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Attacking Tax Shelters: Galloping Toward a Better Step TransactionDoctrine

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Attacking Tax Shelters: Galloping Toward a Better Step Transaction Doctrine

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Since the beginning of the Internal Revenue Code, taxpayers have sought to lower their tax bills through creative tax planning. The step transaction doctrine is one of several tools used by the Internal Revenue Service and courts to challenge tax shelters and tax evasion. The step transaction doctrine provides that the courts may combine two or more allegedly separate steps in a multi-step transaction into a single step to better reflect the economic reality of the taxpayer's actions. Derived from Supreme Court decisions in the 1930s, the doctrine deserves renewed scrutiny today because serious conceptual issues exist regarding the three current tests that courts use to determine when to combine various steps in a tax-motivated multiple-step transaction. This Article addresses two perennial themes in tax law: the role of judicial doctrines in a statutory system and the difficulty of taxing related-party transactions. This Article argues that courts should reformulate the binding commitment, interdependence, and end result tests as two objective tests: an objective test based on the law of offer and acceptance for arms-length transactions and an economic reality test for transactions between related parties. These new tests provide conceptual clarity and promote predictability while protecting the public treasury. The new tests borrow underlying concepts from contract and commercial law. The new tests demonstrate the fruitful possibilities of borrowing across areas of law. They also demonstrate that tax law shares similar concerns

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with other areas of law—a proposition that is sometimes doubted. This Article further contends that the step transaction doctrine, as reformulated, should be available for assertion by taxpayers in transactions between unrelated parties. Acknowledging the availability of the test for assertion by taxpayers will have the salutary effect of aligning the letter of the doctrine with its application.

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INTRODUCTION

The Internal Revenue Code ("IRC" or "Code") and the Treasury Regulations ("Regulations") consume volumes and volumes of provisions. These provisions are worded carefully and often reflect competing policies beyond raising revenue, such as favoring or disfavoring certain taxpayer behavior and advancing social policies. Since the beginning of the Code, taxpayers have sought to lower their tax bills through creative tax planning. This behavior often has been met with judicial approval.[1] Congress, by enacting the anti-abuse provisions of the Code, and the Internal Revenue Service ("IRS"), by promulgating anti-abuse regulations, have sought to combat this behavior.[2]

This Article addresses two of the perennial themes of tax law: the role of judicial doctrines in a statutory system and the difficulty of taxing transactions between related parties. These concerns link this Article to broader themes in the law.

Tax law is governed primarily by code and regulation, as are intellectual property law, immigration law, criminal law, and many other areas of law. In each of these primarily statutory systems of law, when the courts perceive a gap or deficiency in the statutory system, they augment the system with judge-made common law.[3]

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1. *See infra* notes 35–39 and accompanying text.

2. In one recent case, the court noted that

> much of the caselaw using the economic substance, sham transaction, and other judicial doctrines in interpreting and applying tax statutes, represents an effort to reconcile two competing policy goals. On one hand, having clear, concrete rules embodied in a written Code and regulations that exclusively define a taxpayer's obligations (1) facilitates smooth operation of our voluntary compliance system, (2) helps to render that system transparent and administrable, and (3) furthers the free market economy by permitting taxpayers to know in advance the tax consequences of their transactions. On the other side of the scales, the Code's and the regulations' fiendish complexity necessarily creates space for attempts to achieve tax results that Congress and the Treasury plainly never contemplated, while nevertheless complying strictly with the letter of the rules, at the expense of the fisc (and other taxpayers).

CNT Inv'rs, L.L.C. v. Comm'r, 144 T.C. 161, 198 (2015).

3. *See generally* Brett Fischman & Dan Moylan, *The Evolving Common Law Doctrine of Copyright Misuse: A Unified Theory and its Application to Software*, 15 BERK. TECH. L.J. 865 (2000) (discussing the emerging common law doctrine of misuse in copyright law as a judicial attempt to prevent statutory protection from being abused as an anticompetitive tactic); Alan Scott Rau, *Intellectual Property*, 16 TEX. TECH L. REV. 355 (1985) (discussing how and to what extent the Fifth Circuit incorporated the common law doctrine of functionality into its reading of the Lanham Act in *Sicilia Di R. Biebow & Co. v. Cox*, 732 F.2d 417 (5th Cir. 1984)); Kiran H. Griffith, Comment, *Fugitives in Immigration: A Call for Legislative Guidelines on Disentitlement*, 36 SEATTLE U. L. REV. 209 (2012) (discussing the use of the common law doctrine of fugitive disentitlement in immigration law); John M. Mulcahey, Recent Decision, *Res*

In tax law, courts have created doctrines to prevent perceived taxpayer abuse. In certain circumstances, some of these doctrines have been available to taxpayers to characterize their own transactions in a more tax-favorable manner.[4] These doctrines include substance over form, economic substance, business purpose, sham transaction, and step transaction.[5]

The courts and Congress have struggled with related-party transactions[6] since the earliest days of the Internal Revenue Code. The assignment of income doctrine, as embodied in the classic case of *Lucas v. Earl*,[7] was an early effort to address this issue. Specific Code sections, such as §§ 267 and 1239, also address the issues caused by related-party transactions. The Treasury often issues regulations specifically addressing the special difficulties of taxing related-party transactions in a variety of contexts.[8] Among these various efforts, the judicial doctrines mentioned above—substance over form, economic substance, business purpose, sham transaction, and step transaction—all of which have their genesis in *Gregory v. Helvering*,[9] have played a prominent role in regulating transactions between related parties.

Although scholars recently have paid significant attention to the economic substance doctrine, owing in part to its codification, substantially less scholarly attention has been paid in recent years to the step transaction doctrine.[10] This Article contends that the step transaction doctrine is undertheorized given its long history and continuing importance in tax jurisprudence. In recent years, courts have applied the step transaction doctrine in varied cases, such as those regarding distressed asset or debt

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Judicata – Criminal Law – Double Jeopardy – DUI, 31 DUQ. L. REV. 625 (1993) (discussing the use of the common law doctrine of *res judicata* in the criminal law, especially as by the Pennsylvania Supreme Court).

4. This Article refers to a taxpayer's use of these doctrines to recast the form of its own transactions to achieve more favorable tax consequences as an "offensive" use of such doctrines.

5. For a discussion of these doctrines, see 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3 (3d ed. 2000).

6. See discussion *infra* Part I.B.3. on transactions between related parties and the example of such a transaction in *True v. United States*, 190 F.3d 1165 (1999).

7. Lucas v. Earl, 281 U.S. 111 (1930).

8. *See, e.g.*, Treas. Reg. § 1.385-1 (as amended 2017).

9. Gregory v. Helvering, 293 U.S. 465 (1935).

10. For articles discussing the codification of the economic substance doctrine, see generally Karen C. Burke, *Reframing Economic Substance*, 31 VA. TAX REV. 271 (2011); Leigh Osofsky, *The Case Against Strategic Tax Law Uncertainty*, 64 TAX L. REV. 489 (2011); Bret Wells, *Economic Substance Doctrine: How Codification Changes Decided Cases*, 10 FLA. TAX REV. 411 (2010).

shelters,[11] the 501(c)(3) exemption and charitable contributions,[12] gift taxes,[13] and the first time home buyer credit under IRC § 36.[14] As one commentator, discussing the important and complex area of corporate reorganizations, put it 50 years ago, "it is difficult to exaggerate the importance of the step-transaction doctrine."[15]

The step transaction doctrine and economic substance doctrine have similar goals, but even after codification of the economic substance doctrine, the step transaction doctrine has a role to play.[16] At times, courts implicitly have used the step transaction doctrine to aggregate multiple steps or to disaggregate a single transaction into a series of steps and then evaluate the resulting steps under the economic substance doctrine.[17] In this way, courts and the IRS may apply the step transaction doctrine to determine the contours of the "transaction" before considering whether that transaction has economic substance.[18] Furthermore, the codification of the economic substance doctrine did not alter the doctrine itself—it merely set the common law doctrine of 2010 in stone.[19] Congress codified the

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11. *See generally* CNT Inv'rs, L.L.C. v. Comm'r, 144 T.C. 161 (2015); Superior Trading, L.L.C. v. Comm'r, 137 T.C. 70 (2011).

12. *See generally* Gunkle v. Comm'r, 753 F.3d 502 (5th Cir. 2014).

13. *See generally* Linton v. United States, 630 F.3d 1211 (9th Cir. 2011).

14. *See generally* Rodriguez v. Comm'r, 101 T.C.M. (CCH) 1599 (2011).

15. John T. Sapienza, *Tax Considerations in Corporate Reorganizations and Mergers*, 60 NW. U. L. REV. 765, 783 (1966). In illustrating the step transaction doctrine's "long and distinguished history," one commentator notes that it "has become a central feature in income tax adjudication. Its use is particularly pronounced in the corporate income tax area of the law. Courts skillfully apply this doctrine to see the forest rather than taxpayers' deliberately planted trees that would otherwise camouflage their carefully laid tax avoidance schemes." Jay A. Soled, *Use of Judicial Doctrines in Resolving Transfer Tax Controversies*, 42 B.C. L. REV. 587, 597–98 (2001); *see also* Yoram Keinan, *Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification*, 22 AKRON TAX J. 45, 45–49 (1994) (describing the important role the step transaction doctrine and other judicial doctrines have played in challenging corporate tax avoidance schemes).

16. Philip J. Levine & Britt M. Haxton, *"The End Result Test" Revisited, Part 1*, TAX NOTES 1259, 1260–61 (2015).

17. *See* Thomas C. Vanik, Jr., *Torpedoing a Transaction: Economic Substance Versus Other Tax Doctrines and the Application of the Strict Liability Penalty*, 64 CLEV. ST. L. REV. 109, 128 (2015).

18. *Id.*

19. *See generally* Martin J. McMahon, Jr., *Living With the Codified Economic Substance Doctrine*, TAX NOTES (Aug. 17, 2010), https://www.taxnotes.com/tax-notes-today/accounting-periods-and-methods/living-codified-economic-substance-doctrine/2010/08/17/wbd1 [https://perma.cc/7F96-LAXB]; Mark E. Berg, *Tax*

economic substance doctrine at IRC § 7701(o) in the Health Care and Education Reconciliation Act of 2010.[20] That Act's legislative history stated that IRC § 7701(o) "does not change present law standards in determining when to utilize an economic substance analysis."[21] The statute is to be applied "in the same manner as if [§ 7701(o)] had never been enacted."[22]

The step transaction doctrine provides that the courts may combine two or more allegedly separate steps in a multi-step transaction into a single step to better reflect the economic reality of the taxpayer's actions.[23] The doctrine often is applied to protect the underlying purpose of statutory provisions.[24] It usually, but not always,[25] is asserted by the IRS to attack allegedly artificial divisions of transactions by taxpayers trying to characterize recognition events—that is, events that result in a taxable sale or exchange—as nonrecognition events or, more rarely, taxpayers trying to protect nonrecognition events from characterization as recognition events. The step transaction doctrine, like the use of a system of annual accounting, is partly a doctrine to address the often amorphous nature of business affairs. Transactions do not always have a clear beginning or ending. Often, businesses have longstanding relationships with other businesses, and it is hard to determine when one transaction ends and another begins. Yet such divisions are necessary to a realization-based system of taxation, such as the American system.[26]

Planning in the 'Economic Substance' Era, TAX NOTES (Oct. 6, 2015), https://www.taxnotes.com/tax-notes-today/tax-avoidance-and-evasion/tax-planning-economic-substance-era/2015/10/06/fyvg [https://perma.cc/S9BN-QMJN].

20. McMahon, Jr., *supra* note 19; *see also* I.R.C. § 7701(o) (2012).

21. McMahon, Jr., *supra* note 19 (citing STAFF OF THE JOINT COMMITTEE ON TAXATION, 152 (JCX-18-10), TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE RECONCILIATION ACT OF 2010, AS AMENDED, IN COMBINATION WITH THE PATIENT PROTECTION AND AFFORDABLE CARE ACT (J. Comm. Print 2010)).

22. § 7701(o)(5)(C).

23. *See* BITTKER & LOKKEN, *supra* note 5, ¶ 4.3.5.

24. *Id.*

25. See King Enters., Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969), for an example of a taxpayer assertion of the doctrine. *See also* BITTKER & LOKKEN, *supra* note 5, ¶ 4.3.5 at 4-51("Although step transaction cases often are concerned with whether the tax consequences of a particular step with significant legal or business consequences should be determined by treating it as part of a larger single transaction, there are also many cases where particular steps in an integrated transaction are disregarded as transitory events or empty formalities.").

26. *See* BITTKER & LOKKEN, *supra* note 5, ¶ 4.3.5, at 4-48 ("Because business transactions often have no sharp beginning or clearly defined end and because income must be computed annually, it is often necessary to divide a transaction

The three tests regularly used by courts in applying the step transaction doctrine are the binding commitment test, the interdependence test, and the end result test. The binding commitment test requires that for the multiple steps to be integrated "there must be a binding commitment to take the later steps."[27] The interdependence test "requires an inquiry as to 'whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.'"[28] The end result test provides that "purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."[29]

One example of the function of the step transaction doctrine is in the context of Code § 351, which provides for tax-free treatment for transferors to a corporation who emerge with control of the corporation.[30] Code § 351 is meant to prevent businesses from being taxed upon incorporation.[31]

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into its constituent elements for tax purposes."); *see also* Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365, 448–49 (1988) ("A determination of what transaction has occurred ought to rest only on the legal relationships among the parties. A significant reason for basing taxation on transactions rather than on economic income is that economic relationships are simply too difficult to measure; on the other hand, legal relationships are generally clear-cut and readily determinable.") (citations omitted).

27. This "binding commitment" is usually a contractual obligation. *See* Comm'r v. Gordon, 391 U.S. 83, 96 (1968); *see also* McDonald's Rests. v. Comm'r, 688 F.2d 520, 525 (7th Cir. 1982) (citations omitted).

28. *King Enters.*, 418 F.2d at 516 (quoting RANDOLPH E. PAUL & PHILIP ZIMET, STEP TRANSACTIONS, SELECTED STUDIES IN FEDERAL TAXATION 200, 254 (2d Series 1938)); *see, e.g.*, Am. Bantam Car Co. v. Comm'r, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949); Manhattan Bldg. Co. v. Comm'r, 27 T.C. 1032, 1042 (1957) (*acq.*).

29. *King Enters.*, 418 F.2d at 516 (quoting DAVID R. HERWITZ, BUSINESS PLANNING 804 (1966)). Several cases cite *King Enterprises* on this point. *See* Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234 (5th Cir. 1983); Penrod v. Comm'r, 88 T.C. 1415 (1987); *see also* Crenshaw v. Comm'r, 450 F.2d 472, 475 (5th Cir. 1971) ("[T]he tax consequences of an interrelated series of transactions are not to be determined by viewing each of them in isolation but by considering them together as component parts of an overall plan.").

30. *See* I.R.C. § 351(a) (2012) ("Control" is defined as "at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."); *see also id.* § 368(c).

31. *See* Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions under Section 351*, 11 VA. TAX REV. 349, 384–86 (1991).

Consider the consequences if George transfers property with a basis of ten dollars and a fair market value of $100 in exchange for 100 shares of Newco, Inc ("Newco") and ten days later he sells 40 shares to Isabella for $40. If the two transactions are considered separately, George will be deemed first to have made a tax-free contribution to the corporation followed by a sale of 40 shares to Isabella. He will be taxed on the gain of $36 arising from the second transaction. If, however, the two transactions are considered part of a plan, George's initial contribution will be fully taxable, and George will have a gain of $90 because, at the end of the two steps, George, the only transferor, will own less than 80% of the shares of Newco.

This Article argues that courts should reformulate the binding commitment, interdependence, and end result tests as two objective tests: (1) an objective test for arms-length transactions based on the law of offer and acceptance (hereinafter, "objective test"); and (2) an economic reality test for transactions between related parties. For arms-length transactions, the objective test asks whether the parties' actions, as demonstrated by documentary evidence or other admissible evidence regarding contractual obligations, manifest a mutual intention that a series of transactions should be combined into a single transaction. As with the objective test from contract law, when applying this proposed objective test, the trier of fact looks to the ordinary meaning of terms in documents and the understanding of actions that a reasonable person in the position of the other party would have.[32] For related-party transactions, the economic reality test draws upon the articulation of the interdependence test in *True v. United States* and asks whether each step has a "'reasoned economic justification standing alone.'"[33] As with the economic reality test in differentiating a true lease from a financing arrangement, the trier of fact focuses not on the intent of the parties—with the related parties' intent being too easily disguised—but on whether hypothetically unrelated parties facing similar economic and business constraints would construct the transaction with a similar series of steps.

