

THE STEP TRANSACTION DOCTRINE AND ITS EFFECT ON CORPORATE TRANSACTIONS

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In every field of law, courts, litigants and lawyers constantly confront the problem of describing human and business events in terms that are relevant to the particular legal issue involved. In taxation, this search is most often described as one for the substance of transactions as opposed to their forms. But this is a special type of reality, it is reality in a context, the context being the law of taxation. When Mrs. Gregory's¹ wholly owned corporation, United Mortgage Corporation, organized a new subsidiary to which it transferred shares of stock in Monitor Securities Corporation, these were real events; they did take place. But in the context of the tax law they were considered formalities of no consequence in describing the real substance of the tax transaction.

The step transaction doctrine is the name that has been given to one method courts have used in fitting events into the descriptions provided by the statute for taxable transactions. The use of this method occurs over and over in the resolution of tax cases. Sometimes the courts describe what they have done as an application of the step transaction doctrine; sometimes they make no mention of it. But the method is so frequently encountered in corporate tax cases that to catalogue all of such cases would be a monumental undertaking and unlikely to be very useful. On the other hand, a study of examples of the use of this method by the courts is helpful in understanding the Internal Revenue Code.²

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¹This reference is to the taxpayer and the facts of *Gregory v. Helvering*, 293 U.S. 465 55 S.Ct. 266 (1935).

²Credit must be given to Paul and Zimet, *Step Transactions*, in *SELECTED STUDIES IN FEDERAL TAXATION* (2d Series 1938) 200, and Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, Proc. 12 NYU Ann. Inst. on Fed. Tax 247 (1953) for collecting many of the early cases, as well as presenting excellent analysis of the doctrine.

In a broad sense, the step transaction doctrine might be thought of as being involved in four definitional situations. Most common is the combining of two or more steps into a single transaction described by the statute. Or, as it is sometimes put, the law will not permit what is essentially a single transaction to be broken up into component parts with each of the component steps being given independent significance. The *Gregory* case,³ decided by the Supreme Court in 1935, is a classic example of the use of this method, even though the decision makes no mention of "step transaction doctrine." In deciding whether the sequence of the events which took place constituted a "reorganization" the Court combined four steps, the formation of a subsidiary, the transfer of securities to it, a distribution of the stock of the subsidiary and then a liquidation of the newly organized company. As a single transaction, it was merely a distribution of securities which the corporation had owned prior to formation of the subsidiary. Looked at in this way, the transaction did not fit the statute's definition of a reorganization.⁴

This treatment of events as only steps, having no independent tax significance, of a single transaction is frequently all that is meant when the phrase "step transaction doctrine" is used. But other types of cases are closely related. The corollary of combining several steps into a single transaction to take a single event and characterize it as actually involving two or more tax significant transactions. The classic case of *Eisner v. Macomber*⁵ was fought on this ground. The dissenting opinion of Justice Brandeis argued that the same result as a stock dividend was often achieved by a distribution of a cash dividend along with a rights offering to stockholders. The exercises of the rights by either the stockholders or purchasers of the rights would then return to the corporation the same amount of capital which had been distributed as a dividend. He believed the stock dividend should be viewed in this manner. Both Justice Pitney for the majority and Justice Brandeis in dissent spoke of the need to determine the real substance of the transaction, but they differed on this crucial point of whether the single

³ *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266 (1935).

⁴ *Commissioner v. Gordon*, 391 U.S. 83, 88 S.Ct. 1517 (1968) is a recent example of a refusal to combine two events into one distribution transaction. See discussion at note 106, *infra*.

⁵ 252 U.S. 189, 40 S.Ct. 189 (1920).

transaction should be viewed as involving steps having independent tax significance.⁶

In a third type of case, several transactions are considered by the courts to have occurred in different sequence. Thus, in *Commissioner v. Court Holding Co.*⁷ the Supreme Court found that, even though a corporation first liquidated and its assets were then sold, in the context of the tax law the sale of assets had in fact preceded the liquidation.⁸ The shareholders were viewed simply as the conduit through which title was passed.

Finally, the determination of what steps or events, actually constitute the transaction described by the tax law frequently enters into a determination of the character of the taxable event. Thus, in the *Arrowsmith* case,⁹ the payment by a stockholder of a judgment against a corporation four years after the corporation had been liquidated was considered by the Court to be but one step in the liquidation transaction; thus, it characterized the loss as a capital loss instead of an ordinary business loss of the stockholder. In this case, the Court did not speak of the step transaction doctrine, but it still used the same method in defining the liquidation transaction. It said that "The Commissioner viewed the 1944 payment as part of the original liquidation transaction requiring classification as a capital loss". The taxpayer argued that this would violate the principle of an annual accounting for income taxes and the Court answered, "But this principle is not breached by considering all the 1937-1944 liquidation transaction events in

⁶In *U.S. v. Joliet and Chicago Railroad*, 315 U.S. 44, 62 S.Ct. 442 (1942), the Court did apply this corollary of the rule. The taxpayer had leased property, directing that rents be paid direct to its shareholders. Each rent payment was treated by the Court as involving two independent transactions, one, a payment of rent to the taxpayer and, two, a distribution of a dividend to taxpayer's shareholders.

Consider also the Commissioner's attempt to treat a charitable contribution by a corporation as a dividend to the shareholder and a contribution by him. Rev. Rul. 68-658, IRB., 1968-53, p. 10.

⁷324 U.S. 331, 65 S.Ct. 707 (1945). This case has, among other places, been cited as involving step transaction doctrine in *West Coast Marketing Co.*, 46 T.C. 32, 41 (1966).

⁸This type of decision could also fit into the second type such as that in *U.S. v. Joliet and Chicago Railroad Co.*, supra note 6, by considering the event of sale to consist of two transactions, a sale by the corporation and then a distribution in liquidation.

⁹344 U.S. 6, 73 S.Ct. 71 (1952).

order properly to classify the nature of the 1944 loss for tax purposes.”

Many of the reorganization cases that are said to involve an application of the step transaction doctrine are examples of this fourth type of case. The reorganization transaction itself is not taxable; Section 368 only defines “reorganizations.” The taxable (or nontaxable) transactions are the exchanges of stock, securities and other property described in sections 354, 362 and 356. Thus, when a determination is made that certain steps are parts of a single transaction which fits the definition of a reorganization, this determination only helps to characterize the tax treatment to be given to the various exchanges.

Development of the step transaction doctrine has been largely the result of its use by the courts. However, the role of the statute should not be minimized when one attempts to reconcile the cases. The statute describes the transaction which has tax significance. Thus, the courts, using the step transaction doctrine, must wrestle with a particular statutory description. Some transactions described by the Code almost always involve many individual events. Examples abound in the various reorganization provisions. These are normally complex transactions, requiring many individual events. Thus, when deciding whether several steps constitute integral parts of a single reorganization transaction, courts may quite willingly accept a rather loose or tenuous nexus among them as enough cement to bind them together. But when a court is faced with determining whether a corporation has made a “distribution” or whether a “sale” has occurred, it may be quite reluctant to combine several steps into one, because the statutory term with which it is dealing is normally thought of as involving a single event.¹⁰ That is undoubtedly the reason for

¹⁰ For example, compare *Walter S. Heller*, 2 T.C. 371 (1943) (organization of new corporation to purchase assets of old which was then liquidated, a substantial change in proportional interests occurring) where the Tax Court puts great emphasis on the net effect of the series of steps because they were taken pursuant to a plan, with *Waterman Steamship Corp.*, 50 T.C. 650 (1968) (on appeal 5th Cir.) (an intercorporate tax free dividend occurred simultaneously with a sale of the subsidiary at greatly reduced price from that which purchaser had offered) where the Tax Court, considering the substance of a “sale” transaction refused to integrate the dividend with the

the Supreme Court's recent decision in the *Gordon* case,¹¹ as it involved an interpretation of Section 355's use of the term "distribution," a type of transaction commonly achieved with a single event. It would not combine two distributions in different years and treat them as a single transaction unless the second step must necessarily have been taken once the first step occurred.¹²

The determination of what events or steps shall be considered as part of a particular transaction involves, as well, a determination as to what events should be *excluded* from the transaction. The exclusion of events (which may seem closely related to a particular transaction) can produce surprising results at times and today the Commissioner and the courts are giving greater attention to the potential of this type of analysis of transactions. The leading example of what may result is furnished by the Supreme Court's decision in *Bazley v. Commissioner*.¹³ That case held that the distribution of securities accompanying an exchange of stock in the Bazley corporation was a step independent of the recapitalization or stock exchange transaction,¹⁴ thus acquiring independent tax significance as a dividend. The Commissioner, relying on the *Bazley* case, took a similar position in Rev. Rul. 61-156¹⁵ deal-

transfer of stock notwithstanding the step had no purpose other than to reduce tax, was clearly taken pursuant to the plan to sell the subsidiary and coincided in time with the sale.

¹¹ 391 U.S. 83, 88 S.Ct. 1517 (1968).

¹² In *Gordon*, Pacific Telephone and Telegraph spun off a new subsidiary through a series of two rights offerings to its shareholders. At the time of the first offering the plan was to distribute all the stock in this manner, but the time for completing it was uncertain and the corporation was not bound to do so. The balance of the stock was, however, distributed via a rights offering in a later year. The Supreme Court refused to combine the two distributions into one in the absence of a binding commitment at the time of the first rights offering that the remaining stock would be distributed within a certain time period.

¹³ 331 U.S. 737, 67 S.Ct. 1489 (1947).

¹⁴ The Court apparently rejected a holding that a recapitalization for tax purposes had been achieved, but nevertheless there was an exchange of stock for stock and boot in such transaction would have been taxable pursuant to sections 112(b)(2) and 112(c)(1) of the 1939 Code, the predecessors of sections 1036 and 1031(b) of the 1954 Code.

