Step Transaction Doctrine In Reorganizations Still Alive, Thriving, And Confusing

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Step doctrine waxes and wanes. Within the IRS and Congress, concern over the step transaction doctrine ebbs and flows, notes tax attorney Robert Wood. The doctrine (which, broadly stated, integrates all the steps in a corporate transaction to determine its true nature—and thus its proper tax treatment) is typically applied in corporate reorganizations, although it has other applications. Occasionally the IRS waves its step-transaction magic wand and creates a reorganization out of multiple transactions that were not originally intended as such; at other times, the IRS pulls apart deals that were planned as reorganizations and denies that treatment. The IRS and the courts often look at a reorganization to see if the parties' desired result could have been accomplished only after all the steps transpired. If not, the deal could be deemed taxable or certain elements of the deal could be so treated.

Four critical factors usually considered. The IRS and the courts typically apply four factors in assessing whether the step doctrine should be imposed. First, the author instructs, examine whether the steps in a corporate transaction are dependent on each other; if they are not, each step may be viewed as a separate deal. Second (and, historically, most important to the courts), assess whether there is a binding commitment for each of the steps. Third is the amount of time that has elapsed between the various steps. The greater the lapse of time between the steps, the more difficult it is to argue that they are interdependent. Conversely, the shorter the intervals between the steps, the more likely it is that they will be viewed as parts of an integrated plan. Finally, consider the intention of the parties, in what the author terms the "end result" test, which reviews whether the deal could have succeeded only with each and every one of the steps taken to achieve the result.

Not always the key to success. Despite the emphasis by the courts and the IRS on the four factors, they are not always applied consistently as a group or in equal measure with each other. Occasionally, one factor will be given primacy or another may garner little attention. Some cases have required a business purpose for each step and have ignored the step doctrine. The author points to the *Esmark* case from 1988, in which the IRS wanted to apply the step doctrine but the tax court focused primarily on whether there were any steps that should have been ignored. The *Esmark* court found that just because

the final deal was the cheapest in tax dollars due, no route was any more direct than the steps taken by the Esmark dealmakers.

Ruling causes confusion. In an IRS revenue ruling in 2001, confusion reigned in a deal involving some two-step stock acquisitions. Steps were integrated under a reorganization structure but did not result in the parent acquiring control of the target, when all was said and done. Despite the fact that such control is normally required for tax-free treatment, the ruling concluded that the deal satisfied the tax-free reorganization rules. The author points out that the steps in the deal were not interdependent, yet the IRS still applied the step doctrine, a confusing result, to say the least. Practitioners need to stay on top of the cases coming before the IRS and the courts before sounding the step doctrine's death knell.

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