These new tests provide conceptual clarity and promote predictability while simultaneously protecting the public treasury. The new tests borrow concepts from contract and commercial law and demonstrate that tax law shares similar concerns with other areas of law, a proposition that sometimes is doubted.[34] This Article contends that the step transaction

32. *See infra* notes 367–368 and accompanying text.

33. True v. United States, 190 F.3d 1165, 1178 (1999) (quoting Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1247 (5th Cir. 1983)).

34. *See infra* notes 496–498 and accompanying text.

doctrine, as reformulated, should be available for assertion by taxpayers in transactions between unrelated parties. Acknowledging the availability of the test for assertion by taxpayers will have the salutary effect of aligning the description of doctrine with its application.

Part I provides background regarding the judicial development of the step transaction doctrine and scholarly efforts to provide a conceptual framework. Part II elaborates on the proposed new tests and the offensive use of the step transaction doctrine as well as the implications of adopting the new tests. Part III points to fruitful avenues for future exploration, connecting some of the specific issues discussed in this Article to broader themes in legal theory.

I. BACKGROUND ON JUDICIAL DOCTRINES

Initially, courts did not welcome the government's attempts to recharacterize a transaction, as evidenced by Judge Learned Hand's oft-cited statement that "there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible."[35] Around the same time that Judge Hand made this famous statement, another doctrine arose that similarly aimed at limiting the scope of tax law: the doctrine of construing the tax code strictly against the government in the way that a contract is construed against the drafter.[36] One of the earliest cases to apply that doctrine was *Old Colony Railroad Co. v. Commissioner*,[37] a fundamental case in defining the scope of the income tax and one that is excerpted in basic federal income tax casebooks. Specifically, in *Old Colony Railroad Co.*, the United States Supreme Court stated, "[When there is] doubt as to [the] connotation of [a] term, and another meaning might be adopted, the fact of its use in a tax

35. Comm'r v. Newman, 159 F.2d 848, 850–51 (2d Cir. 1947) (L. Hand, J., dissenting). Judge Hand's quote continues to be cited by courts today, including the Supreme Court. *See, e.g.*, United States v. Thompson/Ctr. Arms Co., 504 U.S. 505, 511 n.4 (1992) (Souter, J.) ("In our system, avoidance of a tax by remaining outside the ambit of the law that imposes it is every person's right. 'Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.'"); s*ee also* Edward A. Morse, *Reflections on the Rule of Law and Clear Reflection of Income: What Constrains Discretion*, 8 CORNELL J. L. & PUB. POL'Y 445, 465 (1999).

36. *See* William S. Blatt, *Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form*, 70 OR. L. REV. 381, 387–88 (noting that a majority of courts favored strict construction in the early Twentieth century).

37. Old Colony R.R. Co. v. Comm'r, 284 U.S. 552 (1932).

statute would incline the scale to the construction most favorable to the taxpayer."[38] In other cases, the Supreme Court upheld the principle that "[i]f the words [of a statute] are doubtful, the doubt must be resolved against the [g]overnment and in favor of the taxpayer."[39]

Not long after these cases, the Supreme Court abandoned a strict interpretation of tax statutes and shifted to an attitude of construing tax laws liberally so as to prevent a taxpayer from avoiding tax through her chosen method of stock disposition.[40] All of the major modern judicial doctrines are rooted in a series of early Supreme Court decisions. In those early cases, the Supreme Court did not delineate clearly between the different doctrines and used doctrine-specific language interchangeably.

A. Common Roots of the Judicial Doctrines

In *Gregory v. Helvering*, often classified as one of the earliest Supreme Court cases defining judicial doctrines, the Court decided that the transaction at issue was entered into without a business purpose and thus was not a reorganization as the term was used in the statute.[41] The Court's language in *Gregory* demonstrates both how the Court understood the transaction and how the Court was unwilling to rely on a literal reading of the statutory language. First, the Court found that the transaction was

> [s]imply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares . . . .[42]

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38. *Id.* at 561 (citations omitted).

39. United States v. Merriam, 263 U.S. 179, 188 (1923) (income tax); *see also* Miller v. Standard Nut Margarine Co., 284 U.S. 498, 508 (1932) (excise tax).

40. *See* Gregory v. Helvering, 293 U.S. 465 (1935) (Helvering was the Commissioner of Internal Revenue. At that time, the last name of the Commissioner was used in case names. More recent cases use the title "Commissioner."); *see also* John F. Cloverdale, *Text As Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501, 1522 (1997) (quoting Crooks v. Harrelson, 282 U.S. 55, 61 (1930) to show the Court's former practice of strict construction—a trend replaced by liberal construction in the government's favor).

41. *See Gregory*, 293 U.S. at 469. *See generally* Yoram Keinan, *The Economic Substance Doctrine*, 47 TAX MGMT. MEMORANDUM 259 (June 26, 2006); BITTKER AND LOKKEN, *supra* note 5, ¶ 4.3 (Pervasive Judicial Doctrines).

42. *Gregory*, 293 U.S at 469.

The Court then held that although the taxpayer's motivation to avoid taxation "will not alter the result or make unlawful what the statute allows," the transaction was not a "reorganization" within the meaning of the statute because

> [t]he whole undertaking, though conducted according to the terms of [the applicable statute], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.[43]

The Court held in favor of the Commissioner and, in the process, denominated the substance over form doctrine by describing the Commissioner's position in the following manner: "the reorganization attempted was without substance and must be disregarded."[44]

Interestingly, Judge Hand authored the Second Circuit opinion in *Helvering v. Gregory*. He began by noting, in language that he would revisit in future opinions, that "[a]ny one may so arrange his affairs that his taxes shall be as low as possible."[45] As he continued, however, he eviscerated any notion of strictly construing a tax statute against the government. After accepting the principle that there was "not even a patriotic duty to increase one's taxes," Judge Hand made an about-face and stated,

> Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition . . . the meaning of a sentence may be more than that of the separate words . . . and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.[46]

Judge Hand concluded by highlighting the purpose of the statute:

> The purpose of the section is plain enough; men engaged in enterprises . . . might wish to consolidate . . . their holdings . . . .

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43. *Id.* at 470.
44. *Id.* at 467.
45. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd sub nom.* Gregory v. Helvering, 293 U.S. 465 (1935).
46. *Id.* at 810–11.

> But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand . . . . To dodge the shareholders' taxes is not one of the transactions contemplated as corporate reorganizations.[47]

Thus, Judge Hand held that a transaction might satisfy a plain reading of each word of the statute and still be invalid because the transaction evades the purpose of the statute.

A few years later, in *Commissioner v. Court Holding Co.*,[48] the Supreme Court denominated both the substance over form and the step transaction doctrines. In *Court Holding Co.*, the taxpayer-corporation was wholly owned by a husband and wife.[49] The husband and wife negotiated on behalf of the taxpayer-corporation for the sale of taxpayer-corporation's only asset, an apartment building, to the lessees of the building.[50] After the sale negotiations were complete and an oral agreement was reached, the corporation's attorney realized that a sale by the corporation would result in a large tax on the corporation.[51] Therefore, the parties decided to liquidate the corporation, distribute its assets, and the husband and wife would surrender its stock.[52] The parties took these steps, and the corporation deeded the property to the husband and wife.[53] They then sold the apartment building in their marital capacity to the lessees, applying a payment of $1,000 from the lessees to the corporation to discount the purchase price.[54] The Court held that the corporation had, in fact, sold the property.[55]

The Court, again, used broad language to describe the determination of the tax consequences of transactions. The Court began by noting that "[t]he incidence of taxation depends upon the substance of a transaction."[56] The Court continued:

> The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be

47. *Id.* at 811.
48. Comm'r v. Court Holding Co., 324 U.S. 331 (1945).
49. *Id.* at 332.
50. *Id.* at 333.
51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.*
55. *Id.* at 333–34.
56. *Id.* at 334.

> viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant.[57]

The Court then stated,

> A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.[58]

In these few sentences, the Court not only created—and conflated—the substance over form and step transaction doctrines, but it also raised the important questions asked when determining whether either of these doctrines applies in a given case and when determining the contour of the doctrines themselves.

Finally, the Court insisted on the primacy of "substance" over "mere formalisms."[59] The Court disregarded the account of the transaction provided by a legal document—the title to the property—because tax consequences did not necessarily follow the non-tax legal structure, especially when one party acted as a conduit for another party.[60] The Court insisted that a transaction should be viewed holistically, although each step is relevant.[61]

B. The Step Transaction Doctrine

Although the step transaction doctrine originated in the same jurisprudence as the other judicial doctrines, the step transaction doctrine has its own specific heritage and requirements. In one of the earliest cases, the Board of Tax Appeal, the forerunner of the Tax Court, framed the doctrine as an interpretive device for giving effect to the words of the statute.[62] The Board stated that "the phrase 'in connection with a reorganization' permits, if it does not require, an examination of the several steps taken which culminated in the taxpayer's acquisition of the . . . assets."[63] The Board proceeded to describe the plan for the acquisition of

57. *Id.*
58. *Id.* (footnote omitted).
59. *Id.*
60. *See id.*
61. *See id.*
62. Warner Co. v. Comm'r, 26 B.T.A. 1225 (1932).
63. *Id.* at 1228.

the assets and examine its "substance and effect."[64] The Board ultimately concluded that the steps of the petitioner's plan were separate and rejected the Commissioner's assertion that the steps were all part of a single plan of reorganization.[65]

An early Supreme Court case articulated the purpose of the step transaction doctrine: "A given result at the end of a straight path is not made a different result because reached by following a devious path."[66] The step transaction doctrine requires that a "transaction must be viewed as a whole" when a series of steps is used to "consummat[e] a sale" or otherwise complete a business transaction.[67] The step transaction doctrine is necessary because the point at which one business transaction begins and another ends never is clearly defined.[68] Time, however, is not the only factor; the doctrine has been applied to events that are as far apart in time as five years, and courts have declined to apply the doctrine to events spanning only 30 minutes apart.[69]

The courts apply three primary tests when determining whether to apply the step transaction doctrine: (1) the binding commitment test; (2) the interdependence test; and (3) the end result test.[70]

1. The Binding Commitment Test

The classic fact pattern for the binding commitment test is the two-step merger described in Revenue Ruling 2001-46.[71] In that ruling, two fact patterns existed with the same two steps: the merger of a subsidiary of the acquirer into the target corporation followed by the merger of the surviving target corporation into the acquiring corporation.[72] These steps comprised an "integrated plan."[73] The parties agreed in advance that both steps would take place and that the second step would immediately follow

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64. *See id.*

65. *Id.*

66. Minn. Tea Co. v. Helvering, 302 U.S. 609, 613 (1938).

67. Comm'r v. Court Holding Co., 324 U.S. 331, 334 (1945); *see also* Gregory v. Helvering, 293 U.S. 465, 469–70 (1935).

68. BITTKER & LOKKEN, *supra* note 5, ¶ 4.3.5, at 4-48.

69. *Id.* ¶ 4.3.5., at 4-50 n.93 (citing Douglas v. Comm'r, 37 B.T.A. 1122 (1938); Henricksen v. Braicks, 137 F.2d 632 (9th Cir. 1943)).

70. *See* Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1521–23 (10th Cir. 1991); Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1244–45 (5th Cir. 1983); *see also* BITTKER & LOKKEN, *supra* note 5, ¶ 4.3.5, at 4-50 & n.91 (discussing the interdependence test).

71. Rev. Rul. 2001-46, 2001-2 C.B. 231.

72. *See id.*

73. *See id.*

the first.[74] The first step would not have occurred without the second step.[75] A second fact pattern that implicates the binding commitment test is when the board of directors passes a resolution to accomplish in two steps something that could be accomplished just as easily in a single step.[76]

2. The Interdependence Test

Courts apply the interdependence test to combine separate steps that are "so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series" and in which "it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts."[77] In *Security Industrial Insurance Co. v. United States*, the court of appeals applied the interdependence test in a situation in which an insurance company acquired two target corporations for cash through a series of steps—very similar in each transaction—that the acquiring insurance company claimed qualified first as a purchase of shares and second as a reorganization under § 368(a)(1)(F).[78] E.J. Ourso was the controlling shareholder and chief executive officer of taxpayer Security Industrial Insurance Co. ("Security").[79] Security's primary growth strategy was acquisition of rivals.[80] The taxpayer decided to target Southern Life Insurance Co. ("Southern") for acquisition.[81] Lenders would not finance the acquisition, however, because of a deficit in Security's insurance accounting.[82] Ultimately, a lender was found, but the lender required that Ourso form a holding company, Ourso Investment Co. ("OIC"), and demanded as collateral for the loan the stock of OIC and Security as well as a personal guarantee from Ourso.[83] In addition to owning shares of the taxpayer, OIC owned funeral homes and real estate.[84] On December 9, 1970, the majority shareholders of Southern and OIC executed a purchase agreement for the Southern shares.[85] During their

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74. *Id.*
75. *Id.*
76. *See, e.g.*, Minn. Tea Co. v. Helvering, 302 U.S. 609, 611–13 (1938).
77. Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1244–45 (5th Cir. 1983) (quoting PAUL & ZIMET, *supra* note 28, at 254).
78. *Id.* at 1236–38.
79. *Id.* at 1236–37.
80. *See id.* at 1246.
81. *Id.* at 1237.
82. *Id.*
83. *Id.*
84. *Id.*
85. *Id.*

meeting on January 2, 1971, OIC's directors "resolved to acquire the Southern shares, to borrow the necessary funds from Security and the Bank, and to liquidate Southern and reinsure its outstanding policies following the acquisition."[86] Within the next few days, OIC purchased all of Southern's stock, and Ourso was appointed as liquidator of Southern.[87] Ourso, as liquidator, entered into a reinsurance agreement with Security, and Security assumed all of Southern's outstanding policies and received from Southern sufficient assets to reserve against the assumed risks.[88] Security also agreed to pay OIC in consideration for OIC's consent to Security's reinsurance agreement with Southern.[89] In January 1971, Southern's assets and liabilities were transferred from its books onto OIC's books.[90] OIC then converted Southern's surplus and net worth into cash, used the proceeds to pay off a portion of OIC's loan, and transferred Southern's assets to Security.[91] In June 1971, Southern filed its final federal tax return, and Southern was dissolved under state law in December 1971.[92]

During the summer and fall of 1971, Security used similar methods to acquire Standard Life Insurance Co. ("Standard").[93] On October 19, 1971, OIC's directors "resolved to acquire the Standard shares, to borrow the funds necessary to finance the purchase, and to liquidate Standard and reinsure its outstanding policies following the acquisition."[94] OIC became Standard's sole shareholder within a week and resolved to liquidate Standard, appoint Ourso as liquidator, and reinsure Standard's policies with Security.[95] Security and OIC entered into an agreement, which provided for payments from Security to OIC as consideration for consent to a reinsurance agreement between Security and Standard.[96] At the end of 1971, "Standard's assets and liabilities were transferred onto OIC's books."[97] In April 1972, Standard filed its final federal tax return, and in May 1972, Standard was dissolved under state law.[98]

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86. *Id.*
87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.* at 1238.
94. *Id.*
95. *Id.*
96. *Id.*
97. *Id.*
98. *Id.*

The issue in the case was whether the purported tax-free corporate reorganizations satisfied the continuity of interest requirement, which provides that the owners of the acquired corporation must retain equity interests in the surviving corporation after a reorganization.[99] The requirement is intended to prevent taxpayers from receiving tax-free treatment for the sale of a corporation for cash.[100] The taxpayer argued—and the district court agreed—that continuity of interest should be tested at the time of the merger of Southern and Standard into Security.[101] At that point, OIC owned 100% of all of the corporations involved.[102] The government argued that the stock purchases and reinsurance agreements entered into by OIC were all intermediate steps that were part of the same plan to purchase Southern and Standard for cash and not to effectuate reorganizations.[103] The government pointed out that at the end of all of the transactions, all of the former shareholders of Southern and Standard received only cash and did not have equity interests in OIC or Security.[104]

The court of appeals provided a clear articulation of the business and economic underpinnings of the interdependence test. The court noted that the purpose of the test was to determine "whether the individual steps in a series had independent significance or whether they had meaning only as part of the larger transaction."[105] The court then stated that it would "examine this tandem of transactional totalities to determine whether each step had a reasoned economic justification standing alone."[106] The court commented that the transactions in this case were "dependent for [their] success" upon each other and were "meaningless" in isolation.[107] The court of appeals found that the holding company was a mere shell.[108] The court further found that the purchases of the two targets would have been impossible without liquidating them because the bank financing agreements were dependent on the reinsurance agreements and contingent payment agreements.[109] Without the reinsurance agreements and contingent payment agreements, the holding company would not have

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99. *Id.* at 1243 (citing Treas. Reg. § 1.368–2(a) (2015)).
100. *Id.*
101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*
105. *Id.* at 1246.
106. *Id.* at 1247.
107. *Id.*
108. *Id.*
109. *Id.*

been able to satisfy its debt to the bank.[110] Therefore, the court held that the transactions could not be separated into a stock purchase and an F Reorganization.[111] Rather, they were properly treated holistically as an asset sale.[112] Thus, what actually occurred was an asset sale, triggering certain insurance taxes based upon inclusion of income from policyholders' surplus accounts.[113]

3. The End Result Test

The end result test examines the intent of the parties, and "purportedly separate transactions are to be amalgamated when the successive steps were designed and executed as part of a plan to achieve an intended result."[114] In *Security Industrial Insurance Co.*,[115] the court applied both the end result test and the interdependence test.[116] In applying the end result test to the facts of the case, the court noted that there were a large number of intermediate steps before the final corporate structure was achieved but that "all these machinations cannot disguise the fact that the intended result of each series of transactions was the acquisition of [the target insurance companies'] assets by [the acquiring insurance company]."[117] The court further stated that the acquiring insurance company and its parent holding company "left a clear and well-documented paper trail to this effect" and that the acquiring insurance company had pursued a strategy of acquiring rivals for cash in an "identical" fashion for over 20 years through the same method of "liquidate the rival company and gobble up the assets."[118]

In one of the most frequently cited and debated cases involving the application of the end result test,[119] *King Enterprises, Inc. v. United States*,

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110. *Id.*

111. *Id.* An F Reorganization is "a mere change in identity, form, or place of organization of one corporation . . . ." I.R.C. § 368(a)(1)(F) (2012).

