



How and When to Apply Step Transaction Doctrine in Corporate and Partnership Restructuring Transactions

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I. INTRODUCTION

This outline reviews how the step transaction doctrine has been applied in some of the common types of internal restructuring transactions, in order to illustrate that the approach in the recent tax shelter cases of focusing on “no business purpose” is contrary to the approach followed by the courts and the Internal Revenue Service (“the IRS” or “the Service”) when applying step transaction principles to these various restructurings. While it may be difficult to discern when it may be sensible to apply the more rigorous version of step transaction from the recent tax shelter cases, I propose the test that I used as IRS Deputy Chief Counsel to determine whether to describe a particular transaction as a tax shelter: Was there a structure in search of transaction, or a transaction in search of a structure? The former often had the hallmarks of a tax shelter, while the latter did not. In the latter case, the well-known principles of tax planning in the corporate and partnership restructuring area should continue to apply.

A. General Concepts

The step transaction doctrine is a familiar concept to those who advise corporations on various types of internal restructurings. Often the doctrine is applied without regard to whether there is a tax avoidance motive driving the transaction. For example, if target stock is acquired in a purported “B” reorganization, and then the target is liquidated pursuant to an overall plan, practitioners understand that the transaction may not be tax-free unless it qualifies as a “C” reorganization.¹ Tax avoidance has nothing to do with this concern. Rather, there is simply a factual question presented of whether the stock acquisition and liquidation are part of the “plan of reorganization.”

¹ Rev. Rul. 67-274, 1967-2 C.B. 141.

B. Taxpayers' Affirmative Use of Doctrine

The step transaction doctrine can be a friend as well as an enemy. For example, assume a U.S. parent wants to transfer one controlled foreign corporation (“CFC 1”) to another controlled foreign corporation (“CFC 2”) for cash and then have CFC 1 make a check-the-box election. It is desired that the overall transaction be treated as a “D” reorganization, rather than a §304² transaction followed by a §332 liquidation. Practitioners are entitled to rely affirmatively on step transaction principles in collapsing the stock purchase and liquidation into a transfer of assets by CFC 1 to CFC 2 for cash followed by a liquidation of CFC 1 into the U.S. parent.³

² Unless otherwise indicated, all references to “Section” or “§” in this article refer to the Internal Revenue Code of 1986, as amended (the “Code”), and the regulations promulgated thereunder.

³ Rev. Rul. 2004-83, 2004-2 C.B. 157.

C. Multi-Step Transactions

Multi-step transactions designed to achieve a favorable tax result are often subject to more rigorous scrutiny when the results are significantly different depending on whether the steps are respected or collapsed. These situations must survive the more general principle that “form governs over substance except when it doesn't.” In other words, a taxpayer's form generally will be respected by a court if it has legal and economic substance, even where a different route would have resulted in more tax. Business purpose (or lack thereof) generally does not affect the outcome so long as the multi-step transaction is occurring within the context of a real business transaction.⁴

⁴ In one of the famous tax quotes of all time, Judge Learned Hand said in *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 239 U.S. 465 (1935): “Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”

D. Other Doctrines Appear Related but are Distinct

The step transaction doctrine is a judicially-developed concept which, stripped to its essentials, is a subset of the more general “substance over form” doctrine. It should not be confused with the economic substance doctrine.⁵ Nor should it be used by the government as an opportunity to introduce a business purpose requirement that is not otherwise required in the transaction at hand. The courts have done a reasonably good job of helping us determine when a particular transaction should be respected based on its legal or economic effects, without regard to the underlying tax motivation.⁶

⁵ See *e.g.*, *Rogers v. U.S.*, 281 F.3d 1108 (10th Cir. 2002), *aff'g* 58 F. Supp. 2d 1235 (D. Kan. 2000) (the Tenth Circuit court articulated how the substance over form doctrine is separate and distinct from the economic substance doctrine, the latter being inappropriate when the transaction “was not an attempted tax shelter entered into for the creation of tax losses, a mere sham devoid of economic substance”).

⁶ See, *e.g.*, *Cottage Savings Ass'n v. Comr.*, 499 U.S. 554 (1991) (Supreme Court respected swap of interests in mortgages for interests in other mortgages, notwithstanding taxpayer’s concession that transaction was undertaken solely for tax purposes); *Countryside Limited Partnership v. Comr.*, 95 T.C.M 1006 (2008) (Tax Court upheld transaction designed to effect nontaxable distribution to partners, notwithstanding taxpayer’s concession that particular form of transaction was undertaken solely for tax purposes).

E. Current Trends

Recently, several tax shelter cases involving loss generator transactions have relied on the step transaction doctrine as an alternative holding, after holding that the transaction was a sham under the economic substance doctrine.⁷ The economic substance doctrine denies the tax benefits of a transaction by causing the transaction to be completely ignored for tax purposes. That is, no portion of the transaction is respected — neither the beginning nor the end nor the middle. The alternative holding in these cases applying step transaction doctrine concludes that the middle is collapsed but the beginning and end are otherwise respected. The rationale given is that the taxpayer had no business purpose for the particular structure or set of steps, which was a finding that was already made under one of the two prongs of the economic substance doctrine. Unfortunately, these cases have, by using the step transaction doctrine as an alternative tool to attack tax shelters without any attempt to confine the analysis to the type of transaction involved, created precedent that might conceivably be used by the government to challenge more common corporate and partnership restructuring transactions.

⁷ *H. J. Heinz Co. & Subs. v. U.S.*, 76 Fed. Cl. 570 (2007); *Long-Term Capital Holdings, LP v. U.S.*, 2005-2 USTC ¶150,575 (2d Cir. 2005), *aff'g in unpublished opinion* 330 F. Supp.2d 122 (D. Conn. 2004).

II. STEP TRANSACTION DOCTRINE — GENERAL PRINCIPLES

A. The Analytical Framework

The step transaction doctrine treats a series of formally separate steps as a single transaction if the steps are, in substance, integrated and focused toward a particular result. The courts have applied three alternative tests in deciding whether to invoke the step transaction doctrine in a particular transaction, namely the “end result” test, the “mutual interdependence” test, and the “binding commitment” test.⁸

⁸ See *Penrod v. Comr.*, 88 T.C. 1415, 1428-30 (1987).

B. Binding Commitment

The “binding commitment” test is the narrowest alternative for applying the step transaction doctrine, and it typically favors the party who desires to have the separate steps respected.⁹ The binding commitment test forbids the use of the step transaction doctrine unless, at the time the first step is commenced, there is a binding commitment to take the later step.¹⁰

⁹ Taxpayers occasionally use binding commitments for a series of transactions where they seek to have the series integrated for tax purposes. For example, a parent company desiring to sell a substantial portion of its subsidiary to either the public or institutional investors may consider forming a Newco and transferring the subsidiary stock to Newco with a binding commitment to sell Newco stock, in order to “bust” §351 treatment and cause §338(h)(10) to apply.

¹⁰ See *Redding v. Comr.*, 630 F.2d 1169, 1178 (7th Cir. 1980), *cert. denied*, 450 U.S. 913 (1981);

C. End Result

The end result test is the most liberal version of the step transaction doctrine. Under this test, the step transaction doctrine will be invoked if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the beginning to arrive at the ultimate result.¹¹ The end result test is based upon the actual intent of the taxpayer.

¹¹ *Penrod v. Comr.*, 88 T.C. 1415, 1428 (1987); *Christian Est. v. Comr.*, 57 T.C.M. 1231, 1239 (1989).

D. Mutual Interdependence

The mutual interdependence test focuses on whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."¹² It would appear that the "mutual interdependence" test is most commonly applied by the Service.¹³

¹² *Redding*, 630 F.2d at 1177. See also *Kass v. Comr.*, 60 T.C. 218 (1973), *aff'd in unpub. opinion*, 491 F.2d 749 (3d Cir. 1974); *Farr v. Comr.*, 24 T.C. 350 (1955); *American Wire Fabrics Corp. v. Comr.*, 16 T.C. 607 (1951); *American Bantam Car Co. v. Comr.*, 11 T.C. 397 (1948), *aff'd* 177 F.2d 513 (3d Cir. 1949); *Associated Wholesale Grocers, Inc. v. Comr.*, 927 F.2d 1517, 91-1 USTC ¶150,165 (10th Cir. 1991).

¹³ See Rev. Rul. 79-250, 1979-2 C.B. 156, *modified by* Rev. Rul. 96-29, 1996-1 C.B. 50.

E. Lack of Bright-Line Analysis

Unfortunately, the courts and the Service have not delineated the particular circumstances in which the step transaction doctrine applies. It is not enough in a given case simply to cite the general principles and then claim that a particular step taken by the taxpayer should be ignored because it occurred closely in time to another step, or that it doesn't have economic justification, or that the taxpayer could have structured the transaction a different way. The cases need to be analyzed carefully to understand the particular circumstances in which this doctrine should be applied.

F. Effect is Often to Recharacterize, Not Recast

In some cases, the steps taken are respected as having occurred, but may not have the effect under the tax laws intended by the taxpayer if the step transaction doctrine is applied. For example, if A and B transfer property to Newco in exchange for all of Newco's stock in a purported \$351 transaction and then, pursuant to a binding contract, sell a portion of the Newco stock to a third party in a taxable sale that results in A and B owning less than 80% of Newco stock, A and B will still be treated as having transferred property to Newco for stock and then selling that stock in a taxable sale. However, the requirement under the Code that A and B acquire "control" of Newco will not be satisfied and, therefore, A's and B's transfer of property to Newco will be taxable.¹⁴

¹⁴ *E.g.*, Rev. Rul. 79-70, 1979-1 C.B. 144.

G. Multi-Step Transactions

In the case of multi-step transactions, courts have developed a few ground rules. The Service generally is prohibited from substituting steps for the steps actually consummated, or resequencing steps under the guise of the step transaction doctrine where the steps taken have enduring economic consequences. Where there are two ways to achieve a particular transaction, one being tax favorable and the other being tax adverse, the courts will not apply the step transaction doctrine to "generate events which never took place just so additional tax liability may be asserted."¹⁵ Nor will the courts resequence steps in a way more burdensome from a tax perspective (e.g., the Service treats taxpayer's second step as occurring before the first step) unless the particular steps taken by the taxpayer are "meaningless or unnecessary."¹⁶

1. These principles are well illustrated by the transaction in *Comr. v. Gilmore Est.*¹⁷ In that case, a holding company was merged into its 51%-owned subsidiary because the shareholders desired to eliminate the holding company. The shareholders claimed that the surrender of their holding company shares for subsidiary shares was a tax-free exchange pursuant to an "A" reorganization. The Service argued that since the transaction had the same economic effect as a liquidation of the holding company, the transaction should be treated as if the holding company had distributed its subsidiary stock to its shareholders in a taxable liquidation, since the taxpayer did not have a business purpose for the method chosen. The court refused to recharacterize the transaction, and it held for the taxpayers, stating: "We think this gets down to the proposition that if there are two ways of accomplishing a legitimate business result, one of which clearly creates a taxable transaction, one is equally subject to liability if he chooses the other unless there is an adequate

reason for the particular method used. We do not think this is the rule of the statute, the Regulations, nor, as we read them, the decisions.”¹⁸

2. In *Esmark v. Comr.*, Mobil wanted to acquire Vickers, a subsidiary of Esmark. If Esmark just sold Vickers to Mobil for cash, Esmark would recognize taxable gain. However, Esmark would avoid recognizing taxable gain under the Code if Vickers were transferred to an Esmark shareholder pursuant to a redemption of the shareholder's stock. In order to permit Esmark to rely on the favorable Code provision, Mobil acquired 54% of Esmark's stock through a cash tender offer. Immediately thereafter, Esmark redeemed Mobil's Esmark shares by transferring Vickers to Mobil. The Service argued that, under the step transaction doctrine, the transaction should be recharacterized as if Esmark sold Vickers to Esmark for cash and then used the cash to purchase the tendered shares from the shareholders. The Tax Court faulted the Service for not respecting Mobil's purchase of Esmark stock from Esmark shareholders. That transaction was meaningfully different from a corporate and legal perspective than a tender offer made by Esmark. While the overall plan of Esmark and Mobil to achieve a favorable tax result was not in dispute, the Service “pointed to no meaningless or unnecessary steps that should be ignored.”¹⁹

¹⁵ See *Grove v. Comr.*, 490 F. 2d 241 (2d Cir. 1973); *Comr. v. Gilmore Est.*, 130 F.2d 791 (3d Cir. 1942), *acq.*, 1946-2 C.B. 2 (taxpayer was entitled to merge parent into subsidiary in tax-free “A” reorganization and was not required to liquidate parent in taxable liquidation).