¹⁵ 1961-2 C.B. 62. See the discussion *infra* at note 97.

ing with a liquidation—reincorporation type transaction. Although the Commissioner combined a number of steps to find that a reorganization had occurred, he excluded a planned public sale of stock in arriving at that conclusion, and he excluded what would have appeared to be a boot distribution, thus requiring it to be taxed under section 301 instead of under section 356. In this way he escaped the dividend-within-gain limitation of section 356(a)(2). Recently the Fifth Circuit Court of Appeals has adopted the same approach in defining the reorganization transaction in *Reef Corp. v. Commissioner*¹⁶ and in determining the amount of the dividend distribution in *Davant v. Commissioner*.¹⁷

Not only does the statute describe the various transactions, thus creating the context within which the courts use the step transaction doctrine, but in many instances the statute itself codifies the doctrine for specific situations. For example, the wash sales provisions combine two steps, one of which negatives the other.¹⁸ The result is the same as a finding that the event of sale did not take place, and that there was no taxable transaction. Another example can be seen in section 302(b)(2)(D) of the Code, which combines a series of redemptions into a single stock redemption transaction in order to test whether the redemption is the equivalent of a dividend.

Because of the fact that the step transaction doctrine must deal with a variety of statutory transactions, it is difficult to generalize about the doctrine. One cannot set down any one particular test to determine whether the doctrine will be applied or rejected by a court. Nevertheless, some tests are frequently applied and can be identified, even though it is necessary to examine the treatment of particular issues to determine how important any one test may be in predicting the outcome of a case. Perhaps the test most frequently articulated by the courts is one described by Randolph Paul and Philip Zimet in their 1937 essay on step transactions.¹⁹ That is the mutual interdependency of the steps. Paul and Zimet stated this as requiring a determination of whether “the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.” The Tax Court clearly articulated this as the reason for its

¹⁶ 368 F.2d 125 (5th Cir. 1966).

¹⁷ 366 F.2d 874 (5th Cir. 1966).

¹⁸ I.R.C. §1091.

¹⁹ Paul and Zimet, *Step Transactions*, loc. cit., supra n. 2.

decision in *American Bantam Car Co.*,²⁰ refusing to accept the taxpayer's argument that a transfer of assets to a subsidiary failed to qualify for nonrecognition treatment under section 112(b)(5) as the result of a later transfer of stock to an underwriter as his fee for a public issue of stock. The corporation had argued that the public issue, being contemplated under the plan for organizing the subsidiary, should be treated as part of the transaction, in which event stock being obtained by the underwriters would have resulted in a failure to meet the test of control immediately after the transfer.

Paul and Zimet also described several other factors which at least get involved in the rhetoric used by courts in dealing with step transactions. They are that the intent of the parties, the time factor and the ultimate result of the steps may also have a bearing on whether to combine the steps into a single transaction.²¹ There is little question today that steps can be separated by substantial periods of time and still be considered parts of a single transaction. The intent of the parties was dismissed by Paul and Zimet as of little use and, indeed, the purpose of the steps, i.e., whether they are for separate business reasons or whether they all serve a single purpose, has become a more accurate way of viewing this factor. Finally, the net effect of the steps or their ultimate result is sometimes used by courts to rationalize a result. However, this is a determination that must be made in every step transaction case *after* the determination has been made that the steps must be combined.²² Thus it hardly serves as a reason for integrating the steps in the first place.

Closely related to the mutual interdependence test is that of business purpose. If there is an independent business purpose for each step, then that step would not appear fruitless even if the contemplated series of steps is not completed. The corollary to this is that if avoidance of tax is the motivation for taking the several steps, then one step may not appear to be fruitful unless the series is completed. Thus, in *H. B. Zachry Co.*,²³ a company had organized a subsidiary, transferring an

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

²¹ These are further developed by Mintz & Plumb, *loc. cit.*, *supra* n. 2, pp. 249-50.

²² The Tax Court has made this point in *Southwell Combining Co.*, 30 T.C. 487, 498 (1958) where it said, "Where the facts warrant the integration of a series of steps into one, it is the situation at the beginning and at the end of the series which determines whether there has been a statutory reorganization, or merely a taxable exchange."

²³ 49 T.C. 73 (1967) (appeal to 5th Cir. dismissed).

oil payment to it in exchange for its stock. The subsidiary then made a loan secured by the oil payment and used the cash proceeds to buy preferred stock issued by the parent. Without offering persuasive reasoning the Court held that there were independent business reasons for each of these steps and gave them independent tax significance.²⁴ Contrasted with this is the recent case of *George A. Nye*,²⁵ where the taxpayer organized a corporation one day and sold business assets to it the next. The taxpayer, in explanation, offered only a single business purpose to explain the transactions, and this purpose was one which related to the entire plan, the protection against credit risks. As a result the Tax Court found that the sale and the purchase of stock were so closely related as to require them to be combined in a single section 351 transaction. Nevertheless a tax avoidance motive is not always fatal, as witnessed by *Waterman Steamship Corp.*²⁶ And in some instances the Internal Revenue Service even gives helpful advice on the form with which to clothe a transaction in order to avoid a tax.²⁷

The fact that steps are taken pursuant to a plan is usually enough to bind them together in determining whether a reorganization has occurred, but this test is employed occasionally in nonreorganization contexts as well.²⁸ Of course, if

²⁴ See also *Weyl-Zuckerman & Co.*, 23 T.C. 841 (1955) aff'd 232 F.2d 214 (9th Cir. 1956) where a sale of mineral rights was contemplated by a corporate taxpayer. It organized a subsidiary to which it transferred the tract of land for stock in a section 351 transaction. Six months later, the subsidiary distributed the mineral rights as a dividend, the purpose being to get a stepped-up basis prior to the sale. Because of this tax avoidance motive for the sequence of transfers the Court combined them and refused to give the mineral rights the hoped-for basis.

²⁵ 50 T.C. 203 (1968).

²⁶ *Supra*, n. 10.

²⁷ See, e.g., Rev. Rul. 69-172, I.R.B. 1969-10, p. 10, describing how to avoid a double tax on the sale of a subsidiary's assets.

²⁸ An example of how these tests may blend is furnished by *Baker Commodities, Inc.* 48 T.C. 374 (1967), aff'd —F.2d— (9th Cir. 1968). The rationale of the Tax Court in binding steps together was phrased in terms of being carried out pursuant to a plan. But, the purpose of the plan was to organize a new corporation to take over the assets of a partnership. Thus, although the organization of the company clearly accomplished something of substance, it was fruitless in carrying out the purpose of the plan without the subsequent purchase of partnership assets. See discussion, *infra*, and cf. *Stevens Pass, Inc.*, 48 T.C. 532 (1967), appeal dismissed —F.2d— (9th Cir. 1968).

the plan itself has a certain tax avoidance or business motive which cannot be consummated without carrying out the entire plan, then this test tends to shade into the mutual interdependence test as the initial steps would be fruitless, *in the context of the particular purpose*, without completing the plan. This, however, does not appear to be quite what Paul and the courts have intended when speaking of mutual interdependence. They speak of whether the legal relations would be fruitless if the series is not completed. Yet one may question whether this is meaningful without considering the purposes of each step as well as the purpose of the overall plan. In speaking of mutual interdependence, the courts normally mean something more than that the step simply creates a new or different legal relationship. To speak of it being fruitful, they must be making reference to being fruitful in accomplishing some purpose. Is the purpose, then, one which is dominated by a single purpose for a planned course of action, or is it the purpose, a separate business purpose, of that particular step.

The functional independence of a particular event has been said to be the evolving rationale for excluding that event from a transaction even though it may be closely related to it.²⁹ Thus if the particular event is unnecessary to a finding that a transaction occurred (such as a reorganization in the *Reef* case)³⁰ then the event may be excluded from the transaction if it can be seen to serve a separate function. It is possible to view this as a makeweight argument in some cases because, if inclusion of the step would have resulted in the claimed transaction not occurring, as would have been the case in *Reef*, then the reason for excluding the step must rest on some other ground. However, where exclusion of the step would not change the finding that the particular transaction occurred, but only alter the tax result of the step in question, then the functional independence test might be of greater utility. For example, the Fifth Circuit Court of Appeals would have found that a reorganization occurred in the liquidation-reincorporation type case presented by *Davant*,³¹ no matter what position it took with regard to the events that resulted

²⁹ Pugh, "The F Reorganization: Reveille For A Sleeping Giant?", 24 Tax L. Rev. 437, 445 (1969).

³⁰ *Supra*, n. 16.

³¹ *Supra*, n. 17.

in a withdrawal of cash. But, by excluding the cash withdrawals, from the reorganization transaction, the Court caused this distribution to be treated under section 301 as a simple dividend, rather than as a boot distribution under section 356.

Finally, in some types of cases, courts require not only interdependence, but some type of commitment that once the first step is taken the others will follow. Thus, in the recent *Gordon* case,³² the Supreme Court indicated that it would have required a binding commitment running between the corporation and its stockholders to distribute the balance of the stock of its subsidiary in order to find that two distributions were part and parcel of a single section 355 distribution of stock.

Thus, the court may in one case permit the mere existence of a plan contemplating each of the steps to be the reason for tying them together in one transaction, and in another case require binding commitments that all steps will be taken. Falling somewhere between these extremes are the cases that turn on mutual interdependence or business purpose tests. Which one will be applied in a given case frequently depends on the provision of the Code which is in issue. But one wonders whether the courts may not also be somewhat affected by whether it is the taxpayer or the Commissioner who is seeking application of the doctrine. It is generally said, today, that the doctrine is applicable without regard to which party is claiming its application.³³ In the *Gallagher* case³⁴ the Tax Court combined a number of steps taken pursuant to a plan to avoid dividend treatment of a stock redemption and to find that there was no reorganization in a liquidation-reincorporation type situation. Thus the Tax Court helped the taxpayer to an extremely favorable tax result through an application of the step transaction doctrine. And recently in *Weinert's Estate v. Commissioner*,³⁵ the Court said, "...resort to substance is not a right reserved for the Commissioner's exclusive benefit to use or not to use—depending on the

³² *Supra*, n. 11.

³³ Mintz & Plumb, loc. cit., *supra* n. 2, p. 248.

³⁴ 39 T.C. 144 (1962).