112. *Sec. Indus. Ins. Co.*, 702 F.2d at 1247–48.

113. *Id.* at 1250.

114. *Id.* at 1246 (quoting King Enters., Inc. v. Comm'r, 418 F.2d 511, 516 (Ct. Cl. 1969)).

115. *See supra* notes 77–113 and accompanying text.

116. *Sec. Indus. Ins. Co.*, 702 F.2d at 1245–48.

117. *Id.* at 1246.

118. *Id.*

119. *See* Rev. Rul. 2001-26, 2001-1 C.B. 1297; Rev. Rul. 2001-46, 2001-2 C.B. 321; Jeffrey L. Kwall & Kristina Maynard, *Dethroning* King Enterprises, 58 TAX LAW. 1 (2004) [hereinafter Kwall & Maynard, *Dethroning*]; Jasper L. Cummings, Jr., *Something Old, Something New, and Something Fairly New*, 106 TAX NOTES 1093 (2005); Jeffrey L. Kwall & Kristina Maynard, *We Still Don't*

the taxpayer was a corporation that, at the time of trial, held and managed various investments but previously had been a seller of roasted coffee.[120] It also previously was one of 11 shareholders of Tenco, Inc. ("Tenco"), a producer of soluble coffee.[121] At that time, Minute Maid Corporation ("MM"), a producer of frozen concentrated citrus juices, was looking to acquire corporations in other industries to stabilize its income.[122]

Between January and July 1959, MM made three separate proposals to the directors of Tenco to acquire Tenco's stock.[123] Tenco's directors rejected all three proposals.[124] On August 25, 1959, the two boards approved a fourth proposal.[125] On September 3, 1959, MM and the Tenco board and shareholders signed a purchase and sale agreement.[126] At closing, the Tenco shareholders received "$3,000,000 in cash, $2,550,000 in promissory notes, and 311,996 shares of [MM] stock valued at $5,771,926."[127] The taxpayer's "share of the total consideration consisted of $281,564.25 in cash, $239,329.40 in promissory notes, and 29,282 shares of Minute Maid stock valued at $541,717."[128] In total, the Tenco shareholders received MM stock representing more than 50% of the value of the aggregate consideration received in the acquisition, which represented approximately 15% of the outstanding MM stock.[129]

On December 10, 1959, the MM directors approved a November 24 recommendation of MM's general counsel to merge MM's four subsidiaries, including Tenco, into MM.[130] The merger was to be submitted to MM stockholders for approval at a meeting scheduled for February 1960.[131] MM announced the merger in its annual report to stockholders in December 1959.[132] On February 25, 1960, the Commissioner ruled favorably[133] that the liquidation of Tenco would qualify as a subsidiary

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Like King Enterprises, 106 TAX NOTES 1329 (2005) [hereinafter Kwall & Maynard, *We Still Don't Like*].

120. King Enters., Inc. v. Comm'r, 418 F.2d 511, 513 (Ct. Cl. 1969).

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.* at 513–14.

129. *Id.* at 514.

130. *Id.*

131. *Id.*

132. *Id.*

133. The IRS has a procedure called a private letter ruling. *See* Rev. Proc. 2017-1, 2017-1 I.R.B. 1. A taxpayer may ask the IRS to provide guidance

liquidation under then-existing § 332, and, therefore, the basis of the property received by MM would be determined based on MM's basis in its Tenco stock pursuant to then-existing § 334.[134] On April 30, 1960 and May 2, 1960, Tenco and other subsidiaries were merged into MM.[135] For the fiscal year ending on June 30, 1960, the taxpayer reported the cash and notes received as dividend income subject to the intercorporate dividends received deduction.[136]

Taxpayer King Enterprises, Inc. took the position that the MM stock was received in connection with a nontaxable corporate reorganization.[137] The IRS contended that the stock was received in exchange for a sale of a capital asset.[138] The court found for the taxpayer and held that the ultimate merger of Tenco into MM was "the intended result of the transaction in question from the outset" and "the initial exchange of stock constitut[ed] a mere transitory step."[139] The court provided the classic articulation of the end result test: "purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."[140] The court inferred the result in this case even though it admitted that no explicit testimony existed in the record that showed that, at the time of the initial purchase, the Tenco shareholders knew that MM intended to consummate an upstream merger after the purchase.[141] The court noted that the merger took place too close to the acquisition to believe that the parties did not intend the merger and acquisition to be part of the same plan.[142] The court also implicitly rejected the notion that taxpayers may apply only the "binding commitment test"

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regarding the tax consequences of a transaction in advance of the transaction. *See id.* The taxpayer must provide a full disclosure of all relevant facts and provide a description of the relevant law and legal reasoning supporting the requested tax treatment. *See id.*

134. *King Enters.*, 418 F.2d at 514.

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.* at 519.

140. *Id.* at 516 (citation omitted).

141. *Id.* at 519.

142. *See id.* The court did not conclude that some sort of detailed plan existed; the court concluded only that "[i]t strains credulity, however, to believe other than that the plan to merge was something more than inchoate, if something less than announced, at the time of such exchange." *Id.*

when asserting the step transaction doctrine "offensively," but the IRS may apply any of the tests.[143]

The end result test also is applied in, and well-suited for, cases involving related entities, especially those under common control with one, or very few, owners. Without need for interrelated documentation, the owners of such entities can separate transactions into multiple tax-advantaged steps while still achieving the same economic outcome. *True v. United States*[144] is a good example of related party dealings.

In *True v. United States*, taxpayers—all members of the same family—controlled several entities, including True Ranches, Smokey Oil Co., and True Oil Co.[145] True Ranches was a partnership engaged in ranching and other activities.[146] Smokey Oil Co. was a corporation engaged in oil and gas production and exploration.[147] True Oil Co. was a partnership engaged in oil and gas production and exploration.[148] In several similar transactions, the entities controlled by the Trues acquired certain ranch properties.[149] First, Smokey Oil Co. would purchase the parcels.[150] Then, True Ranches would acquire the operating assets of the ranch that sat on each parcel.[151] Subsequently, Smokey Oil Co. would transfer the parcels to True Oil Co. in exchange for existing oil and gas leases.[152] True Oil Co. then distributed the parcels to the family members as tenants in common.[153] As the final step in the transactions, the family members contributed their undivided interest in the parcels to True Ranches.[154]

The taxpayers claimed that the transactions should be characterized as an acquisition of the parcels, followed by a tax-free like-kind exchange pursuant to Code § 1031, followed by a tax-free contribution to a

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143. *See id.* at 517 ("[T]he Government correctly points out that there was no binding commitment for the merger of Tenco to follow the acquisition of its stock. Defendant [the United States] erroneously concludes, however, that the absence of such a [binding] commitment here renders the step transaction doctrine inapplicable.").

144. True v. United States, 190 F.3d 1165 (10th Cir. 1999).

145. *Id.* at 1168.

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.* at 1168–69.

154. *Id.* at 1169.

partnership pursuant to Code §§ 721 and 731.[155] A taxpayer's basis in assets received in a like-kind exchange equals the basis of the asset that taxpayer exchanged.[156] Therefore, under the taxpayers' theory, the result of this series of transactions was that Smokey Oil Co. received depletable oil and gas leases with the same basis as it had in the land it had acquired.[157] At the same time, the land which was now held by the partnership had a zero basis because the oil and gas leases already were fully depleted and had a zero basis.[158] Thus, Smokey Oil Co. was able to claim depletion on assets that already had been fully depleted after it received such assets in exchange for non-depreciable assets, that is, land.[159]

The court highlighted that the Trues admitted that their intent "from the beginning" was "to ultimately place the ranch properties in the hands of True Ranches."[160] The court dismissed the taxpayers' argument that Smokey Oil Co. had more liquid assets to acquire the parcels, and, thus, there was some business purpose and economic effect to the structure that precluded application of the step transaction doctrine.[161] The court held that although the "absence of economic effects or business purposes may be fatal to a taxpayer's step transaction" argument, the existence of a "business purpose[] by itself does not preclude application of the step transaction doctrine."[162] The court emphasized that no apparent business purpose existed in Smokey Oil Co. and True Oil Co. being involved in the purchase of ranchlands as neither of these companies were in the ranching business.[163]

4. The Relationship Between the Three Tests

In *McDonald's Restaurants of Illinois v. Commissioner*,[164] the court concluded that the transaction at issue should be stepped together—that is, combined pursuant to the step transaction doctrine—under each of the

155. *Id.*
156. I.R.C. § 1031 (2012).
157. *True*, 190 F.3d at 1169.
158. *Id.*
159. *Id.*
160. *Id.* at 1178.
161. *Id.*
162. *Id.* at 1177 (citations omitted).
163. *See id.* at 1178–79.
164. McDonald's Rests., Inc. v. Comm'r, 688 F.2d 520 (7th Cir. 1982).

three tests.[165] The court both defined and applied each of the three tests.[166] It held that the district court applied each test properly to step together the transaction at issue.[167] The court provided a classic alternative hypothetical definition of the interdependence test and broader definition of the binding commitment test.[168] The taxpayers in *McDonald's Restaurants of Illinois* were 27 wholly owned subsidiaries of McDonald's Corporation ("McDonald's").[169] The issue was whether the acquisition of the 27 subsidiaries was a tax-free reorganization followed by a sale of shares by the former owners of the subsidiaries—at the time, independent franchises—or simply one integrated sale of the independent franchises for cash.[170] The court held that the acquisition was a sale for cash because of the ability of the shareholders to register their shares and the connection of that registration to a desire to cash out their interests in McDonald's.[171]

The Garb-Stern group, the owners of the independent franchises, had significant disagreements with McDonald's.[172] McDonald's wanted to acquire the independent franchises in a way that would allow it to use a "pooling of interests" for accounting purposes.[173] McDonald's could use only the "pooling of interests" method of accounting if all of the interests were acquired in one transaction for stock.[174] The Garb-Stern group, however, wanted cash for its interests.[175] The Garb-Stern group companies merged into McDonald's in a Delaware statutory merger on April 1, 1973.[176] The assets received in the merger were transferred to the 27 subsidiaries, the taxpayers in the case.[177] The Garb-Stern group received 361,235 shares of unregistered common stock.[178] The Garb-Stern group was entitled to participate in the anticipated June 1973 registration and in any other registration that might occur within six years of the closing.[179] The Garb-Stern group also had a one-time right to force registration if McDonald's did not seek registration

165. *Id.* at 524.
166. *Id.* at 524−25.
167. *Id.*
168. *Id.*
169. *Id.* at 521.
170. *Id.* at 522–23.
171. *Id.* at 525, 527.
172. *Id.* at 521.
173. *Id.*
174. *Id.*
175. *Id.*
176. *Id.* at 522 & n.4.
177. *Id.* at 522.
178. *Id.*
179. *Id.*

within one year of the closing.[180] The June registration was postponed because of a negative report about McDonald's stock, and the shares ultimately were registered as part of a registration announced on September 17 and completed on October 3.[181] The price per share was $60 immediately before the time that the June registration was to take place.[182] The share price dropped to $52 after the negative report.[183] The Garb-Stern group ultimately sold almost all of its shares after the registration for more than $71 per share.[184]

The court quoted *King Enterprises* for its definition of the end result test.[185] The court held that "there can be little doubt that all the steps were taken to cash out the Garb-Stern group,"[186] even though the court noted that "McDonald's sought to do so in a way that would enable it to use certain accounting procedures."[187] The court acknowledged that it derived its conclusion from the "history of the parties' relationships, the abortive attempt to buy some of the group's holdings, the final comprehensive deal, and the Garb-Stern group's determination to sell out even in the face of falling prices in the stock."[188]

The court cited *Redding v. Commissioner* for its definition of the interdependence test: "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."[189] The court of appeals criticized the Tax Court for limiting the interdependence test to circumstances in which the Garb-Stern group would have been "legally bound to sell its stock."[190] The court provided that the interdependence test is "more practical and less legalistic than that" and that the test "concentrates on the relationship between the steps."[191] The court applied the interdependence test to "ask whether the merger would have taken place without the guarantees of saleability, and

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180. *Id.*
181. *Id.*
182. *Id.*
183. *Id.*
184. *Id.*
185. *Id.* at 524.
186. *Id.*
187. *Id.* (footnote omitted).
188. *Id.* (footnote omitted).
189. *Id.* (citing Redding v. Comm'r, 630 F.2d 1169, 1177 (7th Cir. 1980) (quoting RANDOLPH E. PAUL, SELECTED STUDIES IN FEDERAL TAXATION 200, 254 (2d Series 1938))).
190. *Id.*
191. *Id.*

the answer is certainly no."[192] The court emphasized the Garb-Stern group's "insistence" on saleability as shown by its "historic stance" in the negotiations and the terms of the agreement.[193] The court also emphasized the Garb-Stern group's "one-time right to force registration" and therefore found that "free transferability" was the "*quid pro quo* of the merger agreement."[194]

Finally, the court broadened the binding commitment test to appear more like the interdependence test.[195] The court found that the right to force registration—and the fact that this right would be lost if the Garb-Stern group did not register when given the opportunity—meant that a sale was "extremely likely" to "take place promptly."[196] Thus, the court substituted likelihood of certain actions occurring for a legally enforceable obligation to take those actions.[197]

The court explicitly criticized the Commissioner's position as potentially putting future taxpayers in a double bind and creating "heads-I-win, tails-you-lose law."[198] The court commented that to receive an advance ruling on reorganization treatment, taxpayers must represent that "there is 'no plan or *intention* on the part of the Acquired shareholders to [reduce their new holdings] to a number of shares having, in the aggregate, a value of less than 50[%] of the total value of the Acquired stock outstanding immediately prior to the proposed transaction.'"[199] Furthermore, the court stated that if the reorganization status were available "without constraining post-merger sales," many new opportunities would exist for manipulative and aggressive tax planning, which, the court noted, tax advisors already were advertising after the Tax Court's decision and prior to reversal.[200]

In *Heintz v. Commissioner*,[201] the court separated a series of transactions that took place over three days.[202] The taxpayers were former owners of a corporation ("target corporation") that primarily produced aircraft starters and other goods for the Armed Forces during World War II.[203] The taxpayers felt that the corporation would be unable to transition

192. *Id.*
193. *Id.*
194. *Id.* at 524−25.
195. *Id.* at 525.
196. *Id.*
197. *Id.*
198. *Id.* at 528.
199. *Id.* (emphasis added) (quoting the brief for appellants).
200. *Id.*
201. Heintz v. Comm'r, 25 T.C. 132 (1955).
202. *Id.* at 140−43.
203. *Id.* at 133.

to civilian production, so they decided to search for a purchaser.[204] The taxpayers could not locate a buyer willing to pay all cash at their desired purchase price of $8 million.[205] The best offer that they could find was for $5.5 million in cash and $2.5 million of preferred stock.[206] As part of the negotiations, the purchasing corporation suggested that the target corporation should merge into the purchasing corporation.[207] The taxpayers objected with concerns related to tax consequences, but representatives of the purchasing corporation reassured the taxpayers that the tax benefits would outweigh any tax costs.[208]

A merger agreement was drafted and dated March 5, 1946.[209] The purchasing corporation adopted the agreement on February 27, 1946; the target corporation adopted the agreement on March 2, 1946.[210] On March 4, 1946, the parties signed a stock purchase agreement for the sale of the stock of the target corporation to the purchasing corporation for the cash and preferred stock.[211] On March 5, 1946, a formal closing was held for the stock purchase agreement.[212] That same day, the previously ratified merger agreement was executed.[213] The merger was completed on March 6, 1946.[214]

The court held that the sale and merger were separate transactions.[215] Therefore, under the tax law at that time, the taxpayers were entitled to treat the sale of the stock of the target corporation as capital gains.[216] If the two transactions had been stepped together, that is, combined pursuant to the step transaction doctrine, the gains would have been ordinary income.[217]

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204. *Id.* at 134.
205. *Id.*
206. *See id.*
207. *Id.* at 135.
208. *Id.*
209. *Id.* at 136.
210. *Id.*
211. *Id.*
212. *Id.* at 138.
213. *Id.*
214. *Id.*
215. *Id.* at 142−43.
216. *Id.*
217. *Id.* at 141.