¹⁶ *Esmark, Inc. v. Comr.*, 90 T.C. 171 (1988), *aff'd in unpublished opinion*, 886 F.2d 1318 (7th Cir. 1989); *Turner Broadcasting Sys. Inc. v. Comr.*, 111 T.C. 315 (1998).

¹⁷ 130 F.2d 791 (3d Cir. 1942), *acq.*, 1946-2 C.B. 2.

¹⁸ *Gilmore*, 130 F.2d at 795.

¹⁹ *Esmark*, 90 T.C. at 195.

III. RELATED QUESTION OF ECONOMIC SUBSTANCE DOCTRINE IN CORPORATE CONTEXT

A. Historical Application of the Doctrine

The economic substance doctrine historically has been used by courts in cases involving individual tax shelters such as leases and straddles. These cases have adopted a two-pronged test for analyzing whether a tax shelter transaction is a “sham.” The first factor focuses on the taxpayer's subjective motive for choosing the transaction and is thus an intent test. The second factor is whether the transaction has economic substance. This factor is an objective determination of whether there existed any possibility of an economic profit other than tax benefits.

B. Fourth and D.C. Circuits

The Fourth and D.C. Circuits view the two-pronged test as conjunctive. That is, a transaction motivated solely by tax avoidance is not characterized as a sham unless the court also finds that the transaction lacks economic substance.²⁰ In *Black & Decker v. Comr.*,²¹ for example, the taxpayer conceded that its sole motivation for the transaction was tax avoidance, which meant that the taxpayer needed to fail the objective prong before the transaction could be disregarded.

²⁰ *Rice's Toyota World, Inc. v. Comr.*, 752 F.2d 89, 91 (4th Cir. 1985); *Horn v. Comr.*, 968 F.2d 1229 (D.C. Cir. 1992).

²¹ 436 F.3d 431, 441 (4th Cir. 2006).

C. Majority Approach

Most other courts find either that the taxpayer failed both prongs or that the taxpayer satisfied both prongs, leaving the question of whether the test is conjunctive or disjunctive unanswered in most jurisdictions.²² Many courts roll the two prongs together into a single question of “whether the transaction had any practical economic effects other than the creation of income tax losses.”²³

²² For example, The Second Circuit has not ultimately decided which version of the economic substance test it will use. The U.S. District Court in *Long-Term Capital Holdings*, note 7 above, citing *Gilman v. Comr.*, 933 F.2d 143 (2d Cir. 1991), suggested that it would use a “flexible” conjunctive test for applying the economic substance doctrine, that is, “a finding of either a lack of a business purpose other than tax avoidance or an absence of economic substance beyond the creation of tax benefits can be but is not necessarily sufficient to conclude the transaction is a sham.” Nevertheless, since the district court found that both were lacking, it did not decide whether the test is conjunctive or disjunctive in the Second Circuit. On appeal, the Second Circuit addressed issues other than the economic substance doctrine. The U.S. District Court in *TIFD III-E, Inc. v. U.S.*, 342 F. Supp.2d 94 (D. Conn. 2004), *reversed and remanded*, 459 F.3d 220 (2d Cir. 2006) (a.k.a. *Castle Harbour*), similarly declined to determine whether the standard in the Second Circuit

was conjunctive or disjunctive, but found that taxpayer satisfied both factors in concluding that the transaction was not a sham.

²³ *Keener v. U.S.*, 76 Fed. Cl. 455 (Fed. Cl. 2007).

D. Coltec

Recently, the Federal Circuit in *Coltec Indus., Inc. v. U.S.*,²⁴ stepped away from the pack and declared a disjunctive test in which a transaction may be disregarded “if the taxpayer’s sole motivation is tax avoidance, even if the transaction has economic substance,” and, conversely, “a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer’s sole motive is tax avoidance.” Obviously, if the *Coltec* rule were applied broadly to all corporate tax planning, it would conflict directly with the time-honored principle that taxpayers are free to arrange their affairs in order to minimize taxes.

²⁴ 454 F.3d 1340, 1355 (Fed. Cir. 2006).

E. Application of Economic Substance Doctrine to Commercial Business Transactions

Putting aside the debate over how to articulate the economic substance doctrine, the most difficult question for any court when analyzing a particular tax-driven transaction is whether the transaction should be tested under the rigorous version of the economic substance test as illustrated by *ACM Partnership v. Comr.*,²⁵ *Long-Term Capital Holdings v. U.S.*,²⁶ and *Coltec Indus. v. U.S.*, or the more lenient version of the economic substance test as illustrated by *United Parcel Service v. Comr.*²⁷ and *Kraft Food Co. v. Comr.*²⁸ Once that decision is made, it seems as though the court ends up being driven to a particular result, with the more rigorous approach often resulting in a government victory and the more lenient approach often resulting in a taxpayer victory.

1. Most of the recent corporate tax shelter cases involve isolated transactions outside the taxpayer’s trade or business that are specifically identified to generate a tax loss or deduction item.²⁹ In cases where the transaction occurs as part of the taxpayer’s ongoing business operations and does not have a separately identifiable profit or loss component, the courts generally do not require a business purpose and find the economic substance requirement to be satisfied if the transaction is real and has legal consequences; that is, no attempt is made to measure a pre-tax profit from the transaction.

2. For example, the Eleventh Circuit, in *United Parcel Service v. Comr.*,³⁰ confirmed that the economic substance doctrine traditionally used to analyze tax shelters does not apply when analyzing a transaction entered into as part of a company’s ongoing business activities. UPS restructured its operations so that certain insurance income was moved to an offshore insurance company that was spun off to the UPS shareholders. The Tax Court held for the Service, relying on a combination of the sham and economic substance doctrines and factual findings that the restructuring had no defensible business purpose. The Eleventh Circuit reversed in favor of the taxpayer. The court found that the restructuring had the necessary “economic effects” to remove it from “shamhood.” Further, the restructuring had the necessary business purpose because, “when we are talking about a going concern like UPS,” the transaction has a business purpose “as long as it figures in a bona fide, profit-seeking business.”³¹ The court distinguished the business purpose analysis that is applied to individual tax shelters or those corporate tax shelters such as ACM where the transactions “would not have occurred, in any form, but for tax avoidance reasons.”³² The court compared the U.S. corporation’s formation of offshore corporations to shift income overseas to a corporation’s choice between debt and equity, and acknowledged that a taxpayer does not lack a business purpose when it chooses between “different ways of financing [a] business.”³³

²⁵ 157 F.3d 231 (3d Cir. 1998).

²⁶ 330 F. Supp.2d 122 (D. Conn. 2004), *aff’d*, 2005-2 USTC ¶150,575 (2d Cir. 2005).

²⁷ 254 F.3d 1014 (11th Cir. 2001).

²⁸ 232 F.2d 118 (2d Cir. 1956), *rev’g* 21 T.C. 513 (1954). In footnote 89 of the *Long-Term Capital Holding* decision, the court distinguished the OTC investment from the transactions in *UPS*. The OTC investment “was a one-time purchase of a tax product by Long Term and different in almost every way from Long Term’s core investment business.”

²⁹ *E.g.*, *ACM Partnership v. Comr.*, 157 F.3d 231 (3d Cir. 1998).

³⁰ 254 F.3d 1014 (11th Cir. 2001).

³¹ *UPS v. Comr.*, 254 F.3d at 1019.

³² *Id.* at 1020.

³³ *Id.* at 1019. See also *Rogers v. U.S.*, 281 F.3d 1108 (10th Cir. 2002), *aff'g* 58 F. Supp. 2d 1235 (D. Kan. 2000) (corporation's redemption of shareholder was more appropriately analyzed under the substance over form doctrine than the economic substance doctrine because it "was not an attempted tax shelter entered into for the creation of tax losses, a mere sham devoid of economic substance"); *Northern Indiana Public Service Co. v. Comr.*, 115 F.3d 506 (7th Cir. 1997); *Kraft Food Co. v. Comr.*, 232 F.2d 118 (2d Cir. 1956), *rev'g* 21 T.C. 513 (1954).

IV. RELATED QUESTION OF ECONOMIC SUBSTANCE DOCTRINE IN PARTNERSHIP CONTEXT

A. The hallmarks of many recent economic substance cases involving partnerships are the acquisition and momentary ownership of a partnership interest or other asset — which is critical to achieving the tax benefits — before it is sold or otherwise closed out for a loss. Courts have held that the momentary ownership of a partnership interest lacks economic substance.

B. For example, in *ACM Partnership v. Comr.*, above, the newly formed partnership's acquisition and disposition of notes over a 24-day period, which was designed to generate a gain that was allocated to the foreign partner before such partner was later bought out by the U.S. partner, was held to lack economic substance. The court did not address the legitimacy of the partnership.

C. In *Long-Term Capital Holdings v. U.S.*, above, both business purpose and economic substance were lacking in a transaction involving the contribution of high basis "lease strip" property to a partnership followed by a sale of the partnership interest, the absence of a §754 election, and the partnership's triggering of the loss.

D. In *Santa Monica Pictures, LLC v. Comr.*,³⁴ both business purpose and economic substance were lacking in a transaction in which a foreign bank contributed high basis stock to a partnership and then sold its partnership interest to a U.S. person, where there was no §754 election in place.

³⁴ 89 T.C.M. 1157 (2005).

