the steps as a taxable exchange of stock.¹⁷²

In my view, the interdependence and end result tests differ in one important aspect – while the former test focuses on the question whether, objectively, each step is meaningless without the others, the latter test focuses on the parties' subjective intent in connection with the transaction. Thus, these two tests supplement each other in many aspects.

D. Summary

In my view, while most courts in cases involving the step transaction principle state that there are three alternative tests, as a practical matter, there is only one two-prong test.¹⁷³ As set forth above, the binding commitment test is rarely used and the IRS clearly avoids using it in its argument because it is the hardest to prove. In my view, this test should not be enumerated as one of three tests and could simply become a strong indicator that the step transaction ought to apply. As to the other two tests, in my view, they should become a two-prong test pursuant to which the step transaction doctrine would apply to collapse certain steps if both tests are met.

IV. THE TIMING DIFFERENCE BETWEEN EACH STEP

The essence of the step transaction doctrine involves evaluating whether several steps, typically made within a short period, ought to be collapsed into a single transaction.¹⁷⁴ Thus, "Courts will often, in addition to the tests noted above, examine the timing of the transaction at issue."¹⁷⁵ The Tax Court held that lapse of time between each step

172. *Id.* at 160-163.

173. *See, e.g.,* Del Commercial Props., Inc. v. Comm'r 78 T.C.M. (CCH) 1183, *12 (1999). Regardless of which theory is used under the step-transaction doctrine, the facts in this case result in the same conclusion. The facts reflect a step transaction created simply to bypass U.S. withholding tax. Del Netherlands had minimal assets, and Del Netherlands had only transitory possession of and no control over the \$14 million loan proceeds as the proceeds were passed from Delcom Financial to Del Commercial. Apart from the purported \$14 million loan to Del Commercial, Del Netherlands engaged in minimal business activity, and the Barbados branch of Del Netherlands had no officer with any substantive duties or responsibilities.

Id.

174. *See generally Andantech L.L.C.*, 83 T.C.M. (CCH) at *99-114.

175. *Weikel v. Comm'r*, 51 T.C.M. (CCH) 432 (1986). As the court illustrated in footnote 19: "... if two transactions occur within an hour of each other it would be reasonable to assume that the

may indicate whether such steps ought to be collapsed under the step transaction doctrine.¹⁷⁶

In *Litton Industries v. Comm'r.*,¹⁷⁷ a subsidiary declared a \$30 million dividend, which it paid to the corporation in the form of a promissory note.¹⁷⁸ Two weeks later, the corporation publicly announced its interest in disposing of the subsidiary.¹⁷⁹ At the first step, the corporation prepared a partial public offering of the subsidiary's stock.¹⁸⁰ Then, it decided to make a complete public offering.¹⁸¹ Prior to this public offering, another company bought all of the subsidiary's stock for cash and paid the corporation \$30 million for the promissory note.¹⁸² The Tax Court held that the dividend and acquisition constituted two separate transactions rather than a single transaction, partially on the grounds that a period of six months had elapsed between the dividend and the subsidiary's purchase.¹⁸³ The Tax Court distinguished this case from *Waterman Steamship Corp. v. Comm'r.*,¹⁸⁴ where all of the steps took place *within one hour and a half* and as a result, the court collapsed the steps, applying the step transaction doctrine.¹⁸⁵

In *Waterman Steamship*, the corporation received an offer to purchase the stock of two of its wholly owned subsidiary corporations,

second transaction was prearranged given the fact that it would be difficult to conceive and execute the second transaction in the interval of time available." *Id.* at n.19, citing Mintz and Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. INST. ON FED. TAX'N 247 (1954).

176. *D'Angelo Assoc., Inc. v. Comm'r.*, 70 T.C. 121, 129 (1978). *See also* Treas. Reg. §1.368-2(c) (as amended in 2006) pursuant to which the step transaction doctrine may apply if the relevant steps take place "over a relatively short period of time such as 12 months." *See also* Kimberly S. Blanchard, *NYSBA Comments on Temporary Regs on Affiliate-Owned Stock Rule*, Tax Notes Today, March 23, 2006, LEXIS, 2006 TNT 56-32, at n.45 ("Absent a binding commitment at the time of the first transaction to effect the second transaction, the shorter the period between the two the likelier that step-transaction doctrine will be applied. *See, e.g.*, P.L.R. 8742033 (July 20, 1987) (two transactions separated by 4 months were not independent)); Rev. Rul. 66-23, 1966-1 C.B. 67, declared obsolete on other grounds by T.D. 8760 (Jan. 28, 1998); Rev. Rul. 2003-99, 2003-2 C.B. 388 (discussing notwithstanding requirement, at time of acquisition, to dispose of target within 7 years, acquisition and subsequent disposition not stepped together); Rev. Rul. 69-48, 1969-1 C.B. 106 (discussing two transactions separated by 22.5 months stepped together").

177. 89 T.C. 1086 (1987).

178. *Id.* at 1088.

179. *Id.*

180. *Id.* at 1088-89.

181. *Id.* at 1089.

182. *Id.*

183. *Id.* at 1100. The Tax Court also indicated, however, that that at the time of dividend, the sale was not prearranged. *Id.*

184. 430 F.2d 1185 (5th Cir. 1970).

185. *Litton Industries*, 89 T.C. at 1096-97. *But see* *Uniroyal v. Comm'r* 65 T.C.M. (CCH) 2690 (1993) (noting that the steps took place closely in time, but the court did not collapse them).

Pan-Atlantic and Gulf Florida, for \$3,500,000 in cash.¹⁸⁶ The board of directors countered with an offer to sell the two subsidiaries for \$700,000 after the subsidiaries declared and arranged for payments of dividends to Waterman Steamship amounting in the aggregate to \$2,800,000.¹⁸⁷ The agreements included provisions for the declaration of a dividend by Pan-Atlantic to Waterman Steamship prior to the signing of the sales agreement and the closing of that transaction.¹⁸⁸ Furthermore, the agreements called for the purchaser to loan or otherwise advance funds to Pan-Atlantic promptly in order to pay off the promissory note by which the dividend had been paid.¹⁸⁹

Once the agreement was reached, the entire transaction was carried out by a series of meetings commencing at 12 noon on January 21, 1955, and ending at 1:30 p.m. the same day.¹⁹⁰ As the Fifth Circuit observed: “By the end of the day and within a ninety minute period, the financial cycle had been completed. Waterman had \$3,500,000, hopefully tax-free, all of which came from Securities and McLean, the buyers of the stock.”¹⁹¹

In *Coltec Indus. Inc. v. U.S.*¹⁹² although the step transaction was not explicitly discussed, the court held that the “longer the life span of the corporate vehicle utilized and term of any promissory notes issued, the more likely a court will find the transaction to have been undertaken for a ‘business purpose.’”¹⁹³

In *D’Angelo Assoc., Inc. v. Comm’r.*, immediately upon its incorporation in 1960, the taxpayer transferred its shares to a dentist and his family at the dentist’s direction.¹⁹⁴ At the same time, the dentist made a cash payment to the taxpayer, which assumed a mortgage liability on the dentist’s office building and issued a note to the dentist.¹⁹⁵ On its 1970 income tax return, the taxpayer claimed depreciation on the office building and deductions for life insurance premiums and vehicle expenses.¹⁹⁶ The Tax Court held that:

186. *Waterman Steamship Corp. v. Comm’r.*, 50 T.C. 650, 653 (1968).

187. *Id.* at 653-54.

188. *Id.* at 660.

189. *Id.*

190. *Id.* at 656-57.

191. *Waterman Steamship Corp. v. Comm’r.*, 430 F.2d 1185, 1190 (5th Cir. 1970).

192. 62 Fed. Cl. 716 (2004).

193. *Id.* at 743 (citing *Gregory v. Helvering*, 293 U.S. 465, 469-70 (1935)). *See also* *Estate of Kanter v. Comm’r.*, 337 F.3d 833, 865-66 (7th Cir. 2003).

