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THE STEP-TRANSACTION DOCTRINE IN SUBCHAPTER C:
THE SEARCH FOR A UNIFYING THEORY CONTINUES

by

ROBERT WILLENS*

INTRODUCTION

Perhaps the most pervasive principle employed in the application of the law of taxation is the maxim that the substance, rather than the form in which a transaction is cast, will govern its tax consequences. Nowhere is this principle more rigorously adhered to than in Subchapter C of the Internal Revenue Code — that portion of the Code dealing with corporation distributions and adjustments. This passion for substantive analysis is exemplified by the Supreme Court’s landmark decision in *Gregory v. Helvering*, a case in which a transaction structured as a reorganization was treated as a dividend distribution, a result dictated by an inquiry into the substance of what was actually accomplished. Curiously, it has become apparent that the doctrine is more readily applied to recharacterize transactions involving closely-held corporations. Apparently the presence of a broad base of public shareholders is sufficient to enable the Service to conclude that the form of the transaction is the product of arms-length bargaining and should therefore be respected. Thus, the doctrine of substance over form is one that has become almost exclusively identified with closely-held businesses.

A particular manifestation of the principle that has found widespread application in the Subchapter C arena is the step-transaction doctrine. This doctrine provides for the integration of a series of purportedly separate steps into a unified transaction. Although this rule is deceptively easy to state, and is an eminently sensible application of the substantive approach to the evaluation of tax consequences, the circumstances in which amalgamation is appropriate have varied depending upon the particular set of facts presented.

In this regard, it is generally conceded that the doctrine can apply if any of three alternative tests are met: the “end result” test, the “mutual interdependence” test, or the more restrictive “binding commitment” test. Under

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†293 U.S. 465 (1935).

See, e.g., Rev. Rul. 73-551, 1973-2 C.B. 112 wherein a sale of property to a shareholder pursuant to a Section 337 liquidation was respected where the sale was approved by the entity's shareholders who owned a substantial portion of the shares entitled to vote.

[125]
the end result approach to amalgamation, a series of steps will be telescoped if they were taken for the purpose of achieving a result sought by the participants at the outset. The mutual interdependence test will result in integration only on a finding that the steps were so interdependent that the legal relations created by the initial step would have been fruitless without a completion of the series. Finally, the binding commitment test mandates amalgamation only if a legally enforceable obligation to complete the series was in place at the inception of the transaction.

Notwithstanding the relative objectivity of the foregoing rules, both the Service and courts have had difficulty in determining which test to apply to the particular transaction under scrutiny. It has become clear that the application of each test will vary depending upon the particular section of the Code being evaluated. The confusion thus generated is further compounded by failure to consistently apply the same step-transaction test to a particular Code section. Nevertheless, recent applications of the doctrine seem to embrace the principle that each of the provisions of Subchapter C can be linked with one of the three alternative step-transaction tests. This thesis will be demonstrated through a review of decisions dealing with Section 302 which relates to redemptions; Section 351 which deals with corporate organization; Section 368 which governs corporate reorganizations; and finally, the “integrated transaction” doctrine under which a liquidation-reincorporation may be treated as either a reorganization or a purchase of assets by the reincorporated entity.

I. REDEMPTIONS: THE “ZENZ” DOCTRINE

The tax consequences of a stock redemption, an acquisition by a corporation of its stock from a shareholder in exchange for property, are governed by Section 302. If the transaction satisfies any of the tests enumerated within Section 302(b), the redemption proceeds are treated as received in exchange for the stock and are therefore eligible for capital gain treatment. A failure to satisfy these tests invokes the rule of Section 302(d), and the proceeds are treated as a distribution to which Section 301 applies.

Under Section 302(b)(1) exchange treatment is available if the redemption is not “essentially equivalent to a dividend.” In United States v. Davis, the Supreme Court held that dividend equivalence can be avoided only if the
redemption results in a "meaningful reduction" in the shareholder's proportionate interest in the corporation. A redemption is substantially disproportionate if, after the application of the attribution rules of Section 318, the taxpayer has experienced a greater than 20% reduction in his percentage ownership of both voting and nonvoting common stock. Finally, Section 302(b)(3) is applicable in cases where the redemption results in a complete termination of the taxpayer's stock interest in the redeeming corporation. For purposes of determining whether a complete termination has occurred, Section 302(c)(2) provides that if certain conditions are met, the constructive ownership rules that attribute stock between family members may be waived.

On the theory that the consequences of a stock redemption are principally governed by the effect of the transaction on the quantum of a shareholder's stock ownership, a question arises as to whether non-redemption transactions with respect to the corporate stock may properly be taken into account in testing the redemption. If this inquiry is answered affirmatively, a further question as to when such a transaction is sufficiently related to the redemption must also be evaluated in the crucible of the step-transaction doctrine.