E. The D.C. Circuit has adopted a "sham entity" doctrine for partnerships, which is a somewhat odd form of economic substance doctrine. In the recent cases of *ASA Investerings*,³⁵ *Andantech*,³⁶ *Boca Investerings*,³⁷ and *Saba Partnership*,³⁸ the D.C. Circuit deviated from the standard of *Moline Properties* by adopting, arguably for the first time, a requirement that even if an entity engages in business activity, the entity may still fail the *Moline* standard unless it engages in some activity that is motivated by other than tax avoidance. These decisions seem to confuse the interplay of the *Moline Properties* principle, the *Culbertson* test, and the sham transaction or economic substance doctrine by adopting a single "sham entity" doctrine. The "sham entity" doctrine originated in the D.C. Circuit opinion in *ASA Investerings* which addressed the same "contingent installment sale" transaction that was invalidated in *ACM*. While the D.C. Circuit's opinion in *ASA Investerings* is quite confusing, it appears that it upheld the Tax Court's decision based in large part on the Tax Court's finding that the U.S. taxpayer lacked a non-tax business purpose for forming the partnership, and in the process it effectively added a gloss to the *Culbertson* test. Now, the *Culbertson* test in the D.C. Circuit asks whether "the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance."³⁹ Even if one accepts the D.C. Circuit's approach at face value, it is important to emphasize that the approach does not require a non-tax business purpose for the formation of the entity. Instead, the approach merely requires that the entity engage in some activity that is not motivated by tax avoidance.

³⁵ 201 F.3d 505 (D.C. Cir. 2000).

³⁶ 331 F.3d 972 (D.C. Cir. 2003).

³⁷ 314 F.3d 625 (D.C. Cir. 2003).

³⁸ 273 F.3d 1135 (D.C. Cir. 2003).

³⁹ *ASA Investerings*, 201 F.3d at 513 (emphasis added).

V. RELATED QUESTION OF TAX OWNERSHIP

A. Minimum Time Period

Often a step involves an entity's acquisition of ownership of assets or interests in a second entity for a short period of time before ownership is transferred elsewhere. It is difficult to discern any requirement that the acquired business be held for any minimum period of time in order for tax ownership to be acquired and then transferred to another person. If the interim ownership has sufficient substance to be respected for tax ownership purposes, then it would appear to be respected for all purposes.

B. *Esmark v. Comr.*

In *Esmark*, the government asserted, in addition to its step transaction argument, that Mobil's ownership of petitioner's stock was too transitory to be recognized for tax purposes. The Seventh Circuit rejected that argument in light of how the transaction entirely changed the ownership of Vickers, and served important

corporate, as well as shareholder, purposes. The government next contended that Mobil was not the “beneficial” owner of the Esmark shares acquired from the public shareholders. The Seventh Circuit dismissed that argument by noting that if Mobil did not acquire ownership of the Esmark shares, there must be someone else who is the “true owner” of the shares, which the government failed to identify. Significantly, the public shareholders lost the rights to vote their shares, receive dividends, or sell to anyone else.

Finally, the government contended that Mobil was a mere “conduit,” citing *Comr. v. Court Holding Co.*, 324 U.S. 331 (1945), and *U.S. v. Cumberland Public Service Co.*, 338 U.S. 451 (1950). In rejecting that argument, the court held that “the existence of a prearrangement does not necessarily signify the presence of a conduit that is to be disregarded. In order to disregard an entity as a conduit, the entity must be a mere intermediary in a transaction where the true ‘obligation,’ legal or otherwise, runs between other parties.”⁴⁰ In *Esmark*, there was no conduit because the public shareholders were under no obligation to sell or redeem their shares for cash.

⁴⁰ *Esmark*, 90 T.C. at 194.

C. Dover

The U.S. Tax Court recently held, in *Dover Corp. & Subs. v. Comr.*,⁴¹ that a first-tier controlled foreign subsidiary corporation (CFC) could check the box of a second-tier foreign subsidiary to treat such entity as disregarded, and then immediately sell the stock of the second-tier CFC to a third party and treat the transaction as a sale of assets. In holding for the taxpayer, the Tax Court confirmed that there is no business purpose requirement for the check-the-box election, which resulted in a deemed liquidation of the second-tier CFC. Thus, the first-tier CFC was able to effect a liquidation of the second-tier CFC solely for tax reasons and then immediately sell the assets it was deemed to receive and be respected as having acquired and then sold assets.

⁴¹ 122 T.C. 324 (2004).

D. Heinz

In *H.J. Heinz Co. v. U.S.*,⁴² the Court of Federal Claims held that a transaction between a subsidiary and a parent that was designed to trigger a capital loss was both a sham and subject to attack under the step transaction doctrine, but seemingly survived a tax ownership challenge. A U.S. subsidiary of the public parent purchased the parent's shares on the open market over a three-month period. Within two months of the last purchase, the parent redeemed all but 5% of the shares. The subsidiary treated the redemption as a dividend for tax purposes, which caused the basis in the redeemed shares to shift over to the retained shares. Several months later, the subsidiary sold the retained shares to a third party for a significant loss. The court found that the subsidiary appeared to acquire the benefits and burdens of owning the parent stock because it incurred significant debt to acquire the stock and received dividends during its period of possession, stating that “the fact that the transactions *sub judice* involved a parent corporation and a wholly-owned subsidiary, while suggesting a need for close scrutiny, does not alone provide a basis for ignoring the other indicia of ownership here.”⁴³ Nevertheless, the court held that the subsidiary was not entitled to claim the loss because the transaction failed the economic substance test and, alternatively, was subject to being collapsed under the step transaction doctrine.⁴⁴

⁴² 76 Fed. Cl. 570 (2007).

⁴³ *Heinz*, 76 Fed. Cl. at 582.

⁴⁴ *Cf. Compaq Computer Corp. v. Comr.*, 277 F.3d 778 (5th Cir. 2001) and *IES Industries Inc. v. U.S.*, 253 F.3d 350 (8th Cir. 2001) (momentary acquisition and ownership of stock before sale was respected under the economic substance doctrine).

VI. RELATED QUESTION OF BUSINESS PURPOSE

A. Statutory or Regulatory Business Purpose Requirement

Some transactions, such as §351 incorporations, §368 reorganizations, or §355 spinoff transactions, have their own business purpose requirements which have been developed by Service rulings and court decisions over the years. These requirements vary from one that is nearly nonexistent in the §351 area, to one that requires some credible showing of a reasonably sufficient business purpose in the §368 area, to one in the §355 area that is fairly stringent with one or more distinct categories into which the business purpose must fall.

B. Moline Properties

The formation of an entity — whether a corporation or a partnership — must satisfy the *Moline Properties* principle, which provides that a separate entity will be respected for tax purposes as long as its purpose is the equivalent of business activity or it carries on a business activity.⁴⁵ Apart from some confusion in the D.C.

Circuit as to whether a business purpose is necessary to form a partnership,⁴⁶ the *Moline Properties* principle means that an entity will be recognized for tax purposes if it engages in some amount of business or investment activity, even if it is formed to achieve for the main purpose of achieving a tax benefit.

⁴⁵ 319 U.S. 436 (1943). The Tax Court has applied *Moline Properties* to partnerships. See *Bertoli v. Comr.*, 103 T.C. 501, 511-12 (1994).

⁴⁶ See text accompanying footnotes 35-39.

C. Section 269

If §269 is implicated because control of a corporate entity is being acquired, an analysis of business purpose may be necessary. Section 269 provides that if (i) a taxpayer acquires control of a corporation, and (ii) the principal purpose of the acquisition is the evasion or avoidance of federal income tax by securing the benefit of a deduction, credit, or other allowance which the taxpayer or the acquired corporation would not otherwise enjoy, then the IRS may disallow such deduction, credit, or other allowance. The “control” requirement is met if a taxpayer acquires stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of all classes of stock of the acquired corporation. The second requirement of §269 consists of three interrelated elements, to wit: (1) principal purpose is evasion or avoidance of tax; (2) by securing benefit of deduction, credit, or other allowance; and (3) which taxpayer would not otherwise enjoy.

Section 269 is generally directed at a combination of stock (or property) which is independently owned before the combination (with the exception of the multiple surtax exemption area). The courts have held, in the context of corporations formed to obtain tax benefits specifically intended for corporations, that §269 generally does not apply to the formation of a new corporation even if the corporation is formed for the principal purpose of securing a tax benefit.⁴⁷

⁴⁷ E.g., *Achiro v. Comr.*, 77 T.C. 881, 895 fn. 18 (1981).

D. Is Business Purpose Required to Avoid Step Transaction?

While business purpose is a key component of the economic substance analysis, it is less clear whether business purpose should play a role in applying step transaction doctrine.⁴⁸ It appears to be relevant in some cases⁴⁹ and irrelevant in others.⁵⁰ Outside of the foregoing discrete areas, there is no independent requirement of business purpose in order for a particular transaction to be respected for tax purposes. Clearly, a transaction cannot be a sham and generally must have legal and economic substance to be respected for tax purposes. The courts are, for the most part, quite clear that a transaction having legal and economic substance will be respected for tax purposes even if it is done primarily (or even exclusively) for a tax avoidance purpose, at least outside of the tax shelter context.

⁴⁸ The Tenth Circuit in *Associated Wholesale Grocers, Inc. v. U.S.*, 927 F.2d 1517, 1526-27 (10th Cir. 1991), 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.

⁴⁹ Rev. Rul. 79-250, 1979-2 C.B. 156 (“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”); *Tandy Corp. v. Comr.*, 92 T.C. 1165, 1173 (1989) (step transaction doctrine does not apply “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”). Other courts have rejected the notion that a valid business purpose necessarily bars application of the step transaction doctrine. See *Aeroquip-Vickers, Inc. v. Comr.*, 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 v. U.S.*, 190 F.3d 1165, 1177 (10th Cir. 1999) (stating that a non-tax “business purpose by itself does not preclude application of the step transaction doctrine”); *Kuper v. Comr.*, 533 F.2d 152, 158 (5th Cir. 1976) (“A legitimate business goal does not grant taxpayer carte blanche to subvert Congressionally mandated tax patterns.”); *S. Bay Corp. v. Comr.*, 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. Comr.*, 251 F.3d 210, 213-14 (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").

⁵⁰ See, e.g., *Comr. v. Gilmore Est.*, 130 F.2d 791 (3d Cir. 1942), *acq.*, 1946-2 C.B. 2 (taxpayer was entitled to merge parent into subsidiary in a tax-free "A" reorganization and was not required to liquidate parent in a taxable liquidation); *Esmark, Inc. v. Comr.*, 90 T.C. 171 (1988), *aff'd in unpublished opinion*, 886 F.2d 1318 (7th Cir. 1989).

E. Frequent IRS Audit Position

While there is not an independent requirement of business purpose, the Service often asserts on audit that a particular transaction may not be respected because there is no independent business purpose nevertheless. For example, assume a U.S. subsidiary issues a promissory note to its foreign parent for the sole purpose of providing a vehicle for repatriating funds (i.e., via principal payments) in a tax-advantaged manner. The only issue should be whether the note constitutes debt as opposed to equity. The issuance is effectively a \$301 distribution, for which there is no business purpose requirement. Yet, given all the noise in the recent case law, the Service may still believe that the note should be ignored because there was no business purpose for its issuance.

F. Confusing Case Law

Cases such as *Coltec* and *Heinz* appear to add to the confusion by implying (arguably, at least) that a particular step in a multi-step transaction must have its own independent business purposes. These cases, however, are distinguishable from most complex, multi-step corporate or partnership restructuring transactions.