194. *D’Angelo Assoc., Inc. v. Comm’r.*, 70 T.C. 121, 123 (1978).

195. *Id.* at 123-126

196. *Id.* at 127.

Petitioner has failed to convince us that a sale took place. The events significant to the creation of petitioner occurred almost simultaneously. The formation of petitioner, the transfer of \$15,000 cash to petitioner for the issuance of 60 shares of stock, and the transfer of the rental property to petitioner for the return of the \$15,000 in cash and the notes all occurred within an interval of less than 10 days. See sec. 1.351-1(a)(1), Income Tax Regs. The evidence demonstrates that these steps were integral parts of a plan designed by [the taxpayer] to transfer the assets used primarily in his dental practice from individual to corporate ownership.¹⁹⁷

Recently, in *InterTAN v. Comm'r*,¹⁹⁸ the Tax Court disregarded the issuance and redemption of preferred stock of a Canadian subsidiary that took place *on the same day*.¹⁹⁹ The court found that “[t]he disputed transaction resulted in no change or the economic position of either petitioner or [its subsidiary],”²⁰⁰ and that

[t]he purported issuance to petitioner of [the subsidiary]’s preferred stock was but one fleeting, transitory step in the disputed transaction that was undertaken so that [the subsidiary] could immediately redeem that stock, thereby enabling petitioner to claim that such redemption resulted in a dividend to it under sections 302 and 301.²⁰¹

In conclusion, the lapse of time between the steps is also relevant for determining which alternative test is to be applied. In a case in which the steps take place within a relatively long period, the IRS may attempt to apply the binding commitment test, pursuant to which steps might be collapsed into a single transaction even if the time lapsed between each step is long.²⁰² Nevertheless, since the binding commitment test is hardly used, the lapse of time between the each step would be a factor in either the end result or the interdependence tests. In both tests, steps that take place within a very short time could still be respected as separate, but the taxpayer will have to work harder to prove that each step has its own significance.

197. *Id.* at 129-30.

198. 87 T.C.M. (CCH) 767 (2004), *aff’d*, *InterTAN Inc. v. Comm’r* 117 Fed. Appx. 348 (5th Cir. 2004).

199. *Id.*

200. *Id.* at 40.

201. *Id.*

202. See *Andantech L.L.C. v. Comm’r*, 83 T.C.M. (CCH) 1476, *101-02 (2002) (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1522 n.6 (10th Cir. 1991)) (rejecting use of the binding commitment test because the case did not involve a series of transactions spanning several years).

V. THE RELATIONSHIP BETWEEN THE STEP TRANSACTION PRINCIPLE AND THE ECONOMIC SUBSTANCE/BUSINESS PURPOSE TEST

The step transaction doctrine is strongly related to the substance-over-form and economic substance/business purpose doctrines.²⁰³ In *Associated Wholesale Grocers, Inc. v. U.S.*, the Tenth Circuit further explained that:

The law is unclear as to the relationship between the step transaction doctrine and the business purpose requirement. Our survey of the relevant cases suggests that no firm line delineates the boundary between the two. Most cases applying the step transaction doctrine, far from identifying business purpose as an element whose absence is prerequisite to that application, do not even include discussion of business purpose as a related issue. In some cases, the existence of a business purpose is considered one factor in determining whether form and substance coincide. In others, the lack of business purpose is accepted as reason to apply the step transaction doctrine. We have found no case holding that the existence of a business purpose precludes the application of the step transaction doctrine.²⁰⁴

In some instances, taxpayers enter into a series of steps or transactions, each of which might be valid under the economic substance and/or business purpose tests. Many taxpayers have attempted to argue (some successfully and some not) that in such cases, the step transaction doctrine should not apply.

203. See Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365, 388 (1988).

Because the step transaction doctrine determines only what actions are to be looked at together to determine the "substance" of the transaction, its application is necessarily (but, again, not always explicitly) followed by application of the substance versus form doctrine, in that courts must determine the appropriate tax characterization of the redefined exchanges.

Id.

204. *Associated Wholesale Grocers, Inc.*, 927 F.2d at 1526-27. The Court in *True v. U.S.* stated:

The Trues' evidence and arguments regarding business purpose and economic effects raise issues more relevant to a sham transaction doctrine analysis than a step transaction doctrine analysis. Although both the step transaction and sham transaction doctrines are corollaries of the basic substance over form principle . . . the sham transaction doctrine focuses on whether a questionable transaction has a business purpose and economic effects other than the creation of tax benefits. . . . As described above, the step transaction doctrine is particularly tailored to the examination of transactions involving a series of potentially interrelated steps for which the taxpayer seeks independent tax treatment. Consequently, the step transaction doctrine provides the pertinent analytical framework in this case.

True v. United States, 190 F.3d 1165, 1177 n.11 (10th Cir. 1999) (internal citations omitted).

Many courts have refused to collapse a series of steps or transactions if all of them had legitimate tax consequences.²⁰⁵ As the Tax Court elaborated:

Just as the step transaction doctrine is inappropriate to generate events, neither may it rearrange events so as to cause a significant step in a transaction which actually takes place in one year to be treated for tax purposes as having taken place in a different year. Where a particular step has an independent tax consequence, as is the case here, that step is given its tax consequence in the particular year in which it takes place. The transfer of assets and distribution of stock each had independent substance. . . . We hold that when a taxpayer adheres strictly to the requirements of a statute intended to confer tax benefits, whether or not steps in an integrated transaction, when the result of the steps is what is intended by the parties and fits within the particular statute, and when each of the several steps and the timing thereof has economic substance and is motivated by valid business purposes, the steps shall be given effect according to their respective terms.²⁰⁶

In *Vest v. Comm'r*,²⁰⁷ the taxpayers organized a corporation for the purpose of correcting certain title problems in some land interests and to develop the mineral interests in the land.²⁰⁸ At the time of incorporation, the taxpayers were unaware that an exchange of stock was being contemplated between the formed corporation and an unrelated corporation that was interested in a lease of the oil and gas rights on taxpayers' land.²⁰⁹ The corporation was incorporated on July 21, 1965,²¹⁰ and on August 25, 1965 it signed a plan of reorganization with the unrelated party that provided for an exchange of stock.²¹¹ The corporation did not engage in any business operations and was dissolved shortly after the reorganization occurred.²¹² Despite the close proximity

205. See *Federal Nat'l Mortgage Ass'n v. Comm'r*, 100 T.C. 541, 583 (1993) (“[T]he step-transaction doctrine is inapplicable since the steps comprising each yen borrowing in its entirety were not meaningless—they were genuine and had economic substance”); *Esmark, Inc. v. Comm'r*, 90 T.C. 171, 195 (1988) (“Whether invoked as a result of the ‘binding commitment’, ‘interdependence’ or ‘end result’ tests, the doctrine combines a series of individually meaningless steps into a single transaction”); *MAS One L.P. v. United States*, 271 F. Supp. 2d 1061 (S.D. Ohio 2003), *aff'd*, 390 F.3d 427 (6th Cir. 2004).

206. See *Tandy Corp. v. Comm'r*, 92 T.C. 1165, 1172-73 (1989).

207. 57 T.C. 128 (1971), *aff'd in part and rev'd in part on other grounds*, 481 F.2d 238 (5th Cir. 1973).

208. *Id.* at 128-35.

209. *Id.* at 144-146.

210. *Id.* at 135.

211. *Id.* at 136.