In Zenz v. Quintlivan a taxpayer disposed of her entire interest in a corporation by means of a sale of shares to a third party followed by a redemption of the balance. The Service contended that the steps should be reversed and that the redemption should be taxed as a dividend. The Sixth Circuit Court of Appeals disagreed and held that the redemption element of the transaction could not be examined as a separate transaction. It ruled that the predecessor of Section 302(b)(3) applied, as the integrated series of steps resulted in a complete termination of the taxpayer's interest in the corporation. Accordingly, dividend treatment under Section 115(g) of the 1939 Code was not imposed.

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9 Id. at 313. The IRS has issued several rulings defining the boundaries of these terms. See e.g., Rev. Rul. 75-502, 1975-2 C.B. 111.
11 I.R.C. § 318.
12 I.R.C. § 302(b)(2). The requisite reduction can exist on the basis of a redemption of stock which is constructively owned by the taxpayer. Rev. Rul. 77-237, 1977-2 C.B. 88. Moreover, a failure to reduce common ownership does not preclude Section 302(b)(2) treatment where the shareholder owns only voting preferred. Rev. Rul. 81-41, 1981-1 C.B. 121.
13 I.R.C. § 302(b)(3).
14 I.R.C. § 302(c)(2). These conditions are depicted in Section 302(c)(2)(A) and are activated by a shareholder's non-retention of an "interest" in the corporation for a ten-year period following the redemption coupled with the filing of an agreement to notify the Service of a reacquisition of an interest within the prescribed period. I.R.C. § 302(c)(2)(A). The term "interest" has been expansively defined. See, e.g., Rev. Rul. 56-556, 1956-2 C.B. 177.
15 213 F.2d 914 (6th Cir. 1954).
17 213 F.2d at 917.
18 Id.
The Zenz decision firmly established the principle that the consequences of a redemption could be affected by related transactions. In Rev. Rul. 55-745\textsuperscript{18} the Service agreed to follow Zenz, and in Rev. Rul. 75-447\textsuperscript{19} extended the Zenz principle to redemptions intended to qualify under Section 302(b)(2). In this latter ruling the Service concluded that where a redemption is accompanied by a sale or an issuance of shares, and where both events are clearly part of an integrated plan to reduce stock ownership, effect will be given to the overall result for purposes of Section 302(b)(2).\textsuperscript{20} Conspicuously absent, however, from the Service’s concession regarding Zenz is a statement as to the particular step-transaction test that must be met for purposes of characterizing the series of steps as events that are “clearly part of an integrated plan to reduce a shareholder’s interest . . . .”\textsuperscript{21} It is here that the recent decisions provide guidance.

A. Integrating Steps

Based upon the language of Rev. Rul. 75-447, it appears that the Service employs a variant of the end-result test of the step-transaction doctrine in the redemption area. In view of the fact that the end-result test is the least restrictive step-transaction standard, a bias in favor of integration is readily discernable. Nevertheless, the end-result test is often modified to require written manifestations of a taxpayer’s intentions yielding results that may vary from those that would obtain through a “pure” application of the end-result approach.

In Rickey v. United States\textsuperscript{22} a 72% shareholder entered into an agreement with the corporation to reduce his interest to less than 50%. This was achieved by means of a redemption followed by a charitable contribution of a portion of his stock. Since there was documentary evidence of a plan to reduce ownership, the end-result test was satisfied, and the redemption qualified under Section 302(b)(2).\textsuperscript{23} If the redemption had been evaluated as a separate transaction, the reduction of the shareholder’s interest would not have satisfied the dictates of the statute. Similarly, in McDonald v. Commissioner\textsuperscript{24} a written plan of reorganization envisaged a redemption of a sole shareholder’s preferred stock coupled with an exchange of his common in return for voting stock of a publicly-held corporation. This plan was designed to qualify as a reorganization under Section 368(a)(1)(B). Although the Service initially argued that the redemption should be tested separately, the Tax Court found that both steps were embodied in the written plan of reorganization and under the principles of Zenz.
should be treated as a single transaction. On this basis, the overall result caused a substantial change in the taxpayer’s interest sufficient to qualify the redemption as an exchange.

Notwithstanding the general acceptance of the end-result test in the redemption area, the additional requirement that the taxpayer’s intentions be documented has served to restrict the wholesale adoption of the test. In *Niedermeyer v. Commissioner* a redemption of a taxpayer’s common stock was followed three months later by a charitable gift of his preferred stock. The court refused to integrate the steps even though the temporal proximity of the events indicated that the intent to make the gift was present at the time of redemption. The court concluded that single transaction status would be conditioned on a showing that a “firm and fixed” plan existed. Since the taxpayer’s intentions were neither documented nor communicated to others, the decision to contribute his preferred stock could have been rescinded. The discretionary nature of the steps sought to be integrated was sufficient to render them separate transactions for purposes of evaluating their tax consequences.

A similar approach was employed to thwart the desired tax treatment in *Paparo v. Commissioner*. In that case the redemption deemed as such by Section 304 was not stepped together with the public offering of the redeeming entity’s stock. Even though the redemption was undertaken for the sole purpose of facilitating the public offering, the result which the parties intended from the outset, the absence of an “overall financial plan” and an express agreement between the corporation and the underwriters regarding the timing and magnitude of the offering was sufficient to render the modified end-result test inapplicable. The redemption, viewed as a separate and independent transaction, was taxed as a dividend.