³⁵ 294 F.2d 750, 755 (5th Cir. 1961). And it is interesting to note that as early as *Eisner v. Macomber*, 252 U.S. 189, 40 S.Ct. 189 (1920), the Court used what it viewed as the substance of the transaction to reject a tax on a stock dividend.

amount of tax to be realized. The taxpayer too has a right to assert the priority of substance." But in other situations the courts will sometimes continue to revert to the idea that a taxpayer is bound by the form which he gives to his transactions,³⁶ and it is impossible not to wonder whether this may not occasionally affect a court's judgment as to whether it takes a strict or lenient approach to the application of the step transaction doctrine.

Application of Step Transaction Doctrine in Particular Contexts

Section 332

The few cases decided under Section 332 where the Commissioner has attempted to combine several steps into a single transaction have resulted in the courts giving short shrift to the step transaction doctrine. The issue has arisen primarily in situations where a corporation has wanted to avoid the non-recognition provisions of Section 332 upon liquidating a subsidiary.³⁷ To accomplish this, the corporation makes a pre-liquidation sale of a portion of the stock of the subsidiary in order to divest itself of the eighty percent (80%) control. In each of the litigated cases the corporation has ended up in the same situation it would have been in had it simply liquidated the subsidiary. The proceeds it received from the sale of stock prior to the liquidation were a full substitute for the consideration the corporation would have received upon liquidation. Were the court to have combined the event of sale and the subsequent event of a liquidating distribution into a single transaction, the liquidation of the subsidiary, the effect would have been to ignore the event by which the

³⁶ See, e.g., *ACF-Brill Motors Co.*, 14 T.C. 263 (1950) as compared with the Commissioner's position in a similar situation in Rev. Rul. 69-48, I.R.B. 1969-6, p. 16 (parent company buys stock of X for cash; then subsidiary acquires the assets of X for parent company's stock and X is liquidated—steps are combined because of preexisting plan) and *Northern Natural Gas Co. v. Comm.*, 362 F.2d 781 (8th Cir. 1966) aff'd 44 T.C. 74 (1965) (subsidiary buys gas, incurs transmission expense and resells to parent—parent denied subsidiary's cost as inventory value of gas).

³⁷ *Granite Trust Co. v. U. S.*, 238 F.2d 670 (1st Cir. 1956); *Comm. v. Day & Zimmerman, Inc.*, 151 F.2d 517 (3d Cir. 1945); *Avco Manufacturing Corp.*, 25 T.C. 975 (1956).

corporation divested itself of control. Section 332 would then have applied. But, in each case, the court has rejected the application of the step transaction doctrine, notwithstanding that the sale of stock took place after the corporation had decided on the liquidation and that the sale was motivated by no other reason than to obtain a tax advantage.

Here there was certainly a mutual interdependence between the steps. The sale of stock would not have served any purpose to the corporation without the subsequent liquidation. Furthermore, since the motivations for the sales were not business-oriented and served strictly a tax purpose, there was every reason, applying the general principles of step transaction doctrine, to accept the Commissioner's contention that section 332 applied to the liquidation.

In this situation, however, the courts are dealing with a section of the code which is highly formalistic in its prescription of the transaction giving rise to non-recognition of a gain or loss. In attempting to circumscribe the application of this provision Congress used highly restrictive language saying that it would apply "*only if* the corporation receiving such property was, *on the date of the adoption* of the plan of liquidation, and has continued to be *at all times* until the receipt of the property, the owner of stock (in such other corporations) possessing at least 80 percent of the total combined voting power . . ." (emphasis supplied).³⁸ In perhaps the most extreme of these cases, *Avco Manufacturing Corp.*,³⁹ there was a transfer of stock following the adoption of the plan of liquidation which the court could easily have ignored as being de minimus; yet the formalism of the statute led the court to a decision based on the form adopted by the taxpayer.

On the other side of the issue, in a memorandum decision, the Board of Tax Appeals permitted a corporation to acquire the controlling interest by purchase shortly before the liquidation occurred.⁴⁰ If the court had applied the step transaction doctrine, combining the purchase of stock with

³⁸ The predecessor to § 332, 112(b)(6) did not differ materially for purposes of this discussion.

³⁹ *Supra*, n. 37.

⁴⁰ *Metal Office Furniture Co.*, ¶ 42,337 P-H BTA Memo. Dec.

the liquidation event, then the stockholder who sold his stock to the parent corporation would be viewed as receiving a distribution in liquidation of the subsidiary and the parent company would not be viewed as having the requisite control at the date of liquidation.⁴¹

One would struggle fruitlessly to attempt the reconciliation of these case with other step transaction cases without considering the statutory context in which they were decided. Indeed, the First Circuit Court of Appeals, in its decision in the *Granite Trust Company* case,⁴² explained its reversal of the district court on this very ground, saying that the legislative history of Section 332 showed that this provision was not intended to be an "end-result" section, but to have elective features open to the taxpayer.

Section 351

The step transaction doctrine had much of its early development in transactions governed by the predecessors to Section 351 of the Code, relating to the transfer of property to a controlled corporation. The doctrine has played an important role in the resolution of several types of issues which arise under Section 351 and, because of differences in the particular statutory provisions as well as the regulations, the courts use of step transaction doctrine differs from one issue to another, even within the context of Section 351.

One question importantly affected by the doctrine is what persons shall be considered to be members of the control group. Since the statute speaks in terms of a single transfer of property to the corporation, but by one or more persons, it clearly contemplates that the transaction (the transfer of property) may include more than a single event. The regulations of the Commissioner have construed this liberally, saying that transfers by two or more people will be treated as part of a single Section 351 transaction if they occur in a situation where the rights of the parties have been previously defined and the execution of the agreement has proceeded with an expedition

⁴¹ Cf. *General Motors Corp.*, 35 BTA 523 (1937) (case settled on appeal)—a reorganization case but involving a transitory acquisition of stock prior to effecting an exchange of stock for assets.

⁴² *Supra*, n. 37.

consistent with orderly procedure.⁴³ On this particular 351 issue, the courts have perhaps been even more lenient. An example is the Tax Court's decision in *Baker Commodities, Inc.*⁴⁴ where three partners, together with seven key employees in the partnership organized a corporation, each contributing \$500, or ten per cent (10%) of the capital stock of the corporation. The company then bought the partnership assets and gave in exchange therefore what the Tax Court decided was a security within the meaning of Section 351. It then held that the exchange of partnership assets for securities was sufficiently related to the original organization of the corporation to consider that the control group consisted of all ten of the organizers in the corporation, not just the three partners. Accordingly the court found that the second step was a part of the Section 351 transaction.

A question as to whether control exists immediately after the transfer of property has other potential issues than that of the control group. A number of cases have dealt with the problem of transfers of stock following the initial exchange of the property for stock.⁴⁵ Here again the statute is rather formalistic because of its language that the control need exist "*immediately after the exchange*" (emphasis supplied). Thus it can be expected that courts would tend to reject the application of step transaction doctrine and would not hold that a subsequent transfer and the initial exchange of property for a subsequent transfer of stock divested the original shareholder of his control unless there was a very substantial transfer and the initial exchange of property for stock. The *American Bantam Car Company*,⁴⁶ in rejecting the application of the step transaction doctrine on this issue used the mutual interdependence test; but it should be noted that it did not need more than this in order to reject the use of the doctrine. On the other hand, in *May Broadcasting Company v. U.S.*,⁴⁷ the Eighth Circuit Court of Appeals applied the doctrine, when it found that the subsequent sale of stock was

⁴³ Reg. 1.351-1(a)(1).

⁴⁴ *Supra*, n. 28.

⁴⁵ See cases collected in 54-3rd T.M., *Transfers To Controlled Corporations*, pp. A-16 et. seq.

⁴⁶ *Supra*, n. 20.

⁴⁷ 200 F.2d 852 (8th Cir. 1953).

made pursuant to a binding written commitment in existence when the exchange took place. This has overtones of the holding of the Supreme Court in the *Gordon* case and, with that case as precedent, it seems predictable that courts will tend to take this strict view of the doctrine in subsequent cases involving that issue.⁴⁸

Where it appears that the subsequent transfer is connected to the exchange only because of a plan, with no binding commitment to make the transfer, courts have not been willing to combine the transfer with the exchange.⁴⁹ In the case of a gift of stock immediately following the exchange courts have rejected the use of the doctrine.⁵⁰ But on the other hand where stock has been issued direct to a donee or a person who is not in the control group, the form has been given effect to disqualify the exchange of property for stock. This was the holding of the Fifth Circuit in *Fahs v. Florida Machinery Foundry Company*.⁵¹ This is a situation where a better result might be reached if the court were to apply the corollary of the step transaction doctrine and find that the single step of issuing stock to the donee actually involved two transactions having independent tax significance, being, first, the issuance of stock to the original shareholder and, second a subsequent gift of that stock to his donee.⁵² The case would then be more in harmony with the cases where an exchange

⁴⁸ E.g., *Manhattan Building Co.*, 27 T.C. 1032 (1957).

⁴⁹ E.g., *National Bellas Hess*, 220 F.2d 415, 225 F.2d 340 (8th Cir. 1955). But compare the position of the Commissioner in Rev. Rul. 54-96, 1954-1 C.B. 111, modified by Rev. Rul. 56-100, 1956-1 C.B. 624 where a corporation organized a new subsidiary and then transferred the stock to a third corporation in exchange for its stock. The two steps were taken pursuant to a plan, but there was no binding commitment to proceed with the second step. The Commissioner said that "The two steps of the transaction...were part of a pre-arranged plan, and may not be considered independently of each other...", holding, as a result, that there was not the requisite control immediately after the transfer in order to qualify under section 112(b) (5) of the 1939 Code (Sec. 351, 1954 I.R.C.).

⁵⁰ *Wilgard Realty Co. v. Comm.*, 127 F.2d 514 (2d Cir. 1942). cert. den. 317 U.S. 655, 63 S.Ct. 52 (1942).

⁵¹ 168 F.2d 957 (5th Cir. 1948). See also *Mojonnier & Sons*, 12 T.C. 837 (1949).

⁵² See *Comm. v. P. A. Birren & Sons, Inc.*, 116 F.2d 718 (7th Cir. 1940).

of property for stock is followed immediately by a gift of the stock to a donee; form would give way to substance.