5. Recent Cases Applying the Doctrine

The step transaction doctrine has been applied by courts in recent cases in a variety of transactions.[218] In *Linton v. United States*, the Ninth Circuit addressed the application of the step transaction doctrine in the context of a gift of LLC interests to trusts.[219] After Mr. Linton formed his LLC, WLFB Investments, and created four trusts for his children, two main transactions occurred: (1) the contribution of cash, securities, and real property to the LLC; and (2) the assignment of interest of the LLC to the four trusts.[220] Tax filings showed that contributions were made to Mr. and Mrs. Linton's individual capital accounts in the LLC equally.[221] Filings also showed a transfer of capital from these accounts with a "commensurate" increase of capital in the trust accounts.[222] The Lintons claimed the transfers as gifts of "percentage interest" in WLFB.[223] The WLFB ledger also showed the capital contribution to the LLC and then transfers of percentage interest to the children's trusts.[224] Finally, a share valuation report showed an interest in the LLC was transferred to the children's trusts.[225] The Lintons' tax returns showed the date of the transfers of percentage interest in the LLC as January 31, 2003.[226] Their accounting firm's share valuation report showed the same date.[227] The dates in the company's ledger documenting the transactions, however, were left blank.[228] The district court granted summary judgment on the basis of its finding that because the trusts and the LLC were created at the same time—January 22, 2003—the contributions of the capital to the LLC were made either at the same time or after the gifts of interest in the LLC were granted, making the transfers indirect gifts of cash or property to the trusts.[229]

The court of appeals analyzed all three tests of the step transaction doctrine.[230] Under the end result test, the court considered the Lintons' intent and contemplated whether the Lintons reached their intended result

218. *See infra* notes 219–251 and accompanying text.
219. Linton v. United States, 630 F.3d 1211 (9th Cir. 2011).
220. *Id.* at 1213.
221. *Id.* at 1214.
222. *Id.*
223. *Id.* at 1213.
224. *Id.* at 1214.
225. *Id.*
226. *Id.*
227. *Id.*
228. *Id.*
229. *Id.* at 1215.
230. *Id.* at 1223–24.

of transferring ownership interest to their children.[231] The court found that they did reach their desired end result.[232] Under the interdependence test, the court analyzed whether the "legal relations created by one transaction would have been fruitless without a completion of the series."[233] The court compared the Lintons' transaction to a "bona fide" business transaction and found the placing of assets into an LLC "reasonable . . . with or without any subsequent gift."[234] Finally, the court did not find that the binding transaction test applied because the test applied to "transactions spanning several years," which was not the case here.[235] The court concluded that the IRS was not entitled to summary judgement based on the step transaction doctrine and remanded the case to the district court.[236]

Superior Trading, LLC v. Commissioner[237] was a consolidated case concerning many companies and taxpayers involved in distressed asset/debt ("DAD") transactions.[238] Warwick, LLC ("Warwick") entered into an agreement to purchase past due accounts receivable from a Brazilian consumer goods company, Lojas Arapua, S.A. ("Arapua").[239] Warwick assigned interest in the Arapua accounts to 14 different trading companies in exchange for a 99% interest in those companies.[240] Warwick sold interests in the trading companies to United States investors through "another set of limited liability companies (holding companies)" by transferring "virtually" all of its membership interest to the corresponding holding company.[241] Warwick, the holding company, and the trading companies elected to be treated as partnerships for their income tax returns and claimed a basis in the payment receivables from Arapua equal to the face amount.[242] Soon after the Arapua-Warwick transaction, Arapua "redeemed" itself from the partnership it formed with Warwick, but the holding companies nonetheless used the face amount of the distressed

231. *Id.* at 1224.
232. *Id.*
233. *Id.* (quoting Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1523 (10th Cir. 1991)) (quotation marks omitted).
234. *Id.*
235. *Id.* at 1225.
236. *Id.*
237. Superior Trading, L.L.C. v. Comm'r, 137 T.C. 70 (2011).
238. *Id.* at 71–73.
239. *Id.* at 73. Warwick also acquired the accounts receivable with postdated checks. *Id.* at 76.
240. *Id.* at 74.
241. *Id.*
242. *Id.*

assets as basis in the receivables.[243] United States taxpayers with membership in the various holding companies also claimed losses.[244]

The court held that Warwick did not have a basis in the Arapua accounts receivable because it could not substantiate the payments it made to Arapua.[245] The court analyzed the transactions under all three step transaction doctrine tests.[246] The court characterized the tests by their degrees of "permissiveness" of "subject[ing] the transaction's many twists and turns" to the court's analysis from least permissive to most: the binding commitment test, the end result test, and the interdependence test.[247] Under the binding commitment test, the court analyzed whether Arapua was assured of its redemption after the contribution of account receivables.[248] The court found that although the next step—the redemption—was necessary so that the tax losses were not Arapua's, not enough time passed between the transactions for this test.[249] The court then applied the end result test and found that "arranging . . . [the] tax benefits required the carefully choreographed entry and exit of Arapua."[250] The court also found that the interdependence test was appropriate in this case, reasoning that the intermediate steps in this case can be "properly collapsed into a single transaction" because the redemption did not fit the legitimate purpose analysis and the transaction between Arapua and Warwick could just as well have been a sale.[251]

C. Critical Responses to the Step Transaction Doctrine

Critics of the step transaction doctrine fall broadly into three categories: (1) those that criticize specific applications or interpretations of one or more of the three tests;[252] (2) those that question the existence of one or more of the three tests;[253] and (3) those that suggest an entirely new

243. *Id.* at 77−78.
244. *Id.* at 78.
245. *Id.* at 90. The court also noted that Warwick technically had a basis but that the basis was no greater than the sum of payments made to Arapua, but Warwick was unable to substantiate them. *Id*.
246. *Id.* at 87–90.
247. *Id.* at 88.
248. *Id.* at 89.
249. *Id.*
250. *Id.* at 90.
251. *Id.*
252. *See generally* Kwall & Maynard, *Dethroning*, *supra* note 119.
253. *See generally* Stephen S. Bowen, *The End Result Test*, 72 TAXES 722 (1994).

test to replace the current system of tests.[254] The criticisms of some opponents fall into only one of the categories; others advocate criticisms from multiple categories.[255]

1. Test Application Criticisms

The binding commitment test is the most restrictive of the three step transaction tests. In cases like *Minnesota Tea Co.*, a stockholders' resolution evidencing a clear plan exists,[256] and in Revenue Ruling 2001-46, an "integrated plan" provides for both steps.[257] The test requires that "if one transaction is to be characterized as a first step, there [is] a binding commitment to take the later steps."[258] The binding commitment test has been criticized as being too narrow in scope, failing to recharacterize too many multi-step transactions concocted for tax evasion as a single transaction.[259] One court noted that "the step transaction doctrine would be a dead letter if restricted to situations where the parties were *bound* to take certain steps."[260] One commentator stated that a binding commitment sufficiently justifies an application of the step transaction doctrine, but this commentator also indicates that broad agreement exists that it should not be the only test.[261] Another commentator has argued that, other than in the case in which it was originally applied, the binding commitment test mostly has been explained away and not applied by succeeding courts.[262] Finally, and most problematically, other commentators have provided that the binding commitment test is limited sometimes to situations in which the taxpayer is attempting to use the step transaction doctrine offensively.[263] In other words, in the view of some courts and scholars, the IRS is permitted to assert the step transaction doctrine to recharacterize a transaction on the basis of any test, but if the taxpayer wants to assert the step transaction doctrine to characterize a series of steps it took as a single transaction,

254. *See generally* Rosenberg, *supra* note 26.
255. *See* Bowen, *supra* note 253, at 723−27.
256. Minn. Tea Co. v. Helvering, 302 U.S. 609, 611 (1938).
257. Rev. Rul. 2001-46, 2001-2 C.B. 321.
258. McDonald's Rests., Inc. v. Comm'r, 688 F.2d 520, 525 (7th Cir. 1982) (quoting Redding v. Comm'r, 630 F.2d 1169, 1178 (7th Cir. 1980)).
259. *See supra* notes 248–252 and accompanying text.
260. King Enters., Inc. v. United States, 418 F.2d 511, 518 (Ct. Cl. 1969) (emphasis added).
261. Bowen, *supra* note 253, at 723.
262. Rosenberg, *supra* note 26, at 406.
263. *See* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 12.61[3] (7th ed. 2000 & Supp. 2015-02).

ostensibly the taxpayer only may use the binding commitment test as the basis for its assertion.[264]

The interdependence test is less restrictive than the binding commitment test, casting a wider net. At least one critic, however, has noted that the interdependence test, at times, integrates steps that ought to be separate and separates steps that ought to be integrated.[265] Another critic has proposed an alternative test that includes an economic significance limitation to the interdependence test.[266] This limitation would require that separate steps should not be stepped together under the interdependence test if they have independent economic significance.[267] That critic argues that steps should be combined only when steps must follow each other either based on a binding commitment or economic compulsion.[268] Otherwise, the steps should not be combined.[269]

Many commentators have examined and criticized the end result test.[270] One of the most common criticisms is that it is open-ended and does not provide clear guidance for when two steps should be combined and when they are to be separated.[271]

King Enterprises Inc. v. United States[272] is among the most commonly cited and criticized cases that applied a robust version of the end result test.[273] In particular, in Revenue Ruling 2001-46, the IRS cited *King Enterprises* for the proposition that the step transaction doctrine should be

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264. *See id.*

265. *See* Rosenberg, *supra* note 26, at 411.

266. *See* Bowen, *supra* note 253, at 727.

267. *See id.* Although the *Security Industrial Insurance* court stated that "under this test we examine this tandem of transactional totalities to determine whether each step had a reasoned economic justification standing alone," it, in summarizing its application of the test, stated that "no single step would likely have been taken had the others not followed," which seems to speak to taxpayer intent. Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1247 (5th Cir. 1983). In its fuller analysis, however, that particular court looked at the dependency of steps on each other and whether they had a "symbiotic relationship." *Id.*

268. *See* Bowen, *supra* note 253, at 727.

269. *See id.*

270. *See id.*; *see also* Rosenberg, *supra* note 26; Kwall & Maynard, *Dethroning*, *supra* note 119; Cummings, Jr., *supra* note 119; Kwall & Maynard, *We Still Don't Like*, *supra* note 119.

271. *See* Bowen, *supra* note 253, at 724, 727 (criticizing limitations on the end result test as inconsistently applied).

272. King Enters. v. United States, 418 F.2d 511 (1969).

273. *See, e.g.*, Klauer v. Comm'r, 99 T.C.M. (CCH) 1254 (2010) (citing *King Enterprises* as the only example case for the end result test).

applied in the merger context in which the first step is a stock acquisition followed by a second step: a merger.[274]

King Enterprises is relevant to the concern that the end result test is too open-ended, as discussed above, because of the offensive use[275] of the step transaction doctrine by the taxpayer in that case.[276] The *King Enterprises* decision subsequently was cited by two IRS revenue rulings, prompting a critical response from commentators.[277] Critics argued that "the tax consequences to one party to a transaction should not be changed by a subsequent unilateral act of another party when the first party neither knew, nor should have known, that the later act would occur."[278] Critics noted that the court simply inferred that the tax benefits of tax-free reorganization treatment must have been intended from the outset because they were significant, even though no evidence existed to show that the taxpayer knew about MM's future plans.[279] Critics highlighted that the key to application of the end result test must be the intent of the parties; at least the affected party, and probably both parties, must intend the end result.[280] The danger in applying the end result test without the intent of both parties is the possibility that the government could assert the end result test against a taxpayer when there is no "factual connection between the steps" and the taxpayer simply is a passive party with respect to the future steps.[281] Another danger is a whipsawing of the IRS, which actually happened in the *King Enterprises* transaction.[282] MM achieved a stepped up basis because it successfully treated the transaction as a taxable stock purchase, and the taxpayer achieved tax-deferred treatment from the receipt of MM stock.[283]

Other commentators have defended *King Enterprises* on the grounds that principles can be derived from it that do not result in whipsawing of the IRS.[284] One commentator suggested three principles for application of

274. Rev. Rul. 2001-46, 2001-2 C.B. 321.

275. The use of the step transaction doctrine was offensive in the sense that the taxpayers asserted the doctrine to combine two steps that the Commissioner argued should be treated separately. *See King Enters.*, 418 F.2d at 514.

276. *See id.* at 518.

277. Rev. Rul. 2001-26, 2001-1 C.B. 1297; Rev. Rul. 2001-46, 2001-2 C.B. 321; Kwall & Maynard, *Dethroning*, *supra* note 119, at 33−38.

278. Kwall & Maynard, *Dethroning*, *supra* note 119, at 5.

279. *See id.* at 11.

280. *See id.* at 16−19.

281. *Id.* at 22.

282. *Id.*

283. *See id.* at 22−23.