B. The Service Deviates

In keeping with the thesis that the application of step-transaction principles is not always a model of uniformity, the Service has strayed from a strict
adherence to the requirements of case law. In Rev. Rul. 77-226 a corporate shareholder surrendered stock in redemption and shortly thereafter sold the balance of its holdings. The redemption was structured to flunk Section 302(b) and yield dividend treatment so as to enable the shareholder to reap the benefits of the 85% intercorporate dividends received deduction. The Service applied the Zenz doctrine and treated the redemption and sale as a unit. The redemption, to the taxpayer's dismay, was taxed as an exchange. The ruling is difficult to reconcile with the decision in Niedermeyer, a case involving nearly identical facts. The infirmities which prompted the Niedermeyer decision, most notably the absence of documentation and the discretionary nature of the second step disposition, were equally present in the ruling. Nevertheless, the step-transaction doctrine was applied in the latter but not in the former. This result is contrary to the goal of achieving certainty and predictability of our tax laws.

A similar degree of opportunism is present in the conclusions expressed by the Service in Rev. Rul. 75-83. The issue involved the taxation of boot received in an acquisitive reorganization. Although the Service gratuitously agreed that the dividend equivalence of boot is tested under Section 302 principles, it chose to treat the redemption as one which occurred prior to and separate from the reorganization. This result, flies in the face of the Zenz doctrine and is in direct conflict with the rationale of McDonald. The McDonald court tested a pre-reorganization redemption by giving effect to the overall result that was achieved. This was supported by evidence of a written plan of reorganization which unmistakably encompassed each of the steps. Although a similar set of facts was present in Rev. Rul. 75-83, the Service has chosen to ignore the rightful application of the step-doctrine for the purpose of achieving a beneficial tax result.

C. Series of Redemptions

While the end-result test is generally applicable in the redemption-disposition arena, the binding commitment branch of the step-transaction doctrine is the order of the day when a taxpayer seeks to integrate a series of redemptions. In the absence of integration, each redemption is tested separately against the standards set forth in Section 302(b).

Where a series of redemptions is undertaken, the parties must establish that a "firm and fixed" plan to achieve a particular result is present. Generally,
a firm plan with fixed conditions can be evidenced only by a written agree-
ment creating bilateral obligations to redeem a particular amount of stock at
specified intervals. In the case of corporations owned by members of a family,
the courts have assiduously applied these requisites to deny single transaction
status. In the context of closely-held corporations owned by unrelated
shareholders, the standards for finding a firm and fixed plan are not applied
quite as vigorously.

Thus, in Benjamin v. Commissioner\textsuperscript{39} a plan to terminate a family mem-
ber’s stock interest through a series of redemptions was found not to be firm
and fixed due to the absence of a common understanding as to the “time or
procedure” for effecting the transactions.\textsuperscript{40} Similarly, in Johnston v.
Commissioner\textsuperscript{41} separate transaction status was found notwithstanding the
existence of a written agreement which created a binding obligation of annual
redemptions culminating in an elimination of the taxpayer’s interest. Although
the obligations were binding, the taxpayer elected not to enforce her rights in
several years in which the corporation failed to redeem her shares. Thus, in
cases where an agreement to redeem is not enforced, and where owners of the
entity are family members, the obligations created will not give rise to integra-
tion treatment.\textsuperscript{42}

The presence of unrelated shareholders or the existence of conditions im-
posed by a third party has resulted in a relaxation of the standards normally
required for amalgamation. For example, in Bleily & Collishaw, Inc. v.
Commissioner\textsuperscript{43} a single transaction was found notwithstanding the absence
of a written agreement. Since the shareholders of the redeeming entity were
unrelated, and since the alacrity with which the redemptions were effected clearly
indicated that a complete termination of interest was intended, the tests typically
applied when testing for a firm and fixed plan were eschewed. Similarly, in
Roebling v. Commissioner\textsuperscript{44} a plan for the periodic redemption of a taxpayer’s
preferred stock in a bank was subject to the approval of regulatory authorities.
Although each redemption was conditioned upon the maintenance of certain
levels of working capital, the court found that the plan was as firm and fixed
as a bank could legally construct. On this basis, the court concluded that the
rigidity required in a family-held setting was unnecessary and the realities of

\textsuperscript{39}66 T.C. 1084 (1976), aff’d, 592 F.2d 1259 (5th Cir. 1979).
\textsuperscript{40}66 T.C. at 1113.
\textsuperscript{41}77 T.C. 679 (1981).
\textsuperscript{42}The use of the binding commitment test is not surprising. It is often adopted in cases where the steps
sought to be integrated span several years. In the absence of assurances that the series will be completed,
tax consequences can remain “open” in contravention of the dictates of our annual accounting system.
\textsuperscript{43}72 T.C. 751 (1979), aff’d, No. 79-7601, unpubl. op. (9th Cir. Mar. 26, 1981).
\textsuperscript{44}77 T.C. 30 (1981).
the environment in which the corporation operated mandated a decision in its favor.\textsuperscript{45}

As these decisions demonstrate, the standards for amalgamating a series of redemptions are fluid. Although a strict application of the binding commitment test almost certainly applies in the context of a family corporation, the courts have shown a welcome degree of flexibility in cases where mitigating circumstances exist to warrant a deviation from all of the rigors of this most restrictive of the step-transaction tests.