The early development of the step transaction doctrine can best be seen in a line of cases involving the question of whether a particular transfer of property to the corporation for cash or notes is a step in the Section 351 exchange or whether it constitutes a separate sale of property to the corporation. The early decisions of the Board of Tax Appeals were extremely formalistic in permitting the separation of the stock subscriptions from the sale of property.⁵³ Generally these cases involved situations where the taxpayer wanted to establish a loss on property which had depreciated in value. He would organize a corporation and sell the loss property to the new corporation. Frequently these two events would take place simultaneously and the amount contributed to the corporation for stock would be virtually identical in amount to the purchase price of the property. Judge Murdock wrote some of the earlier opinions in this field holding that the transactions were indeed separate and to be given independent tax significance. A typical example is the case of *Seymour Knox*⁵⁴ where the taxpayer subscribed for 11,550 shares of a holding company which had been organized to stabilize the market in the shares of the Midland Bank. His stock subscription was paid on November 18 by a check in the amount of \$402,426.25. At the same time he was advised that the holding company would buy 11,550 shares of the Midland Bank stock from him for \$407,137.50 and this sale took place the very next day. Other individuals, also having losses on their Midland Bank shares, did the same thing. The taxpayer deducted his loss of \$247,000 on the sale of the Midland Bank stock and the Board of Tax Appeals held that these steps were in fact separate and permitted the deduction.

It seems likely that this line of cases may have had its genesis in the case of *Minnie Bracket*⁵⁵ where the check that

⁵³ Saul, 4 B.T.A. 639 (1926); *Minnie Bracket*, 19 B.T.A. 1154 (1930) *aff'd* 57 F.2d 1072 (7th Cir. 1931); *Chandler Shipbuilding Co.*, 22 B.T.A. 5 (1931); *J. Hampton Houtt*, 24 B.T.A. 79 (1931); *James Wells*, 29 B.T.A. 222 (1933); *Hardwick*, 33 B.T.A. 249 (1935); *Knox*, 33 B.T.A. 972 (1936); *Contra: Labrot*, 18 B.T.A. 332 (1929), *aff'd* 57 F.2d 413 (D.C. Cir. 1932).

⁵⁴ *Supra*, n. 53.

⁵⁵ *Supra*, n. 53.

the shareholder gave to the corporation for its stock, wasn't even cashed, but was simply endorsed back to him in payment for the property transferred to the corporation. In that case it was the Commissioner who argued that the transactions were independent and that the non-recognition provisions should not apply. The Board of Tax Appeals accepted the argument of the Commissioner and this was affirmed by the decision of the Seventh Circuit in 1931. In subsequent decisions, where taxpayers were trying to establish losses, Judge Murdock seemed particularly influenced by the fact that the Government had been arguing for this position in the *Bracket* case where this provided an advantage for the revenue. However, when *Gunby, Inc.*⁵⁶ came before the Board of Tax Appeals in 1940, Judge Murdock changed his view and wrote a dissenting opinion holding that the two events should be considered a part of a single transaction, thus preventing recognition of gain or loss on the transfer of property to the corporation. This view was adopted by the Circuit Court of Appeals for the District of Columbia. That reversal of the Board appears to mark the transition from a refusal to apply the step transaction doctrine in this context to a situation where the doctrine is given substantial influence in the resolution of such cases.

The early development may continue to linger, however, as courts today sometimes phrase the issue not in terms of the step transaction doctrine but on the question of whether a "true sale" has been made to the corporation. In a case similar to *Baker Commodities, Inc.*⁵⁷ and decided at very nearly the same time, the Tax Court arrived at a diametrically opposite result through this type of analysis.⁵⁸ A new corporation had been organized by some of the stockholders of the old corporation and some new investors. The new corporation then purchased the shares of stock of the old corporation and liquidated it. The court held that the control group would consist of all the stockholders of the new corporation and thus it was presented directly with the question of whether the purchase of the shares of the old corporation was one of the steps of a section 351 transaction. On a finding that this

⁵⁶ 41 B.T.A. 884 (1940), *aff'd* 122 F.2d 203 (D.C. Cir. 1941).

⁵⁷ *Supra*, n. 28.

⁵⁸ *Stevens Pass, Inc.*, 48 T.C. 532 (1967). See also *Charles E. Curry*, 43 T.C. 667 (1965).

was a "true sale" the Tax Court took the transfer out of the section 351 transaction without discussion of step transactions. The result was a step up in basis of assets under section 334 (b) (2), which would not have applied had a transfer of the stock of the old corporation been a part of the section 351 transaction. A similar result was avoided by the Tax Court in *Baker Commodities, Inc.* by a finding that the two events, the subscription for stock in the new corporation and the purchase of assets from the old partnership, were simply steps in a single transaction.

This type of issue might arise oftener except for the fact that the Commissioner usually tries for larger stakes. Normally the sale is made in exchange for notes of the corporation. The Commissioner's traditional attack on this has been that the notes constitute stock of the corporation and that interest on the notes and repayments of the notes represent dividends from the corporation. Seldom does he argue that the notes represent securities of the corporations or other boot received in the section 351 transaction. In many cases this may be because the result would not thereby be changed.⁵⁹ But one suspects there might be some revenue in the argument in more cases than those in which the Commissioner presents the argument. Were he to succeed in such argument, the corporation would lose the stepped-up basis for the property if the notes were securities and the shareholders would receive capital gain treatment with respect to the payments on the notes. This was the result of the *George A. Nye* case⁶⁰ where the Tax Court rejected the thin incorporation argument but accepted the alternative contention that the ten-year installment note was a security and the transfer of property to the corporation for the note was a part of the section 351 transaction.

Notwithstanding the Commissioner's failure to consistently press this argument, the courts occasionally speak in terms of the steps being interdependent. With the Commissioner having an increasingly difficult time in the thin incorpora-

⁵⁹ Upon organization of the corporation, gain would no doubt be taxed as long term capital gain to the extent of boot, it may often be that there would be the same amount of tax in that situation as there would be if the sale is considered to be separate, and gain is computed on it alone.

⁶⁰ *Supra*, n. 25.

tion cases it would not be unusual to see him begin to make alternative arguments based on step transaction doctrine as it was used in the *Baker Commodities* case, accepting the step-up in basis and the capital gain treatment to the shareholders in order to avoid losing all of the potential revenue gain.

Redemptions of Stock

When one views the statutory provisions dealing with dividends and redemptions of stock it may be understandable that a court would take a rather strict view and limit the applicability of the step transaction doctrine as the Supreme Court did in the *Gordon* case when it dealt with the statutory term "distribution". It was apparently this view that the Sixth Circuit Court of Appeals took in 1953 in *Chamberlin v. Commissioner*,⁶¹ a case which led to the enactment of section 306 of the 1954 Internal Revenue Code. In *Chamberlin* the corporation had distributed a preferred stock dividend. The stock was subsequently sold to an insurance company pursuant to prior negotiations which had been carried out with the insurance company relating to the terms of the preferred stock. It was clear that the preferred stock would later be redeemed, not later than a mandatory redemption date, thus achieving a preferred stock bailout of corporate earnings should the court fail to tax the stock dividends or the sale of the preferred stock at ordinary income rates. The failure of the court to apply the step transaction doctrine is one of the high water marks of judicial rejection of this doctrine.⁶² Had the Court given greater effect to the provisions of the 1939 code dealing with redemption equivalent to dividends, it might have found the necessary broad statutory language to tie the three events, the stock dividend, the sale to the insurance company and the subsequent redemption of the preferred stock into two transactions having independent tax significance: first the distribution of a cash dividend to the shareholders, and second, a purchase of the preferred stock by the insurance company. In this way

⁶¹ 207 F.2d 462 (6th Cir. 1953) cert. den. 347 U.S. 918, 74 S.Ct. 516 (1954).

⁶² Compare the treatment by the Tax Court of a sale of common shortly before its redemption. The Court ignored the sale as simply a part of a transaction involving a redemption equivalent to a dividend in *Idol*, 38 T.C. 444 (1962) aff'd 319 F.2d 647 (8th Cir. 1963).

the Court would not have had to deal with the subsequent redemption transaction.

Of course there are other ways for publicly-held corporations to achieve similar results without declaring a preferred stock dividend. If a corporation follows a systematic plan of repurchasing its own shares, the resulting increase in the percentage ownership of the various stockholders who do not sell their shares will permit them to retain their proportionate interest in the corporation even if they should sell small amounts of their shares. In this way the corporation, acting in concert with the shareholders, can achieve the effect of a distribution of cash to the shareholders without having it taxed at ordinary rates. Professor Chirelstein has recently suggested that an application of the step transaction doctrine in this type of situation might possibly permit courts to view either the sale of shares by a stockholder to a new shareholder or the sale of shares to the corporation as the event by which each shareholder realizes a taxable cash dividend.⁶³ Each shareholder is seen to have a choice of receiving either cash or an increased proportionate interest in the corporation and thus would be taxable on his share of an ordinary dividend in the year that the corporation repurchases its stock from the public.

There has been a substantial amount of litigation involving variations on the fact situation in *Wall v. United States*.⁶⁴ In that case an individual acquired shares of stock of a corporation on an installment purchase plan and then he caused the corporation to discharge his obligation, surrendering the shares for redemption. He contended for an application of the step transaction doctrine, that a portion of the shares were in fact purchased by the corporation and that he should not be charged with a dividend upon the redemption transaction which the Commissioner contended was equivalent to a dividend. The taxpayer lost his argument because it did not appear that there was anything more than a plan on the part

⁶³ Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 Yale L. Jour. 739 (April 1969).

⁶⁴ 164 F.2d 462 (4th Cir. 1947). See also the discussion and cases collected in Bittker & Eustice, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (2d ed. 1966) 294-300.

of the taxpayer to have the corporation purchase a portion of the shares. But seldom is there consistency in tax cases and this is no exception in one case, it has been held that the purchase of some of the stock by the new shareholder was made on behalf of the corporation and the redemption was not treated as dividend to the new shareholder.⁶⁵ This was an application of the step transaction doctrine solely because the court found there was a plan for the corporation to acquire the stock. It considered the purchase by the shareholder to be just a way of carrying out that plan.

