The Step Transaction Doctrine: What Factor's Will Affect the Court's Decision?

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Abstract

Logit analysis was used to evaluate the factors considered by the Tax Court in deciding step transaction doctrine cases. Using a sample of 117 Tax Court cases, a logit model was estimated based upon eight variables. The existence of a preconceived plan and the economic interdependence of the steps were identified as the variables mostly likely to affect the decision of the Tax Court.

Introduction

The step transaction doctrine (STD) requires that, in appropriate circumstances, one or more seemingly separate transactions be treated as one transaction for tax purposes. Conversely, a complicated transaction with several steps may be treated as several transactions rather than one. The doctrine has been applied to a broad range of tax issues.

Ordinarily, in interpreting tax law, one looks to the Internal Revenue Code, Treasury Regulations and court decisions. When issues are complex and litigation results, the courts also rely upon various common law doctrines to interpret the tax law. The step transaction doctrine (STD) is often used by the courts to look past the form of a transaction and examine any underlying motives and issues that might indicate the transaction's substance is something other than its form.(1)

Unfortunately, there is no guidance in the code or regulations as to when the STD will be applied. When a taxpayer is entering into a complex transaction that may consist of several related steps, there may be a great deal of uncertainty as to how the IRS and the courts will view the transaction. The difference in treating the steps as one transaction or as many may be significant in terms of tax liabilities. The resulting uncertainty is generally viewed as a serious deficiency in the tax law.(2)

The purpose of the study reported in this article is to attempt to determine if there is a set of objective and predictable factors used by the courts in deciding these cases upon which a taxpayer may rely when trying to determine the tax effect of a contemplated transaction. If these factors could be identified, this information could be used to reduce uncertainty.

Factors

The following factors have been used in court cases involving the STD:

1. Timing of the transactions - (DAYS) - A short period of time between transactions may imply that the steps should be viewed as a whole and a long period of time may imply the converse. The common wisdom often dispensed is that an "old and cold" transaction will not be stepped together with a "new and hot" transaction. Although it appears that this is generally the case, there are many instances where the opposite has been true. In several cases, a period of several years did not prevent the application of the step transaction doctrine.(3) In other cases, the doctrine was not applied even though only hours lapsed between the transactions.(4)

2. Binding commitment - (CONTRACT) - A legal document which requires all parties to enter into all steps of a contemplated transactions would appear to require the application of the step transaction doctrine. In at least one instance, a binding contract is required in order for the doctrine to be applied. In applying Code Section 355, the courts have decided that for subsequent transactions to be grouped with an earlier transaction for the purpose of finding whether control had been transferred, there must be a binding agreement to take the later steps.(5) However, in other cases, the existence of a binding contract has not been sufficient evidence to require the application of the doctrine. In a "Type A" reorganization case the court did not apply

the binding commitment test.(6)

Clearly, the step transaction doctrine would be a dead letter if restricted to situations where the parties were bound to take certain steps. The doctrine derives vitality, rather, from its application where the form of a transaction does not require a particular further step be taken; but, once taken, the substance of the transaction reveals that the ultimate result was intended from the outset.

The Tax Court applied the binding commitment test in another case where it decided there was an "A" reorganization even though the former shareholders entered into an agreement to sell their acquired stock six months after the merger but were not bound to do so. This decision was reversed under the interdependence test.(7)

3. Interdependence of steps - (INTERDEPENDENCE) - The courts have often stepped together one or more transactions when the court felt that one step would have been fruitless without another or that the legal relationship between the steps would make it unreasonable to enter into one of the steps unless the complete series of transactions was completed.(8) The doctrine will usually be applied when the steps are so interdependent that, if any one step were missing, the others would not have been taken, and that separation of the steps would defeat their purpose.(9)

4. Intention of the parties - (PLAN) - Some courts have applied the doctrine when the result of a series of transactions was intended from the outset. Other courts have looked to the results desired by the taxpayers, and applied the step transaction doctrine to all transactions that played a part in achieving that end result.(10) It appears that if the parties had a preconceived plan involving a series of transactions to achieve a particular end result, the courts will be likely to apply the doctrine.

In addition to these four variables that are commonly discussed, some other factors were found that could have some effect upon the court's decision.