1. First, these cases involve "listed transactions" in which the taxpayers claimed significant losses, and are more easily in the category of an isolated transaction, like the one in *ACM*, than a business restructuring or transaction like the one in *UPS*.
2. Second, the business purpose analysis was in the context of applying the two-pronged economic substance test that has generally been reserved for tax shelters, and was not described as some kind of independent business purpose requirement.
3. Third, these cases involved bad facts, and as we know, "bad facts make bad law." In *Coltec*, for example, the Federal Circuit held that a contingent liability transaction failed the economic substance doctrine because it lacked business purpose and economic reality. The court narrowly defined the "transaction" at issue as the transfer that gave rise to the tax benefit, which in that case was Coltec's transfer of assets to its subsidiary and the subsidiary's assumption of Coltec's asbestos-related liabilities. The court then examined "the objective reality of the transaction" rather than the taxpayer's subjective intent, believing that "a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance."⁵¹ Coltec's claim that its decision to enter into the transaction was partially motivated by a desire to insulate itself from future asbestos-related liability, which the Claims Court had accepted, was insufficient to establish economic substance because according to the Federal Circuit, "looking at the transaction objectively, there is no basis in reality for the idea that a corporation can avoid exposure for past acts by transferring liabilities to a subsidiary."⁵² The essential reason why the taxpayer lost is that the transaction did not accomplish what the taxpayer said it did.

⁵¹ *Coltec Industries*, 454 F.3d at 1355-56.

⁵² *Id.* at 1359.

VII. RECENT LOSS GENERATOR CASES

A. Long-Term Capital Decision

1. Facts

At the core of *Long-Term Capital Holdings v. U.S.* is a lease strip effected by a foreign corporation, Onslow Trading and Commercial LLC ("OTC"). OTC acquired the rights to lease computer equipment or trucks as a lessee, and then immediately subleased its rights as lessee to another party, with the sublessee prepaying 92.5% of the rent due under the sublease. As a foreign corporation, OTC paid no U.S. taxes on the prepayment, nor did it pay taxes in any other country. Following this transaction, OTC claimed it owned an asset worth \$1 million with a \$99 million built-in loss. The first transactions to duplicate basis occurred when OTC transferred its positions in the lease and sublease and its rights in the bank deposit to U.S. subsidiaries of two large U.S. corporations in exchange for preferred stock, in transactions designed to qualify as tax-free under §351. OTC claimed a \$100 million basis in the preferred stock. The second transactions to duplicate basis occurred when OTC transferred the preferred stock to Long-Term Capital Partnership which in turn contributed the preferred stock to a lower-tier partnership called Portfolio. Approximately one year later, in

1997, OTC sold its partnership interest in Long-Term Capital Partnership to Long-Term Capital Management, a partnership that itself was a partner in Long-Term Capital Partnership, pursuant to put options that OTC acquired from Long-Term Capital Management at the time it contributed the preferred stock in the §721 transactions. The purchase price was substantially less than \$100 million. Then, two months later, at the end of 1997, Portfolio sold the preferred stock in the two U.S. corporations to an investment bank. Portfolio allocated the capital loss from the sale of the preferred stock to Long-Term Capital Partnership, as it was required to do under §704(c).⁵³ Long-Term Capital Partnership then allocated the capital loss it received from Portfolio to Long-Term Capital Management, again as required under §704(c). That is, when OTC contributed the preferred stock to Long-Term Capital Partnership, §704(c) principles required that any capital loss from the sale of the preferred stock be allocated to OTC. However, when OTC sold its interest to Long-Term Capital Management, the purchaser stepped into the shoes of OTC with respect to the §704(c) loss. If a §754 election were in place for Long-Term Capital Partnership, then the capital loss that shot out to Long-Term Capital Management would have been offset by the purchaser's negative §743 adjustment, and effectively denied.⁵⁴

⁵³ Section 704(c)(1)(C), as amended by the 2004 Jobs Act, would prohibit OTC's §704(c) gain from being transferred to Long-Term Capital Management.

⁵⁴ Section 743(b), as amended by the 2004 Jobs Act, would mandate a §743(b) adjustment in these circumstances.

2. District Court Opinion

The U.S. District Court for the District of Connecticut held that the OTC's contribution of the preferred stock to Long-Term Capital Partnership, OTC's sale of its partnership interest to Long-Term Capital Management, and Portfolio's subsequent sale of the preferred stock to an investment bank lacked economic substance and must be disregarded for federal income tax purposes. The court in *Long-Term Capital Holdings* reinforced its implosion of the tax shelter by also relying on the "end result" version of the step transaction doctrine. OTC's transfer of the preferred shares to Long Term Care followed by OTC's put of the Long-Term Capital Partnership interest to Long-Term Capital Management was considered a prearranged series of transactions by all the parties who had complete control over all of the steps. Distinguishing *Grove v. Comr.*⁵⁵ and *Esmark v. Comr.*,⁵⁶ the court characterized the transaction simply as a premeditated sale of preferred shares by OTC to Long-Term Capital Management followed by a transfer of those shares to Long-Term Capital Partnership.

⁵⁵ 490 F.2d 241 (2d Cir. 1973).

⁵⁶ *Esmark, Inc. v. Comr.*, 90 T.C. 171 (1988), *aff'd in unpublished opinion*, 886 F.2d 1318 (7th Cir. 1989).

3. Second Circuit's Opinion

The Second Circuit Court of Appeals upheld the district court's decision on the step transaction doctrine. Since the "sole purpose of the transaction ... was to transfer losses from OTC to LTCM ... any intervening steps taken in pursuit of this goal were economically meaningless." The Second Circuit cited *True*, above, for the proposition that "any economic effects that may have resulted from the partnership do not preclude the imposition of the step transaction doctrine." On the face of this language, it is difficult to reconcile the Second Circuit's analysis with a case such as *Esmark*, where tax planning drove the particular steps yet the steps were still upheld because they were not considered meaningless. Again, the most plausible way to reconcile these decisions is that *Long-Term Capital* involved an underlying transaction designed for purpose other than tax avoidance, while *Esmark* involved a real business transaction with the question being whether the particular structure chosen to implement that transaction should be respected.

B. Heinz Decision

1. Facts

In *H.J. Heinz Co. v. U.S.*, a U.S. subsidiary of the public parent purchased parent's shares on the open market over a three-month period. Within two months of the last purchase, the parent redeemed all but 5% of the subsidiary's shares. The subsidiary treated the redemption as a dividend for tax purposes, which caused the basis in the redeemed shares to shift over to the subsidiary's retained shares. Several months later, the subsidiary sold the retained shares to a third party for a significant loss. The taxpayer was unable to convince the court of a business reason why a subsidiary would purchase parent stock from the public only to later have such stock redeemed, as opposed to having the parent simply purchase stock from the public in the first place. The court held that the subsidiary was not entitled to claim the loss.

2. Tax Ownership Holding

As to the government's first argument, that the subsidiary never acquired ownership of the parent stock, the court held for the taxpayer. The court found that the subsidiary incurred significant debt to acquire the parent stock, received dividends on the stock during the period of the subsidiary's possession, bore the risk of loss and the opportunity for gain as to the value of the parent stock it possessed, and was under no obligation to distribute or disgorge the profits it received. On the basis of those facts, the court stated that "it appears

preliminarily that [subsidiary] possessed the benefits and burdens associated with the [parent] stock.”⁵⁷

⁵⁷ Cf. *Compaq Computer Corp. v. Comr.*, 277 F.3d 778 (5th Cir. 2001) and *IES Industries Inc. v. U.S.*, 253 F.3d 350 (8th Cir. 2001) (momentary acquisition and ownership of stock before sale was respected under the economic substance doctrine).

3. Economic Substance Holding

The primary basis for the *Heinz* decision was the taxpayer's failure to prove the business purpose prong of the economic substance doctrine. The court followed the “more flexible” approach to the economic substance doctrine adopted in *Coltec*, described as requiring that “the taxpayer prove that its transaction was both purposeful [*i.e.*, was entered into for a business purpose] and substantive [*i.e.*, was economically substantive] — if proof in either regard is lacking, the transaction is a sham.” Because it was difficult for the taxpayer to show a convincing reason why the subsidiary was necessary to repurchase parent stock from the public, the court rather easily concluded that the transaction was a sham without ever addressing whether the subsidiary's acquisition and ownership of the parent stock for two months — which was already acknowledged by the court to be valid for tax purposes — had economic effects or substance under the economic substance prong of the economic substance doctrine. As previously stated, the Federal Circuit's explicit adoption of the “disjunctive” approach is a departure from the norm among the other circuits.

4. Step Transaction Holding

The court then offered the step transaction doctrine as a second reason for its holding, presumably to protect its decision on appeal. The court's analysis is quite superficial, and there is not even a reference to the *Esmark* principle that steps having economic effect cannot be ignored. That is, it is surprising that the step transaction doctrine would so easily be applied by the court after it concluded that the subsidiary bore the benefits and burdens of owning the stock in the interim period. What appeared to bother the court was the fact that the parent typically had repurchased its stock from the public on its own. The use of a wholly owned subsidiary to purchase parent stock was a departure from the norm. The subsidiary's purchase of the stock followed by the transfer of such stock to the parent was viewed as part of a circuitous route to reach the same end result as the base case transaction.

VIII. COMMON CORPORATE RESTRUCTURING TRANSACTIONS

A. Section 351 Transactions

1. Control Requirement

Section 351 requires that the transferor or transferors of property be “in control” of the corporation immediately after the transfer. Control for this purpose is defined in §368(c) as ownership of at least 80% of (i) the total combined voting power of all classes of stock entitled to vote, and (ii) the total number of shares of all other classes of stock of the corporation. Ownership of stock for §351 control purposes must be direct, and not by attribution.⁵⁸ The courts and the Service hold that the §351 control requirement is not met where, pursuant to a pre-existing binding contract, the transferor loses control of the corporation by a taxable sale of all or part of that stock to a third party who does not also transfer property to the corporation in exchange for stock.⁵⁹

⁵⁸ See *Brams v. Comr.*, 734 F.2d 290 (6th Cir. 1984); Rev. Rul. 56-613, 1956-2 C.B. 212.

⁵⁹ See, e.g., *S. Klein on the Square, Inc. v. Comr.*, 188 F.2d 127 (2d Cir. 1951); Rev. Rul. 79-194, 1979-1 C.B. 145; Rev. Rul. 2003-51, 2003-21 I.R.B. 938.

When control is lost pursuant to a binding contract, the steps as taken may be respected as having occurred, but may not have the effect under the tax laws intended by the taxpayer. For example, if A and B transfer property to Newco in exchange for all of Newco's stock in a purported §351 transaction and then, pursuant to a binding contract, sell a portion of the Newco stock to a third party in a taxable sale that results in A and B owning less than 80% of Newco stock, A and B will be still be treated as having transferred property to Newco for stock and then selling that stock in a taxable sale. However, the requirement under the Code that A and B acquire “control” of Newco will not be satisfied and, therefore, A's and B's transfer of property to Newco will be taxable.⁶⁰ In a few cases where the transferor retained no direct interest in the transferee entity (although the transferor received stock in the acquiring entity), such entity was subsequently liquidated by the entity acquiring the transferee entity, and there was no purpose other than tax avoidance for the transferee entity's formation, the Service has prevailed in treating an incorporation followed by a sale of stock as if the property was sold directly to the third party followed by the third party's contribution of the property to the corporation.⁶¹

⁶⁰ E.g., Rev. Rul. 79-70, 1979-1 C.B. 144.