212. *Id.* at 136.

of the incorporation to the exchange of stock, the Tax Court held that the step transaction doctrine was inapplicable because there was a business purpose for the formation of the corporation, (*i.e.*, to develop the mineral rights of the taxpayers' properties and to resolve the title problems inherent in those properties).²¹³

In *Falconwood Corp. v. United States*,²¹⁴ a parent corporation (TMCH) owned the stock of three companies, Mocatta, RC, and FSC.²¹⁵ Mocatta owned 100 percent of the stock of MFC, which owned 100 percent of the stock of WCI.²¹⁶ On December 23, 1986, TMCH and RC merged into Mocatta,²¹⁷ and WCI merged into MFC.²¹⁸ As a result, Mocatta owned all of the stock of MFC and FSC.²¹⁹ Several hours later Mocatta sold the stock of MFC and FSC to its shareholders.²²⁰ Mocatta filed a consolidated return for 1987 and claimed a \$10.3 million loss incurred after December 23, 1986, against the group's income for the 1984, 1986, and 1987 tax years.²²¹

Applying the step transaction principle, the IRS determined that the group terminated on December 23, 1986, that it must file a final consolidated return for the short tax year from April 1, 1986, to December 23, 1986, and that Mocatta, MFC, and FSC, would need to file individual returns for the period from December 24, 1986, to March 31, 1987.²²²

The Court of Federal Claims²²³ agreed with the IRS and determined that the group did not survive the merger because retaining the subsidiaries for only three hours following the merger did not satisfy the requirement under Treas. Reg. § 1.1502-75(d)(2)(ii)²²⁴ that there

213. *Id.* at 143-146. See also *Weikel v. Comm'r*, 51 T.C.M. (CCH) 432, *37-38 (1986) (citing *Vest v. Comm'r*, 57 T.C. 128, 143-146 (1971), *aff'd in part and rev'd in part on other grounds*, 481 F.2d 238 (5th Cir. 1973)); *Yamamoto v. Comm'r*, 73 T.C. 946, 955 (1980) ("The mere fact that steps occur close in time does not mean they are interrelated").

214. 422 F.3d 1339 (Fed. Cir. 2005).

215. *Id.* at 1341.

216. *Id.*

217. *Id.* at 1342.

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.* at 1343.

222. *Id.*

223. *Falconwood Corp. v. United States*, 60 Fed. Cl. 485 (2004).

224. Treas. Reg. § 1.1502-75(d)(2)(ii) provides:

The group shall be considered as remaining in existence notwithstanding that the common parent is no longer in existence if the members of the affiliated group succeed to and become the owners of substantially all of the assets of such former parent and there remains one or more chains of includible corporations connected through stock

“remains” a chain of subsidiaries.²²⁵ The court also applied the end result test of the step transaction doctrine (see below) and concluded that because the parties never intended to leave in place “a chain of corporations connected through stock ownership with a common parent”²²⁶ the group terminated on December 23, 1986.²²⁷

The Federal Circuit, however, reversed and remanded on two grounds.²²⁸ First, the Federal Circuit observed that pursuant to Treas. Reg. § 1.1502-75(d)(2)(ii), for a consolidated group to survive the merger of its common parent, the regulations should be read literally rather than substantively.²²⁹ Second, the Federal Circuit held that the step transaction principles have no role in the analysis because the transaction was supported by independent business purpose.²³⁰ The court observed that the step transaction doctrine “cannot override the statutory and regulatory context governing consolidated tax returns from which this case arises.”²³¹ The court concluded that “the regulations at issue leave no room for an application of the step transaction doctrine, where the [TMCH group] proceeded [with the initial mergers] for an independent business purpose and was thereafter bound to follow the consolidated return regulations at issue.”²³²

In *MAS One L.P. v. United States*,²³³ MAS One Limited Partnership was formed for the purpose of owning and operating an office building and had one general partner (“Generals”) and one limited partner (“Midland”).²³⁴ In 1989, MAS One amended its partnership agreement to expand its purpose to constructing and operating a second office building.²³⁵ To fund the expansion, MAS One borrowed \$14.5 million from The Huntington National Bank.²³⁶ Generals’ liability notwithstanding, Huntington required Midland to execute two guarantee

ownership with a common parent corporation which is an includible corporation and which was a member of the group prior to the date such former parent ceases to exist.

Id. (as amended in 2006).

225. *Falconwood Corp.*, 60 Fed. Cl. at 490-91.

226. *Id.* at 491

227. *Id.*

228. *Falconwood Corp. v. United States*, 422 F.3d 1339, 1353 (Fed. Cir. 2005).

229. *Id.* at 1348-49.

230. *Id.* at 1349-51.

231. *Id.* at 1353.

232. *Id.* at 1351.

233. *MAS One L.P. v. United States*, 271 F. Supp. 2d 1061 (S.D. Ohio 2003).

234. *Id.* at 1062.

235. *Id.*

236. *Id.* This loan was on a recourse basis, and under the loan’s terms, Generals, as the general partner, would be liable for its repayment. *Id.*

agreements.²³⁷ The first required Midland to pay \$2.5 million of the principal of the tower loan upon substantial completion of the office building.²³⁸ The second agreement required Midland to guarantee all interest payments for the life of the tower loan.²³⁹

In 1994, for other business reasons, Midland sought to divest itself of its MAS One investment.²⁴⁰ Therefore, on December 28, 1994, Midland abandoned its interest in MAS One immediately after a new, nominal partner was admitted to the partnership as a limited partner (for a contribution of only \$10).²⁴¹ On December 29, 1994, MAS One sold the property for \$4.1 million (paid to Huntington).²⁴² Midland then paid Huntington approximately \$8.3 million, the remaining balance of the tower loan, even though it was not liable to repay the loan principal under its guarantees.²⁴³

On its 1994 return, MAS One treated Midland's \$8.3 million payment to Huntington as a capital contribution.²⁴⁴ MAS One also claimed a \$7.3 million loss on the sale of the office building (allocating 98% to Generals and 2% to the new partner).²⁴⁵ The IRS, however, disagreed and treated Midland's \$8.3 million payment as partnership income under I.R.C. § 61.²⁴⁶

The IRS asked the District Court to apply the step transaction doctrine because "the individual steps involved with Midland's divestment of its Partnership interest should be as a single transaction, not a series of independent transactions."²⁴⁷ The taxpayer responded by stating that each independent transaction had business purpose and therefore, the step transaction doctrine was thus inapplicable.²⁴⁸

The court agreed with the IRS that Midland's \$8.3 million payment constituted income to the partnership, but still had to consider whether the step transaction applied.²⁴⁹ The court first noted that "the step transaction doctrine is not merely a method preventing tax avoidance,

237. *Id.*

238. *Id.*

239. *Id.*

240. *Id.*

241. *Id.* at 1063.

242. *Id.*

243. *Id.*

244. *Id.*

245. *Id.*

246. *Id.* at 1064.

247. *Id.*

248. *Id.* at 1067.

249. *Id.*

but can also be used for a taxpayer's benefit."²⁵⁰ As to the present case, the District Court held that "The step transaction doctrine is inapplicable in this case because the substance and the form of the transaction in question do not differ in any meaningful way."²⁵¹ Furthermore, the court elaborated that "each of the 'steps' of Midland's divestment of its interest in the Partnership had its own legitimate tax consequences. In fact, the tax consequences of each step of the transaction would be the same regardless of whether the Court views the transaction as a whole or as a series of isolated steps."²⁵² The District Court concluded that:

MAS One makes no attempt to avoid taxation in this case by focusing on isolated steps of a transaction rather than a whole transaction. Instead, each of the "steps" of Midland's divestment of its interest in the Partnership had its own legitimate tax consequences. In fact, the tax consequences of each step of the transaction would be the same regardless of whether the Court views the transaction as a whole or as a series of isolated steps.²⁵³

It appears that the meaning of the phrase "legitimate tax consequences" for this purpose is that each "step," standing alone, had economic substance and business purpose.²⁵⁴ The court, therefore, refused to apply the step transaction and disregard the separate steps.²⁵⁵ Under this approach, the step transaction doctrine is inapplicable whenever the taxpayer can show that each step could sustain the economic substance examination.²⁵⁶

Nevertheless, several courts have held that the existence of business purposes and economic substance for each individual step in a series of steps or transactions does not preclude the application of the step transaction doctrine.²⁵⁷ As the Tenth Circuit explained in *True v. U.S.*:

250. *Id.* (citing *Comm'r v. Clark*, 489 U.S. 726, 738 (1989) (applying the step transaction doctrine to reject the "counterintuitive conclusion urged by the Commissioner").