284. *See generally* Cummings, Jr., *supra* note 119.

the doctrine when a future unilateral act is included in the completed transaction's tax treatment:

> (1) the fact that another unrelated party to the transaction did have such a plan (that is, the subsequent step was not a total afterthought), (2) the assumption that a reasonable application of the step transaction doctrine could require the knowledgeable party to report according to the substance of the transaction, and (3) the policy asserted here that once the transaction is recharacterized as to the knowing party all other parties should be required to report it according to that characterization, whether or not they had advance knowledge of the planned step.[285]

One commentator, Karen B. Brown, has argued that the courts have been inappropriately hesitant to apply the step transaction doctrine when the taxpayer has been able to demonstrate a business purpose.[286] Brown argues that courts should focus on statutory intent instead.[287] According to Brown, when a transaction is within the taxpayer's control and the result of the transaction subverts statutory intent, a court should apply the step transaction doctrine.[288]

2. Criticism of the Existence of Specific Tests

One critic of the end result test, Stephen S. Bowen, has suggested that the interdependence test and the binding commitment test should be the only tests and that the interdependence test should be based on economic compulsion.[289] Thus, Bowen no longer would permit the use of the end result test.[290] Bowen argues that steps should "not be regarded as mutually interdependent if they have independent economic significance, based on the economic significance and equal step limitations."[291] Bowen lists one piece of additional evidence of economic effect: parting with the traditional benefits and burdens of stock ownership is sufficient evidence for the independence of a step.[292] Bowen argues that to avoid the open-ended

285. *Id.* at 1095−96 (footnote omitted).
286. Karen B. Brown, *Applying Circular Reasoning to Linear Transactions: Substance Over Form Theory in U.S. and U.K. Tax Law*, 15 HASTINGS INT'L & COMP. L. REV. 169, 173 (1992).
287. *See id.* at 173, 214.
288. *See id.*
289. *See* Bowen, *supra* note 253, at 727.
290. *See id.* at 722.
291. *See id.* at 727.
292. *See id.*

nature of the end result test, the concept of economic compulsion must be narrow.[293] He gives as examples "actual or threatened lawsuits and foreclosures and various rights and obligations set forth in unrelated or collateral agreements."[294] Bowen specifically excludes market forces and likely or potential income tax consequences.[295] He also excludes situations in which a substantial possibility exists that taking the second step would be impossible after taking the first step.[296]

Under Bowen's theory, steps are independent if they meet the economic significance limitation and the equal-step limitation.[297] Both of these limitations, Bowen notes, derive from court rulings limiting the application of the end result test.[298]

The economic significance limitation provides that two transactions are not stepped together if the "'economic motivation' of each was 'sufficiently meaningful' on its own account and 'was not dependent upon the other transaction for its substantiation.'"[299] As an example, Bowen provides a modified version of the situation in Revenue Ruling 75-406 in which a target owns a subsidiary and it spins off that subsidiary by distributing stock of the subsidiary to shareholders of the target.[300] The distribution was required by a government divestiture order.[301] The shareholders of the target, now shareholders of the subsidiary, voted for the subsidiary to merge into the acquiring corporation.[302] The IRS ruled that the continuity of interest requirement for spin-offs was satisfied, despite the merger following immediately after the spin-off, because the new shareholders of the subsidiary could have voted against the merger.[303]

The equal-step limitation provides that taxpayers are free to choose between two different routes to achieving the same end if each involves the same number of steps.[304] Bowen illustrates this limitation with a

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293. *See id.*
294. *See id.* (footnotes omitted).
295. *See id.*
296. *See id.*
297. *See id.*
298. *See id.* at 723−24.
299. *Id.* at 723.
300. *See* Rev. Rul. 75-406, 1975-2 C.B. 125; *see also* Bowen, *supra* note 253, at 723.
301. *See* Rev. Rul. 75-406, 1975-2 C.B. 125; *see also* Bowen, *supra* note 253, at 723.
302. *See* Rev. Rul. 75-406, 1975-2 C.B. 125; *see also* Bowen, *supra* note 253, at 723.
303. *See* Rev. Rul. 75-406, 1975-2 C.B. 125; *see also* Bowen, *supra* note 253, at 723–24.
304. *See* Bowen, *supra* note 253, at 724.

discussion of Revenue Ruling 75-161.[305] In that ruling, a parent company had two wholly owned subsidiaries, X and Y.[306] The liabilities of X exceeded X's basis in its assets.[307] The liabilities of Y did not exceed its basis in its assets.[308] The transaction could have been structured as a merger in either direction, but the parent structured it so that X merged into Y.[309] The IRS respected the transaction and noted that, pursuant to § 357(c), Y would not have recognized gain if X had been the acquirer rather than the target.[310]

The problem, however, with focusing on economic compulsion is that some events are interdependent but not economically compelled. The best example of this is *McDonald's Restaurants of Illinois v. Commissioner*.[311] In *McDonald's Restaurants of Illinois*,[312] the owners of independent franchises wanted to receive cash for their ownership, but the purchasing company, the franchisor, needed to use stock for accounting reasons.[313] Therefore, McDonald's used a two-step process to acquire the independent franchises. The target shareholders were given unregistered stock and registration rights as well as the right to force registration but were not compelled to register and then sell the stock.[314] Almost all of them registered and sold the stock, however.[315] The court thus stepped together the two transactions.[316] Forcing reorganization treatment in cases like this could result in taxpayers selling loss corporations and claiming losses while the corporate acquirers report a higher carryover basis and claim the resulting higher depreciation, making it easier to sell loss corporations.[317]

Furthermore, an interdependence test based on economic compulsion is too narrow and does not properly account for some transactions that

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305. *See id*.; *see also* Rev. Rul. 75-161, 1975-1 C.B. 114.
306. *See* Rev. Rul. 75-161, 1975-1 C.B. 114; *see also* Bowen, *supra* note 253, at 724.
307. *See* Rev. Rul. 75-161, 1975-1 C.B. 114; *see also* Bowen, *supra* note 253, at 724.
308. *See* Rev. Rul. 75-161, 1975-1 C.B. 114; *see also* Bowen, *supra* note 253, at 724.
309. *See* Rev. Rul. 75-161, 1975-1 C.B. 114; *see also* Bowen, *supra* note 253, at 724.
310. *See* Rev. Rul. 75-161, 1975-1 C.B. 114; *see also* Bowen, *supra* note 253, at 724.
311. McDonald's Rests., Inc. v. Comm'r, 688 F.2d 520 (7th Cir. 1982).
312. *See supra* notes 164−171 and accompanying text.
313. *See McDonald's Rests.*, 688 F.2d at 521.
314. *See id.* at 522.
315. *See id.*
316. *See id.* at 524−25.
317. *See id.* at 528.

clearly should be stepped together. Such transactions include two-step mergers in which the second step is intended but contingent on some external event, such as board or shareholder approval. The first step is still economically desirable, even if not preferable, when isolated from the second step.

3. Critics Favoring an Entirely New Test

One commentator, Joshua D. Rosenberg, argues that none of these tests will be sufficient because they lack a reasoned conceptual basis.[318] In his work, Rosenberg presents a broad critique of the judicial doctrines that are used to recharacterize transactions or to find tax avoidance in a transaction that satisfies statutory requirements but otherwise is found lacking.[319] Specifically, Rosenberg criticizes the step transaction doctrine on several grounds, including the following principles: (1) three tests exist but there is no clear guidance as to when each test should be applied; (2) the doctrine bases its determination of "what was done" on more than legal rights—something that courts are not competent to determine; and (3) intent or purpose often is applied to only one party and then extrapolated to determine the mutual intent of both parties.[320] Rosenberg suggests a new definition for all problems related to tax avoidance. Rosenberg defines tax avoidance as existing "only when there is a convergence of undermeasurement of economic income with a failure to achieve the specific goals underlying the provision that allows for that undermeasurement."[321]

Rosenberg argues that courts should bifurcate their determinations in tax avoidance cases into two parts: "(1) What is the transaction that has occurred?

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318. *See* Rosenberg, *supra* note 26 at 385, 388. Rosenberg argues, "[E]ach of these three tests will often lead to the intuitively correct result. But, because none of these tests has a valid conceptual foundation, none of them will *always* do so." *Id.* at 403−04 (footnote omitted). Rosenberg adds one commentator's suggestion that all of the step transaction doctrine tests could be meshed into one test of "'purposive analysis.'" *Id.* at 404 n.108 (quoting Thomas Litz, Comment, Redding v. Commissioner*: Step Transaction Doctrine Applied to Distribution of Stock Warrants in a Section 355 Spin-Off*, 35 TAX LAW. 257, 267 (1981)). This single test, according to Rosenberg, appears to focus on statutory interpretation and congressional intent, as it requires courts to "'first, characterize the parties' intent . . . second, construe the purpose of the relevant Code provision[s]; and third, determine whether the parties' intent is consistent with the purpose of the statute.'" *Id.* (quoting Litz, *supra*, at 267).

319. *See generally* Rosenberg, *supra* note 26.

320. *See id.* at 413–17.

321. *See id.* at 447.

and (2) To what extent has the taxpayer engaged in tax avoidance?"[322] For step one, Rosenberg argues that state contract law should govern the determination of the relationship of the parties and the facts of a case.[323] Rosenberg asserts that separate exchanges should be integrated only if they "form an integrated contract under basic principles of contract law."[324] Rosenberg cites an old Board of Tax Appeals case discussing the basic principle of contract integration and argues that if a party can enforce one part of an agreement based on consideration provided in another part, then an integrated contract exists and the exchanges ought to be stepped together.[325] Rosenberg argues that basing integration on state contract law will be more predictable than the end result test or the other step transaction tests.[326] He also asserts that relying on state contract law for guidance does not restrict the inquiry to the four corners of the contract because that contract may be found to depend on another contract and parol evidence might be admitted to show that the four corners of the contract do not express the intent of the parties.[327]

Rosenberg's first step—determining the transaction by relying only on legal obligations as would be determined in an ordinary contract case—does not give courts sufficient flexibility to delineate the boundaries between multiple transactions, especially when some of those transactions are governed by formal documents and others by informal arrangements and expectations of reciprocation. An example of a case in which informal agreements and expectations or reciprocation play a substantial role is a modified version of the factual scenario in *King Enterprises*.[328] Shareholders of a company may exchange all of their stock with another company for various types of consideration, including consideration that is primarily stock of the other company.[329] The stock may be enough that if a formal merger were effected, the transaction would qualify as an A reorganization and meet all of the non-statutory requirements, such as continuity of interest

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322. *See id.* at 448.

323. *See id.* at 449–50.

324. *See id.* at 449.

325. *Id.* at 449–50 (citing First Seattle D. H. Nat'l Bank v. Comm'r, 27 B.T.A. 1242, 1247 (1933), *aff'd*, 77 F.2d 45 (9th Cir. 1935)).

326. *See id.* at 450.

327. *See id.*

328. *See* King Enters., Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); *see also* Note, *Step Transactions in "A" Reorganizations: A Proposal for a Binding Commitment Test*, 56 VA. L. REV. 255, 264 (1970) [hereinafter *Step Transactions in "A" Reorganization*]; Rosenberg, *supra* note 26, at 450−51.

329. *See generally Step Transactions in "A" Reorganizations*, *supra* note 328.

and continuity of business enterprise.[330] The merger, however, may take place shortly thereafter and be a part of a separate instrument.

In fact, the Treasury Department promulgated anti-abuse provisions in the Treasury Regulations, knowing that many intended events are not recorded in the same instrument but are done shortly after each other, maybe even to avoid adverse tax consequences.[331] Therefore, the Treasury Regulations provide all sorts of anti-abuse rules that create presumptions that certain events are part of the same plan if they take place within a stated timeframe.[332] These rules acknowledge that informal agreements and undocumented intentions are a significant part of economic reality. A judicial test that is supposed to connect events that are connected economically should be flexible enough to account for informal agreements and undocumented intentions.

Most significantly, related-party transactions, such as those in *True*, often involve parties who do not need to document their intentions because they are not worried about other parties' actions.[333] The Trues knew that no one would interfere with True Ranches ultimately owning the ranch parcels and with Smokey Oil Company ultimately owning the oil and gas leases.[334]

In step two of his proposal, Rosenberg classifies all tax avoidance problems as either "substituted reference" problems or "gross measurement" problems.[335] Rosenberg defines substituted reference problems as situations in which Congress has to substitute some status or behavior when economic income becomes too difficult to measure.[336] As an example of substituted referents, Rosenberg provides that comparing business motives of the taxpayer to personal motives of the taxpayer could help determine whether an expense is deductible. Rosenberg argues that this would be better than the economic income test, which would ask whether there was consumption corresponding to the amount of an investment.[337]

With regard to substitute reference problems, Rosenberg suggests focusing on motive to determine whether the mismeasurement was

330. *See id*. An A Reorganization is a reorganization pursuant to a state's corporation law. I.R.C. § 368(a)(1)(A) (2012).

331. *See, e.g.*, Treas. Reg. § 1.355-2(d)(2)(iii)(A) (as amended 2011) (stating that evidence of device in the context of a spin-off of a controlled corporation includes the sale of shares of the spun-off corporation shortly after the spin-off).

332. *Id.*

333. *See supra* notes 144–159 and accompanying text.

334. *See supra* notes 160–163 and accompanying text.

335. *See* Rosenberg, *supra* note 26, at 456.

336. *See id.*

337. *See id.* at 456–57.

intentional or merely coincidental.[338] Rosenberg admits that the proof of intentionality will look similar to the proof currently offered in step transaction cases.[339] He argues, however, that the proof will be more accurate because it will focus on motives rather than on a factual determination.[340] He argues that under his proposal step transactions would become "strong evidence of tax avoidance" rather than "themselves the tax avoidance."[341] Rosenberg argues that a strength of his approach is that his approach does not rely on claiming "what happened did not happen."[342] Instead, his approach relies on examining whether the transactions were motivated, fully or partially, by tax avoidance, with the result being a "full or partial withdrawal of the tax benefit that would otherwise be improperly granted."[343] Rosenberg admits that allowing a finding of partial tax avoidance will result in more predictability regarding the result of litigation and less predictability regarding when the IRS would bring a case.[344]

The weakness of Rosenberg's argument, however, is that he underestimates the extent to which potential nit-picking could create unpredictability in the outcome of application of his proposal to real cases. Therefore, it will be no easier to determine motive—the same indirect proof still will be required—and courts and the IRS will be empowered now to determine that a partial tax avoidance motive existed. Such a determination allows many more taxpayers to be subject to audit and redetermination of the amount of tax due by the IRS and the courts.[345] Although this unpredictability may serve a deterrent purpose, as Rosenberg argues, the vagueness of any proof of motive creates danger for taxpayers who engage in transactions that, under the current system, are

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338. *See id.* at 484–85.
339. *See id.* at 486.
340. *See id.* at 486–87.
341. *See id.* at 487.
342. *See id.* at 488–89.
343. *See id.* at 489.
344. *See id.* at 491.
345. *Cf. id*. at 490–92. Rosenberg dismisses the possibility of creating uncertainty for taxpayers who currently engage in transactions when they would never expect an IRS audit as being inherent in "any situation where motive is at issue." *Id*. at 492. By placing more emphasis on motive through allowing finding of a partial motive of tax avoidance, however, Rosenberg creates uncertainty for a greater number of taxpayers. His argument that this would create more accuracy in situations with mixed motives might be true, but the uncertainty created would still be large. *Cf. id.*

beyond reproach.[346] This change would greatly undermine the predictability of the outcome of application of the step transaction doctrine.

Rosenberg's suggested solution would require a radical rewriting of current tax laws, regulations, IRS procedures, and court decisions while yielding limited benefits of consistent administration and theoretical coherence. Accuracy of measurement and predictability would not be enhanced greatly—as even Rosenberg admits.[347]

D. Recent Scholarship

Recent scholarship in the area of anti-abuse doctrines generally has focused on the divergence between the articulation of doctrine and its application as well as the benefits and drawbacks of the use of either standards or rules in articulating anti-abuse doctrines. Professors Joshua Blank and Nancy Staudt analyzed every Supreme Court case alleging the presence of a corporate tax sham since 1909.[348] The study aimed to identify the controlling factors that convince judges that corporate tax behavior "crosses the line from legal acceptability to abusive activity."[349] Blank and Staudt found that courts follow predictable patterns and do not focus on business purpose in the way that scholars and policymakers typically suppose.[350] Rather, they found five factors that controlled the majority of decisions:

> We found that when government lawyers seek to convince the Court to invoke an anti-abuse doctrine, they routinely point to a small collection of very specific facts and circumstances. Three of the factors are tied to the nature of the transaction itself and two are linked to the position taken by the corporation on its tax return filed with the IRS. These five factors are: (1) the presence of third parties in the transaction; (2) multistep transactions; (3) the lack of a business purpose other than tax avoidance; (4) accounting irregularities, such as book-tax differences; and (5) a claim for a tax refund on the initial return. We found . . . that the government

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346. *See supra* note 345.
347. *See* Rosenberg, *supra* note 26, at 479–80, 486, 491.
348. Joshua D. Blank & Nancy Staudt, *Corporate Shams*, 87 N.Y.U. L. REV. 1641, 1646 (2012).
349. *Id.* at 1645.
350. *Id.* at 1647.

> cited to at least one of these factors in 81% of all corporate tax abuse controversies litigated in Court.[351]

One recent article draws a distinction between rules that state their underlying principle of application accurately and rules that "prescribe[] an outcome for a set of anticipated factual situations by applying, but not stating directly, the underlying principle."[352] Prescriptive rules, this scholar posits, can be more complex, more challenging to administer, and more expensive for corporate compliance than principle-based rules.[353] The relative benefit of principle-based rules in corporate tax law depends, in part, on the level of complexity employed by the enforcers of the rules.[354] In high complexity settings, prescriptive rules leave gaps in the tax code that can be exploited.[355] Principle-based rules, such as the step transaction doctrine, undermine the certainty offered to legitimate and abusive actors alike by prescriptive rules but close the gaps and combat abuse.[356] Principle-based rules could make tax law less complicated and more effective at the cost of increasing uncertainty.[357]

II. A NEW VISION OF THE STEP TRANSACTION DOCTRINE

This Article proposes that the step transaction doctrine should be redefined by courts to consist of an objective test and an economic reality test. This redefined conception should replace the current binding commitment test, interdependence test, and end result test. The new definition gives greater clarity to the tests and makes outcomes more predictable.