From the seller's side it is not uncommon for the two steps to be treated as one in order to avoid dividend equivalency. If a seller of a corporation submits a portion of his shares for redemption and at the same time sells the remaining shares to a third party, the events will be considered as a single transaction; a disposition by the selling shareholder of all of his stock in the corporation, thus avoiding any dividend equivalency determination with respect to the redeemed shares.⁶⁶ This is an example of the fourth aspect of the step transaction doctrine outlined above. A combining of the two steps into one taxable transaction has the effect of only changing the character of the income on the redemption transaction. It is not necessary for the court to make any decision as to whether or not the taxable events shall be combined into a single transaction. Thus, if the redemption took place on December 31, 1969 and the sale to the acquiring shareholder took place on January 1, 1970, it is quite possible that the court would tax the redemption in 1969 and the sale of shares in 1970 but consider the two transactions as one in determining that the redemption is not the equivalent of a dividend.

In the case of redemptions, the statute has codified the step transaction in two situations. In section 302(b)(2) a

⁶⁵ *Decker*, 32 T.C. 326 (1959), aff'd 286 F.2d 427 (6th Cir. 1960). This type of case is rare.

⁶⁶ *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); *Auto Finance Co. v. Comm.*, 24 T.C. 416 (1955) aff'd 229 F.2d 318 (4th Cir. 1956). In Rev. Rul. 55-745, 1955-2 C.B. 223 the Commissioner announced he would follow the *Zenz* case. See also *Lukens v. Comm.*, 246 F.2d 403 (3d Cir. 1957) (the redemption was coupled with a gift of the remaining shares) and *Arthur McDonald*, 52 T.C. No. 8 (1969) (the redemption of preferred stock was coupled with an exchange of all the common for stock of Borden in a B reorganization).

series of redemptions is treated as a single transaction for purposes of determining whether any one of the redemptions qualifies under the disproportionate redemption test of 302(b)(2). Again, the combining of the steps is for the purpose of characterizing the income from the transaction and does not have the result of creating a single taxable transaction out of the series. In section 304 there is an example of the corollary of the step transaction doctrine. If two corporations are controlled in common, then one event, the purchase of shares of stock by one from the other is treated as though it were two taxable transactions, first a contribution to the capital of the purchasing corporation of the stock by its sister corporation and second a distribution of a dividend by the purchasing corporation.

Reorganizations

Reorganization transactions are extraordinarily complicated statutory transactions. Frequently they involve many events and the exchange provisions refer to actions taken pursuant to a plan of reorganization; consequently there is a substantial leniency on the part of the courts in what they will require in order to characterize a series of steps as a single reorganization transaction.

A Reorganizations

Statutory mergers and consolidations have not spawned much controversy involving step transactions. Where combined with spinoffs to rid the companies of unwanted assets, several cases have involved the qualification of the spinoff under section 355, but the merger transaction itself has not been questioned.⁶⁷ An issue does arise, however, with respect to whether gain or loss should be separately computed for each share of stock exchanged where boot is involved in the exchange. In a sense, the step transaction doctrine can be seen as having a bearing on this issue because, if events are combined in a single transaction, there would be reason for holding that gains and losses should be netted. However, the Fourth Circuit Court of Appeals, in *Curtis v. United States*⁶⁸ has recently agreed

⁶⁷ *Curtis v. U.S.*, 336 F.2d 714 (6th Cir. 1964) (held spinoff did not qualify); *Morris Trust v. Comm.*, 367 F.2d 794 (4th Cir. 1966) held spinoff was tax free under §355); Rev. Rul. 68-603, 1968-47 I.R.B. 10 accepts the result of the *Morris* case.

⁶⁸ *Supra*, n. 67.

with the position taken by the Commissioner in Rev. Rul. 68-23⁶⁹ that losses on high basis shares cannot be netted against gains on low basis shares. Thus, the losses would not be recognized and receipt of boot results in gain being recognized on low-basis shares.⁷⁰

B Reorganizations—Stock for Stock

The B reorganization cases have produced a variety of step transaction issues, several of which involve creeping acquisitions. One form of this occurs when the shareholder of an acquiring corporation purchases stock of the corporation to be acquired and this is followed by an exchange of stock for stock between the acquiring corporation and the stockholders of the acquired company. The newly acquired subsidiary may then be kept in existence or liquidated. Where it remains as a subsidiary, the question of whether the shareholder's acquisition for cash should be attributed to the corporation, thus disqualifying the B reorganization as not solely for voting stock, has been resolved in favor of tax free treatment by the Commissioner in Rev. Rul. 68-562,⁷¹ with the caveat that the shareholder was under no obligation to surrender the stock which he acquired in the B reorganization and the acquiring corporation did not reimburse him for the purchase price of the stock. Thus, the possibility of the B reorganization being disqualified is left open through an application of the step transaction doctrine should there be any obligation on the shareholder's part to make the subsequent exchange. Nevertheless, the Commissioner would undoubtedly have difficulty with the latter arrangement too if the acquiring corporation did not give anything but its voting stock in the exchange.⁷²

⁶⁹ 1968-3 I.R.B. 14.

⁷⁰ The consideration received has been held, in one case, *Starr v. Comm.*, 82 F.2d 964 (4th Cir. 1936) to be allocated pro rata to all the shares exchanged, The Court specifically relied on step transaction doctrine for this result. But a contrary result was reached in *Bloch v. Comm.*, 148 F.2d 452 (9th Cir. 1945) and *Crespi v. Comm.*, 126 F.2d 699 (5th Cir. 1942).

⁷¹ 1968-43 I.R.B. 11.

⁷² To establish this it would be necessary to assume a new step, not actually taken, being a contribution of capital to the acquiring company. The transaction would then have the appearance of a transfer of cash from the shareholder to the acquiring company and a transfer by it of the cash plus its own stock to the shareholders of the acquired company. The Internal Revenue Service was not willing to

Where the subsidiary is liquidated, the Commissioner has taken the position that the reorganization may be treated as a C reorganization.⁷³ This involves telescoping the liquidation transaction and the acquisition of the stock and treating all of this as a single transaction. A recent decision of the Second Circuit Court of Appeals involves a similar fact situation in the setting of the 1924 Internal Revenue Code.⁷⁴ There a shareholder had acquired stock of several corporations for cash. The taxpayer corporation then acquired this stock from the shareholder for stock and cash and immediately thereafter obtained the assets in a liquidation-type transaction. Under the 1924 act, the acquisition of the stock from the shareholder, isolated from his prior purchase of the stock, was a reorganization and the Tax Court viewed the transaction in this way, refusing to combine all the steps because of what it believed was a lack of mutual interdependence under the tests established in *American Bantam Car Co.* The taxpayer appealed this decision contending that all of the steps should be combined, in which event the transaction would appear as a purchase of assets by the taxpayer corporation. The Second Circuit upheld this contention in a decision that rejected the rigidity of the Tax Court's approach to the step transaction doctrine. The Court held that this doctrine did not operate as an estoppel against taxpayers, that they had an equal right with the Commissioner to its application. Then it delineated

go that far. However, it has taken a contrary position where it is considering the qualification of the transaction as a C reorganization. In Revenue Ruling 69-48, 1969-6 I.R.B. 16 the Service considered an acquisition by a parent corporation of the stock of a second corporation for cash. The parent then had one of its subsidiaries acquire assets of the second corporation in exchange for stock of the parent company. The second corporation ended up with the parent's stock, some of which was distributed to the parent corporation in liquidation. The Commissioner said that the subsidiary had, in substance, paid cash in addition to transferring stock of its parent corporation. Since the cash paid and the liabilities assumed were in excess of twenty (20) per cent of all the assets the Commissioner ruled that no C reorganization resulted. In the ruling the Commissioner distinguished his own prior Revenue Ruling 57-278, 1957-1 C.B. 124, saying that the events described therein had not been taken pursuant to a plan.

⁷³ Reg. sec. 1.382(b)-1(a)(6). See also *Comm. v. Dana*, 103 F.2d 359 (3d Cir. 1939); *Mente & Co.*, 24 B.T.A. 401 (1931); *WAGE, Inc.*, 19 T.C. 249 (1952).

⁷⁴ *The South Bay Corp. v. Comm.*, 345 F.2d 698 (2d Cir. 1965), rev'g 41 T.C. 888 (1964).

a "transactional purpose" test, which is basically a different articulation of the idea that if the steps are taken pursuant to a plan which has as its purpose the achievement of a particular end result, then the steps will all be combined into the single transaction which would accomplish that end result. The Court said,⁷⁵

That there must be some species of integrating factor to make it rational to define steps as parts of a single transaction is apparent, but it must be doubted that the degree of integration requisite can be, or ought to be, reduced to any rigid formula of integration or interdependence of steps or 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. That would import a rigidity of interpretation appropriate only to legislative enactment and inappropriate to the interpretation of a statute that is general in its formulation.

Thus the Court states that the step transaction doctrine cannot have a single test which will be applied in every statutory context. When the statute is general, a loose nexus may be enough to bind steps together, whereas in other contexts it may not be enough. It didn't reject the mutual interdependence test; it merely found it inappropriate in a reorganization context, even where its decision had the effect of *disqualifying* the transaction as a reorganization, and making it, in effect, a *purchase*.

In regulation section 1.368-2(c) the Commissioner has treated a series of exchanges over a "relatively short period of time such as twelve months" as a single transaction in order to arrive at a B reorganization with no reference to a plan or any mutual interdependency of the steps. Apparently the Commissioner finds enough reason to bind the transactions together from the mere fact that they transpired in a short time interval. This provision became an important element in the 1968 decision of the Court of Claims in *American Potash and Chemical Corporation v. United States*.⁷⁶ That case involved a series of acquisitions of stock of a corporation which

⁷⁵ Id at 704.