251. *Id.*

252. *Id.*

253. *Id.*

254. *Id.*

255. *Id.*

256. *Id.*

257. *Andantech L.L.C. v. Comm'r*, 83 T.C.M. (CCH) 1476, *97-98 (2002) ("The existence of business purposes and economic effects relating to the individual steps in a complex series of transactions does not preclude application of the step transaction doctrine") (citing *True v. United States*, 190 F.3d 1165, 1176-77 (10th Cir. 1999)); *Aeroquip-Vickers, Inc. v. Comm'r*, 347 F.3d 173, 183 (6th Cir. 2003) ("Here, although the individual steps of the transaction had a legitimate business reason, the transaction must be treated as a single unit and judged by its end result"); *True*, 190 F.3d at 1177 (stating that a non-tax "business purpose by itself does not preclude application of the step transaction doctrine"); *Kuper v. Comm'r*, 533 F.2d 152, 158 (5th Cir. 1976) ("A legitimate

To ratify a step transaction that exalts form over substance merely because the taxpayer can either (1) articulate some business purpose allegedly motivating the indirect nature of the transaction or (2) point to an economic effect resulting from the series of steps, would frequently defeat the purpose of the substance over form principle. Events such as the actual payment of money, legal transfer of property, adjustment of company books, and execution of a contract all produce economic effects and accompany almost any business dealing. Thus, we do not rely on the occurrence of these events alone to determine whether the step transaction doctrine applies. Likewise, a taxpayer may proffer some non-tax business purpose for engaging in a series of transactional steps to accomplish a result he could have achieved by more direct means, but that business purpose by itself does not preclude application of the step transaction doctrine.²⁵⁸

Similarly, in *Long Term Capital Holding* (discussed below) the court rejected a similar argument made by the taxpayer and held that “[the] application of the step transaction doctrine by its nature may

business goal does not grant taxpayer carte blanche to subvert Congressionally mandated tax patterns.”); *South Bay Corp. v. Comm’r*, 345 F.2d 698, 704 (2d Cir. 1965) (“[I]t must be doubted that the degree of integration requisite . . . can, or ought to, go to the extreme of requiring that each step be devoid of business significance unless united with one or more of the other steps”). *But cf.* *Del Commercial Props., Inc. v. Comm’r*, 251 F.3d 210, 213 (D.C. Cir. 2001). (“Under the step-transaction doctrine, a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes”).

258. *True*, 190 F.3d at 1177. *See also* *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1527 (10th Cir. 1991). The *Associated Wholesale Grocers* Court distinguished *Vest* and *Weikel*, stating:

Vest . . . considers business purpose as one factor among many in declining to apply the step transaction doctrine. After identifying a business purpose, the court undertakes a thorough discussion of whether to treat a stock exchange as a step transaction. 57 T.C. at 145. The court remarked “[t]he fact that there were business purposes for the incorporation of V Bar is an indication that its formation was not a step mutually interdependent with the subsequent stock exchange” and continued to consider other factors, including the existence of a binding commitment, the timing of the steps, and the actual intent of the parties. *Id.* at 145-46 (emphasis added). Far from precluding step transaction analysis, the business purpose was not even considered the most significant factor in *Vest*.

Weikel . . . appears to support the proposition [that the existence of a business purpose precludes the application of the step transaction doctrine]. *Weikel*, however, erroneously states that *Vest* declined to apply step transaction analysis because a business purpose was found. *Id.* at 440. Because *Vest* said no such thing, *Weikel* must be discounted.

Id. at n.15. *See* *Long Term Capital Holdings v. United States*, 330 F. Supp 2d 122, 193 (D.C.Conn. 2004) (citing *Associated Wholesale Grocers*, 927 F.2d at 1527). *See also* *Long-Term Capital Holdings, LP v. United States*, 150 Fed. Appx. 40, 43 (2d Cir. 2005) (“[A]ny economic effects that may have resulted from the partnership do not preclude the imposition of the step transaction doctrine.”).

ignore economic relations created by the parties, notwithstanding impact on bona fide economic effects.”²⁵⁹ Nevertheless, because the court first discussed the economic substance and business purpose aspects of the transaction and concluded that the transaction had neither of these, it would follow that the step transaction analysis ought to result in favor of the government. In other words, as I conclude below, when a transaction has no economic substance, it is hard to imagine that a court will allow tax benefits under the step transaction principle.

In *Del Commercial Props., Inc. v. Comm’r*, the facts were as follows. Del Commercial Properties, Inc. is a fourth-tier subsidiary of an affiliated group whose parent is DL Shekels Holdings Ltd.²⁶⁰ Delcom Financial Ltd. is a second-tier subsidiary in the group.²⁶¹ Delcom Financial is a Canadian corporation that owns 100% of the stock of Delcom Holdings, Ltd., another Canadian corporation.²⁶² Delcom Holdings owns 100% of Delcom Cayman, Ltd. (Cayman Islands), which owns 100% of the outstanding stock of Delcom Antilles, N.V. (Netherlands Antilles).²⁶³ “Delcom Antilles owns 100% of the outstanding stock of Del Investments Netherlands B.V., a corporation organized in the Netherlands.”²⁶⁴

On July 18, 1990, the Royal Bank of Canada loaned \$18 million to Delcom Financial.²⁶⁵ That same day, Delcom Financial made two unsecured interest-bearing loans to Delcom Holdings, one of which (the one relevant to this case) was for \$14 million.²⁶⁶ Delcom Holdings then contributed about \$14 million to Delcom Cayman for common stock.²⁶⁷ On the same day, Delcom Cayman contributed about \$14 million to Delcom Antilles and received common stock in that entity.²⁶⁸ Later that date, Delcom Antilles contributed about \$14 million to Del BV and received common stock in that entity.²⁶⁹ The following day, Del Commercial borrowed \$14 million from Del BV.²⁷⁰ That same day, it

259. *Long Term Capital Holdings*, 330 F. Supp 2d at 193.

260. *Del Commercial Props., Inc.*, 251 F.3d at 211. From 1990 through 1993, Del Commercial Properties, Inc.’s principal business was leasing industrial real estate it owned in the United States. *Id.* at 212.

261. *Id.* at 211-12

262. *Id.* at 212.

263. *Id.*

264. *Id.*

265. *Id.*

266. *Id.*

267. *Id.*

268. *Id.*

269. *Id.*

270. *Id.*

guaranteed repayment of a portion of amounts owed by Delcom Financial to Royal Bank and authorized Royal Bank to place a mortgage on its real property in the U.S.²⁷¹ On January 1, 1991, Del Commercial began repaying Del BV.²⁷² Beginning in July 1992, Del Commercial began making its loan payments directly to Delcom Financial, and Delcom Financial then forwarded funds to Royal Bank in payment on the Royal Bank loan.²⁷³

The Tax Court held that the series of loans and stock contributions that began with Delcom Financial and ended with Del Commercial “reflect a step transaction created simply to bypass U.S. withholding tax.”²⁷⁴

The D.C. Circuit affirmed the Tax court’s decision and observed that “[i]n step-transaction cases, ‘the existence of formal business activity is a given but the inquiry turns on the existence of a nontax business motive.’”²⁷⁵ Accordingly, the court further explained that “[t]he Internal Revenue Service—and the courts—will ignore a step in a series of transactions if that step does ‘not *appreciably* affect [the taxpayer’s] beneficial interest except to reduce his tax.’”²⁷⁶

In *Associated Wholesale Grocers, Inc. v. U.S.*, the taxpayer relied on Rev. Rul. 79-250,²⁷⁷ pursuant to which:

The Internal Revenue Service has indicated on several occasions that threshold steps will not be disregarded under a step transaction

271. *Id.* Del Commercial “also agreed to provide Royal Bank with ‘annual financial statements, to insure its real property, to assign the insurance policies to Royal Bank, to defer paying dividends to shareholders, and to use the proceeds from any sales of real property to make payments on the \$14 million Royal Bank loan.’” *Id.* (quoting Brief for Appellee, *Id.* (No 01-681) at 3).