One of the main problems of the current set of tests is that they are poorly defined.[358] In particular, the end result test has been the subject of much

351. *Id.* at 1676 (footnote omitted).

352. Rachelle Y. Holmes, *Deconstructing the Rules of Corporate Tax*, 25 AKRON TAX J. 1, 6 (2010) (footnote omitted).

353. *Id.* at 21.

354. *See id.* at 24 (listing seven factors that affect the effectiveness of rules).

355. *Id.* at 25.

356. *Id.* at 31–33.

357. *Id.* at 38.

358. *See* Linda D. Jellum, *Codifying and Miscodifying Judicial Anti-Abuse Tax Doctrines*, 33 VA. TAX REV. 579, 603–04 (2014) ("While one may say, half seriously, that the step transaction doctrine is the most finely etched of judicial tax doctrines, the truth of this assertion lies more in the clarity of the doctrine's articulation than in its application." (quoting Daniel M. Schneider, *Use of Judicial Doctrines in Federal Tax Cases Decided by Trial Courts, 1993-2006: A Quantitative Assessment*, 57 CLEV. ST. L. REV. 35, 48 (2009))); Alan Gunn, *The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Anti-abuse*

criticism because it is so malleable.[359] Courts have looked to the intent of the taxpayer and analyzed whether the taxpayer intended from the outset to take the second or successive steps when the taxpayer took the first step.[360] Because a view inside the mind of the taxpayer is impossible to

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Regulations, 54 SMU L. REV. 159, 160 (2001) (calling the step transaction doctrine "ubiquitous if obscure"); Anthony B. Casarona, Comment, *Regulating Corporate Tax Shelters: Seeking Certainty in a Complex World*, 50 CATHOLIC UNIV. L. REV. 111, 130–31 (2000) ("As currently applied, the law governing corporate tax shelters is a patchwork of ambiguous statutory authority, which is sometimes arbitrarily applied to the detriment of legitimate business transactions. . . . The rules promulgated to counter corporate tax shelters are inadequate because they fail to provide a clear standard to consistently or predictably judge alleged abuses."); *see also* Falconwood Corp. v. United States, 422 F.3d 1339, 1350 (Fed. Cir. 2005) ("[V]arious expressions of the step transaction doctrine may have different meanings in different contexts" (citing King Enters., Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969))).

359. Discussing the end result test as the farthest-reaching test on the continuum from binding commitment to interdependence to end result, the Tax Court stated,

> The end result test is based upon the actual intent of the parties as of the time of the [transaction in question]. It can be argued that any test which requires a court to make a factual determination as to a party's intent promotes uncertainty and therefore impedes effective tax planning . . . . [T]he end result test is flexible and bases tax consequences on the real substance of the transactions, not on the formalisms chosen by the participants.

Penrod v. Comm'r, 88 T.C. 1415, 1430 (1987); *see also* Philip Sancilio, *Clarifying (or Is It Codifying) the Notably Abstruse: Step Transactions, Economic Substance, and the Tax Code*, 113 COLUM. L. REV. 138, 153 n.72 (2013) (noting the courts' preference for the end result test because of its "breadth and conceptual flexibility"); Calvin H. Johnson, *A Full and Faithful Marriage: The Substantially-All-the-Properties Requirement in a Corporate Reorganization*, 50 TAX LAW. 319, 348 (1997) (discussing the end result, the author states that "[s]ubjective tests have a history of manipulation."). A problem with this test, according to Rosenberg, is that "while it provides a ready means to support an allegation that two legally independent exchanges are actually parts of a single, integrated transaction, it provides almost no basis whatsoever to support an allegation that two actions are ever separate." Rosenberg, *supra* note 26, at 407. Because the end result test will join two separate exchanges together if "at the time the first is engaged in, the taxpayer also intends to engage in the second, this test could treat as a 'transaction' every single exchange intended by a taxpayer at the time he engages in any other, seemingly unrelated, exchange." Rosenberg, *supra* note 26, at 407.

360. "Application of [the end result test] requires examination of the actual intent of the taxpayer, regardless of the purported form of chosen transactions." Allen D. Madison, *The Tension between Textualism and Substance-over-Form*

obtain, external factors have to be examined.[361] Defining a test one way and then actually implementing it another way, however, creates problems of fairness, notice, and certainty. Furthermore, at times the courts have confused the tests.[362] For example, the court in *McDonald's* defined the binding commitment test such that it was almost indistinguishable from the interdependence test.[363]

The proposed tests thus would vindicate several tax policy objectives. They would be more predictable than the current tests because they would be objective rather than subjective.[364] The proposed tests would rely on a

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Doctrines in Tax Law, 43 SANTA CLARA L. REV. 699, 730 (2003) (footnote omitted).

361. Stephen J. McGarry, *State of Mind Standards in Taxation*, 7 AM. J. TAX POL'Y 249, 249–50 (1988) ("Determination of the [taxpayer's] state of mind . . . may depend on an evaluation of external activities."). Discussing the end result test, one commentator explained the problem with subjective tests in the corporate context:

> A subjective test may be appropriate if the corporation has "left a clear and well-documented paper trail" against its interest, but if the intent is hidden or the evidence ambiguous then the subjective emphasis does not make a great deal of sense. Corporations are artificial entities, which themselves have no mind. Thus, purposes or plans must be imputed to the target and acquirer corporations from statements or actions of the principal officers or shareholders. Intents are things that happen inside of heads, and if the evidence of intent would be adverse to the corporation on taxes, one would expect the intent would be kept well inside of the head. The only evidence available will commonly be the self-serving statements of the principal officers. Still under a subjective test, the taxpayer's own characterization of the transaction may be the only evidence that is available. Where millions of dollars of tax are at stake, moreover, a taxpayer "intent," even within the mind, can be quite plastic.

Johnson, *supra* note 359, at 347 (footnote omitted).

362. *See, e.g.*, *Falconwood*, 422 F.3d at 1349–51 (discussing the courts' varied application of the step transaction doctrine and its tests); Oliver C. Murray, Jr., *Step Transactions*, 24 U. MIAMI L. REV. 60, 67 (1969) (discussing the "uncertainty in the field of step transactions").

363. *See* McDonald's Rests., Inc. v. Comm'r, 688 F.2d 520, 525 (7th Cir. 1982) ("The registration and underwriting provisions in the parties' agreement did not just enhance salability; they were essential to it.").

364. Legal academics have expressed the view that the step transaction doctrine's effect is unpredictable due to its subjectivity. *See, e.g.*, Ralph S. Rice, *Judicial Techniques in Combating Tax Avoidance*, 51 MICH. L. REV. 1021, 1047 (1952–1953). Rice discusses the problems with a subjective test:

reasonable third party's understanding of a transaction or the behavior of a hypothetical reasonable business rather than an attempt to ascertain subjective intent.[365] Thus, they also would promote greater certainty. The proposed tests still would protect the public treasury sufficiently, however, because, in at least some cases, taxpayers have been able to use offensively the existing, more malleable tests to their own benefit.[366] Although this Article advocates acknowledging and accepting limited offensive use, the tighter and more objective tests will make that use rarer. Also, by drawing on ideas from other areas of law, the test will dovetail with parties' expectations regarding the consequences of a transaction.

A. Objective Test

For arms-length transactions, the objective test this Article proposes would ask whether the parties' actions, as demonstrated by documentary evidence or other admissible evidence regarding contractual obligations, manifested a mutual intention that a series of transactions should be combined into a single transaction. As with the objective test from contract law, the trier of fact would look to the ordinary meaning of terms in documents and the understanding of actions that a reasonable person in the position of the other party would have.[367] An objective test borrowed from contract law may draw upon preexisting cases for setting the contours of the standard.[368] The simple example would be when the parties consummated one transaction followed immediately by a second transaction, and the contract for the second transaction clearly presupposed a state of affairs that would exist only after the first transaction or, even more blatantly, referred to terms and events from the contract for the first transaction.

The objective test proposed above, like the mutual interdependence test, is a reasonable person test. Unlike the mutual interdependence test,

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> [U]nder [the step transaction] doctrine, . . . prediction is difficult to the point of impossibility. The success of the tax saving enterprise is measured by the intention of the taxpayer—whether he intended one transaction or separate transactions—and the intention must be ascertained from objective evidence. Since the objective evidence (facts) in each case will be different, and no patterns appear to be emerging under the doctrine, its significance appears dubious.

Id.

365. *See, e.g.*, Rosenberg, *supra* note 26.

366. *See* Schneider, *supra* note 358, at 62.

367. *See* E. ALLEN FARNSWORTH, CONTRACTS § 3.6, at 209–10 (4th ed. 2004).

368. *See, e.g.*, Dorton v. Collins & Aikman Corp., 453 F.2d 1161 (6th Cir. 1972); C. Itoh & Co. (Am.) Inc. v. Jordan Int'l Co., 552 F.2d 1228 (7th Cir. 1977).

however, it does not require speculation regarding hypotheticals; rather, it relies upon whether the parties manifested intentions that could be understood by a reasonable third-party observer. The mutual interdependence test asks whether a reasonable person would enter into transactions, which requires thinking about a reasonable business or businessperson and guessing what they would do.[369] Judges and juries do not have the expertise necessarily to speculate regarding the behavior of a reasonable businessperson. The objective test this Article proposes only asks courts to assess whether parties' own actions manifested an intent to take certain future steps—whether or not those future steps were a good idea. The proposed test also is not limited to whether the parties foreclosed other options. It simply asks whether the parties' actions manifested a mutual intent to combine two steps.

Contract law adopted the objective test because it protects the reasonable expectations of the parties by relying on the ordinary meaning of words and actions.[370] This facilitates reliance on promises because one party does not have to know the intent of another party but only has to look to the ordinary meaning of the words and actions of the other party.[371] Thus, unless one has reason to know that the other party does not intend to be bound by a contract, the signing of the contract creates binding obligations even in the case in which the other party does not intend to be bound, has not read the contract, or does not understand the legal consequences.[372] This reliance on ordinary meaning facilitates business transactions and the smooth operation of the marketplace by creating predictable consequences for commonplace activities.[373]

In the example from the Introduction involving George and Isabella, if George and Isabella were unrelated, the objective test would ask whether they, through references in contracts prior to the contribution, or through other dealings or actions prior to the contribution, manifested an intent to

369. *See* Murray, Jr., *supra* note 362, at 65–66 (discussing the objective nature of the interdependence test).

370. FARNSWORTH, *supra* note 367, § 3.6.

371. *Id.* § 3.6, at 209–10; Hotchkiss v. Nat'l City Bank, 200 F. 287, 293 (S.D.N.Y. 1911) (L. Hand, J.), *aff'd*, 201 F. 664 (2d Cir. 1912), *aff'd*, 231 U.S. 50 (1913) ("If, however, it were proved by twenty bishops that either party, when he used the words, intended something else than the usual meaning which the law imposes upon them, he would still be held, unless there were some mutual mistake, or something else of the sort.").

372. FARNSWORTH, *supra* note 367, § 3.7; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 21 cmt. a (AM. LAW INST. 1982).

373. FARNSWORTH, *supra* note 367, § 3.7.

complete the sale of George's stock immediately after George's contribution of property to Newco.

The proposed test differs from Rosenberg's application of state contract law in this area in one significant way. The proposed test asks whether a third party would understand objectively that two transactions are dependent on each other even if the documents do not obligate one transaction to be performed after the other and one document does not rely on terms from another document. Here, concepts from commercial law may be useful. Using concepts similar to courses of performance, dealing, and trade may influence an understanding that two transactions were dependent on each other. For example, if two parties historically have engaged in a certain type of transaction followed by another type, and the same pattern occurs here, the two transactions properly may be stepped together. Concepts like course of dealing, trade, and performance may be more important for the proposed test than in the interpretation of obligations under a contract when the literal language contradicts inferences drawn from course of performance, dealing, or trade.

The interdependence test and the binding commitment test are the currently existing tests that both, in some sense, are objective. These two tests have weaknesses, however. First, the binding commitment test rarely is used and is easily manipulated.[374] Taxpayers need only to avoid obligating themselves in writing to take later steps.[375] The interdependence test is objective in the sense that it asks whether a reasonable person would see the steps as so interdependent that they cannot be separated.[376] This test is even more disconnected from any conception of the contract than the end result test. The interdependence test does not look to whether the parties indicated in their agreement whether the steps are connected but asks a third person to determine whether the steps appear to that third person to be so interdependent as to be inseparable.[377] Objective standards have many benefits that help the standards prevail in contract law and other areas. Objective standards limit evidentiary concerns, as state of mind is hard to determine, encourage reliance, and encourage economically beneficial transactions.[378]

374. See *supra* Part I.B.1., for a discussion of the binding commitment test.

375. *See id.*

376. *See* Murray, Jr., *supra* note 362, at 65; *see also* Jasper L. Cummings, Jr., *Circular Cash Flows and the Federal Income Tax*, 64 TAX LAW. 535 (2011).

377. *See* discussion *supra* Part I.B.2.

378. *See generally* Wayne Barnes, *The Objective Theory of Contracts*, 76 U. CIN. L. REV. 1119, 1127–31 (2008); Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 808 (1941) (noting that an objective interpretation of contracts fosters the principle of private autonomy as well as security of

Besides the benefits applicable to objective standards generally, applying an objective test in the step transaction doctrine advances a number of general tax policy concerns. An objective test promotes predictability and certainty because the test works through the lens of a third party.[379] Taxpayers do not need to be concerned about a judge or jury construing their intentions—something that taxpayers have to worry about under the end result test or even the interdependence test.[380] Furthermore, borrowing concepts from contract law also promotes predictability because a preexisting body of caselaw can be drawn upon to see how the relationship between two transactions might be construed based upon concepts such as course of performance and course of dealing.[381]

On the other hand, the objective test is more flexible than the current binding commitment test. There is broad agreement that limiting the step transaction doctrine to the binding commitment test would almost defeat the purpose of the step transaction doctrine.[382] Thus, the objective test strikes a balance between predictability and flexibility.

Some individuals may criticize the proposed objective test by arguing that sometimes only one party cares about the tax consequences of the transaction; the other party is a so-called tax indifferent party.[383] In such

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transactions). Rose v. Comm'r, 88 T.C. 386, 414 (1987) explains the benefits of an objective approach:

> [A] unified approach emphasizing objective factors is preferable in cases involving generic tax shelters . . . . First, because this approach emphasizes objective factors, it is more susceptible to consistent and predictable application. Second, because it does not require weighing the objective facts against a taxpayer's statement of his intent, it should be more understandable to taxpayers who doubt our ability to determine their subjective state of mind. Third, taxpayers similarly situated will be treated the same for tax purposes. Fourth, the test allows us to separate the real economic aspects from the 'financial fantasies' surrounding a transaction and to apply the tax laws accordingly . . . .

379. *C.f.* Blake D. Morant, *The Salience of Power in the Regulation of Bargains: Procedural Unconscionability and the Importance of Context*, 2006 MICH. ST. L. REV. 925, 942–43 (2006) (discussing that the rules of contract formation promote certainty and administrability).

380. *See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE §§ 4-2, 4-3, 4-4 (2013).

381. *See* U.C.C. § 1-303 (AM. LAW INST. & UNIF. LAW COMM'N 1977) (defining "course of performance" and "course of dealing").

382. *See supra* notes 256–262 and accompanying text.

383. A tax indifferent party includes a foreign party not subject to tax, a tax-exempt organization, or a corporation with net operating losses. *See* Mark A. Luscombe, *Tax Trends,* 77 TAXES, Apr. 1999, at 3, 4.

cases, often one of the parties is not a taxpayer because of net operating losses or because the tax would be imposed upon shareholders and the majority of those shareholders are not taxpayers themselves—institutional investors such as pension funds, for example, which are not taxed.[384] Thus, a deal could be negotiated to place the tax consequences on the party who pays little or no tax, making the public treasury the only party that suffers. To foreclose this possibility, courts should create an additional safeguard: if the government can show that the combined steps would result overall in a significantly greater amount of income pre-tax for one party and at least as much—or nearly as much—income pre-tax for the other party or parties, and the government can show that the primary purpose of the structure was to reduce or avoid income tax, then the economic reality test will be applied in place of the objective test.[385] If the tax consequences will occur only in the future, for example, upon a future sale of property, then the court should assume that the party subject to those consequences will have a tax imposed unless that is impossible, for example, if the party is not a taxpayer, or highly improbable, for example, if the party has an enormous carry forward available for a long period of time that will offset any applicable gain. Although this second requirement adds a subjective element to an otherwise objective test, the requirement is necessary to prevent the objective test from becoming hollow.[386] Objective tests always are open to the possibility of manipulation by wily taxpayers.[387] If one

384. *See id.*

385. Philip J. Levine & Britt M. Haxton, *"The End Result Test" Revisited, Part 1*, 149 TAX NOTES 1259, 1260–61 (2015). For a description of the economic reality test, see *infra* notes 387–421 and accompanying text.