D. The Corning Transaction

A fascinating practical application of the step-transaction doctrine involves the divestiture being engineered by Corning Glass Works of its stock in Owens-Corning Fiberglass.\textsuperscript{46} Pursuant to an antitrust decree, Corning must dispose of at least 90\% of its interest in Owens. It will accomplish this result through a redemption coupled with the issuance of 25-year debentures that are convertible into its Owens stock. In light of the court decree it would appear that the conditions precedent to the application of Zenz are present. The redemption should be tested by taking into account the overall result accomplished by both the redemption and the debenture conversion. Nevertheless, the extent of the reduction in the taxpayer's interest will theoretically remain "open" for up to twenty-five years pending the eventual redemption or conversion of the debentures. One wonders whether the Service will balk at what appears to be a classic step-transaction case due to the attenuated period within which the steps are to be consummated.\textsuperscript{47}

II. The Step-Transaction Doctrine and Section 351

Section 351 of the Code governs the tax treatment of corporate organizations. It provides for non-recognition treatment where property is transferred to a corporation by one or more persons, solely in exchange for stock or securities, if the transferors are in control of the corporation immediately after the transfer.\textsuperscript{48} For this purpose, control is defined as the ownership of stock possessing 80\% of the total combined voting power and 80\% of the total number of shares of all other classes of stock.\textsuperscript{49}

In the Section 351 area, the step-transaction issue most often encountered involves the effect of subsequent dispositions of stock by the transferors on the "control immediately after" requirement. If the disposition is properly integrated with the transfer, the control test is applied after the disposition is made. If, however, the disposition is a separate transaction, the requirements

\textsuperscript{45}Id. at 55.
\textsuperscript{46}CORNING GLASS WORKS, INC., PROSPECTUS (Nov. 30, 1982).
\textsuperscript{47}See supra note 42.
\textsuperscript{48}I.R.C. § 351(a).
\textsuperscript{49}I.R.C. § 368(c). The Service has ruled that ownership of 80\% of the total number of shares of each class of non-voting stock is required. Rev. Rul. 59-259, 1959-2 C.B. 115.
of Section 351 are applied by reference to the percentage of ownership existing the moment the transferors initially obtain the corporate stock.

In response to the implications of the phrase "immediately after", the courts have been chary in applying the step-transaction doctrine in this area. As a result, it is generally agreed that a disposition will only be integrated with a transfer if the steps are found to be mutually interdependent or they are undertaken pursuant to a binding agreement in existence at the time of the exchange.

Thus, in what is perhaps the most celebrated step-transaction case, *American Bantam Car Co. v. Commissioner*, the property transferors agreed to transfer stock to an underwriter if the latter was successful in marketing an issue of preferred stock. The underwriter succeeded and stock sufficient to deprive the transferors of statutory control was ultimately conveyed. Although the incorporation, marketing of preferred stock, and conveyance to the underwriters were steps which were taken pursuant to an integrated plan, the court concluded that the absence of mutual interdependence was probative with regard to their status as separate transactions. Although the issuance of preferred stock was intended from the outset, the issuance was not an indispensable step without which no other step would have been taken. Since the incorporation step was not conditioned on the issuance, the legal relations created thereby would not have been fruitless without a completion of the series.

This approach to integration has remained the standard throughout the evolution of Section 351. In *Intermountain Lumber Co. & Subsidiaries v. Commissioner*, Section 351 was held inapplicable over the Service's objections in a case in which the incorporator had entered into a pre-exchange agreement to dispose of 50% of his stock in the transferee. The inapplicability of Section 351 yielded a fair market value rather than carryover basis for the assets that were obtained. Notwithstanding its expedient litigating position in *Intermountain*, the Service's rulings have also generally adopted the principle of *American Bantam Car*. In Rev. Rul. 79-70, the Service applied the step doctrine to oust Section 351 of application in a case in which the incorporation would not have occurred but for the agreement of a buyer to purchase 40% of the incor-