272. *Id.* Del BV transferred these payments either to Delcom Holdings or Delcom Financial. *Id.*

273. *Id.* “Throughout this time, Del BV reported the interest paid by appellant as income on its Netherlands tax returns. Meanwhile, Del Commercial did not file United States withholding tax returns or deposit withholding taxes on any payments related to the loan.” *Id.*

274. *Del Commercial Properties, Inc. v. Comm’r*, 78 T.C.M. (CCH) 1183, *11 (1999) (“We have applied the step-transaction doctrine to disregard the use of intermediaries and conduits for Federal tax purposes”). Because the taxpayer had not “presented any credible argument” that its failure to file a tax return or deposit withholding taxes was “attributable to reasonable cause,” the Tax Court concluded that appellant owed penalties in addition to the withholding taxes. *Id.* at 14.

275. *Del Commercial Props., Inc.*, 251 F.3d at 214 (quoting *ASA Investerings Partnership v. Comm’r*, 201 F.3d 505, 512 (D.C. Cir. 2000)).

276. *Id.* (quoting *ASA Investerings*, 201 F.3d at 514 (quoting *Knetsch v. United States*, 364 U.S. 361, 366 (1960))) (emphasis in original). The court elaborated that “if the sole purpose of a transaction with a foreign corporation is to dodge U.S. taxes, the treaty cannot shield the taxpayer from the fatality of the step-transaction doctrine.” *Id.*

277. *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1526-27 (10th Cir. 1991).

analysis if such preliminary activity results in a permanent alteration of a previous bona fide business relationship. Thus, the substance of each of a series of steps will be recognized and the step transaction doctrine will not apply, if each such step demonstrates independent economic significance, is not subject to attack as a sham, and was undertaken for valid business purposes and not mere avoidance of taxes.²⁷⁸

The court, however, refused to rely on this ruling, and held that “We therefore reject the contention that a valid business purpose bars application of step transaction analysis in this context.”²⁷⁹

In conclusion, the court in *The Falconwood Corp. v. United States*²⁸⁰ provided an excellent summary of the competing authorities on that matter and concluded that

[b]ecause the regulations [broke] no discretion on the part of Falconwood in filing a consolidated tax return once the Mocatta Group proceeded to Configuration B, a move motivated by an independent business purpose, we think it correct to require both parties, turning square corners, to live with the end result of Falconwood’s regulatory compliance We thus determine that an independent business purpose precludes application of the step transaction doctrine in the context of the particular regulatory scheme at issue here. . . .²⁸¹

On the other hand, as discussed above, other circuits such as the Second Circuit in *Long-Term Capital Holding* have different view.²⁸²

In my view, the existence of business purpose and economic substance for each step could be a factor in not applying the step transaction doctrine, but not the only one. Thus, a court should consider all the relevant facts and circumstances, including the existence of such business purpose in determining the application of the doctrine.

278. *Id.* at 1526 n.8 (quoting Rev. Rul. 79-250, 1979-2 C.B. 156).

279. *Associated Wholesale Grocers*, 927 F.2d at 1527. *See also* *Aeroquip-Vickers, Inc. v. Comm’r*, 347 F.3d 173, 183 (6th Cir. 2003).

Here, although the individual steps of the transaction had a legitimate business reason, the transaction must be treated as a single unit and judged by its end result. “To ratify a step transaction that exalts form over substance merely because the taxpayer can either (1) articulate some business purpose allegedly motivating the indirect nature of the transaction or (2) point to an economic effect resulting from the series of steps, would frequently defeat the purpose of the substance over form principle.”

Id. (quoting *True v. United States*, 190 F.3d 1165, 1177 (10th Cir. 1999)).

280. 422 F.3d 1339 (Fed. Cir. 2005).

281. *Id.* at 1352.

282. *See* *Long-Term Capital Holdings, LP v. United States*, 150 Fed. Appx. 40 (2d Cir. 2005).

VI. THE STEP TRANSACTION DOCTRINE AS A BACKSTOP

As discussed herein, in many cases involving a series of transactions or steps, the IRS challenged the associated tax benefits with the step transaction principle. In these cases, the doctrine was used by the IRS as the primary weapon in its challenge, and the courts followed with a decision based on the doctrine.²⁸³ Nevertheless, in several recent high-profile tax shelter cases, the IRS has been raising the step transaction argument as an alternative (rather than primary) argument to disallow tax benefits. In particular, in *Anadantech, L.L.C., Long Term Capital Holding*, and *Santa Monica* (discussed below) the IRS has mainly relied on the economic substance/business purpose analysis, but as an alternative, argued that the disputed transaction ought to be reclassified under the step transaction principle, resulting in disallowance of tax benefits. In these cases, as discussed below, the courts agreed with the IRS, applied the doctrine, and reached the same conclusion that was reached under the economic substance analysis.

A. *Andantech, L.L.C. v. Comm'r.*

Andantech, L.L.C. was formed by two Belgian²⁸⁴ individuals with \$200,000 of equity (\$196,000 by one partner and \$4,000 by the other)²⁸⁵ and a \$14.9 million loan from a Swiss Bank.²⁸⁶ Andantech purchased computers from Comdisco for \$14.9 million in cash and \$107 million in notes and leased them back to Comdisco for 36 months.²⁸⁷ Andantech sold the rents due from Comdisco to a NationsBank for \$87.8 million.²⁸⁸ This sale resulted in redemption of \$87.8 million of the notes due from Andantech to Comdisco, leaving approximately \$19.5 million of the notes outstanding.²⁸⁹

Shortly after, the Belgian members assigned their interests in Andantech to U.S. entities.²⁹⁰ In return for the assignment, the assigning members holding 98% interest received preferred shares in RDL that provided for a 6.878 dividend rate and a liquidation preference or

283. *Associated Wholesale Grocers*, 927 F.2d at 1521-26; *Penrod v. Comm'r*, 88 T.C. 1415, 1428 (1987).

284. *Andantech L.L.C. v. Comm'r*, 83 T.C.M. (CCH) 1476, *11 (2002).

285. *Id.* at *49-50.

286. *Id.* at *52.

287. *Id.* The computers were leased to end-users. *Id.* at *51.

288. *Id.* at *62.

289. *Id.* at *20-41, charts 1-12.

290. *Id.* at *63. Two percent were sold to an entity ultimately owned by a charitable trust and 98% interest was sold to RDL Leasing, Inc. *Id.* at *64.

\$615,000.²⁹¹ The members treated the assignments of interests as a termination of a partnership;²⁹² therefore, the income from the sale of the rent income would not be subject to U.S. tax.²⁹³ RDL viewed its basis in Andantech the same as the transferor's basis under I.R.C. §362(a).²⁹⁴ Andantech treated the assignment of interests as a deemed distribution and re-contribution of partnership property to a *new partnership* under Treas. Reg. §1.708-1(b)(1)(iv).²⁹⁵ Accordingly, Andantech took the view that it has a substituted basis in the computers equal to the computers' adjusted basis in the hands of the contributing partners, and that such computers are eligible for depreciation in the hands of the new U.S. partners.²⁹⁶

The Tax Court disallowed the tax benefits under a number of theories. First, the Tax Court observed that Andantech did not constitute a valid partnership for federal income tax purposes because the partners never intended to join together for the purpose of carrying on a business and sharing in the profits and losses from an equipment leasing activity.²⁹⁷ The Tax Court observed that for this purpose, “[b]usiness activity” excludes activity whose sole purpose is tax avoidance.²⁹⁸ Accordingly, the Tax Court held that “[t]he record reveals that Andantech-Foreign was not created for the purpose of carrying on a trade or business but rather to strip the income from the transaction and avoid U.S. taxation. Consequently, we will not recognize Andantech-Foreign as a partnership for Federal income tax purposes.”²⁹⁹

Second, the Tax Court applied the step transaction principle and concluded that even if Andantech constituted a valid partnership for federal income tax purposes, the period when Andantech was owned by the Belgian members, through the sale of the rent income, should be disregarded under the step-transaction doctrine because the involvement of the Belgian members was merely to act as a shell or conduit to strip the rental income from the overall transaction.³⁰⁰ The Tax Court first observed that “Under the step transaction doctrine, a series of formally

291. *Id.* The loan from the Swiss Bank was accelerated by virtue of the assignment; therefore, the new domestic members contributed capital to repay the loan. *Id.* at *66.