386. RANDOPH E. PAUL, SELECTED STUDIES IN FEDERAL TAXATION 300 (1938) ("The desirability of subjective motive . . . as a test of tax liability revolves around the essential antimony of all tax law,—the desire for certainty on the one hand, and on the other, the twin needs of providing exemptions for transactions which—because of business or other reasons—deserve exemption, and of preventing loss of revenue through avoidance devices.").

387. *See* Montgomery B. Angell, *Tax Evasion and Tax Avoidance*, 38 COLUM. L. REV. 80, 83 (1938) ("[A]side from [some] . . . exceptions, the substantive provisions of our revenue statutes are drawn so that a tax is imposed depending upon the existence or non-existence of objective facts, and the existence or non-existence of an intent to escape the tax plays no part in the determination of the tax liability."); Stephen J. McGarry, *State of Mind Standards in Taxation*, 7 AM. J. TAX POL'Y 249, 252 (1988) ("The goal of tax standards is to both determine the what, where, when, and how income is to be to be taxed and to encourage or discourage particular activities by taxpayers. Although the objective standards appear at first to be merely a method of measuring income or deductions, the ability of taxpayers to use the rules to their advantage soon raises the question

taxpayer is tax indifferent, it is easier to structure the objective elements of a transaction so that they mask the actual intent of the transaction. If both taxpayers will be subject to tax consequences, then the bargain that they strike should be respected in accordance with the normal rule that courts respect the agreements of parties negotiating at arms-length.[388] The safeguard provided by the government's ability to prove tax indifference raises the question of whether there should be only one test: an economic reality test.

B. Economic Reality Test

For related-party transactions, the economic reality test, drawing on the articulation of the interdependence test in *True v. United States*, would ask whether each step has a "reasoned economic justification standing alone."[389] As with the economic reality test in differentiating a true lease from a financing interest,[390] the trier of fact would focus not on the intent of the parties but on whether unrelated parties facing similar economic and business constraints would construct the transaction with a similar series of steps.

The test for related parties must, by necessity, be different than the test for unrelated parties. Related parties do not have to write out their contracts but can rely on unwritten understandings.[391] Furthermore, there may be no previous course of performance, dealing, or trade to look to in order to understand which transactions typically have followed one another. Having a non-tax business purpose or having economic effects, as measured by "actual payment of money, legal transfer of property, adjustment of company books, and execution of a contract," however, independently are not sufficient to deem a step as having economic justification.[392]

The economic reality test would determine reasoned economic justification by looking to the behavior exhibited by businesses engaged in

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whether the taxpayer comes within the standards as they were intended by Congress.") (footnote omitted).

388. *See* Fuller, *supra* note 378, at 806–10.

389. *See* True v. United States, 190 F.3d 1165, 1178 (citing Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1247 (5th Cir. 1983)). Commercial law uses an economic realities test to draw the distinction between a true lease and a security interest. *See* U.C.C. § 1-203 (AM. LAW INST. & UNIF. LAW COMM'N 1977).

390. *See* § 1-203.

391. *See* WHITE & SUMMERS, *supra* note 380, § 4-3, at 137 (terms supplied by course of dealing).

392. *True*, 190 F.3d at 1177 (footnote omitted).

similar arms-length transactions.[393] If businesses engaged in arms-length transactions would never engage in the intermediate, challenged steps, the steps probably do not have reasoned economic justification. A taxpayer could overcome this presumption by showing substantial economic effects on all related parties involved—especially effects that influenced dealings with unrelated third parties. If the only advantage to one of the parties came from tax savings, the tax savings would not be sufficient to show reasoned economic justification. A taxpayer could overcome this presumption by showing a significant lapse in time, during which the various related parties continued to conduct their businesses before taking the asserted last step of the purported multi-step, integrated transaction. Although this is similar to the hypothetical reasonable person, it is necessary to have this hypothetical in related-party transactions. It simply is too easy for related parties to create paper entities and paper cashflows that do not change the economics of a transaction.[394]

The idea here for an economic reality test is borrowed from Uniform Commercial Code ("UCC") § 1-203. The section begins by acknowledging that the determination is based on the "facts of each case."[395] The section goes on to list a number of factors that would transform something that was in the "form of a lease" into something that in substance is for a financing transaction.[396] These factors focus on whether the supposed lessor has a residual economic interest in the property.[397] In other words, whether the supposed lessor has a residual economic interest depends on whether the lessor is expected to derive further economic benefit from the property after the date on which the property is expected to return to the lessor's full control.[398]

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393. *Id.* at 1179.

394. *See, e.g.*, Bowen v. Comm'r of Internal Revenue, 78 T.C. 55, 78 (1982) (holding that transactions among related parties should be subject to a heightened level of skepticism "because of the greater potential for complicity between related parties in arranging their affairs in a manner devoid of legitimate motivations"); George C. Koutouras, Mark O. Tizabqar & James E. Carreon, *Related Party Transactions*, BNA 564-2nd, Tax & Accounting (BNA), at I.A (2018).

395. § 1-203.

396. § 1-203(b).

397. *See* Daniel Hemel, *The Economic Logic of the Lease/Loan Distinction in Bankruptcy*, 120 YALE L. J. 1492, 1498 (2011) ("[W]hat distinguishes a lease from a loan is that in a lease, the provider of funds (the lessor) retains a residual interest in the underlying asset *regardless* of whether the asset user (the lessee) remains solvent, whereas in a loan, the provider of funds (the creditor) has an interest in the underlying asset only if the user (the debtor) becomes insolvent.").

398. § 1-203(b) looks at the remaining economic life of the goods and the term of the lease.

The official comment to UCC § 1-203 emphasizes "greater certainty in commercial transactions" as a reason for adopting a "sharper line between leases and security interests disguised as leases."[399] The comment continues by noting that the "[r]eference to the intent of the parties . . . led to unfortunate results."[400] Thus, the drafters removed references to intent in the UCC and moved to a series of tests that "focus on economics."[401] This focus on economics was intended to avoid a focus on the surrounding circumstances of the deal and instead focus on whether the purported lessee has the right to own the goods for their remaining economic life.[402] The previous focus on intent and surrounding circumstances had led courts to render decisions on the basis of criteria that could apply just as easily to true leases as to security interests.[403] A series of factors described as a "bright-line test" indicate the creation of a security interest; if those factors are not met, courts look to all of the facts and circumstances to determine whether the parties created a lease or a security interest.[404] One of the reasons for the focus on economics is that in some circumstances, only one of the parties—usually the purported lessee—cares about the structure of the transaction.[405] Tax or other reasons might favor a lease characterization.[406] Thus, a focus on economics eliminates the need for a roving exploration of intent.[407] A focus on economics in the context of related parties and the step transaction doctrine is similarly beneficial.

In the example from the Introduction involving George and Isabella, if George and Isabella were related—if they were siblings, for example—and they had a series of dealings, the court would ask whether reasonable business people would structure their transactions in a similar manner. The court would look at whether various transactions between the siblings changed their economic positions in ways unrelated to tax. The economic reality test would require a broader and more rigorous examination than the examination required by the objective test if George and Isabella were unrelated. The economic reality test would not look simply at George and Isabella's manifested intent regarding the structure of the transaction but

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399. *Id.* cmt. 2.

400. *Id.*

401. *Id.*

402. *See* WHITE & SUMMERS, *supra* note 380, §§ 22–23.

403. *Id.*; *id.* § 30-3; *In re* QDS Components, Inc., 292 B.R. 313, 326 (Bankr. S.D. Ohio 2002).

404. § 1-203; *In re QDS Components, Inc.*, 292 B.R. at 332.

405. *See* LARY LAWRENCE, LAWRENCE'S ANDERSON ON THE UNIFORM COMMERCIAL CODE, 1-203:5 (3d ed. rev. 2011).

406. *See id*.

407. § 1-203(b) cmt. 2.

whether unrelated parties would structure the transaction in a similar manner.

An economic reality test promotes certainty and predictability better than the end result test or the interdependence test.[408] Although it requires thinking about a reasonable business or businessperson—a disadvantage in comparison to the objective test—the economic reality test does not require taxpayers to guess how a judge would infer intent from their actions like the end result test requires.[409] In *True* and other cases, courts often have articulated the end result test in terms of the subjective intent of the taxpayer—something that the taxpayer may know but that a court can only guess.[410] And, in some cases, such as *McDonald's*, the court has added a subjective element even to the interdependence test or has articulated the test in terms other than the economic relationship between the steps.[411]

In constructing the hypothetical reasonable businessperson, courts could look to other areas of tax law, such as transfer pricing, for inspiration. Transfer pricing is a much discussed area of law, especially with the ongoing Base Erosion and Profit Shifting ("BEPS") project of the Organization for

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408. *See, e.g.*, E. Carolyn Hochstadter Dicker & John P. Campo, *FF&E and the True Lease Question: Article 2A and Accompanying Amendments to UCC Section 1-201(37)*, 7 AM. BANKR. INST. L. REV. 517, 532–33 (1999) (discussing the 1990 amendments to UCC § 1-201(37), which distinguishes between a true lease and a secured sale). The amendments eliminated reference to "intent" and replaced it with an economic realities test to create greater certainty and eliminate confusion in commercial transactions. *See id.*

409. The official comment to UCC § 1-203, the section that replaced old UCC § 1-201(37), states that

> [p]rior to enactment of the rules now codified in this Section, the 1978 Official Text of Section 1–201(37) provided that whether a lease was intended as security (*i.e.*, a security interest disguised as a lease) was to be determined from the facts of each case [subject to two exceptions] . . . . Reference to the intent of the parties to create a lease or security interest led to unfortunate results. In discovering intent, courts relied upon factors that were thought to be more consistent with sales or loans than leases. Most of these criteria, however, were as applicable to true leases as to security interests . . . . Accordingly, this section contains no reference to the parties' intent.

§ 1-203 cmt. 2.

410. *See* True v. United States, 190 F.3d 1165, 1175 (10th Cir. 1999); Brown v. United States, 782 F.2d 559, 564 (6th Cir. 1986) ("[The end result] test clearly makes intent a necessary element for application of the [step transaction] doctrine . . . . [It] is a question of fact to be determined by the . . . court.").

411. McDonald's Rests., Inc. v. Comm'r, 688 F.2d 520, 524–25 (7th Cir. 1982).

Economic Co-operation and Development ("OECD").[412] Under current transfer pricing standards accepted by the OECD and applied by the IRS, the gold-standard method for determining the tax consequences of an intragroup transaction is to use the comparable uncontrolled price method.[413] The comparable uncontrolled price method looks to find a comparable transaction in the marketplace that involved arms-length parties.[414] The method then requires an inquiry into how much the arms-length parties paid for the product.[415] The Treasury Regulations describe how the comparable uncontrolled price method is applied to a transfer of goods.[416] The method looks for an arms-length transaction involving, most importantly, similar products and also looks at product quality, contractual terms, type of market, geography, date, and other factors.[417] The analogy here would be to ask whether parties undertaking a similar transaction that seeks to take advantage of tax-deferral provisions within the Internal Revenue Code—or avoid the application of such provisions out of a desire for immediate taxation and related basis consequences—are entering into the transaction on similar terms and using similar steps as arms-lengths parties, in the same position as the original parties, would use. One would try to find transactions that had a similar result—tax-free incorporation, tax-free division—and were similar in other ways: the size and scope of the business of the parties; the industry of the parties; the geographic location of the parties; the relative size of the parties in relation to each other; and other similar factors.

An economic reality test would have several benefits in the context of related parties and the step transaction doctrine. First, by ignoring the parties' intent, the test ignores the transaction's form and, therefore, prevents manipulation of the law.[418] Additionally, the test emphasizes the parties' relative economic positions resulting from the transaction's

412. *See BEPS Actions*, OECD, www.oecd.org/tax/beps/beps-actions.htm (last visited Sept. 8, 2017) [https://perma.cc/FY6U-P5FK].

413. *See* Treas. Reg. § 1.482–3(a)(1) (as amended 1995).

414. *See* § 1.482–3(b)(2).

415. *See id.*

416. *See id.*

417. § 1.482–3(b)(2)(ii).

418. *Cf.* Corinne Cooper, *Identifying a Personal Property Lease under the UCC*, 49 OHIO ST. L.J. 195, 202 (1988) (criticizing the previous version of the test for distinguishing between a true lease and a security interest, Cooper argues the following: "Obviously, the expressed intent of the parties cannot be the only distinguishing factor . . . since they may call their transaction one thing in an attempt to avoid the consequences of calling it what it really is.").

substance.[419] Consequently, the test places the court's attention on the economic interests of the parties rather than their intent: "[W]hat economic value represented by the goods is being transferred from the seller to the buyer, or from the lessor to the lessee, or from the debtor to the secured party?"[420] When a court implements an economic reality test, it proceeds through the thought process of an economically rational actor.[421] Finally, the test is flexible yet concrete, which is important because of the range of industries and parties involved as well as the uncertainties affecting elements of the test.[422]

Although the economic realities test in commercial law differs from the uncontrolled price method—a test that is more like the hypothetical reasonable person test—the economic realities test in commercial law is useful as an analogy for describing the rebuttal to the hypothetical reasonable person test. The rebuttal requires testing the economic effects of each step, similar to the factors that are examined in the economic realities test in commercial law. Thus, if a taxpayer is able to provide economic reasoning for each step, a court may find that the transaction reflects economic reality even if reasonable business people in similar circumstances would not have constructed the transaction in the same series of steps.

An economic reality test protects the public treasury and prevents evasion better than an objective test or a binding commitment test. Regarding the existing interdependence and end result test, although the economic reality test is arguably more difficult for the government to meet, it is, in a sense, less capricious for all parties involved. Furthermore, the existing tests sometimes have been asserted "offensively" by the taxpayer successfully.[423] By contrast, the economic reality test is less susceptible to guesswork by a judge or jury because the test requires a judge or jury to examine the economics of the transactions rather than the intentions of the parties. In addition, the test should not be available for offensive use by the taxpayer.

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419. *Id.*
420. *Id.*
421. *Id.*
422. *Cf.* Edwin E. Huddleson, III, *Old Wine in New Bottles: UCC Articles 2A—Leases*, 39 ALA. L. REV. 615 (1988).
423. *See, e.g.*, King Enters., Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); McDonald's Rests., Inc. v. Comm'r, 688 F.2d 520 (7th Cir. 1982).

C. Why Two Tests?

The overarching reason for having two tests is the fundamental difference between unrelated-party transactions and related-party transactions. Unrelated-party transactions involve parties who negotiate a deal with interests that compete in most areas. Although tax is a part of every business deal, tax is not usually the primary motivator.[424] Rather, business decisions usually are motivated by concerns related to future profitability, opportunities to expand to new markets, and many other motivations unrelated to reducing tax.[425] Even accounting considerations often outweigh tax considerations.[426] Underlying much of business law is a basic respect for the autonomy interest of unrelated parties contracting with each other.[427] The objective test will protect that autonomy interest for unrelated parties. An economic reality test properly balances that autonomy interest against concerns regarding the ability of related parties to manipulate generally applicable laws and thus evade tax.

An objective test also promotes the predictable administration of the tax law. Taxpayers could be less concerned that an individual judge will examine the economics of the transaction and redefine the relationship of the parties. Although some loss to the public treasury exists with an objective test, the loss likely will be small and the greater predictability likely outweighs the loss. Greater predictability promotes business

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424. Parties contemplating corporate reorganizations and mergers must consider many factors in addition to tax consequences. As one scholar notes, "'tax considerations' encompass only one set of factors to be studied in determining the feasibility or desirability of a particular corporate acquisition and the possible methods of achieving it." John T. Sapienza, *Tax Considerations in Corporate Reorganizations and Mergers*, 60 NW. U. L. REV. 765, 766 (1966) (footnote omitted). The scholar further provides that

> [t]he decision on the feasibility and precise form of a proposed acquisition will be based on a balancing of innumerable factors—ranging from . . . stockholder-relations, corporate policies and the economic or financial aspects of the basic business deal itself . . . to complex questions under federal and state tax and regulatory laws . . . .