⁷⁶ 399 F.2d 194 (Ct. Cl. 1968) rehearing granted, 402 F.2d 1000 (Ct. Cl. 1968).

was eventually liquidated. The acquisitions, made pursuant to two tender offers, extended over a 14 month period and the Commissioner argued that, since they were all pursuant to a plan of acquiring 100% of the company, the steps should be treated as a part of a single transaction qualifying as a C reorganization. Thus, he contended it was necessary to combine not only the acquisitions of stock but the subsequent liquidation of the new subsidiary. The Court of Claims, first, however, considered whether the acquisitions of stock could be a B reorganization, using the step transaction doctrine because of the existence of the plan, it held that the entire sequence of acquisitions of stock could not be qualified as a B reorganization if it extended over a greater period than the 12 months used by the Commissioner as an example of a short enough time period. This decision was particularly dependent upon an application of the step transaction doctrine because the statute implies, and the Commissioner's regulation states specifically,⁷⁷ that if a corporation owns a portion of the stock of a corporation to be acquired, then a subsequent acquisition of the control stock in exchange for voting stock of the acquiring company will qualify, on its own, as a B reorganization. Only by combining the first acquisitions with those made 14 months later was it possible to avoid the conclusion that the last acquisition was a reorganization. It would be difficult indeed to say that the first acquisitions were not fruitful without the later ones. They may have been made pursuant to a plan of acquiring a company, but they certainly could have been said to stand on their own. This case, then, is another example of the liberality with respect to which a Court will bind events together into a single transaction for purposes of testing whether a reorganization has occurred. Without including the first tender offer with the second it would have been an easy case for the court to hold that the second acquisition of stock, which resulted in control, qualified as a B reorganization. When the first event was combined with it, the court was faced with deciding whether a series of acquisitions extending over a period in excess of 12 months would qualify. Construing the regulations' use of 12 months as the upper limit of the time over which the acquisitions could be made, the Court said this did not qualify as a creeping B reorganization.

⁷⁷ Reg. sec. 1.368-2(c).

The Court then considered the argument of the taxpayer that all of the transactions, including the subsequent liquidation, should still be bound together for purposes of deciding whether the *Kimbell-Diamond Milling Company*⁷⁸ doctrine should apply to an acquisition of assets where 334(b)(2) does not apply. It held that the rule would apply, and, integrating all of the acquisitions with the liquidation into a single transaction because the purpose of all these events was to obtain the assets of the acquired company, the Court held that the taxpayer should obtain a stepped-up basis for the acquired assets. Notwithstanding the court's verbal reliance on the mutual interdependency theory, it appears that its decision could be rationalized only by combining steps taken pursuant to a single plan.⁷⁹

The Court then considered whether a C reorganization might have taken place. It recognized the validity of the Commissioner's position that an acquisition of a corporation pursuant to a B reorganization followed by a liquidation of that corporation can constitute a C reorganization. However, the Court said that the first acquisition must qualify as a B reorganization in order that the entire transaction will qualify as a C reorganization. This seems somewhat inconsistent with its use of the step transaction doctrine in applying the *Kimbell Diamond* doctrine. If all of the steps are to be tied together in a single transaction then there seems to be no persuasive reason that the mere passage of a period of time should prevent the transaction from qualifying as a C reorganization. Once the decision has been made that events constitute a single transaction then the period of time should be irrelevant to the decision.⁸⁰

On rehearing the Court of Claims has indicated a willingness to reconsider its opinion. The Commissioner, apparently for the first time, effectively articulated the argument that

⁷⁸ 14 T.C. 74 (1950) aff'd 187 F.2d 718 (5th Cir. 1951) cert. den. 342 U.S. 827, 72 S.Ct. 50 (1951).

⁷⁹ If the plan has an ultimate purpose, one might still stretch the mutual interdependence theory to the point of saying that all the steps of a plan must be completed if any are to be fruitful in accomplishing that purpose. This is similar to the approach of the Second Circuit in *The South Bay*, supra n. 73. It would appear that this plan was one formulated unilaterally by the acquiring company.

⁸⁰ Compare *May Broadcasting v. U.S.*, supra, n. 47.

the second acquisition of stock could constitute a B reorganization standing on its own. If this were the case then the *Kimbell-Diamond* arguably would not apply.⁸¹

In still another B reorganization issue, involving the question of whether the acquisition is solely for voting stock, the courts and the Internal Revenue Service have sometimes considered whether a related redemption or other event may disqualify the reorganization if it is pursuant to the particular plan. In Rev. Rul. 54-96⁸² where, pursuant to a plan, a corporation transferred some of its assets to a new subsidiary and then exchanged the stock of the the subsidiary for voting stock of a third corporation, the Commissioner held that the two steps must be integrated and a B reorganization did not result because the effect of the transaction was a transfer of assets for stock.⁸³ And in Rev. Proc. 66-34⁸⁴ the Commissioner has ruled that a sale, redemption or other disposition of stock occurring prior or subsequent to the exchange which is "part of the plan of reorganization" will be considered part of the transaction in determining whether the requisite continuity of interest exists following the exchange. But, curiously, the Commissioner in a recently decided Tax Court case⁸⁵ conceded that a redemption of preferred stock which was part of a plan to transfer the ownership of the corporation to Borden in

⁸¹ The Court left open the question of whether there could be a step-up in basis of assets attributable to the portion of the stock acquired in the first acquisition, which, if the Commissioner's argument is correct, would not have been a reorganization transaction. This decision too seems somewhat suspect as it seems to combine various aspects of Section 334(b)(2), which the court said would not apply in the case, with the *Kimbell-Diamond* rule. It seems to ignore the question of whether the *Kimbell-Diamond* rule should ever apply where the stock is obtained in a tax-free transaction under section 332. Since American Potash Chemical Corporation would not realize any gain or loss as a result of the issue of its stock for stock of the new subsidiary, it would seem unusual for it to get a stepped-up basis when it liquidates a wholly owned subsidiary. This would seem a rather clear case for the application of Section 332 and 334(b)(1).

⁸² 1954-1 C.B. 111, modified by Rev. Rul. 56-100, 1956-1 C.B. 624.

⁸³ This was similar to the situation in *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1938) where there was a spinoff of the new subsidiary followed by a transfer of assets for stock. The Court held that substantially all the property was not transferred pursuant to the second step. See discussion *infra* at note 92.

⁸⁴ 1966-2 C.B. 1232.

⁸⁵ McDonald, 52 T.C. No. 8 (1969).

exchange for Borden's voting stock was not part of the transaction, thus not disqualifying the B reorganization. Nevertheless the Tax Court considered the two steps as part of a single transaction in order to determine that the redemption of the preferred was not equivalent to a dividend. The Tax Court said that "the redemption was merely a step in the plan of Borden for the acquisition of E & M, so that it is the results of the plan that are significant to us." Relying on *Zenz v. Quinlivan*,⁸⁶ the Tax Court combined the steps in spite of the Commissioner's concession with respect to the reorganization issue and one conjectures whether the Court might not have used the step transaction doctrine to disqualify the transaction as a B reorganization had it not been for the Commissioner's concession.

C Reorganizations—Assets Acquired for Stock

The *Bausch & Lomb Optical Company* case,⁸⁷ decided by the Tax Court in 1958, and affirmed by the Second Circuit Court of Appeals in 1959, has been widely said to bar all creeping C acquisitions. This rule was followed in *American Potash & Chemical Corp. v. United States*.⁸⁸ However, to be consistent with the step transaction doctrine it would appear that if the events of acquisition are intergrated into a single transaction, then the time interval should be ignored.⁸⁹ Under this view of the situation a creeping C reorganization would be possible where the acquisitions are all for stock as was the case in *American Potash*, or where the boot is not in excess of 20% of the acquired assets. It would seem that the Court of Claims should have taken this position in *American Potash* once it had decided that all steps of the acquisition, plus the liquidation, were the equivalent of a single transaction for tax purposes.

At an earlier time in the development of the law, an acquisition of assets followed by a transfer of these assets to a new subsidiary ran into difficulty because of the step transaction doctrine. If the transfer to the subsidiary was pursuant to a plan, then the parent was not considered a

⁸⁶ *Supra*, n. 66.

⁸⁷ 30 T.C. 602 (1958) *aff'd* 267 F.2d 75 (2d Cir. 1959).

⁸⁸ *Supra*, n. 76.

⁸⁹ *Cf. May Broadcasting Co.*, *supra* n. 47.

party to the reorganization.⁹⁰ The same result was reached in a C reorganization context in the *Anheuser-Busch* case,⁹¹ decided by the Eighth Circuit Court of Appeals in 1940. This, however, has been changed by statute so that under section 368(a)(2)(C) it is now possible for a C reorganization to be accompanied by a transfer of the assets to a new subsidiary. By statute, the holding of the assets is not considered transitory by the parent, and no disqualification results.

In one of the earlier cases that articulated the Court's reliance on the step transaction doctrine in reorganization cases, the Fourth Circuit Court of Appeals dealt with what is now a C reorganization. It considered, in *Helvering v. Elkhorn Coal Company*⁹² whether there was a transfer of substantially all of the assets of the company, where some of the assets had been distributed in a tax free spin-off shortly before the transfer of the rest of its property. The Court said that the steps were taken pursuant to a plan and were also interdependent, it being necessary to complete the series to accomplish the tax avoidance purpose of the plan. Accordingly it held that the steps should be integrated into a single transaction; as a result, less than substantially all the assets were transferred and no reorganization was achieved.

D and F Reorganizations—Liquidation-Reincorporation

One of the most active issues currently occupying the attention of the courts involves variations on the perennial attempts of taxpayers to bail out corporate earnings through transactions which terminate the existence of one corporation and continue its business in another entity.⁹³ It is here

⁹⁰ *Helvering v. Bashford*, 302 U.S. 454, 58 S.Ct. 309 (1938).

⁹¹ *Anheuser-Busch, Inc. v. Helvering*, 115 F.2d 662 (8th Cir. 1940).

⁹² 95 F.2d 732 (4th Cir. 1938).