⁶¹ *West Coast Marketing Corp. v. Comr.*, 46 T.C. 32 (1966).

Because a strict binding commitment test has been used for purposes of the control requirement, taxpayers

have been able to comfortably structure a tax-free §351 transaction, notwithstanding that a loss of control may be contemplated, so long as the control group of transferors is not legally bound to relinquish control.

The authorities addressing the control requirement in a §351 transaction generally fall into several categories. One category involves incorporation transactions involving one or more transferors who, pursuant to a pre-existing binding commitment, sell more than 20% of the transferee stock in a taxable transaction. These authorities hold that control is not met because the transferor lacks ownership in the transferee shares, by having “irrevocably foregone or relinquished at that time the legal right to determine whether to keep the shares.”⁶² These same authorities recognize that if there is no binding legal commitment, then “it is immaterial how soon thereafter the [transferor] elects to dispose of his stock or whether such disposition is in accord with a preconceived plan not amounting to a binding obligation.”⁶³ The Service has reached the same conclusion when addressing similar facts.⁶⁴

⁶² *Intermountain Lumber Co. v. Comr.*, 65 T.C. 1025 (1969).

⁶³ *Id.* at 1031-32. See also *S. Klein on the Square, Inc. v. Comr.*, 188 F.2d 127 (2d Cir. 1951); *Hazeltine Corp. v. Comr.*, 89 F.2d 513 (3d Cir. 1937).

⁶⁴ Rev. Rul. 79-194, 1979-1 C.B. 145; Rev. Rul. 79-70, 1979-1 C.B. 144; Rev. Rul. 70-522, 1970-2 C.B. 81.

A second category of cases involves incorporation transactions followed by taxable transfers of the transferee stock that occur, not by reason of a binding commitment, but pursuant to a prearranged plan. The seminal case is *American Bantam Car Co. v. Comr.*⁶⁵ Over a 15-month period following the incorporation, about one-third of the stock was transferred to an underwriter as compensation for having sold preferred stock of the transferee to the public. The court stated that the operative test was one of mutual interdependence. However, the court declined to integrate the later transfers of stock with the incorporation transaction because, unlike the facts in cases like *Hazeltine Corp. v. Comr.*,⁶⁶ there was no written contract requiring a transfer of stock to the underwriters. The court found that many of the prior cases found the control requirement to have been met with facts even more suggestive of a binding contract to lose control.⁶⁷

⁶⁵ 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949).

⁶⁶ 89 F.2d 513 (3d Cir. 1937).

⁶⁷ See also *O'Connor v. Comr.*, 16 T.C.M. 213 (1957), *aff'd* 260 F.2d 358 (6th Cir. 1958); *Scientific Instrument Co. v. Comr.*, 17 T.C. 1253 (1952), *aff'd per curiam*, 202 F.2d 155 (6th Cir. 1953); *Evans Products Co. v. Comr.*, 29 BTA 992 (1934) (“It is not essential that Evans should retain control for any length of time. It is sufficient that he was momentarily in control.”).

A third category of transactions involves incorporation transactions followed by a transferor making a gift of the transferee stock. The key case in this area is *Wilgard Realty Co. v. Comr.*⁶⁸ On the same day that an individual transferred property to a corporation for all the stock, 75% of the stock was given away to relatives pursuant to a prearranged plan. The Second Circuit distinguished binding commitment cases like *Hazeltine* from the facts at hand, and held that the control requirement was met because the transferor had the legal right to keep or give away the shares as he pleased: “It is immaterial how soon thereafter he elects to dispose of his stock by gift or otherwise and whether or not such disposition is in accord with a preconceived plan not amounting to a binding obligation.”⁶⁹

⁶⁸ 127 F.2d 514 (2d Cir. 1942).

⁶⁹ *Wilgard*, 127 F.2d at 516.

The foregoing concepts have been applied in related party settings. The classic example is Rev. Rul. 84-111, above, in which a partnership transferor was deemed to be in control of a corporate transferee even though the partnership immediately distributed the stock to its partners. In GCM 37540 (May 18, 1978), which provided support for the Service's position in Rev. Rul. 84-111, the Service stated that the partnership's momentary control of the transferee corporation was sufficient to meet the control requirement: “Thus, a preconceived plan which falls short of a binding obligation would not be given effect for purposes of applying the step transaction doctrine. Therefore, in some instances momentary control of the transferee corporation may be sufficient to meet the requirement of section 351(a)” where there is no written, legally-binding plan to transfer stock.

There are some authorities that appear to support the proposition that a prearranged plan will affect the §351 control requirement on the grounds of business purpose, but these authorities are limited to specific fact situations. First, where property is transferred to a corporation solely to facilitate a prearranged tax-free exchange of the corporation's stock for stock of another corporation, the courts have occasionally treated the transaction as taxable rather than apply §351.⁷⁰ Second, where built-in gain property is transferred to a corporation for the sole purpose of then selling the property at the corporate level and utilizing the

corporation's net operating losses to offset the gain, the courts have denied §351 treatment and have characterized the corporation as a conduit whose participation in the transaction should be disregarded.⁷¹

⁷⁰ *E.g.*, *West Coast Marketing v. Comr.*, 46 T.C. 32 (1966). *See also* Rev. Rul. 70-140, 1970-1 C.B. 73 (transaction recast as a direct transfer of property to acquiring corporation in a taxable transaction followed by a transfer of the property to the transferred corporation).

⁷¹ *E.g.*, *Stewart v. Comr.*, 714 F.2d 977 (9th Cir. 1983); *Hallowell v. Comr.*, 56 T.C. 600 (1971). *But cf.* *Smalley v. Comr.*, 32 T.C.M. 373 (1973) (court finding a valid business purpose of reducing corporation's debt when taxpayer transferred personal assets to corporation and used corporation's tax losses to shelter a gain). However, the mere incorporation of assets, even if done solely for tax reasons, has rarely been questioned by the courts. Moreover, recent efforts by the Service to challenge a taxpayer's check-the-box election have failed. *See Dover Corp. & Subs. v. Comr.*, 122 T.C. 324 (2004).

2. Rev. Rul. 2003-51

In Rev. Rul. 2003-51,⁷² the Service addressed whether, under certain circumstances, the binding commitment rule should not be imposed to “bust” a §351 transaction. A transferor transferred assets to a newly formed corporation (“Newco 1”) in a purported §351 transaction and then, pursuant to a pre-existing binding agreement with a third party, transferred the stock of Newco 1 to a second corporation owned by the third party (“Newco 2”) in a second purported §351 transaction. The Service ruled that the first transaction was respected as a transfer of assets for stock, and therefore qualified as a §351 transaction, even though the transferor immediately retransferred the Newco 1 stock to a second corporation pursuant to a binding contract. The Service's rationale in Rev. Rul. 2003-51 was two-fold. First, the “busted 351” rulings and cases⁷³ all involve a transfer of property to a corporation (Newco) followed immediately by a *taxable* transfer of all or a portion of the Newco stock to a third party. Because the second transfer to Newco 2 was a transfer that qualified as tax-free under §351, the Service believed that it would be inconsistent with the purposes of §351 to find that the control requirement in the first transfer to Newco 1 was violated.⁷⁴ Second, the one authority that does actually recast the first transfer as an “over the top” transfer — Rev. Rul. 70-140⁷⁵ — was held to be limited to its unique facts. Specifically, the transfer of assets to the first corporation was designed to qualify the transfer of stock of the first corporation to the second corporation as a tax-free “B” reorganization, and a transfer of the assets directly to the second corporation for stock would have been a taxable transaction. The Service ruled in Rev. Rul. 2003-51 that an “over the top” recast was not appropriate where a transfer of the assets directly to the second corporation in exchange for stock would have been a tax-free transaction in any event.

⁷² 2003-1 C.B. 938.

⁷³ *See, e.g.*, *S. Klein on the Square, Inc. v. Comr.*, 188 F.2d 127 (2d Cir. 1951), *cert. denied*, 342 U.S. 824 (1951); *Hazeltine Corp. v. Comr.*, 89 F.2d 513 (3d Cir. 1937); *Intermountain Lumber Co. v. Comr.*, 65 T.C. 1025 (1976); Rev. Rul. 79-194, 1979-1 C.B. 145; Rev. Rul. 79-70, 1979-1 C.B. 144; Rev. Rul. 70-522, 1970-2 C.B. 81.

⁷⁴ It should also be noted that all the “busted 351” authorities (with the exception of Rev. Rul. 70-140, discussed below) actually respect the transfer of assets to Newco as having been made; they simply hold that the control requirement was violated. That is, these authorities do not attempt to recharacterize the transaction as having occurred in a different manner just because the Newco is immediately sold in a taxable transaction. *E.g.*, Rev. Rul. 79-70, 1979-1 C.B. 144.

⁷⁵ 1970-1 C.B. 73.

The government's approach to step transaction doctrine in Rev. Rul. 2003-51 is quite telling. It chose not to apply the binding commitment rule because that would frustrate the purposes of the statute. This approach may sound like *Gregory v. Helvering* and the substance-over-form doctrine. In effect, the government believed that since step transaction doctrine is really a subset of the more general substance-over-form doctrine, it has a similar function, that is, to ensure that the clearly defined purposes of a statute are not frustrated by a transaction which may technically meet the statute but still defeat the statute's purposes. While the step transaction has sometimes been applied in a fairly mechanical manner to simply determine what the facts are,⁷⁶ the government acknowledged that the doctrine is more flexible than that and should be used judiciously. There are, in fact, other recent instances where the government has chosen not to apply step transaction principles where it believed the taxpayer's form satisfied the purposes of the statute.⁷⁷

⁷⁶ *See, e.g.*, Rev. Rul. 67-274, 1967-2 C.B. 141 (B reorganization must qualify as a C reorganization where target is liquidated pursuant to plan); Rev. Rul. 67-448, 1967-2 C.B. 144 (merger of transitory subsidiary into target is treated as two-party “forced B reorganization”); Rev. Rul. 78-130, 1978-1 C.B. 114 (§351 transaction followed by merger of transferred company into subsidiary of acquiring corporation is treated as triangular C reorganization); Rev. Rul. 79-273, 1979-2 C.B. 125 (merger of transitory subsidiary into target for cash is treated as two-party taxable acquisition). In the “circular flow of cash” context, the IRS has also applied a fairly mechanical

approach for applying the step transaction doctrine. See Rev. Rul. 83-142, 1983-2 C.B. 68 (U.S. parent purchases business from its first-tier foreign subsidiary for cash, and then subsidiary distributes cash to U.S. parent as a dividend; cash payment is disregarded); Rev. Rul. 80-154, 1980-1 C.B. 68; Rev. Rul. 78-397, 1978-2 C.B. 150 (cash contributions to corporation solely to meet state capitalization requirements was ignored because it was circled back to the original source); Rev. Rul. 74-564, 1974-2 C.B. 124 (similar to Rev. Rul. 78-397).