292. *Id.* at *68.

293. *Id.* at *87.

294. *Id.* at *84.

295. *Id.* at *85.

296. *Id.*

297. *Id.* at *90.

298. *Id.* at *91 (citing *ASA Investering P'ship v. Comm'r*, 201 F.3d 505, 512 (D.C. Cir. 2000)).

299. *Id.* at *95 (citing *ASA Investering*, 201 F.3d at 512).

300. *Id.* at *96.

separate steps may be collapsed and treated as a single transaction if the steps are in substance integrated and focused toward a particular result.”³⁰¹

Under this standard, thus, the Tax Court held that the transaction should be treated as directly between Comdisco and RDL (the majority U.S. member who would enjoy the rental income as well as deductions associated with the computers).³⁰²

The Tax Court discussed all three alternative tests under the step transaction doctrine and observed that “[m]ore than one test might be appropriate under any given set of circumstances; however, the circumstances need satisfy only one of the tests in order for the step transaction doctrine to operate.”³⁰³ The Tax Court first discussed the binding commitment test and observed that

[b]ecause the transactions in the present case do not span a long period of time or involve a binding commitment to pursue successive steps, we do not analyze them under the binding commitment test. Thus, in this case, only the end result and interdependence tests are relevant to our step transaction analysis.³⁰⁴

The Tax Court, therefore, continued and applied the end result test. The Tax Court explained the application of the end result test:

The end result test combines into a single transaction separate events that appear to be components of something undertaken to reach a particular result. Under the end result test, if we find that a series of closely related steps in a transaction is merely the means to reach a particular end result, we will not separate the steps but instead will treat them as a single transaction.³⁰⁵

Applying this standard, the Tax Court observed that it must examine “whether Comdisco and Norwest intended from the outset to transfer the benefits and burdens of the sale-leaseback of the equipment to RD Leasing.”³⁰⁶

Accordingly, the court continued “[i]f the intended end result was for RD Leasing to have those benefits and burdens, then petitioners cannot claim a right to favorable tax treatment for the various

301. *Id.* at *99.

302. *Id.* at *109.

303. *Id.* at *99.

304. *Id.* at *101.

305. *Id.* at *101-02 (internal citations omitted).

306. *Id.* at *103.

intermediate transactions leading up to that intended result.”³⁰⁷

The Tax Court concluded that

[t]he record clearly indicates that every step taken by the parties (the formation of Andantech, the sale-leaseback of the equipment between Comdisco and Andantech, the sale of the Comdisco rents to NationsBank, and the contribution by Mr. Parmentier of his interest in Andantech to RD Leasing) were but transitory steps.³⁰⁸

Finally, the Tax Court reached the same result under the interdependence test. The Tax Court explained the essence of this test: “The interdependence test requires a court to find whether the individual steps had independent significance or had meaning only as part of the larger transaction.”³⁰⁹ Reviewing all the steps of the transaction, the Tax Court concluded that

[s]tanding alone, none of the individual steps in the transaction at issue is the type of business activity one would expect to see in a bona fide, arm’s-length business deal between unrelated parties, and none of them makes any objective sense standing alone without contemplation of the subsequent steps in the transaction. Each step in the transaction leads inexorably to the next. Consequently, the interdependence test is satisfied for application of the step transaction doctrine.³¹⁰

The District of Columbia Circuit affirmed the Tax Court’s decision that a partnership formed to engage in a lease stripping transaction should be disregarded for tax purposes.³¹¹ The D.C. Circuit only focused on the economic substance of the partnership and agreed with the Tax Court that the record established that the parties never intended to join together as partners to run a business and that the partnership had no legitimate non-tax purpose.³¹² The D.C. Circuit followed its decision in *ASA Investerings*³¹³ and stated that “the absence of a non-tax business purpose for a partnership is fatal to its validity.”³¹⁴

Thus, the D.C. Circuit affirmed the Tax Court’s decision that the partnership had no economic substance.³¹⁵ The Court of Appeals did not address the remaining Tax Court’s holdings invalidating the entire

307. *Id.*

308. *Id.* at *103-04.

309. *Id.* at *106.

310. *Id.* at *111.

311. *Andantech L.L.C. v. Comm’r*, 331 F.3d 972, 981-82 (D.C. Cir. 2003).

312. *Id.* at 980.

313. *ASA Investerings P’ship v. Comm’r*, 201 F.3d 505 (D.C. Cir. 2000).

314. *Andantech L.L.C.*, 331 F.3d at 979-80 (citing *ASA Investerings*, 201 F.3d at 513).

315. *Id.* at 980.

transaction on economic substance and similar grounds.³¹⁶ Instead, the D.C. Circuit remanded the case to the Tax Court to determine whether the Tax Court had jurisdiction to decide the tax consequences of the individual “partners” on a separate taxpayer basis.³¹⁷

B. Long Term Capital Holding

During 1996, Onslow Trading & Commercial LLC (“OTC”) contributed cash and the loss stock to Long Term Capital Partners LP (“LTCP”) in exchange for a partnership interest in LTCP.³¹⁸ OTC borrowed the cash component of its contribution from Long-Term Capital Management UK, a UK entity related to Long-Term Capital Management LP (“LTCM”), the general partner of LTCP.³¹⁹ In addition, OTC purchased from LTCM a “liquidity put” and a “downside put” with respect to its interest in LTCP.³²⁰ In December 1997, LTCP sold some of the preferred stock with a basis of \$107M for approximately \$1M, producing a loss of \$106 M,³²¹ which was allocated to LTCM under I.R.C. §704(c).³²²

The IRS argued that under either the end result test or the interdependence test, OTC’s contributions of the preferred stock to LTCP in exchange for a partnership interest and the subsequent sale of that partnership interest to LTCM must be stepped together into a single sale transaction with the result that LTCM acquired the stock for its cost of \$1.1 million.³²³

The court agreed with the IRS and applied the end result test.³²⁴ Specifically, the court observed that:

OTC’s contributions of preferred stock to LTCP followed by the sale of the received partnership interest to LTCM was in substance a sale of the preferred stock for a purchase price determined as the greater of

316. *Id.* at 978.

317. *Id.*

318. Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 136 (D. Conn. 2004).

319. *Id.* at 136-37.

320. *Id.* In general, these puts, each of which could only be exercised on or between October 27, 1997 and October 31, 1997, gave OTC the right to put its interest in LTCP to LTCM for an amount equal to the greater of (i) the value of such interest at the date of the put or (ii) OTC’s original capital investment in LTCP. *Id.* at 137. OTC exercised its liquidity put on October 28, 1997, selling its entire interest in LTCP to LTCM for \$12,614,188, representing approximately a 22% return on OTC’s investment. *Id.* at 137-38. Of course, no I.R.C. §754 election was made.

321. *Id.* at 199.

322. *Id.* at 139.

323. *Id.* at 191.