⁹³ In some of the earlier cases, the device used was to simply liquidate the corporation and then transfer operating assets to a new corporation, hence the generic term, liquidation-reincorporation transaction. In *Survaunt v. Comm.*, 162 F.2d 753 (8th Cir. 1947) and *Bard-Parker Co., Inc. v. Comm.*, 218 F.2d 52 (2d Cir. 1954) the courts were willing to bind the steps together to find that a reorganization had taken place and the assets withheld upon organization of the successor corporation were taxed as boot. The existence of a plan was sufficient in each case for the court to reach such result. The absence of a commitment, however, in *U.S. v. The Arcade Co.*, 203 F.2d 230 (6th Cir. 1953) and the passage of nine months between liquidation and rein-

that the Commissioner is achieving some notable success by emphasizing the *exclusion* of certain steps from the reorganization transaction. His main victories have been in two cases decided by the Fifth Circuit Court of Appeals, *Reef Corp. v. Commissioner*⁹⁴ and *Davant v. Commissioner*.⁹⁵ In both of these cases there was a sale of assets from one corporation to a second, followed by a liquidation of the first. This is quite similar to the earlier *Liddon* and *Pebble Springs Distilling* cases (see note 93) except that the transferee corporation in *Davant* was an existing corporation. It had not been organized merely for the purpose of taking over the old business.

In the *Reef* case, stockholders owning 52% of the stock of a corporation organized a new one with the plan that it take over the business of the old. To it they transferred some of the stock which they held in the old corporation. The old corporation then sold its assets to the new corporation for notes of the new corporation.⁹⁶ Then the notes were distributed to the stockholders in liquidation of the old corporation. All of the original shareholders received some of the notes and, of course, some of the notes were returned to the new corporation in exchange for the stock it had received upon its organization. On the issue of whether there was an

corporation in *Mathis*, 19 T.C. 1123 (1953) were considered adequate reasons for not applying the step transaction doctrine in similar cases. A different form involves the organization of the successor corporation first, which then buys certain assets from the original corporation which is then liquidated. In *Liddon v. Comm.*, 230 F.2d 304 (6th Cir. 1956) and *Pebble Springs Distilling Co. v. Comm.*, 231 F.2d 288 (7th Cir. 1956) the presence of a plan in this variant of the liquidation-reincorporation transaction was enough to cause the courts to apply the step transaction doctrine and find that D reorganizations had been the net result of the steps. Rev. Rul. 61-156, 1961-2 C.B. 62 represents the Commissioner's new approach to this situation. See discussion at note 97, *infra*. Still another variation is that a subsidiary is organized and certain assets are transferred to it. The parent then liquidates. In *Lewis v. Comm.*, 176 F.2d 646 (1st Cir. 1949) the Commissioner successfully contended for combining all steps into a single reorganization with a boot distribution.

⁹⁴ *Supra*, n. 16.

⁹⁵ *Supra*, n. 17.

⁹⁶ The facts were complicated by the use of a conduit through whom most of the transactions were made. The Court brushed this aside in an obvious situation for application of step transaction doctrine and I have ignored it in summarizing the facts of the case.

F reorganization, the Court held (one judge dissenting) that there was an identify of shareholders in the old and new corporations, notwithstanding the fact that stockholders owning 48% of the old corporation's shares were completely eliminated in the transaction. The Court reached this result by finding there were two separate and distinct transactions having independent tax significance. It said:

"Distilled to their pure substance, two distinct and unrelated events transpired. First, the holders of 48% of the stock in Reef Fields [the old corporation] had their stockholdings completely redeemed. Second, new Reef was formed and the assets of Reef Fields were transferred to new Reef. The business enterprise continued without interruption during both the redemption and the change in corporate vehicles.

Much confusion flows from the fact that the corporate reorganization took place simultaneously with the stock redemption. But taking the Code as a standard, these two elements were functionally unrelated. . . . A complete redemption is not a characteristic of a reorganization. . . .none of these provisions [368(a)(1)] focuses on a complete redemption as a characteristic of a reorganization. Congress did not have redemption of stock as a primary purpose of any of the forms of a reorganization. . . .

. . . When the primary characteristics of the reorganization conform to those described by 368(a)(1)(F), we should parse the occurrences into their functional elements. The reorganizational characteristics present in the instant case do not conform to those generally intended to be covered by section 354 and therefore we should not be blinded by the 356 boot provision. To effectuate the intention of Congress manifested in the Code, we must separate this transaction into its two distinctly separate functional parts. The test of whether events should be viewed separately or together as part of a single plan is not temporal but functional."⁹⁷

In this way the Fifth Circuit labeled as a "functional in-

⁹⁷ *Supra*, n. 16 at 134.

dependence test" its reason for excluding certain steps that were clearly taken pursuant to the overall plan. Had it included them in the reorganization transaction, it would still have found a D reorganization, but it would have rejected the F reorganization on the grounds that there wasn't a sufficient identity of interest in the two corporations. At first blush, this may seem to be a rejection of the step transaction doctrine; however, the Court had clearly accepted the doctrine with respect to many events that it found to be contemplated by the plan and necessary for a finding of reorganization. It simply regarded the issue with more precision as involving not only the question of what steps to include, but which ones to exclude; with this innovative emphasis on an aspect of the doctrine that has always been implicit in it, the Court was able to conclude that an F reorganization had been achieved.

In the *Reef* case it is difficult to perceive how the functional independence test is anything more than a way of saying that the Court will ignore a certain part of a plan in order to achieve a result it wants. It was clearly essential to the plan that one of the groups of shareholders obtain 100% control of the business. Thus, there would appear to be a mutual interdependence between the steps. And, being taken according to a plan, the traditional reorganization approach would have been to combine all of them. But the Court said there were enough steps to find an F reorganization without including the retirement of the interests of the 48% shareholders, and it would consider only those steps necessary to hold that an F reorganization had taken place. At that point, the other steps, isolated as they were from the reorganization, could only be viewed as a redemption. In a sense this is similar to the transactional purposes test by which the Second Circuit explained its disagreement with the Tax Court in *The South Bay* case. But, in *Reef*, the court found that there were two essential purposes. One was the reorganization; the second was the bail out of earnings of the corporation through a redemption of stock. Having found this, it combined only those steps which were functionally important to the first purpose and called that one transaction. The remaining steps were then isolated as a second transaction.

In the *Davant* case the Fifth Circuit again applied its

test of functional independence to exclude certain steps from the reorganization. Two existing corporations were each owned in equal proportions by four families. One corporation, Warehouse, sold its operating assets to another, Water, for \$700,000 in cash. Warehouse then liquidated, distributing the proceeds of the sale plus cash of \$230,000 which it had retained. The Court reasoned that the businesses could have been merged without the transfer of the \$700,000 from Water to Warehouse and thence to the stockholders or the distribution of the \$230,000 in cash held by Warehouse. Thus, the Court felt these transactions were functionally unrelated to and independent of the reorganization transaction. Accordingly, it held them to be separate distributions under section 301, saying:

“The fact that we held that the transfer of Warehouse’s assets and the ‘sale’—liquidation of Warehouse’s stock should be viewed as an integrated transaction does not mean that we are being inconsistent when we separate the distribution of Water’s cash to its stockholders. We are merely recognizing that two distinct and functionally unrelated types of transactions were carried on simultaneously—one was a dividend and the other reorganization.”⁹⁸

The Court was, therefore, able to avoid the dividend-within-gain limitations of the boot provisions under section 356 and measure the dividend by the earnings and profits of both corporations. Here, however, a holding that all the steps had to be integrated for all purposes would not have disqualified the reorganization. It would have merely changed the characterization of a portion of the cash received by the shareholders.

Thus, the Fifth Circuit is moving towards an acceptance of position taken by the Commissioner in Rev. Rul. 61-156.⁹⁹ In that ruling, the Commissioner considered a series of events whereby a new corporation was organized by shareholders of

⁹⁸ *Supra*, n. 17 at 888.

⁹⁹ 1961-2 C.B. 62. See also Rev. Rul. 68-349, 1968-27 I.R.B. 16 (a section 351 type transaction, followed by liquidation of one transferor, used as device to acquire assets of another person. Commissioner finds both an F reorganization and a purchase of property).

another corporation to buy operating assets of the latter and continue its business. The latter then liquidated, distributing cash to the shareholders. As part of the plan, however, a public offering of stock was made and the shareholders divested themselves of 55% of the stock of the new corporation. The Commissioner disregarded this sale as a separate transaction, saying,

The issuance of stock to new investors was not needed to implement the dominant purpose and, therefore, the rest of the transaction was not fruitless without it and so dependent on it."¹⁰⁰

Furthermore, giving no reason for it, the Commissioner treated the distribution of cash and notes as an independent transaction, thus taxing it as a section 301 distribution instead of as a boot distribution under section 356.¹⁰¹

With the support of the Fifth Circuit in *Reef* and *Davant*, together with the rationalizing rhetoric—a “functionally independent transaction”—we may now anticipate that in cases involving bailouts, only those steps which are necessary to the finding of a reorganization, will be combined; other redemptions, distributions and the like will be treated as separate transactions, frequently resulting in a greater tax liabil-

¹⁰⁰ Reliance on dominant purpose and the absence of mutual interdependence of the steps is suspect here because it could have been said with equal force that the dominant purpose was to transfer the control and operation of the business to public ownership. However, the Fifth Circuit would point out that this could be done by a simple sale of stock. The bailout was completely unnecessary to this transaction. The liquidation and bailout, then, would be seen as having another and separate purpose—the strip-off of corporate earnings at capital gain rates. With respect to *this purpose*, the *public sale* was unnecessary. Thus, the steps taken to accomplish the two purposes were functionally independent of each other.

¹⁰¹ This is more difficult to rationalize. Without either this step or the public sale, the remaining steps are simply a liquidation and reincorporation with no boot, a simply recapitalization. But since boot distributions are clearly contemplated in the reorganization provisions and this was part of the plan, no good reason appears to disregard this step. To do so goes beyond the *Reef* case where there was a redemption of shares of the 48% shareholders. It was this redemption that led the Fifth Circuit to conclude it was not the type of event intended by Congress to be part of a reorganization; thus it was “functionally independent” of the reorganization.

ity because of the avoidance of the boot provisions. This marks a sort of new era for step transactions. No longer can tax planners count on all steps of a plan being considered as part of a single transaction. They must now face the specter of the courts and the Commissioner choosing to combine some steps and omit others. The attempt to bailout corporate earnings has thus become more difficult and the stakes have been raised.