⁷⁷ See, e.g., Rev. Rul. 96-29, 1996-1 C.B. 50 (step transaction principles not applied to disqualify a transaction as an F reorganization); Rev. Rul. 90-95, 1990-2 C.B. 67 (step transaction principles should not applied to integrate qualified stock purchase with subsequent liquidation or merger; position later adopted in Regs. §§1.332-2(d), 1.338-3(c)(1)); Rev. Rul. 2001-24, 2001-22 I.R.B. 1290 (parent in forward triangular merger considered to be "in control" of acquiring subsidiary even the subsidiary stock was dropped down the chain pursuant to a prearranged plan); Rev. Rul. 2001-46, 2001-42 I.R.B. 321 (step transaction principles are applied to integrate qualified stock purchase with subsequent merger *only* if the result would be a tax-free A reorganization).

We need to be reminded of one important caveat: Just because the government may turn off step transaction principles when appropriate, taxpayers do not necessarily have the same prerogative. Taxpayers always run the risk that they are held to their form, and may not enjoy the benefit of some other route it might have chosen but did not. ⁷⁸ Clearly, taxpayers are entitled to rely on published guidance that turns off step transaction principles where the taxpayer's fact pattern is similar to the fact pattern in the guidance. Where the taxpayer's fact pattern differs from the fact pattern in the guidance, the taxpayer is still entitled to argue that the same result should apply based on the rationale or the policy behind the guidance, but there is more risk that the government will take a different position.

⁷⁸ *Comr. v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

3. Drop-Down Transactions

There are numerous other examples where, in connection with a partnership or corporate restructuring, assets are acquired by one entity and then immediately transferred to another entity with each transaction respected as independent of the other. ⁷⁹

⁷⁹ E.g., Rev. Rul. 77-449, 1977-2 C.B. 110; Rev. Rul. 83-34, 1983-1 C.B. 736; Rev. Rul. 83-156, 1983-2 C.B. 66 (all involving successive drop-downs of assets in §351 and §721 transactions); Rev. Rul. 79-194, 1979-1 C.B. 145 (transferor in §351 sells stock to co-transferor immediately after its receipt).

B. Corporate Liquidations

The Service and the courts have addressed situations where stock is transferred to a new owner shortly before a redemption or liquidating distribution takes place, with the issue being whether the new owner should be respected as the owner when the redemption or liquidating distribution occurs. Generally, the transfer is respected for tax purposes so long as it occurs before any formal decision is made at the corporate level to make the redemption or to liquidate.

The Service has addressed a situation where stock was transferred to another shareholder and then the stock was redeemed or the corporation was liquidated. In Rev. Rul. 75-521, ⁸⁰ a 50% corporate shareholder purchased the stock of the other 50% shareholders, and then adopted a plan to completely liquidate the corporation under §332. The Service respected the steps because there was no official corporate action at the time of the stock purchase that approved the liquidation.

⁸⁰ 1975-2 C.B. 120.

Conversely, the courts and Service have permitted controlling shareholders desiring a §331 liquidation to sell a portion of their stock to a third person before the formal adoption of a plan of liquidation, so that the controlling shareholder will own less than 80% of the stock when the liquidation plan is adopted. ⁸¹ In each case, the statutory language requiring the adoption of a plan of liquidation provided the basis for the court's pro-taxpayer decision. ⁸² In effect, the ability of a taxpayer to effect either a §332 or a §331 liquidation is largely elective.

⁸¹ See *Day & Zimmerman, Inc. v. Comr.*, 151 F.2d 517 (3d Cir. 1945); *Granite Trust Co. v. Comr.*, 238 F.2d 670 (1st Cir. 1956); *Riggs v. Comr.*, 64 T.C. 474 (1975); Rev. Rul. 78-285, 1978-2 C.B. 137, *obsoleted by* Rev. Rul. 95-71, 1995-2 C.B. 323; FSA 200148004. In a similar vein, the courts and the Service have upheld a shareholder's ability to contribute stock to a charity before any formal corporate action approving a redemption of such stock, so long as the charity is under no binding contract to sell the stock at the time of the contribution. As a result, the shareholder can claim a charitable deduction for contributing the stock and avoid any income upon the redemption. See *Palmer v. Comr.*, 62 T.C. 684 (1974), *acq.* 1978-2 C.B. 1; *Grove v. Comr.*, 490 F.2d 241 (2d

Cir. 1973); Rev. Rul. 78-197, 1978-1 C.B. 83. *But cf. Blake v. Comr.*, 697 F.2d 473 (1982) (stating that a reasonable expectation by the donor combined with an advance understanding that the donee charity will sell the stock will be looked at as a unitary transaction).

⁸² A similar approach was adopted in *The Falconwood Corp. v. U.S.*, 422 F.3d 1339 (Fed. Cir. 2005), in which the language of a consolidated return regulation was at issue. P owned the stock of three corporations, S1, S2, and S3. S1 owned 100% of the stock of S4, which in turn owned 100% of the stock of S5. As Step 1, P and S2 merged into S1. As Step 2, S5 merged into S4. As Step 3, hours later, S1 sold the shares of S3 and S4 to its shareholders. Subsequently, S1 filed a consolidated return and claimed a post-transaction loss incurred against the group's income that accrued before the transaction, even though S1 was a stand-alone corporation after the transaction steps. Although P desired to end its existence as a consolidated group and convert to Subchapter S form, it did not set out to achieve the particular tax result at issue in the case. The issue was whether there "remained" a chain of includible corporations comprised of pre-transaction members after Steps 1 and 2, even though there was no chain of includible corporations after Step 3. Recognizing that some courts seemed to require an independent business purpose for the transaction in order to prevent application of the step transaction doctrine, the court found there was a business purpose for the downstream merger, notwithstanding that the entire transaction was designed to convert a C corporation into an S corporation. Then, in light of such business purpose, the court found that the regulations must be applied based on their plain meaning, and that the regulations simply required that a chain "remain" without any explicit temporal requirement, stating that "the regulations at issue leave no room for an application of the step transaction doctrine, where [the consolidated group converted to an S corporation] for an independent business purpose and was thereafter bound to follow the consolidated return regulations at issue." The Federal Circuit cited *Granite Trust* for the proposition that "the applicable regulations 'emphasize the rigid requirements of the section and make no allowance for the type of step transaction theory advanced in this case.'"

C. Section 304(a)(2) Transactions

Over the years, case law has developed in favor of taxpayers who partially redeemed their shares and later sold the remaining shares pursuant to an overall plan. These taxpayers, desirous of capital gain treatment for the partial redemption, hoped to integrate the redemption with the later sale in order to claim that the redemption qualified as a complete redemption under §302(b)(3). *Zenz* and cases that followed established a principle that the redemption would be integrated with the later sale if there was a "firm and fixed plan" at the time of the redemption to eventually sell the remaining shares.⁸³

⁸³ *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); *Roebbling v. Comr.*, 77 T.C. 30 (1981).

In *Merrill Lynch & Co., Inc. v. Comr.*,⁸⁴ as a result of the "step transaction doctrine," cross-chain sales of the transferee subsidiaries pursuant to §304 transactions and later sales of the transferor subsidiaries that terminated affiliation between them were treated as steps of a single transaction and were therefore integrated, when a "firm and fixed plan" to terminate such affiliation was found to exist at the time of the §304 transactions. In *Merrill*, the taxpayer wanted just the opposite result: to treat the redemption transaction as separate from the later sale of stock. The parent of a consolidated group of corporations decided to sell the stock of several subsidiaries (the "disposed subsidiaries") outside of the consolidated group. However, since it wanted to retain some of these subsidiaries' assets, while minimizing or eliminating gain on the sale of stock, the parent adopted and implemented a plan with respect to each of these subsidiaries, which in its simplified form consisted of the following steps: (1) contribution by each of the disposed subsidiaries of the retained assets, to the lower tier subsidiaries; (2) cross-chain sale of the lower-tier subsidiaries holding the retained assets, in a transaction that qualified as a §304 deemed redemption; (3) distribution of the proceeds of the cross-chain sale as a dividend; and (4) sale of the slimmed-down subsidiaries to a third party.

⁸⁴ 386 F.3d 464 (2d Cir. 2004).

The issue before the Tax Court was whether a firm and fixed plan to sell the stock outside the consolidated group existed at the time the cross-chain sales took place. If such firm and fixed plan existed, the cross-chain sale of stock should be integrated with the sale to a third party, resulting in termination of actual and constructive stock ownership of the issuing corporation. The Tax Court determined that such firm and fixed plan existed at the time of the cross-chain sales. In arriving at this decision, the Tax Court considered several facts. First, shortly after the cross-chain sale, a formal presentation was made to Merrill's Board of Directors regarding the sale to a third party. In addition, on the date of the cross-chain sales, not only had Merrill already engaged in substantial negotiations with regard to the sales to a third party, but it had entered into a letter of intent, which included a tentative purchase price. Although no binding agreement to sell existed at the time of the §304 transactions, the Tax Court believed that the purchaser had informally confirmed that it was prepared to purchase the stock. In addition, with respect to sales of subsidiaries for which Merrill had not obtained a letter of intent before cross-chain sales, the Tax Court considered that integration was also appropriate, since Merrill had structured the "playing field" to expedite the sale, by, among other things, preparing a proposed stock purchase agreement that advised prospective purchasers that the seller did not

intend to engage in substantial negotiations with respect to its terms, and by securing appraisals of disposed subsidiaries' assets, in anticipation of the sales.

On appeal, the Second Circuit confirmed the Tax Court's finding that, at the time the cross-chain sales took place, a firm and fixed plan existed to dispose the stock of the transferor subsidiaries outside the consolidated group, and therefore, the deemed redemptions were to be treated as an exchange, rather than as dividend distributions. Although the Second Circuit considered that the plan was not binding in a legal sense, it held that it was binding in an economic sense, since there was no economic purpose to the cross-chain sales without the sale of stock.

D. Intercompany Stock Transfer Followed by Liquidation

If a corporation acquires stock of a target corporation in a purported tax-free "B" reorganization and then immediately liquidates the target pursuant to a prearranged plan, it is well accepted that the intermediate steps of acquiring target stock and then liquidating target will be ignored and the transaction will be viewed as an acquisition of target's assets for purposes of determining whether the transaction qualifies as a tax-free reorganization.⁸⁵

⁸⁵ *E.g.*, Rev. Rul. 67-274, 1967-2 C.B. 141.

In Rev. Rul. 2004-83, the Service addressed the question of when a purported §304 transaction may be characterized as a D reorganization. Corporation P owns 100% of corporations S and T. P sells T stock to S for cash. Then, pursuant to a plan, T liquidates into S. If the sale of T stock is respected as separate from the liquidation of T, the transaction is a §304 transaction followed by a §332 liquidation of T into S. If step transaction principles are applied and the transaction is viewed as a sale of assets from T to S for cash followed by a liquidation of T into P, the transaction is a D reorganization under the authority of Rev. Rul. 70-240.

The Service first considered what should happen if P, S, and T are members of a consolidated group. In that case, §304 is turned off under Regs. §1.1502-80(b). Nevertheless, it is appropriate to apply step transaction principles and treat the overall transaction as a sale of assets, under authorities such as Rev. Rul. 67-274. Because the sale of T stock to S is not a qualified stock purchase by virtue of P and S being related parties, the authorities that turn off the step transaction doctrine following a qualified stock purchase, such as Regs. §1.338-3(d) and Rev. Rul. 90-95,⁸⁶ do not apply.