324. *Id.*

\$103,824 (\$10,340,000 minus \$121,000 option premiums, \$787,883 interest on loan from LTCM (U.K.), \$9,327,293 loan principal from LTCM (U.K.)) or that amount plus the excess of the value of the partnership interest over \$10,340,000 between October 27-31, 1997.³²⁵

The court also concluded that this result was supported by the fact that Long Term had no business purpose for the transaction other than tax avoidance.³²⁶ Thus, as discussed above, the court made a clear connection between the business purpose and step transaction principles.³²⁷ In particular, the court said that: (i) Long Term had no interest in OTC as an investor; (ii) OTC had no interest in investing specifically in LTCP and was only interested in obtaining cash for its preferred stock; and (iii) OTC intended to exercise its put options and Long Term understood and agreed to accommodate such intent.³²⁸

Thus, the court concluded that “the various steps of the OTC transaction were prearranged to ensure that OTC would sell its partnership interests to LTCM by exercise of its put options, and that B&B was not interested in an investment vehicle for OTC but looked to earn fees (however disguised) from the sale of tax benefits.”³²⁹

On appeal, the Second Circuit affirmed the lower court’s decision.³³⁰ In particular, the taxpayer argued that the step transaction principle should not apply where each step of the transaction had a valid business purpose.³³¹ The Second Circuit disagreed and held that:

The district court did not err in finding that the sole purpose of the transaction here was to transfer losses from OTC to LTCM and that any intervening steps taken in pursuit of this goal were economically meaningless. The manner in which LTCM increased its partnership share—by routing money through OTC—was economically meaningless because “[u]nder the step transaction doctrine, a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no purpose than to avoid U.S. taxes.”³³²

Affirming the District Court’s decision on this ground, the Second

325. *Id.*

326. *Id.*

327. *Id.*

328. *Long Term Capital Holdings*, 330 F. Supp. 2d at 191-92.

329. *Id.* at 192.

330. *Long-Term Capital Holdings, LP v. U.S.*, 150 Fed. Appx. 40 (2d Cir. 2005).

331. *Id.* at 43.

332. *Id.* (quoting *Del Commercial Properties, Inc. v. Comm’r*, 251 F.3d 210, 213 (D.C. Cir. 2001)).

Circuit concluded that “any economic effects that may have resulted from the partnership do not preclude the imposition of the step transaction doctrine.”³³³

*C. Santa Monica*³³⁴

Similar to *Long Term Capital Holdings*, at the heart of this case were high-basis, low-value assets, which the Tax Court described as having “tantalizing tax attributes.”³³⁵ The government argued that the taxpayers entered into partnership transactions designed to allow the tax losses from certain assets to be deducted by parties that had not suffered the losses and, to some extent, to allow the same economic losses to be deducted twice.³³⁶ To achieve this result, (1) the owners of the high-basis assets transferred them to a partnership in exchange for partnership interests while the taxpayer contributed cash to the same partnership, (2) within the same month, the high-basis partnership interests were sold to another partner, at a time when the partnership did not have an I.R.C. § 754 election, to step down the basis of the assets to their fair market value, in effect and (3) shortly thereafter, some of the high-basis, low-value assets were sold by the partnership, with the loss being allocated to the partner that had purchased the partnership interest of the original asset owner.³³⁷

Applying the economic substance doctrine, and, alternatively, the step transaction doctrine, the Tax Court rejected the taxpayer’s argument that formalistic compliance with statutory provisions necessarily entitles it to the tax benefits provided therein, and held that “[n]otwithstanding its form, the transaction did not, in substance, represent contributions of property in exchange for partnership interests”³³⁸

Similar to *Long Term Capital Holding*, the IRS invoked the “end result” test and argued that the contributions of the high-basis, low-value receivables and stock to the partnership and purchase of the preferred interests were really component parts of a single transaction intended from the outset to transfer the built-in tax losses.³³⁹

Furthermore, under the “interdependence” test, the IRS argued that that these steps were so interdependent that “either transaction alone

333. *Id.*

334. *Santa Monica Pictures, L.L.C. v. Comm’r*, 89 T.C.M. (CCH) 1157 (2005).

335. *Id.* at *10.

336. *Id.* at *146-294

337. *Id.*

338. *Id.* at 287.

339. *Id.* at 293.

would have been fruitless without the other.”³⁴⁰ Accordingly, under both tests, the IRS asked the court to conclude that the transaction should be recast as a direct sale of the high-basis, low-value receivables.³⁴¹

The court held that the step transaction applies to the transaction under both tests.³⁴² The court observed that the contributions were made solely for the purpose of transferring built-in tax losses to the Ackerman group, which “could not obtain the built-in tax losses through a direct purchase of the . . . receivables and stock, but could only obtain those losses by interposing a partnership and manipulating the partnership basis rules.”³⁴³

Furthermore, the court concluded that

[f]rom the beginning, both parties planned and understood that CLIS would receive a \$5 million advisory fee and that the banks would exercise their put rights at the earliest possible point (December 31, 1996), exiting the partnership. The contributions, the payment of the advisory fee, and the exercise of the put rights were mutually interdependent steps taken to dispose of Generale Bank’s and CLIS’s ‘bad’ investments in the SMHC receivables and stock and to transfer the built-in tax losses to the Ackerman group.³⁴⁴

D. Summary

In all three cases, the courts began with the economic substance analysis and concluded first that the transactions had neither economic substance nor business purpose. Thus, when the courts turned to the step transaction discussion, it followed very naturally that the courts would not accept the taxpayers’ arguments that the step transaction doctrine should not apply. Thus, in cases where the transaction is challenged on both grounds, the economic substance challenge takes priority and, normally, the step transaction analysis will be heavily influenced by the decision on the first ground.

VII. PROPOSAL FOR CODIFICATION

In recent years, several legislative proposals to “codify” or “clarify”

340. *Id.* at 294.

341. *Id.*

342. *Id.*

343. *Id.* at 295.

344. *Id.* at 295-96.

the economic substance doctrine have been introduced in the United States Congress.³⁴⁵ These proposals, however, have been criticized not only by commentators but also by Government officials on various grounds.³⁴⁶ Some commentators have indicated that rather than “codifying” or “clarifying” a common law doctrine, the proposed legislation would set forth a new and higher standard, which has not been adopted by the vast majority of courts.³⁴⁷ Various commentators

345. See generally Monte A. Jackel, *For Better or For Worse: Codification of Economic Substance*, Tax Notes Today, May 18, 2004, LEXIS, 2004 TNT 96-33 (discussing the various legislative proposals). Senators Grassley and Baucus, the Chairman and Ranking Member of the Senate Finance Committee, have been the leading forces in promoting the codification of the economic substance doctrine. *Id.*

“It has been over two years since the collapse of Enron, and corporate scandals are still rampant,” Baucus said. “Over the past year, I have included this tax shelter legislation within a number of separate bills, and am now introducing it as a stand-alone bill in the hopes of achieving passage once Congress returns in January. It is inexcusable that Congress has not passed a single piece of tax shelter legislation to shut down these abusive tax practices . . . Tax shelters are not fair to the corporations and taxpayers who strive to comply with the law,” said Baucus. “We need to work on restoring faith in our tax system. Every day we fail to address abusive tax shelter practices, honest taxpayers pay the bill. The legislation Chairman Grassley and I introduced today will help combat abusive tax avoidance transactions. . . . There may be other proposals that should be examined to see if they can better shut down transactions without economic substance. I intend to work with Senator Grassley on alternative and additional proposals in the coming months,” Baucus said. . . . “I look forward to continuing to work together with Chairman Grassley to enact strong and meaningful tax shelter legislation early next year,” Baucus added. “I urge all of my congressional colleagues—in the House and the Senate—to join forces and send tax shelter legislation to the President for his signature. It is time to shut down these tax shelters and restore professional ethics. Congress cannot ignore this problem any longer.

Id. (quoting Sen. Max Baucus, *Baucus Introduces Bill to End Abusive Tax Shelters*, Tax Notes Today, Nov. 25, 2003, LEXIS, 2003 TNT 227-28).