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10[65 T.C. 1025 (1976). See also Rev. Rul. 83-23, 1983-5 I.R.B. 9, where a binding obligation to dispose of stock was taken into account in determining whether a United States shareholder received stock of a controlled foreign corporation in a Section 355 distribution. Since the recipient was obligated to dispose of the stock, holding it pursuant to a binding obligation was considered to be transitory, and as a result, the shareholder was required to include the value in gross income pursuant to Treas. Reg. § 7.367(b)-10(i)(2), T.D. 7530, 1978-1 C.B. 92, 109.
11[But see Rev. Rul. 70-140, 1970-1 C.B. 73 (a disposition pursuant to a mere plan or intention violates control based primarily on consideration of fiscal policy rather than consistent application of tax principles).]
12[Rev. Rul. 79-70, 1979-1 C.B. 144. Compare Rev. Rul. 79-194, 1979-1 C.B. 145, which illustrates the effects of an integrated sale where the buyer is a co-transferor. A buyer's status as such will be disregarded, however, where the stock received from the corporation is obtained in exchange for property of a "relatively small value."]
porator's stock. On the other hand, in Rev. Rul. 78-294, a disposition of stock by an underwriter pursuant to a "firm commitment" was not integrated with an incorporation even though such disposition was planned since the underwriter assumed the risk of reselling and thereby could be forced to retain a portion of the stock for a long time. Finally, in an exhaustive exegesis of its approach to Section 351 presented in a recent Technical Advice Memorandum, the Service declined to step together a Section 351 exchange that was followed by a gift of all of the transferee's stock. Although the existence of a pre-arranged plan to dispose of the stock could easily be inferred from the timing of the steps, the fact that the transferors had the legal right to keep the stock indicated that the steps were not mutually interdependent, therefore, not subject to amalgamation.

Accordingly, the application of the step-transaction doctrine to the issue of "control immediately after" is relatively well-settled. A less restrictive approach has been sanctioned in determining the "steppability" of a disposition of stock following a reorganization under Section 368 analysis. If the approach approved under Section 368 were employed in circumstances governed by Section 351, the relative certainty that has characterized the corporate organization area could be thrown into turmoil. A graphic example involves the recent creation of Energetics, a company formed to receive limited partnership interests in oil programs. As a sweetener, Energetics granted registration rights to the incorporators and permitted them to sell their shares for up to a year following the exchange. In the reorganization area, sales pursuant to registration rights are often stepped together with the reorganization exchange for the purpose of finding a lack of continuity of interest. If this principle were applied to the Energetics exchange, the control requisite to Section 351 might be found to be lacking. The Service's capricious application of the step doctrine in other areas makes such an expansion of the doctrine something more than a theoretical possibility.

III. Stock Purchases as Asset Purchases: The Kimbell-Diamond Approach

One of the best known manifestations of the step-transaction concept is the Kimbell-Diamond doctrine. In Kimbell-Diamond Milling Co. v. Commissioner one corporation purchased the stock of another for the purpose of a 2 C.B. 141.


5This parallels the rationale of a celebrated exchange/gift decision. Wilgard Realty Co., Inc. v. Comm'r, 127 F.2d 514 (2nd Cir. 1942), aff'd per curiam, 317 U.S. 655 (1942).


7The presence of registration rights may make a disposition pursuant thereto mutually interdependent with the receipt of the stock. McDonald's Restaurants of Illinois, Inc. v. Comm'r, 688 F.2d 520 (7th Cir. 1982). A finding of interdependence is sufficient for step-transaction purposes in the context of Section 351.

814 T.C. 74 (1950), aff'd per curiam, 187 F.2d 718 (5th Cir. 1951), cert. denied, 342 U.S. 827 (1951).
pose of obtaining specific assets of the target through a prompt and prearranged liquidation. The court invoked the "single transaction" doctrine and treated the transaction as a purchase of assets, thus denying the buyer the right to carryover the target's bases in the assets. The Kimbell-Diamond doctrine was a rather unique application of step-transaction principles; it was based solely on a finding of the purchaser's unilateral intent to acquire assets. In response to the difficulties inherent in demonstrating the requisite intent and to various judicial inroads, the doctrine was eventually codified as Section 334(b)(2) of the 1954 Code. The codification, one of the few known attempts to legislate the step doctrine, was made applicable only to corporate purchasers of a target's stock. As a result, noncorporate buyers remained subject to the vicissitudes of Kimbell-Diamond. The recent revision of Section 334(b)(2) and its reincarnation as Section 338 did nothing to redress this problem. Individual purchasers of stock must satisfy the dictates of Kimbell-Diamond in order to obtain asset purchase treatment for a stock acquisition that is followed by a liquidation.

In this context, the most common scenario involves the potential application of the step doctrine to a three-step transaction encompassing (1) a purchase of stock, (2) a complete liquidation, and (3) a transfer of the assets to a newly-created corporation. If each step is merely a component part of a single transaction, the net result yields a basis for the assets which is equal to their fair market value. If the stock purchase is found to be separate from the latter steps, the net effect is merely a reorganization under familiar liquidation-reincorporation principles. This results in Newco inheriting the target's bases in its assets and any assets not conveyed to Newco by the distributee shareholders will be taxable as a dividend pursuant to Section 356(a)(2).

In light of the fact that Kimbell-Diamond is activated only upon a con-

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4United States v. M.O.J. Corp., 274 F.2d 713 (5th Cir. 1960). See also, John Simmons Co. v. Comm'r, 25 T.C. 635 (1955). These decisions struggled with the issue of whether Kimbell-Diamond was limited to acquisitions of particular assets rather than going businesses.