⁸⁶ 1990-2 C.B. 67.

The Service then considered what should happen if P, S, and T are not members of a consolidated group. In that case, the sale of T stock to S, viewed in isolation, is a §304 transaction. However, the Service believes there is no policy that would turn off step transaction principles and require that §304 be applied when §368 (a)(1)(D) would otherwise apply. In fact, the legislative history to the provisions that adopted the §304(c) control test for D reorganizations makes it clear that §304 was not intended to override reorganization treatment.⁸⁷

⁸⁷ See H.R. Rep. No. 98-432 Pt. 2, 1624 (1984).

The differences between a §304 transaction and a D reorganization can be significant. For example, in a D reorganization, the cash or other property received by the shareholders of the issuing corporation is taxable as a dividend only to the extent of their realized gain in their stock, under the "boot within gain" rule of §356. D reorganizations also avoid the gain recognition agreement requirement that is applicable to cross-border §304 transactions.

E. Taxable Third Party Stock Acquisition Followed by Intercompany Merger

1. General

Step transaction principles may be applied to integrate stock purchases with a subsequent merger. For example, acquiror may purchase target stock directly from the target shareholders and later merge target into acquiror or a subsidiary of acquiror. If the consideration given in the stock purchase consists of sufficient acquiror stock for continuity of interest purposes, but not enough to qualify the purchase as a "B" reorganization, it must be determined whether the purchase and merger should be treated as a single tax-free transaction under the step transaction doctrine. If so, the target shareholders would be treated as exchanging their target stock for acquiror stock pursuant to an "A" reorganization (or a forward triangular merger if target is merged into a controlled subsidiary of acquiror),⁸⁸ and nonrecognition and carryover basis rules would apply to target. If the step transaction doctrine were inapplicable because the initial stock purchase is "old and cold," the initial stock purchase would be taxable to the target shareholders.⁸⁹

⁸⁸ *King Enterprises, Inc. v. U.S.*, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-46, 2001-42 I.R.B. 321 (acquisition merger of acquiror's newly formed subsidiary into target followed by upstream

merger of target into acquiror collapsed into single statutory merger of target into acquiror qualifying as "A" reorganization). In *King Enterprises*, acquiror purchased target stock for cash, notes, and acquiror stock, with the stock comprising 51% of the overall consideration. Acquiror subsequently merged target upstream. Target shareholders claimed that the two transactions were parts of a single plan, resulting in a nontaxable acquisition of their stock in an "A" Reorganization. The court agreed on the basis of the step transaction doctrine. See also Rev. Rul. 69-48, 1969-1 C.B. 106 (acquiror's acquisition of 19% of target stock for cash as an integral step in a preconceived plan to acquire target's assets in a "C" reorganization is treated as cash consideration in the reorganization).

⁸⁹ Because the stock acquisition would not qualify as a "B" Reorganization, the shareholders' gain or loss would be recognized under §1001. See also Rev. Rul. 90-95, 1990-2 C.B. 67.

When acquiror purchases target stock in a qualified stock purchase under §338, the Service generally will not apply step transaction principles to integrate a subsequent merger or liquidation of target with the stock purchase. ⁹⁰ That is, a subsequent liquidation or merger of target into acquiror will be respected as a tax-free liquidation under §332, ⁹¹ and a subsequent merger of target into a subsidiary of acquiror will be respected as an "A" reorganization (and also a "D" reorganization), regardless of whether a §338 election is made.

⁹⁰ *Id.* See Regs. §1.338-3(c)(1); Rev. Rul. 90-95, 1990-2 C.B. 67, distinguished, Rev. Rul. 2001-46, 2001-42 I.R.B. 321.

⁹¹ Regs. §1.332-2(d). When the requirements for a liquidation are not satisfied, a merger of target upstream into acquiror may qualify as an "A" reorganization. See also *King Enters., Inc. v. U.S.*, 418 F.2d 511 (Ct. Cl. 1969).

2. Rev. Rul. 2001-46

In 2001, the Service issued guidance regarding whether step transaction principles will still be applied to characterize a stock purchase and subsequent merger of target into acquiror as an "A" reorganization where the aggregate consideration paid by acquiror includes sufficient acquiror stock for continuity purposes. In Rev. Rul. 2001-46, ⁹² the Service ruled that if, pursuant to an integrated plan, acquiror's newly formed wholly owned subsidiary merges into target, and target later merges into acquiror, the transaction will be treated as a single statutory merger of target into acquirer, assuming the integrated transaction qualifies as an "A" reorganization. ⁹³ Accordingly, in issuing Rev. Rul. 2001-46, the Service made it clear that it would no longer view the first step (i.e., acquiror's acquisition of target stock) as a qualified stock purchase if the integration of the steps qualifies as a good "A" reorganization. ⁹⁴

⁹² 2001-42 I.R.B. 321.

⁹³ Commentators have proposed that a reverse triangular merger followed by (i) the merger of target into a disregarded entity of acquiror, (ii) a conversion of target into a disregarded entity of acquiror, or (iii) a liquidation of target, pursuant to a single plan, should result in an integrated transaction that qualifies as an "A" reorganization. Schuck, "Treatment Under Section 368(a)(1)(A) of a Merger or Conversion of the Target Corporation into a Disregarded Entity following a Reverse Triangular Corporate Merger," 2004 *Tax Notes Today* 97-40 (5/11/04); see Swartz, "Multiple Step Acquisitions: Dancing the Tax-Free Tango," 2005 *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* 153 (2005). Regs. §1.368-2(b)(1)(iii), Ex. 9, clarifies that pending further guidance, a stock purchase followed by a conversion to a LLC does not satisfy the requirements of an "A" reorganization.

⁹⁴ Absent Rev. Rul. 2001-46, the IRS would continue to be whipsawed as it was in *King Enterprises*, where the acquiror received a stepped-up basis in target's assets under former §334(b)(2), while target's shareholders received tax-free treatment under §368.

In response to comments regarding Rev. Rul. 2001-46, however, Treasury issued regulations providing that the step transaction doctrine will not be applied if a the acquiror and target shareholders jointly file a valid §338(h)(10) election with respect to one step in a multi-step transaction, even if the transaction otherwise would qualify as a reorganization, if that step, standing alone, is a qualified stock purchase. ⁹⁵ Accordingly, a taxpayer can break the application of the step transaction doctrine if acquiror and target shareholders jointly file a valid §338(h)(10) election with respect to the first step stock purchase. ⁹⁶

⁹⁵ Regs. §1.338(h)(10)-1(c)(2), and (e), Exs. 11, 12, 13, 14, T.D. 9271, applicable to stock acquisitions occurring on or after July 5, 2006; Regs. §1.338(h)(10)-1T(c)(2), and (e), Exs. 11, 12, 13, 14, T.D. 9071, 68 Fed. Reg. 40766 (7/9/03), applicable to stock acquisitions occurring on or after July 9, 2003.

⁹⁶ The IRS has not issued similar guidance regarding the ability to break the application of the step transaction doctrine by making a valid §338(g) election. In issuing Regs. §1.338(h)(10)-1(c) regulations on July 3, 2006, the IRS expressly noted that a similar rule was not adopted for §338(g) elections due to concerns regarding potential inconsistent reporting in the case of §338(g) elections

(which are unilateral (purchaser only) elections), as opposed to §338(h)(10) election which are bilateral (purchaser and seller) elections.

3. Two-Step Merger Technique

The ability to rely on integrating a stock purchase followed by a second step merger for purposes of testing the requirements of a transaction under the reorganization provisions provides significant potential planning opportunities in structuring corporate acquisitions. For example, assume that acquiror wishes to acquire the business of target with 40% stock and 60% boot. Structuring the transaction as a single step merger of target with and into acquiror (or an LLC wholly owned by acquiror) would have been the logical transaction structure before the issuance of Rev. Rul. 2001-46. Note, that if the transaction failed to qualify as an "A" reorganization, the acquiror would inherit a corporate tax liability on the gain inherent in the target assets (i.e., the risk of taxable forward merger). With the issuance of Rev. Rul. 2001-46, well-advised acquirors now will likely choose to structure similar transactions as two-step transactions (i.e., typically a first step reverse subsidiary merger and a second step forward merger with and into acquiror (or an LLC wholly owned by acquiror)). The benefit of the two-step structure under Rev. Rul. 2001-46 is that a transaction that fails to qualify as an "A" reorganization on an integrated basis should not be integrated under Rev. Rul. 2001-46. Accordingly, assuming the first step reverse subsidiary merger constitutes a qualified stock purchase, the transaction should be characterized as a taxable stock purchase followed by a tax-free liquidation.⁹⁷ Therefore, the risk of a failed reorganization in this structure is limited to a target shareholder risk (i.e., one level of taxation), rather than a risk at the target shareholder and target corporate levels (i.e., two levels of taxation).

⁹⁷ Regs. §1.338-3(c); Rev. Rul. 90-95, 1990-2 C.B. 67; Rev. Rul. 2001-46, 2001-42 I.R.B. 321.

A common technique for mitigating the risk of corporate target level gain is for the purchaser first to acquire the target's stock and then immediately to merge the target into a wholly owned limited liability company subsidiary of the purchaser. Under Rev. Rul. 2001-46, the stock acquisition and merger are stepped together as if the target merged directly into the purchaser, provided that the transaction would thereby qualify as a Type A reorganization. Conversely, many (if not most) practitioners believe that this ruling does not apply if the stepped together transaction would not qualify as a Type A reorganization. If it does not apply, then, under different authority,⁹⁸ the overall transaction in those circumstances would be viewed as a taxable purchase of stock followed by a separate tax-free §332 liquidation.

⁹⁸ Rev. Rul. 90-95, 1990-2 C.B. 67; Regs. §1.338-2.

Accordingly, the two-step transaction protects the purchaser from inheriting a target-level gain if, for example, the IRS says that the 40% continuity test is not met. In those circumstances, the purchaser would argue that, under the worst case, the shareholders have a taxable gain on the sale of their stock, but that the second-step merger is a tax-free transaction that occurs as a separate transaction following the taxable stock purchase. Practitioners are aware that the two-step structure makes it less worthwhile for the IRS to challenge the 40% continuity test and they therefore typically do not do so.

4. Rev. Rul. 2008-25

In Rev. Rul. 2008-25, the IRS confirmed that step transaction principles will not be applied to recharacterize a reverse triangular merger followed by a liquidation of target into a failed C reorganization. The first step was an acquisition of target stock by acquiror pursuant to a reverse triangular merger that, standing alone, qualified as tax-free under §§368(a)(1)(A) and (a)(2)(E). As part of an integrated plan, target then completely liquidated into acquiror in a transaction that was not a statutory merger. By virtue of the cash boot and the amount of liabilities assumed, the two steps could not be collapsed into a tax-free C reorganization.

The IRS first concluded that it was compelled under Rev. Rul. 67-274 to take the liquidation into account in determining whether the first step qualified as a tax-free reverse triangular merger. As such, this transaction does not qualify as a reorganization described in §368(a)(1)(A) by reason of §368(a)(2)(E) because, after the transaction, target does not hold substantially all of its properties and the properties of the merged corporation.