5. Tax avoidance motive - (MOTIVE) - The existence of a tax avoidance motive is not only part of the issue being decided by the court, it is also one of the facts presented as evidence by the IRS in many of these cases. In *Court Holding* (11), the taxpayers had entered into an agreement to sell assets of their corporation. While at the lawyer's office for the purpose of effecting the sale, they were advised by the lawyer to restructure the sale to avoid taxes at the corporate level. The fact that they restructured the sale after learning of the adverse tax consequences of the original agreement led the court to infer that avoiding taxes was the only motive for restructuring a transaction. The court determined that the taxpayers were engaging in excessive avoidance and the transaction should be treated as it was originally structured.

6. Intervening event - (EVENT) - The existence of an intervening event between two transactions that substantially changes the economic effect of entering into the second transaction should reduce the probability that the step transaction doctrine will be applied. In *Bruce vs. CIR* (12), a stockholder sold stock for cash early in the day. Later that day, she received an offer to exchange her stock in a reorganization. Since she had no knowledge of the reorganization when the cash sale was made, the two transactions were not stepped together. Examples of other intervening events would be a substantial change in the value of stock or other property, death of significant party to a transaction, and changes in the demand for a product due to a specific event.

7. Party arguing for application of the doctrine - (ARGUER) - There is a tendency in the literature to believe that the courts will apply the doctrine only when the IRS is arguing that it should be applied. Since the taxpayer structured a transaction in a certain way, it has been argued that tax effect should be given to the form the taxpayer adopted. This would prevent the taxpayer from arguing that the doctrine should be applied to a series of steps. Since there are some obvious exceptions to this argument, this variable was included in the study.(13)

8. Economic effect - (DOLLARS) - One interesting variable would be some measure of the extent of the economic effect of applying the doctrine. The only information reported in Tax Court cases that approximates such a measure is the deficiency assessed by IRS. There are some obvious limitations in this information. Multiple issues may be involved in a case, but the deficiency is only a total dollar amount for all issues involved. In addition, the deficiency is only for the years at issue. The decision of the court may affect subsequent years which are not included in the deficiency assessed. Despite these weaknesses, the deficiency assessed by the IRS was included as a variable.

Methodology

A statistical model was used to determine how important each of these variables were in explaining whether the Tax Court applied the step transaction doctrine or decided not to apply the doctrine. Statistical models have been used in many studies to explain the relative importance of factors considered by the courts in deciding a variety of issues.(14)

Description of the Data

The cases selected for analysis for this study included only the cases where the Tax Court or its predecessor, the Board of Tax Appeals, considered application of the step transaction doctrine. The decisions of other courts were not included.

The sample used in this study was all Tax Court regular and memorandum cases and Board of Tax Appeals cases involving the application of the step transaction doctrine to corporate formation, redemptions, liquidations, distributions, and reorganizations, hereafter referred to as Subchapter C issues. Using Lexis (15) and other traditional research methods, 125 cases were selected for analysis. These cases represent all of the cases tried in the Tax Court or the Board of Tax Appeals from the inception of the Board of Tax Appeals through late 1985. Of these cases, 55 were appealed. However, the Circuit Court of Appeals reversed the Tax Court's decision as it applied to the doctrine in only eight of the cases appealed. Although the parties attempted to appeal many of the cases to the Supreme Court, certiori was granted in only one case. In that case, the Supreme Court upheld the Tax Court's original decision. In the analysis of the cases, the cases that were reversed by the Circuit Court of Appeals were not included in the general model. The eight cases represent only about six percent of the cases and should not significantly affect the model.

A sample of step transaction doctrine cases involving Subchapter C issues was used for a variety of reasons. There are two primary reasons for this choice of sample. First, Subchapter C is an exceedingly complex area of tax law.(16) In addition to a complex set of code sections and regulations governing this area, the resultant problems have prompted an excessive amount of litigation in this area. Corporate reorganizations are often complex transactions. The necessity to apply the STD has been one of the contributing factors to the complexity of applying tax law to the these transactions.

Secondly, as alluded to above, there are a large number of Subchapter C cases involving the STD. Statistical models provide better information with larger samples.