4Another example is pre-TEFRA Section 311(d)(2)(A) in which a shareholder who had owned his stock for at least one year would be given credence as a shareholder even in cases where the stock was purchased for the purpose of tendering it for redemption. I.R.C. § 311(d)(2)(A), amended by TEFRA § 223(a)(1), 96 Stat. 483 (1982). But compare Rev. Rul. 80-221, 1980-2 C.B. 107 where the stock is purchased directly from the corporation.

4See supra note 62.


4Typically the transaction is treated as a reorganization under Section 368(a)(1)(D), the most common characterization of a liquidation-reincorporation. See e.g., James Armour, Inc. v. Comm'r, 43 T.C. 295 (1964).

4I.R.C. § 362(b).

4See supra note 36.
clusive showing of a unilateral intent to acquire assets, the courts have been less than generous in allowing ill-advised taxpayers to belatedly achieve the desired tax result. In *Estate of Suter v. Commissioner*, however, the intent to acquire assets was shown to exist where the purchase, liquidation and transfer to Newco all occurred within a period of little more than a month. Although the Service asserted reorganization treatment, the court concluded that the purchaser’s ownership of the target’s stock was transitory and should therefore be disregarded. Since the sellers who were historic shareholders of the target obtained no interest in Newco, the continuity of proprietary interest needed to establish a reorganization did not exist.

In *Griswold v. Commissioner*, however, asset purchase treatment was denied in a case in which the stock purchase contract expressly prohibited a liquidation. The court distinguished *Suter* wherein a supplemental agreement between the parties permitted a later liquidation. In view of the contract terms, the court in *Griswold* had little difficulty in finding that an intent to liquidate did not exist from the outset. The stock purchase was a transaction separate from the liquidation/reincorporation.

More recently, in *Harold C. Lang* the infirmities of *Griswold* were employed to deny a fair market value basis. In *Lang* a contract provision precluded liquidation, or any other movement of assets, in the absence of the seller’s permission. In addition, there was a three-year hiatus between the stock purchase and the commencement of the remaining steps. Although the contract terms were not as restrictive as those that existed in *Griswold*, the unduly long passage of time was determinative of the issue of whether a contemporaneous intent to acquire assets existed at the time the stock was purchased. The court had little difficulty in finding for the Service.

On the basis of these decisions, asset purchase treatment appears to be uniquely within the control of the buyer. If the contract provisions are drafted with care and the steps are expeditiously taken consistent with a preconceived intent to obtain assets, the requirements of the step-transaction doctrine should be readily satisfied. The Service generally agrees as evidenced by its reasoning in *Rev. Rul. 69-242*, in which a stock purchase followed by liquidation within thirty days was treated as an asset purchase for purposes of Section 1033. Deviation from established guidelines will have the effect of severing the stock purchase and yielding reorganization treatment for the liquidation/reincorporation.

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**29 T.C. 244 (1957).**

**400 F.2d 427 (5th Cir. 1968).**

**Id. at 430.**

**T.C.M. (P-H) ¶ 82, 149 (1982).**

IV. THE STEP-TRANSACTION DOCTRINE IN SECTION 368: THE CONCEPT OF A PLAN OF REORGANIZATION

The most significant applications of the step-transaction doctrine have populated the portion of Subchapter C that deals with the status of a transaction as a tax-free reorganization. The application of the doctrine in Section 368 is dominated by the concept of the "plan of reorganization."74 All steps that are taken pursuant to the plan are to be considered in evaluating the effect of the integrated transaction.

Since the certification of "the plan" as the touchstone for the application of the doctrine evokes notions of the end-result theory, a crucial question involves the issue of whether the unilateral intentions of one party will be sufficient, or whether a step will be integrated only if it is taken pursuant to the bilateral plans or intentions of all participants.

The step doctrine in the area of reorganization, while admittedly based upon the end-result theory, will only encompass steps taken pursuant to bilateral plans or intentions. It is almost universally true that a step taken pursuant to the unilateral desires of one participant will not be treated as part of the plan of reorganization.75

A. Bilateral Intent

The foregoing rule is supported by numerous precedents. A graphic illustration of the need for bilateral intent76 is presented by the contrasting decisions in Anheuser-Busch, Inc. v. Commissioner77 and Campbell v. Commissioner.78 In Anheuser-Busch a reorganization was followed by a "drop-down" of the acquired assets to the buyer's wholly-owned subsidiary. Although the contract did not require this transfer, it expressly gave the buyer the right to do so. The drop-down was construed as a step contemplated by the parties and considered part of the plan of reorganization. Since the Anheuser-Busch decision pre-dated the enactment of Section 368(a)(2)(C), the finding of integration was sufficient to deny reorganization status.79 In Campbell, the plan evidenced by the contract did not raise the prospect of a drop-down. Consequently, the conveyance to the acquiring corporation's subsidiary the day after the acquisition was not considered part of the plan of reorganization.