The IRS then concluded that if it were to treat the two steps as a failed C reorganization, that would violate the principles behind the repeal of the *Kimbell-Diamond* doctrine in connection with the enactment of §338, to-wit, that the only way a stock purchase could be recast into an asset purchase is through compliance with §338. Accordingly, consistent with such legislative history and the analysis set forth in Rev. Rul. 90-95, the Service treated the acquisition of the target stock as a qualified stock purchase by acquiror followed by the liquidation of target into acquiror under §332.

IX. COMMON PARTNERSHIP RESTRUCTURING TRANSACTIONS

A. Section 721 Transactions

It is generally accepted that parties forming a partnership have a great deal of flexibility in structuring the

transaction. Assume A desires to contribute property to a partnership in which A and B share 50/50, and receive cash for 50% of the property's value. If A contributed property to the partnership and B contributed cash equal to 50% of the property's value and the cash were immediately distributed to A, A would be treated as having sold 50% of the property to the partnership and contributed the other 50%. Alternatively, A could first sell 50% of the property to B for cash and each could then transfer a 50% interest in the property to the partnership, and that transaction would be respected as such.⁹⁹

⁹⁹ Cf. Regs. §1.197-2(k), Exs. (17), (18), and (19).

It is relatively rare for a transfer of property to a partnership followed by a prearranged transfer of the partnership interest to a third party to be recharacterized as if the property were sold directly to the third party followed by the third party's contribution of the property to the partnership, at least where the transferor retains a meaningful interest in the partnership. The Service has prevailed in having such a recharacterization adopted in a few analogous cases in the corporate context where the transferor retained no direct interest in the transferee entity (although the transferor received stock in the acquiring entity), such entity was subsequently liquidated by the entity acquiring the transferee entity, and there was no purpose other than tax avoidance for the transferee entity's formation.¹⁰⁰ Recently, the Service effectively ruled in the corporate context that it would take that position only in a situation where the initial transfer of property to a transferee corporation is needed to ensure the tax-free treatment of the subsequent transfer of the transferee corporation stock to the acquiring corporation in exchange for stock of the acquiring corporation; otherwise, the initial transfer of property to the transferee corporation would be respected even if there is a binding contract to transfer stock in the transferee corporation for stock of the acquiring corporation.¹⁰¹

¹⁰⁰ *West Coast Marketing Corp. v. Comr.*, 46 T.C. 32 (1966).

¹⁰¹ Rev. Rul. 2003-51, 2003-1 C.B. 938; Rev. Rul. 79-194, 1979-1 C.B. 145. Cf. Rev. Rul. 70-140, 1970-1 C.B. 73.

On the other hand, if a taxpayer transfers property to a corporation or partnership and then sells the stock or partnership interest to a third party for cash or other non-equity consideration, and retains no direct or indirect equity interest in the transferred property, the authorities that provide flexibility in choosing how to organize a corporation or partnership do not apply on their face. In that case, the real question is whether the transferor ever acquired an ownership interest in the transferee entity. The court's recast of the transaction in *Long-Term Capital Holdings* as a taxable sale by the contributing partner directly to the other partner might have been more persuasive had the court engaged in a pure tax ownership analysis rather than an application of the step transaction doctrine.

B. Incorporation of Partnership

Another example of flexibility is when a partnership incorporates. Rev. Rul. 84-111¹⁰² illustrates three situations that are respected. A partnership may transfer its assets to a corporation for stock and then distribute the stock in liquidation, all pursuant to a prearranged plan. The partnership's "momentary control" is considered sufficient to meet the control test in the absence of a binding contract to transfer the stock.¹⁰³ Alternatively, the partnership may distribute its assets to its partners, who then contribute the assets to a corporation for stock. Or the partners may transfer their partnership interests to a corporation. This ruling supports the ability of a partnership to convert its assets into corporate form immediately before a partnership distribution, and the partnership's acquisition and disposition of the stock will be respected.

¹⁰² 1984-2 C.B. 88.

¹⁰³ GCM 37540 (May 18, 1978).

C. Liquidation of Partnership

Several authorities in the corporate context address what happens when stock is acquired by a shareholder shortly before a corporate liquidation in order to control the outcome under §331 or §332. (See the discussion in VIII, B, above). The few relevant authorities in the partnership area involve situations where a partnership interest was transferred when the liquidation of the partnership was well underway in order to shift income from one person to another. In these cases, the income from the partnership liquidation was taxed to the transferor under an assignment of income theory.¹⁰⁴

¹⁰⁴ E.g., *Findley v. Comr.*, 62 T.C.M. 219 (1991); *Seyburn v. Comr.*, 51 T.C. 578 (1969).

D. Section 731 Distributions

It seems logical that the same type of flexibility afforded to taxpayers when forming partnerships should be extended to taxpayers when they are structuring distributions from partnerships. The Tax Court, in one of its first decisions of 2008, did just that. In *Countryside Limited Partnership v. Comr.*,¹⁰⁵ two of the four partners

holding 95% of the partnership's interests caused the partnership to borrow approximately \$12 million from an unrelated lender in October 2000. On October 31, 2000, the partnership purchased four privately issued notes from AIG and contributed the notes to lower-tier partnerships. On December 26, 2000, the partnership distributed interest in the lower-tier partnerships (which held the AIG notes) to the two partners in complete liquidation of their interests. The distributing partnership had a §754 election in effect, but the lowest-tier partnership did not. Accordingly, the withdrawing partners took the partnership interests with a basis write-down (which allowed the distributing partnership to increase the basis of its real property under §734). The partnership, with the remaining two partners, agreed on January 26, 2001 to sell its real estate, as a result of negotiations that began in May or June of 2000 with reduced gain recognition (as a result of the §734 adjustment). The sale closed on April 19, 2001 and \$8.5 million of the loan was repaid; the remaining \$3.5 million was repaid several years later. The taxpayers treated the notes as non-marketable securities, and because the lowest-tier partnerships did not have §754 elections in effect, there was no step-down in the basis of the notes. The taxpayer moved for a summary judgment that the liquidating distribution was not a taxable event, conceding for that purpose that the liquidating distribution was structured solely to defer tax.

¹⁰⁵ 95 T.C.M. 1006 (2008).

The Service argued that the liquidating distribution, the sale of the real estate, and the redemption of the notes were all part of integrated transactions that should be treated, in substance, as if the two partners had received a taxable distribution of cash, relying on both the economic substance doctrine and the partnership anti-abuse regulations. Because the taxpayer resided in the D.C. Circuit, the Tax Court looked to *Boca Investorings* for an explanation of economic substance and cited a statement that "transactions must have a legitimate non-tax avoidance purpose to be recognized as legitimate for tax purposes," but, interestingly, also cited *Northern Indiana Public Service Co. v. Comr.*¹⁰⁶ for the proposition that the Service cannot disregard "economic transactions ... which result in actual, non-tax related changes in economic position." In holding for the taxpayer, the Tax Court, in an apparent attempt to describe the transaction as having a business purpose despite taxpayer's concession, stated:

¹⁰⁶ 115 F.3d 506 (7th Cir. 1997).

While the employed means were designed to avoid recognition of gain to [the two partners], those means served a genuine, nontax, business purpose; viz, to convert the [two partners'] investments in [the partnership] into 10-year promissory notes, two economically distinct forms of investment ... In this case, what "occurred" was a distribution of nonmarketable securities in redemption of limited partnership interests ... All of the parties to the transaction had legitimate business purposes, and the manner in which those parties accomplished those purposes cannot be disregarded and converted by [IRS] into a transaction (an exchange of [the two partners'] interests for cash) that never occurred simply because the transaction that did occur was tax motivated

The Tax Court further held that the partnership anti-abuse regulations did not change the result. The distributing partnership was "bona fide," as that was not disputed by the Service. The transactions were undertaken for a "substantial business purpose," which was to enable the two partners to withdraw their partnership interests for the AIG notes. The transactions did not violate substance over form principles because "[b]oth in form and substance, [the two partners] exchanged interests in a real estate partnership for promissory notes." Finally, because of these findings, the taxpayers' reporting no gain on the transaction "clearly reflected their income from that transaction."

X. CONCLUSION

So how does a practitioner plan various multi-step corporate and partnership restructurings in the wake of cases such as *Long-Term Capital Holdings* and *Heinz*? These cases appear to suggest that steps taken to implement a transaction could be regarded as "meaningless," regardless of whatever legal or economic effect they may have, if the overall purpose for taking the steps is to minimize tax. Practitioners frequently face situations where the entire result depends on particular steps being respected for tax purposes. The examples of common corporate and partnership transactions discussed above to illustrate how step transaction principles are applied in various restructurings are just the tip of the iceberg; there are numerous other transactions where step transaction principles have been addressed by the Service or the courts.¹⁰⁷

¹⁰⁷ *E.g.*, Rev. Rul. 96-29, 1996-1 C.B. 50 (step transaction principles not applied to disqualify a transaction as an F reorganization).

First, practitioners should determine if the particular step or series of steps has been addressed in published guidance. The government has on a number of occasions confirmed to taxpayers that the step transaction doctrine will not be applied to recharacterize a particular transaction, often in order to avoid frustrating the purposes of a statutory policy. If the particular step or series of steps is covered by the guidance, the practitioner should become relatively comfortable that the government will not successfully disregard the transaction, for example, on the grounds that the steps were taken purely for tax avoidance purposes.

According to Chief Counsel Notice 2003-014, IRS Chief Counsel attorneys are prohibited from taking positions in litigation or advice that are inconsistent with the Service's published guidance. As we've seen, attempts by the government to take positions contrary to its published guidance do not go over well in court. ¹⁰⁸

¹⁰⁸ See, e.g., *Dover*, note 71 above.

Second, to the extent that the particular step or series of steps has not been adequately addressed by published guidance, a practitioner should look to the relevant cases and determine whether the transaction is more similar to those transactions upheld by courts based on a review of the legal or economic effects without regard to the underlying tax motivation, as opposed to those transactions disregarded by courts based in large part on the taxpayer's underlying tax motivation. As stated above, a useful guide is to ask the following: *Was there a structure in search of transaction, or a transaction in search of a structure?*

This guide is more than just a personal theory. It helps explain, for example, why Judge Halpern chose to uphold the steps chosen to effect a nontaxable liquidation distribution to partners in the *Countryside* case, notwithstanding the taxpayer's concession that the liquidating distribution was structured solely to defer tax. The partners' interests were truly liquidated in exchange for a notes issued by a third party. The legal and economic effect of that transaction could not be questioned. The fact that the parties caused the partnership to purchase the notes in order to make a nontaxable distribution, rather than just receiving a taxable distribution of cash, was not important to the court.

Hopefully, the government will not invoke step transaction holdings in cases such as *Heinz* and *Long-Term Capital Holdings* to challenge legitimate business transactions that are structured in a particular manner to minimize tax. These cases focused on step transaction as an alternative holding only after the *entire transaction* was disregarded under the economic substance doctrine. To apply the step transaction holdings in these cases to transactions where the economic substance doctrine is otherwise considered inappropriate would itself be inappropriate.

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