Nevertheless, in neither the *Reef* nor the *Davant* cases did new stockholders enter the picture. Where this has happened, Rev. Rul. 61-156 notwithstanding, the courts have rejected the idea that a reorganization has taken place.¹⁰² But with a legitimate concern to prevent bailouts, the trend may well be towards ignoring the change in ownership as being functionally independent of the other steps and Rev. Rul. 61-156 may well win the day.

The courts have also been imaginative in the area of D reorganizations in finding transfers necessary for the event of reorganization even though no actual transfer took place. In a D reorganization there must be a transfer of property by one corporation to another in exchange for stock of the latter which is then distributed. But where the two corporations are owned by substantially identical interests, courts have been willing to find that the exchange of stock took place even though no stock was in fact issued by the transferee corporation.¹⁰³ This would be an illustration of the corollary of the step transaction doctrine. Then in a similar decision, the Ninth Circuit Court of Appeals, in *Moffatt v. Commissioner*,¹⁰⁴ found that there had been a transfer of substantially all the assets of one corporation to another, even though the stockholders of what was essentially a personal service company simply organized a new corporation which began

¹⁰² *Berghash*, 43 T.C. 743 (1965) aff'd 361 F.2d 257 (2d Cir. 1966) (a new stockholder got 50% of the new corporation and the court would not ignore this purchase), and *Gallagher*, supra n. 34 (a 38% interest in the old corporation was retired and 28% of the new corporation was purchased by new stockholders; again the court would not ignore these two steps and find an identity of interest necessary for an F reorganization).

¹⁰³ Rev. Rul. 66-23, 1966-1 C.B. 67.

¹⁰⁴ 363 F.2d 262 (9th Cir. 1966).

to do business in the same field that the old corporation had formerly occupied. An actual transfer of the business did not take place. Instead, the old corporation was simply permitted to wither away for lack of any new business. Yet, it was an assumed transfer of the intangible value of the business that the Court used to find a transfer of substantially all of the assets in order to meet the requirements of section 354(b) (1) (A).

Continuity of Interest

The general requirement of reorganizations that there be a continuity of shareholder interest has produced some step transaction cases. These have generally been similar to the requirement in a section 351 transaction that control exist in the transferors immediately after the transfer of property. Following the reorganization it sometimes happens that the shareholders will transfer shares of stock received by them in the exchange. There can be a difference in the reorganization context, however, from the result in the section 351 cases such as *American Bantam Car Co.* Thus, the Commissioner has suggested that a disposition of stock within a five year period of time following a reorganization could possibly destroy the continuity of interest if the disposition is pursuant to a plan or arrangement in existence at the time of the exchange.¹⁰⁵ However, the Tax Court, in dealing with this question, has been more inclined to use the same tests developed in section 351 cases. For example, a public offering of stock immediately after a C reorganization did not destroy the continuity of interest in *Scientific Instrument Co.*¹⁰⁶ notwithstanding that there was a plan to make this offering at the time of the reorganization.¹⁰⁷

Section 355 Distributions

The most recent pronouncement of the Supreme Court about step transactions has come in the context of an alleged section 355 spinoff. *Commissioner v. Gordon*¹⁰⁸ involved the creation of a new subsidiary by Pacific Telephone and Tele-

¹⁰⁵ Rev. Rul. 66-23, 1966-1 C.B. 67.

¹⁰⁶ 17 T.C. 1253 (1952).

¹⁰⁷ See also *Southwell Combing Co.*, 30 T.C. 487 (1958) and *American Wire Fabrics Corp.*, 16 T.C. 607 (1951).

¹⁰⁸ *Supra*, n. 11.

graph Company and the distribution of this new company to its shareholders through two rights offerings, one of which occurred in the year 1961 (by which 57% of the stock was distributed) and the second of which occurred in the year 1963. There were a number of reasons why the transactions might not have qualified for nonrecognition under section 355, but the Supreme Court chose to rest its decision on the grounds that the two steps taken in 1961 and 1963 could not be combined into a single transaction fitting the description of a distribution under section 355. Emphasizing the language of the Code it was interpreting the Court said,¹⁰⁹

The code requires that "the distribution" divest the controlling corporation of all of, or 80% control of, the controlled corporation. Clearly, if an initial transfer of less than a controlling interest in the controlled corporation is to be treated for tax purposes as a mere first step in the divestiture of control, it must at least be identifiable as such at the time it is made. Absent other specific directions from Congress, code provisions must be interpreted so as to conform to the basic premise of annual tax accounting. It would be wholly inconsistent with this premise to hold that the essential character of a transaction, and its tax impact, should remain not only undeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen. This requirement that the character of a transaction be determinable does not mean that the entire divestiture must necessarily occur within a single tax year. It does, however, mean that if one transaction is to be characterized as a "first step" there must be a binding commitment to take the later steps.

This language has created some concern that the Supreme Court may have substantially narrowed the effectiveness of the step transaction doctrine. But, as the Court itself has noted on numerous occasions, decisions of the Court cannot be read abstractly as providing exhaustive definitions of statutory terms; what it says about a concept must be read in the context of the issue being discussed.¹¹⁰ In the context of an

¹⁰⁹ 391 U.S. 83, 96, 88 S.Ct. 1517, 1524 (1968).

¹¹⁰ See, e.g., *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430-431, 75 S.Ct. 473, 476-477 (1955) where the Court said,

interpretation of the statutory term, "distribution", the decision appears entirely understandable and correct. To bind the two transactions into a single distribution because taken pursuant to a plan, or even because it may have been convinced of the interdependence of the steps, would create a rather chaotic condition for section 355 transactions.

The step transaction doctrine has also recently been involved in section 355 cases where a spinoff has preceded a merger as a device to get rid of unwanted assets. In *Curtis v. United States*,¹¹¹ the Sixth Circuit Court of Appeals, in 1964, held that the distribution would not qualify under section 355 because the company making the distribution of the stock was not engaged in a separate trade or business immediately following the distribution. This was a strict application of the step transaction doctrine in a section 355 context where the steps were taken pursuant to a pre-existing plan. It might have been said that the steps were at least functionally independent of one another, and in fact, that the spin-off under section 355 would not have been a fruitless step to take even if not followed by the subsequent merger. In 1966, the Fourth Circuit Court of Appeals reached an opposite result in *Morris Trust v. Commissioner*¹¹² in a decision more nearly in line with the Supreme Court's decision in *Gordon*. However, it also suggests that the Court may be ready to accept the functionally independent test by which the Fifth Circuit Court of Appeals in the *Reef* and *Davant* cases has excluded certain steps which have been taken pursuant to a plan. In Revenue Ruling 68-603¹¹³ the Internal Revenue Service accepted the result of the *Morris Trust* case. It may be that the Commissioner has taken this position to try to press the advantage he sometimes obtains by excluding certain steps from a reorganization or spin-off transaction

Nor can we accept respondents' contention that a narrower reading of sec. 22(a) is required by the Court's characterization of income in *Eisner v. Macomber*, 252 U.S. 189, 207, as 'the gain derived from capital, from labor or from both combined.' ... In that context—distinguishing gain from capital—the definition served a useful purpose. But it was not meant to provide a touchstone to all future gross income questions.

¹¹¹ 336 F.2d 714 (6th Cir. 1964).

¹¹² 367 F.2d 794 (4th Cir. 1966).

¹¹³ 1968-47 I.R.B. 10.

in order to assert that the separate step is a distribution of a taxable dividend.

In two situations the Commissioner has ruled that a recapitalization can precede a section 355 distribution even though it is done pursuant to the same plan for making the distribution and where the purpose of the recapitalization is to increase the holding of the parent corporation to more than 80% of the voting stock.¹¹⁴ The reason for doing this is that the distribution would not qualify under section 355 unless control of the subsidiary existed immediately before the distribution. This result is almost reminiscent of the reluctance to apply step transaction doctrine in the section 332 liquidation cases, but with some stretch of the imagination the functional independence rule of *Reef* and *Davant* might also be employed to ignore the recapitalization. At any rate it indicates again that where a statute employs the term "control *immediately* before" or "*immediately* after" that step transaction doctrine has a very narrow scope in which to operate.

Conclusion

This is but a sampling of the cases where the step transaction doctrine has an impact on the taxation of corporate transactions, although it does include the most important of the various issues that are frequently involved. The lack of consistency in the decisions points up the fact that predictability in this field sometimes seems to come more from a feel for the subject than an academic knowledge of the rhetoric which the courts use in groping for the rubric which will rationalize all the cases. Thus, this is probably one more area where, in the words of Justice Brennan in his opinion in the *Duberstein* case,¹¹⁵ decisions are frequently based "on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts" of the cases. When he added that this would "not satisfy an academic desire for tidiness, symmetry and precision" he could also have been speaking of step transactions. Nevertheless, this doctrine is not so completely the province of the fact-finders as is the question of whether a gift has been

¹¹⁴ Rev. Rul. 69-407, I.R.B. 1969-30, p. 7; Rev. Rul. 56-117; 1956-1 C.B. 180.

¹¹⁵ *Commissioner v. Duberstein*, 363 U.S. 278, 80 S.Ct. 1190 (1960)

made. Appellate courts have established some standards by which they do review the decisions of the trial courts, and if proper attention is given to the words of the statute which the judges are dealing with, it may be possible to inject a small degree of certainty in an area which intrinsically must frustrate those who seek guidance for planning future transactions. Statutes dealing formalistically with relatively simple transactions will normally result in a restricted use of step transaction doctrine. But in dealing with statutes describing more complicated transactions, courts will give rather free rein to this doctrine and will tend to combine steps whenever taken pursuant to a planned course of action. Finally, we are beginning to see more attention being given to the purpose of the plan. Where two purposes are found which appear to motivate the planned steps, then, if they are found to be functionally independent, in that they relate to two different types of transactions described in the Code, the steps may be separated into the two transactions notwithstanding that they are taken contemporaneously and pursuant to a single plan.