74Mintz & Plumb, supra note 3, 273-74.
75But cf. King Enterprises Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969) in which an acquisition of stock for stock and boot followed by a preplanned merger was taxed as an "A" reorganization. Although based on unilateral intent, the decision can be rationalized as an application of Kimbell-Diamond precepts. See supra notes 61-70 and accompanying text.
76See Mintz & Plumb, supra note 3, at 276-77.
7740 B.T.A. 1100 (1939), aff'd, 115 F.2d 662 (8th Cir. 1940), cert. denied, 312 U.S. 699 (1941).
7815 T.C. 312 (1950).
Other examples of the need for a mutuality of purpose abound. In Rev. Rul. 56-345, a redemption occurring one month after a "C" reorganization was treated as a separate transaction where the agreement and plan of reorganization made no mention of the offer received by the target shareholders that prompted them to surrender their shares for redemption. Since the acquiring corporation had made no prior commitment in regard to the redemption, and was not even aware of the event which motivated it, the duality of purpose needed for amalgamation did not exist. In Yoc Heating Corp. v. Commissioner, a purchase of stock followed by a merger of the target into a newly-created shell was viewed as a single transaction not qualifying as a reorganization. The Service's attempt to separate the purchase from the merger for the purpose of finding a continuity of proprietary interest was rejected. Since the purchase contract specifically envisioned the formation of Newco, both steps were considered as taken pursuant to the bilateral intentions of the parties and were therefore ripe for integration. On this basis continuity did not exist since the historic shareholders of target did not obtain a stock interest in Newco.

In recognition of the fact that its proposed regulations endorsed an overly broad step-transaction theory, the Service recently revised its final regulations dealing with the continuity of business enterprise requirement for a reorganization. Continuity of business exists if the transferee continues the historic business of the transferor. The historic business is defined as the one which the transferor most recently conducted other than one entered into as part of a plan designed to achieve a reorganization. In one example describing this rule, the Service denied historic business status to an investment business that had been conducted by the taxpayer for more than a three-year period following the sale of its operating assets. This was true despite the fact that such business was entered into prior to the time it had identified the entity into which it ultimately merged. The final regulations correct this unduly ambitious application of the step-transaction doctrine. A business will now only be denied historic status if it was entered into as part of the plan of reorganization. Use of the phrase, "the plan of reorganization," should necessitate a showing of bilateral intent. Unless the business was entered into pursuant to an agreement to which the merger partner was a participant, it will be treated as the historic

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**Rev. Rul. 56-345, 1956-2 C.B. 206. See also Rev. Rul. 76-334, 1976-2 C.B. 108 in which the event that prompted redemption was not considered part of the "agreement."**

**61 T.C. 168 (1973).**


business for continuity of business purposes.

B. Post-Merger Continuity of Interest: The McDonald’s Case

A statutory merger will only qualify as a reorganization if the doctrine of continuity of proprietary interest is satisfied. Continuity exists if the shareholders of the target maintain a proprietary interest in the entity to which the target’s assets are transferred. Although the focus is generally on the qualitative nature of the consideration initially received by the shareholders, continuity of interest can also be affected by post-merger dispositions of stock. If the disposition and merger are treated as a unit under step-transaction principles, the continuity test is properly applied to the interest ultimately retained by target’s historic owners. On the other hand, a failure to justify integration would eliminate the disposition as a relevant consideration for continuity purposes. In this context the decisions discussed above clearly indicate the amalgamation is warranted only if the disposition is part of the plan of reorganization, that is, if the disposition was effectuated pursuant to the bilateral intentions of the participants.

In McDonald’s of Zion v. Commissioner the Tax Court found that a post-merger sale of stock pursuant to a pre-merger intent to sell was a separate transaction. The sellers did not want to become shareholders of McDonald’s and wanted only cash in return for their stock. McDonald’s insisted on the use of its stock so that it could enjoy the benefits of pooling of interest accounting treatment. In order to satisfy the sellers, McDonald’s promised to include the seller’s shares in a planned registration and underwriting. It also granted the sellers demand registration rights should it fail to successfully structure an offering within one year of the merger. Such an offering was in fact accomplished, and the target shareholders disposed of their newly acquired stock within six months of the merger.

Despite this fact pattern, the Tax Court declined to amalgamate the steps. This refusal was based on the view that the proper step-transaction test was the one employed under Section 351, the mutual interdependence test. Since there was no showing that the merger was conditioned on the subsequent disposition of the stock, and the sellers were not legally bound to dispose, the conditions needed for amalgamation were not met. The decision was curious for reasons other than the court’s selection of the interdependence test. The Service was placed in the unusual posture of arguing for a tax-free reorganization in order to deny the buyer’s a stepped-up basis for the target’s assets. In so
doing, the Service’s conception of the step doctrine seemed opportunistic. Under “normal” circumstances, such as in the advance ruling area, the Service would invoke the step doctrine merely on a showing that the disposition was pursuant to a seller’s pre-merger intent to sell.\(^{92}\)

It is apparent that both the Tax Court’s approach\(^{93}\) and the Service’s advance ruling guidelines are patently violative of the accepted tests. The Tax Court was unduly restrictive whereas the Service’s approach was unjustifiably broad. Neither the court nor the Service heeded the bilateral plan or intention standard that is traditionally applied in the reorganization area.