Statistical Model

The dependent variable used in this study was dichotomous. That is, it was assigned one of two responses. When the question was asked, "Were one or more steps treated as one transaction?" only two responses were possible: yes or no. This binary response limits the possible statistical methods which can be used effectively. Linear probability model analysis, multiple discriminate analysis, probit analysis, and logit analysis have been used in similar studies.(17) Logit analysis was used for this study.

The LOGIST procedure employed in the Statistical Analysis System was used to estimate the model. The procedure fits the logistic multiple regression model to a single binary dependent variable using maximum-likelihood estimates. The procedure computes test statistics for assessing the goodness-of-fit of the model. Individual coefficient estimates and estimates of the associated standard errors are reported. A t-statistic is used to test the null hypothesis that a coefficient is zero.

In ordinary least squares multiple regression, an F statistic is used to test the hypothesis that all coefficients except the intercept are zero. The test used in logit analysis produces a statistic called the likelihood ratio statistic:

$$c = 2 \log(L(0)/L(1))$$

where $L(1)$ is the value of the likelihood function for the full model as fitted and $L(0)$ is the maximum value of the likelihood function if all coefficients except the intercept are 0. This statistic approximately follows a chi-square distribution.

Findings

The model estimated was based upon 117 cases which did not include decisions reversed by a higher court. In 47 of the cases, the Tax Court held that the step transaction doctrine should not be applied and in 70 cases, the Court held that the doctrine should be applied. The likelihood ratio for the model was 57.35. The critical value of chi-square with 8 degrees of freedom at a .1 significant level is only 1.65 so the null hypothesis that all variables except the intercept are 0 is rejected.

The coefficients derived by the program and the statistics related to the various coefficient are summarized in Table 1. Two variables were found to be statistically significant. **Interdependence** of the steps was the most significant. The existence of a **plan** were less significant but was significant at a the .01 level.

The model's classification accuracy is presented in Table 2. The model correctly classified 93 of 117 cases. This represents almost 80 percent of the cases. An analysis of the misclassified cases revealed no discernable pattern to which to attribute the misclassification.

A more detailed explanation of the interpretation of these results may be found in "An Analysis of the Factors Used by the Tax Court in Applying the Step Transaction Doctrine" (Smith, 1987).

TABLE 1
EIGHT-VARIABLE LOGIT MODEL

Variable	Beta	Standard Error	Probability
Intercept	-3.34832168	1.01588310	0.0010
Dollars	0.00000000	0.00000000	0.9422
Event	0.79447281	0.69989996	0.2563
Days	0.00002345	0.00049119	0.9619
Arguer	0.14751579	0.52917451	0.7804
Motive	0.58791522	0.55258410	0.2882
Interdependence	2.27080082	0.57066134	0.0001
Plan	2.19915594	0.85496596	0.0101
Contract	0.65103903	0.89989635	0.4694

TABLE 2
CLASSIFICATION ACCURACY

Actual Group to which the Case Belonged	Percent of Outcomes Classified Correctly	Predicted Outcome Applied	Predicted Outcome Not Applied
Doctrine Applied	80.0	56	14
Doctrine Not Applied	78.7	10	37
Total	79.5	66	51

Conclusions and Recommendations

Since only two variables were statistically significant and the models correctly predicted more than 80 percent of the court's decisions, it would appear that taxpayers could reduce the uncertainty surrounding their transactions by paying attention to those variables. But a careful analysis of these variables implies that the solution is not that simple. The existence of a preconceived **plan** and the economic **interdependence** of the steps were statistically significant. Due to the subjective nature of the determination of whether these two situations existed, it was not surprising that these factors had the most effect upon the Tax Court's decisions. In nearly all of the cases, the taxpayer has presented a large number of facts supporting his/her contention that the doctrine should or should not be applied. The IRS has presented an equally large number of facts to support the opposite contention. All of these facts must be evaluated in order to determine whether there really was a preconceived plan and whether the steps were economically interdependent. It appears that an objective appraisal based on consistent guidelines is difficult because each set of facts is different and must be analyzed in light of the parties' conflicting objectives. It can be readily understood why these are the issues being decided by the court. (Other issues such as the time between transactions are more objective and may not be at issue before the court because both the taxpayer and IRS auditors have "prescreened" the transactions). Both the taxpayer and the IRS officials believe their interpretation of the situation is valid, and in these complex situations where large numbers of tax dollars are involved, the issue must be decided by an impartial third party. The subjective nature of these decisions makes this process appear to be inconsistent based upon a reading of a sample of cases. It is difficult to predict whether or not the court will decide that a preconceived plan existed, or that the steps were economically interdependent, based on any set of complex facts.