346. See Jane G. Gravelle, *CRS Reviews Revenue-Raising Proposals Of The 108th Congress*, Tax Notes Today, Feb. 28, 2005, LEXIS, 2005 TNT 38-68, which notes the following commentary opposing the codification:

[T]he letter from Andrew Berg to Chairman Thomas and Senator Grassley on the economic substance doctrine and the Apr. 24 letter to Chairman Grassley and Ranking Member Baucus from Herbert Beller of the American Bar Association (reprinted in the Bureau of National Affairs, *Daily Tax Report*, Apr. 28, 2003). See also New York State Bar Association Tax Section, “Economic Substance Codification,” Tax Notes, June 23, 2003; Peter L. Faber, letter to the Chairman Thomas, reprinted as “Practitioner to Congress: Don’t Try to Codify Economic Substance,” Tax Notes, Oct. 21, 2002, pp. 423-424; James M. Peaslee, letter to the Finance Committee, reprinted as “More Thoughts on Proposed Economic Substance Clarification,” Tax Notes, May 5, 2003, pp. 747-750, May 5, 2003.

Id.

347. See *id.*, n.13, citing the following commentary opposing the codification: an August 5, 2003 letter from Andrew Berg to Chairman Thomas and Senator Grassley on the economic substance doctrine, and an Apr. 24 letter to Chairman Grassley and Ranking Member Baucus from Herbert Beller of the American Bar Association, reprinted in the Bureau of National Affairs, *Daily*

have also warned that the proposed legislation could apply to common tax structuring and otherwise clearly permissible transactions.³⁴⁸

In my view, codification of the step transaction doctrine would be more acceptable because the doctrine is less controversial than the economic substance doctrine. In particular, while there are many uncertainties pertaining to the application of the economic substance's two prong test, courts have been more consistent in applying the step transaction doctrine. As discussed above, the main controversies involved in the application of the step transaction doctrine are as follows. First, some courts have stated that if the IRS satisfies one of the three alternative tests, it would be enough to conclude that the step transaction ought to apply, while other courts have determined that the IRS should satisfy more than one test. Assuming that the binding commitment test is rarely used, in my view, it is very unlikely that court will determine that the transaction falls under the end result test but not the interdependence test or vice versa. Thus, as I conclude herein, it is really a two-prong test.

Second, another issue pertaining to the application of the step transaction doctrine is whether satisfying the economic substance/business purpose test for each step can preclude the application of the step transaction doctrine. In my view, if a taxpayer can show that each step has economic substance, it should be another factor in not applying the doctrine, and then the court will consider all the other relevant factors and determine if the step transaction doctrine should apply to the disputed transaction. Thus, the existence of economic substance will be one factor out of several.

I suggest, therefore, to codifying the step transaction doctrine in a way that will be consistent with the vast majority of court decisions as well as IRS pronouncements.

First, the proposed code section would define the term "step transaction doctrine" as "the common law doctrine under which separate transactions or steps may be treated as a single, unified transaction for tax purposes." The provision can also state that it only codifies the step

Tax Report, Apr. 28, 2003. See also New York State Bar Association Tax Section, *Economic Substance Codification*, Tax Notes Today, June 23, 2003, Lexis, 2003 TNT 121-26; Peter L. Faber, letter to Chairman Thomas, reprinted as *Practitioner to Congress: Don't Try to Codify Economic Substance*, Tax Notes Today, Oct. 21, 2002, Lexis, 2002 TNT 204-60, 423-424.

348. See James M. Peaslee, *Economic Substance Codification Gets Worse*, Tax Notes Today, May 20, 2003, LEXIS, 2003 TNT 97-28 ("The profit test will be failed by many transactions that should be found to have economic substance"); Terrill A. Hyde and Glen Arlen Kohl, *The Shelter Problem Is Too Serious Not To Change The Law*, Tax Notes Today, July 8, 2003, 2003 TNT 130-44.

transaction doctrine but not other common law anti abuse rules.

Second, the proposed code section should state that the step transaction doctrine would apply to a given transaction if *both* the following two conditions are met: (i) the separate steps are a part of a single scheme designed to achieve a single result; and (ii) the steps are interdependent on one another. Thus, the IRS would have to show that both tests are satisfied to prevail. As set forth above, while the first prong is subjective and the second one is objective, it is very unlikely that a court would find that one prong is satisfied but not the other.

The code provision would add the following factors that can assist in a determination that the doctrine should apply or not: (i) whether at the time the first step takes place, the taxpayer was under a *commitment* to complete the remaining steps; (ii) whether the time between each step was significantly short (*e.g.*, several hours); and (iii) whether each step separately has economic substance. As discussed herein, while the first two factors would be in favor of the government, the last one would be in favor of the taxpayer. None of the factors, however, would be conclusive by itself.

Once it is determined that applying the step transaction doctrine to the particular case is appropriate, the proposed code provision should state the related actions by the IRS. If the step transaction doctrine applies, the court could either: (i) disregard transactions or steps in a transaction that it believes are unnecessary; or (ii) change the order of such transaction or steps. Nevertheless, the provision should emphasize that the IRS may not generate events which never took place.

Finally, regulations with particular examples would have to be issued by Treasury to provide the practical aspects of the rule. Such regulations could supply exemptions for individuals, for example, or for small transactions. Also, the examples contained in such regulations could include some of the cases discussed herein.

VIII. CONCLUSIONS - THE FUTURE OF THE STEP TRANSACTION PRINCIPLE

When courts are faced with a set of disputed steps or transactions the result of which provides a tax benefit to the taxpayer, the generally react by:

[E]nunciat[ing] a variety of doctrines, such as step transaction, business purpose, and substance over form. Although the various doctrines overlap and it is not always clear in a particular case which one is most appropriate, their common premise is that the substantive

realities of a transaction determine its tax consequences.³⁴⁹

Nevertheless, as discussed above, in many recent cases, the IRS first challenged, and the courts first discussed, the economic substance/business purpose of the disputed transactions. Then, as an alternative argument and when it was applicable, the IRS has raised the step transaction doctrine. Furthermore, in many cases, the courts held that the question whether the step transaction ought to apply to a disputed transaction at all depends on whether the transaction had economic substance. Some courts have refused to apply the step transaction doctrine when each step of the transaction had economic substance. Thus, it appears that the step transaction doctrine has become another “prong” of a bigger economic substance/business purpose analysis.

In my view, the role of the step transaction principle has diminished over the years and as of today, the principle serves as an alternative argument rather than the primary one.³⁵⁰ When a series of steps or transactions can be challenged in general as lacking economic substance and business purpose, the IRS prefers to begin with the economic substance doctrine. Once a court determines that the transaction had neither economic substance nor business purpose, it can move to the step transaction discussion, if applicable and “transform” the steps or transaction into their “true” substance.

As a result, codification of the doctrine would benefit not only the IRS but also the taxpayers; both will have some certainty pertaining to the question whether the doctrine should apply to the disputed transaction. In my view, this proposed codification is not only consistent with existing case law but also with the IRS’s view of the doctrine.

349. *King Enters., Inc. v. United States*, 418 F.2d 511, 516 n.6 (Ct. Cl. 1969).

350. For a similar view, see Ray A. Knight & Lee G. Knight, *Substance Over Form: The Cornerstone of Our Tax System or a Lethal Weapon In The IRS’s Arsenal?*, 8 AKRON TAX J. 91, 107 (1991).

Several recent cases, however, indicate that the step-transaction doctrine, as well as the related one of substance over form, may be easier for the taxpayer to overcome than at any time in the past. The IRS seems reluctant to argue its position on the basis of the step-transaction doctrine (favoring instead the more general substance over form doctrine), and the courts appear equally hesitant to apply it where the taxpayer has rigidly adhered to the form of the transactions. Thus, while the step-transaction doctrine has historically caused much anxiety because of its lack of precision, recent cases suggest that it is less threatening-i.e., less of a lethal weapon, and perhaps less of a cornerstone of sound taxation.

Id. (internal citations omitted); See also Robert W. Wood, *Is the Step Transaction Doctrine Still a Threat for Taxpayers?*, 72 J. TAX’N 296 (1990) (“Recent decisions indicate that the step-transaction doctrine may not be assiduously applied by the courts as it has been in the past”).

Thus, it is not expected to be heavily criticized as the proposed codification of the economic substance doctrine was. In addition, since the step transaction has become only an alternative route rather than the primary weapon against tax shelters, it seems that the codification of the doctrine should draw so much public attention.