C. The Seventh Circuit Reverses

Against this backdrop and in response to the welter of scholarly comment criticizing the Tax Court’s decision,\(^{94}\) the Seventh Circuit Court of Appeals reversed the lower court.\(^{95}\) In so doing it restored the concept of bilateral plans or intentions as the controlling theory for application of the step doctrine in the reorganization area. It found that the granting by McDonald’s of demand registration rights was probative of the issue of whether the sale was part of the transaction negotiated by the participants.\(^{96}\) This facilitation of the sale by the buyer through the granting of such rights was sufficient to render it an active participant to such sale. As the sale was therefore a step undertaken pursuant to the bilateral actions of the participants, it was clearly part of the plan of reorganization. McDonald’s granting of demand registration rights was analogized to the actions of the buyer in *Heintz v. Commissioner*,\(^{97}\) a case in which a post-merger sale was also encompassed within the plan of reorganization. In *Heintz* the buyer promised that the seller’s stock would be sold in a public offering. When the offering did not eventuate, the buyer arranged for a private sale of the stock. These actions were sufficient to demonstrate that the sale was part of the agreement between the parties and therefore part of an overall plan.

At this juncture it is difficult to determine whether the mere presence of demand registration rights will be sufficient to warrant integration, or whether their existence in *McDonald’s* was merely a shred of additional evidence supporting a result otherwise dictated by the seller’s unwavering intentions to “cash out.” The mere granting of such rights, without more, should not be accord-

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\(^{92}\)Rev. Proc. 77-37, § 3.02, 1977-2 C.B. 568, 569.

\(^{93}\)In addition to its “incorrect” adoption of mutual interdependence principles, the court added in dictum that a unilateral intent to dispose might be sufficient to integrate a sale. 76 T.C. at 995 fn. 38 (citing Anheuser-Busch, Inc. v. Comm’r. 40 B.T.A. 1100, 1107 (1939) (a bilateral intent case)). See supra note 77.


\(^{95}\)McDonald’s Restaurants of Illinois v. Comm’r, 688 F.2d 520 (7th Cir. 1982), rev’d 76 T.C. 972 (1981).

\(^{96}\)The court correctly applied that the mutual interdependence test and found it satisfied, and found the “spirit” of the binding obligation test also satisfied. 688 F.2d at 524-25. See supra note 60.

ed conclusive weight. This view is supported by the conclusions stated in Rev. Rul. 67-275,98 wherein registration was undertaken for the purpose of promoting "the orderly marketing of the acquiring corporation's stock."99 The ruling implies that registration should not per se violate continuity where a sale pursuant to those rights occurs shortly after the merger. According a preclusive quality to the granting of rights would appear to penalize taxpayers whose stock must be registered before it may be alienated. If the effects of a post-merger sale are to be equitably evaluated, something more than mere registration must be present.

However, the granting of demand registration rights, if coupled with other factors, should be enough to find the degree of mutuality otherwise needed to treat a step as a component part of the plan of reorganization. The Seventh Circuit was correct in according significance to these rights and employing them to find that the sale was part of the transaction. The facts elucidated by the trial court demonstrated the existence of a settled and firm determination to sell at the earliest opportunity. The fact that the rights exacted from the buyer were of paramount importance to the sellers was sufficient to classify the sale as a component part of the plan of reorganization. Integration resulted from the "bargained-for" nature of this element of the agreement.

The McDonald's decision will also affect reorganizations of closely held businesses. Although the factor of registration rights will not be present, their absence will not free these entities from the rigors of the principle espoused by the court. Instead, transactions involving privately held corporations will be scrutinized for other objective indicia that a post-merger sale was part of the plan or reorganization. In some cases, these indicia will be contained within the terms of the stock, as in mandatory serial redemption features. In other cases, the totality of circumstances, including pre-merger discussions and understandings, not rising to the level of a binding commitment, will provide the Service with the ammunition needed to integrate the merger exchange with the disposition.

CONCLUSION

The step-transaction doctrine is a fact of tax life in the Subchapter C area. What has become increasingly difficult is the identification of the appropriate test, the satisfaction of which will invoke its principles. What is painfully clear, however, is the view initially expressed by Mintz and Plumb that no universal test for application of the doctrine exists. Instead, the circumstances necessary for its application will vary depending upon the Code section and the nuances of the statutory language being examined.100 Just as the phrase "control im-

99Id.
100See generally Chirelstein & Lopata, Recent Developments in the Step-Transaction Doctrine, 60 TAXES 970 (1982).
mediately after” mandates a restrictive application of the doctrine, the concept of the “plan of reorganization” or the ephemeral” integrated transaction approach” of the Kimbell-Diamond doctrine warrant a broader outlook. Although the recent decisions bring us further along the path toward predictability in the application of the alternative step-transaction tests, certain aberrant interpretations by the Service remind us that true certainty in this corner of tax law has yet to be achieved.