The uncertainty involved with the courts' use of the step transaction doctrine can be reduced only if objective variables can be identified which the court consistently uses to apply the doctrine. These variables must be "objective" in the sense that, before a transaction is entered into, it is possible to predict how the courts will interpret them. In this study, although it was possible to determine how these variables had been interpreted in past court cases, the variables identified are difficult to predict in advance. In areas where this situation exists, the law is not likely to be simplified by statutes or regulations that attempt to establish guidelines as to when a provision of law (or doctrine in this case) will be applied.

A taxpayer contemplating a transaction where the STD might conceivably be applied faces a difficult dilemma. Where the potential tax liability is significant, a ruling request should be considered. In all cases, care should be taken to document the existence of or lack of interdependence of the steps or of a plan.

Suggestions For Future Research

Statistical analysis of court decisions allows for quantitative analysis of tax law in addition to the traditional qualitative analysis of tax planners and practitioners. The dichotomous variables often encountered in this type of analysis dictate the use of statistical methods such as logit or probit. The use of these methods can provide a great deal of understanding of complex areas of judicial tax law. The understanding of any area of tax law which has resulted in a great number of court decisions could be enhanced by this type of analysis.

Another future direction of this type of research could involve the use and evaluation of additional methods of analysis. For example, the use of neural network methods or recursive partitioning could provide added insight into these complex areas of law.

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*****Footnotes*****

1. Two other commonly used doctrines are the form vs. substance doctrine and the business purpose doctrine. The form vs. substance argument implies that tax consequences should be based on the substance of the transaction (what it really is) rather than on its form (what it appears to be). The business purpose doctrine would require that a transaction not be given effect for tax purposes unless it serves some purpose other than tax avoidance. There is a great deal of overlap in the application of the three doctrines. (Bittker, 1978).
2. For example, see Roberts, et. al., (1972).
3. For example, see *Fry vs. CIR*, 5 TC 1058 (1945).
4. For example, see *Bruce vs. CIR*, 76 F.2d 442 (D.C. Cir. 1935).
5. *Gordon vs. CIR*, 391 U.S. 83 (1968).
6. *King Enterprise, Inc. vs. U.S.* 418 F. 2d 511 (Ct. Cl. 1969).
7. *McDonald's Restaurants of Illinois, Inc.*, 82-2 USTC 9581 (7 Cir. 1982) reversing 76 TC 972 (1981).
8. For example, *see American Bantam Car Co. vs. CIR*, 11 TC 397 (1948).
9. For example, see *Reeves vs. CIR*, 71 TC 727 (1979).
10. For example, see *Ericsson Screw Machine Products Co. vs. CIR*, 14 TC 757 (1950).
11. *Court Holding*, 45-1 USTC 9215 (Sup. Ct., 1945) reversing 44-2 USTC 9404 (5 Cir., 1944) reversing and remanding 2 TC 531 (1943).
12. *Bruce vs. CIR*, 76 F.2d 442 (D.C. Cir., 1935).
13. *Kimbell-Diamond Milling Co.*, 51-1 USTC 9201 (5 Cir., 1951), cert. den., affirming 14 TC 74 (1950).
14. For example, see Robison (1983) and Stewart (1982).
15. LEXIS is a service of Mead Data Central. It is a legal data base that stores the texts of court cases, including the Board of Tax Appeals and Tax Court decisions issued since 1924 and Tax Court Memorandum decisions since 1942.
16. For discussions of the problems related to complexity in this area see Staff of Senate Comm. on Finance (1983) and Clark (1977).
17. There are many discussions of the appropriate statistical model to be used in these studies. For example, see Eisenbeis (1977) and Pindyck and Rubinfeld (1976).

*****References*****

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9. Staff of Senate Comm. on Finance, "Reform and Simplification of the Income Taxation of Corporations" reprinted in *Daily Tax Report*, (Bureau of National Affairs) No. 187 at J-1, September 29, 1983.