Id. at 766 n.4.

425. *See, e.g.*, Melvin Aaron Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1, 18 (1969) ("The primary objective . . . of a business corporation must be to turn a profit.").

426. For example, the importance for current investors, current lenders, and potential investors of showing an accounting profit may outweigh the expense of greater current and/or future taxation. This often is important for covenants in transactions unrelated to the current transaction being negotiated by the parties.

427. *See* Fuller, *supra* note 378, at 806–10.

transactions that grow the economy, creating more income and thus ultimately generating additional tax.[428]

An economic reality test is more appropriate for related-party transactions because an objective test is far too malleable.[429] Furthermore, the economic reality test is less malleable than the current interdependence and end result tests because it looks to economics rather than intent, which makes the test less subjective, thus promoting predictable outcomes.[430]

D. Offensive Use of Judicial Doctrines

This Article argues that taxpayers who are not related parties should be able to use the step transaction doctrine "offensively" when there is a manifested mutual intent to combine steps into a completed transaction, absent unanticipated intervening events. There are three reasons supporting the argument to permit the "offensive" use of the step transaction doctrine: (1) permitting "offensive" use conforms better with the reasoning for having a step transaction test separate and apart from the other pervasive judicial doctrines; (2) permitting "offensive" use is supported, to some degree, by actual court practice;[431] and (3) in recent years, the IRS even has conceded to limited offensive use of the doctrine by taxpayers.[432]

The IRS and the courts have been hesitant to allow taxpayers to use judicial doctrines offensively—that is, to characterize their transactions as having a substance different from their form.[433] The courts have formulated this hesitancy to permit taxpayers to disavow the form of their transaction with two different rules: (1) the *Danielson* rule;[434] and (2) the strong proof rule.[435] The *Danielson* rule, the more restrictive and less

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428. Frank B. Cross, *Law and Economic Growth*, 80 TEX. L. REV. 1737, 1769 (2002) ("[T]he most robust predictor of growth was the predictability of judicial enforcement, which was significant in every regression.").

429. *See* discussion *supra* Part III.B.

430. *See* discussion *supra* Part III.B.; *see also* Harry Ebersohn, *Tax Avoidance and the Rule of Law*, 2012 NEW ZEALAND L. REV. 243, 245 (arguing that a test focusing on economics protects the collection of revenue, as well as the efficiency, equity, and simplicity of the tax system, while upholding rule of law values).

431. *See* Schneider, *supra* note 358, at 66.

432. *See* Rev. Rul. 2001–46, 2001–2 C.B. 321.

433. *See* Comm'r v. Danielson, 378 F.2d 771 (3d Cir. 1967); Ullman v. Comm'r, 264 F.2d 305 (2d Cir. 1959); Rev. Rul. 2001-64, 2001-2 C.B. 321; BITTKER & EUSTICE, *supra* note 263, ¶ 12.61[3]. *But see* King Enters., Inc. v. United States, 418 F.2d 511, 518 (1969); Blatt, *supra* note 36.

434. Named after the case of Comm'r v. Danielson, 378 F.2d 771 (3d Cir. 1967).

435. *See Ullman*, 264 F.2d 305; Hamlin's Trust v. Comm'r, 209 F.2d 761 (10th Cir. 1954); Levinson v. Comm'r, 45 T.C. 380 (1966); Bennett v. Comm'r,

widely adopted of the two, only permits taxpayers to disavow their form if they can prove certain contractual defenses, such as fraud or mutual mistake.[436] The strong proof rule, as the name suggests, only permits such disavowal if the taxpayer provides strong proof that the form does not reflect the substance of the transaction.[437] In the context of the step transaction doctrine, the analogy would be permitting only taxpayers to use the binding commitment test when offensively asserting the step transaction doctrine. Some courts and the IRS apparently accept this analogy and have adopted this approach.[438]

In the context of the application of the step transaction doctrine, however, the analogy to *Danielson* and the strong proof rule does not hold, and the courts should permit unrelated taxpayers to use the objective test to recharacterize their own transactions.[439] In *Danielson*, a taxpayer has selected his form; in step transaction, the taxpayer has selected form, but the taxpayer has done so for more than one step and the question is not "What is the form—singular—of the transaction?" but "Are two steps a

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29 T.C.M. 1230, 1235 (1970). The phrase "'strong proof' doctrine" first was used in *Bennett*. *See* Nickolas J. Kyser, *Substance, Form, and Strong Proof*, 11 AM. J. TAX POL'Y 125, 127 (1994). At least one commentator has noted that the strong proof doctrine can be justified, if at all, only as a "qualitative rule of law" rather than a "quantitative burden of proof." Kyser, *supra*, at 146. That commentator went on to argue that the *Danielson* rule is the more appropriate rule: taxpayers should be bound to their agreements because bilateral agreements generally reflect the economics of the deal except when contractual defenses are applicable. Kyser, *supra*, at 152. Given that the step transaction doctrine is about connecting or separating steps that uncontroversially did occur and not about establishing whether a certain event did, in fact, occur, the analogy does not extend here and taxpayers should have access to all legally accepted theories that form the core of the doctrine. Of course, the one way in which the doctrine should be applied to prevent whipsaw is if the parties agreed—especially if they documented their agreement—to treat a series of steps in the same way for each party's tax purposes. Then, the parties should be held to their bargain, absent normal contract defenses, to prevent whipsaw for the Commissioner. Kyser, *supra*, at 152. Christian A. Johnson, Note, *The* Danielson *Rule: An Anodyne for the Pain of Reasoning*, 89 COLUM. L. REV. 1320, 1333 (1989) (stating that absent such agreement, whipsaw, the Commissioner's strongest argument for preventing taxpayer's from using the full range of legal theories for the step transaction doctrine, is not applicable).

436. *See Danielson*, 378 F.2d at 774, 775.

437. *See supra* note 435.

438. *See* Rev. Rul. 2001-46, 2001-2 C.B. 321; BITTKER & EUSTICE, *supra* note 263, ¶ 12.61[3].

439. *See Danielson*, 378 F.2d at 774, 775.

part of one and the same transaction both for form and substance?"[440] The notions embodied in the strong proof rule and the *Danielson* rule are similar to the notion of *contra proferentem* in contract law.[441] Thus, taxpayers draft their own contracts, create their own forms, and should be bound to these contracts and forms. Of course, the problem is that in merger transactions, for example, the contract is not drafted simply by one party; it is drafted by two parties negotiating with each other. In at least some cases in mergers and reorganizations, the tax interests of the parties align rather than oppose each other.[442] The question remains whether the step transaction doctrine is similar to substance over form, the main context in which *Danielson* has been applied, a "subset" of it as some commentators and courts have said, or whether it is qualitatively different. This Article argues that it is qualitatively different.

In the context of complicated transactions with many steps, when the question is determining the place in which one transaction begins and another ends, the step transaction doctrine or some other similar doctrine must be available to taxpayers, either implicitly in characterizing a series of events as one single transaction or multiple separate transactions for their returns or explicitly in allowing its use in court. In a world of complicated multi-step corporate transactions, it is sometimes hard to say where one transaction begins and another ends.[443] Often, different transactions with different parties will take place in quick succession with the intent that a certain economic and business result is achieved for the parties.[444] Because of very reasonable IRS concerns regarding potential for abuse, the IRS officially has sanctioned only the use of the binding commitment test in the context of a taxpayer asserting the step transaction doctrine to combine two steps into a larger merger.[445]

440. In cases in which contracts bind the parties to take the second step, whether the second step should be merged with the first is clearly an issue of how to treat two steps—as separate or together—and not whether the form of any one step reflects its substance. This concept also is true when a merger or some other transaction would take place even if a second step were not completed but the parties clearly contemplate—especially when documented—the second step if it is permitted or approved.

441. *Compare Danielson*, 378 F.2d at 774, 775, *with* Metcalf Constr. Co. v. United States, 53 Fed. Cl. 617, 629 (2002).

442. In other cases, however, the tax interests of the parties clearly are opposed. When a stepped-up basis may be involved, one party may want such a stepped-up basis and the other may prefer tax-free treatment.

443. *See supra* note 26.

444. *Id.*

445. *See* Rev. Rul. 2001-64, 2001-2 C.B. 321.

Just as it can be helpful to look to contract law for defining the types of tests, one may look to contract law for the basis for determining whether the step transaction doctrine should be available to taxpayers. There is an analogy to the doctrine of *contra proferentem*, however, that used to hold sway in tax law. *Contra proferentem* is the notion that taxing statutes should be construed against the government.[446] The analogy has long since lost favor.[447] In a sense, ambiguity should be construed against the drafter—the government.[448] One scholar has noted that courts have moved away from such strict construction based in textualism and moved toward construction based on statutory purpose in the interpretation of tax statutes.[449] Forcing taxpayers to report taxes consistent with the form of a transaction rather than its purpose or economic effect, however, holds taxpayers to a different standard than the government.

Another reason for allowing the use of the step transaction doctrine is that, empirically, courts have allowed its use offensively.[450] A recent empirical study found that each of the pervasive judicial doctrines has been raised by the taxpayers in recent cases.[451] And with all of the doctrines, the taxpayer has been successful in at least some of those cases in convincing the court to apply the doctrine.[452] Furthermore, in the majority of those cases, the taxpayer has not been limited by a requirement of showing fraud or duress before arguing that she, he, or it could abandon the original form of the transaction.[453] Therefore, there is a need to reconcile theory with practice. At least in the case of the step transaction doctrine, the best way for reconciliation to occur is to accommodate some form of offensive use of the step transaction doctrine.

The third reason for allowing offensive use of the step transaction doctrine is that the IRS has allowed such offensive use in a recent revenue ruling.[454] Revenue Ruling 2001-46 discusses two factual situations. The first factual situation involves a parent corporation forming a new wholly owned subsidiary.[455] The parent then acquires all of the stock of a target in a statutory merger of the new subsidiary into the target ("Acquisition

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446. *See* Morse, *supra* note 35, at 465.
447. *Id.* at 478.
448. *Id.*
449. *See generally* Michael Livingston, *Practical Reason, "Purposivism," and the Interpretation of Tax Statutes*, 51 TAX L. REV. 677 (1996).
450. *See* Schneider, *supra* note 358, at 62.
451. *See id.*
452. *Id.*
453. *See id.*
454. Rev. Rul. 2001-46, 2001-2 C.B. 321.
455. *See id.*

Merger"). The target shareholders receive as consideration 70% parent stock and 30% cash. The target survives and merges into the parent in a statutory merger ("Upstream Merger"). The ruling assumes that, absent some prohibition, the step transaction doctrine would apply to treat the two mergers together as a single, integrated acquisition by the parent of all of the assets of the target. The ruling also assumes that the integrated transaction would satisfy the nonstatutory requirements for a reorganization. The second factual situation is the same as the first except that it assumes that all of the consideration in the Acquisition Merger is stock of the parent so that the Acquisition Merger viewed alone would qualify as a valid reverse subsidiary merger under § 368(a)(2)(E).

The ruling notes that, under § 338, if a corporation makes a qualified stock purchase followed by an election, then the target corporation is treated as having sold all of its assets at the close of the acquisition date at fair market value and is treated as a new corporation that purchased all of its assets as of the beginning of the day after the acquisition.[456] A qualified stock purchase is defined as the acquisition by one corporation of stock of another that results in the acquirer achieving control, defined as holding 80% of the total voting power and 80% of the total value of stock of the target corporation.[457] Revenue Ruling 90-95 held that a reverse subsidiary merger—in which the consideration was all cash and thus did not qualify under § 368(a)(2)(E), followed by a merger of the surviving target into the parent—would be treated as a qualified stock purchase followed by a liquidation under § 332.[458] Revenue Ruling 90-95 reached this holding even though the step transaction doctrine is applied properly to disregard the existence of the merger subsidiary, which had merged into the target in the first step; nonetheless, the acquisition of stock of the target was granted independent significance from the subsequent liquidation of target. Revenue Ruling 2001-46 notes that Treasury Regulation § 1.338-3(d) incorporates the approach of Revenue Ruling 90-95 by requiring a purchasing corporation to treat certain asset transfers following a qualified stock purchase independently of the qualified stock purchase.[459] Finally, in its discussion of the applicable law, Revenue Ruling 2001-46 notes that the much earlier Revenue Ruling 67-274 integrated two steps that would have been treated separately as an invalid reorganization under §

456. *See* I.R.C. § 338 (2012).
457. *See id.* §§ 338(d)(3), 1504(a)(2).
458. *See* Rev. Rul. 90-95, 1990-2 C.B. 67 (Situation 2).
459. *See* Treas. Reg. § 1.338-3(d)(5)(example) (2006).

368(a)(1)(B) followed by a liquidation under § 332.[460] The two steps integrated instead qualify as a reorganization under § 368(a)(1)(C).[461]

At the beginning of its analysis of the two factual situations, Revenue Ruling 2001-46 notes that two approaches can determine the tax consequences for the two steps in each situation: one approach is to treat the steps separately as in Revenue Ruling 90-95, and the other approach is to integrate them as in Revenue Ruling 67-274.[462] In Situation One, treating the steps separately and following Revenue Ruling 90-95 would result in the Acquisition Merger being treated as a qualified stock purchase and the Upstream Merger being treated as a liquidation under § 332. Integrating the steps, following Revenue Ruling 67-274, would result in a single statutory reorganization under § 368(a)(1)(A).

The analysis in Revenue Ruling 2001-46 cited *King Enterprises, Inc. v. United States*,[463] a case that predated § 338, in which the court applied the step transaction doctrine to treat an acquisition of stock of a target corporation followed by the merger of the target corporation into the acquiring corporation as an integrated reorganization under § 368(a)(1)(A). The ruling then framed the question as whether the approach of Revenue Ruling 90-95 applies when the step transaction doctrine otherwise would integrate the steps as one valid reorganization under § 368.[464] Revenue Ruling 2001-46 rejected the application of Treasury Regulation § 1.338-3(d) and Revenue Ruling 90-95 to this situation by citing the congressional intent that § 338 "replace any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine."[465]

The ruling continues by explaining that the policy underlying § 338 is not violated because, rather than receiving a cost basis in the assets under § 1012, the acquiring corporation will receive a carryover basis under § 362.[466] Thus, Revenue Ruling 2001-46 concludes that an otherwise invalid reverse subsidiary merger without a § 338 election, followed by a forward subsidiary merger that would be tax-free if the reverse merger was ignored, should be treated as an integrated valid forward subsidiary merger.[467] For Situation Two, Revenue Ruling 2001-46 holds that the steps should be integrated as in Situation One—notwithstanding the fact that the

460. *See* Rev. Rul. 67-274, 1967-2 C.B. 141.
461. *See id.*
462. *See id.*
463. King Enters., Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969).
464. Rev. Rul. 2001-46, 2001-2 C.B. 321.
465. *Id.* (citing H.R. REP. NO. 97-760, at 536 (1982)).
466. *Id.*
467. *Id.*

first step would be a valid reorganization if viewed separately from the second step.[468]

The consequence of this ruling was that parties, through the use of an extra step, could consummate a forward subsidiary merger with all of the flexibility in consideration provided to forward subsidiary mergers.[469] Further, the parties undertaking the merger could know that if the integration of the two steps were not respected, the only tax that would be imposed would be at the shareholder level.[470] The ruling requires that the steps be taken pursuant to a "written agreement that (subject to customary conditions) is binding."[471] A further consequence of this ruling was that it gave the same treatment of an integrated forward subsidiary merger to a two-step merger when the first step, in fact, was a valid reverse subsidiary merger. Revenue Ruling 2001-46 was received positively by the tax practitioner community.[472]

The logic of permitting offensive use of the step transaction doctrine in Revenue Ruling 2001-46 makes sense, and the test required for offensive use is similar to the one that this Article advocates. Revenue Ruling 2001-46 promotes more flexible structuring and removes the draconian penalty of two levels of tax when companies are committed to a reorganization.[473] The ruling thus functions as a recognition by the IRS that having the special 80% requirement for forward subsidiary mergers should be limited to situations in which such a merger is the only feasible route for a combination of the parties' interests. Under the standard advocated by this Article, if parties sign a plan of reorganization that contemplates a reverse subsidiary merger followed by a forward subsidiary merger but the occurrence of the forward subsidiary merger depends upon certain contemplated and anticipated, but not guaranteed, events, then the parties may assert the step transaction doctrine offensively.[474] Thus, under the proposed test, taxpayers may assert offensively the step transaction

468. *Id.*

469. *See id.*

470. *See supra* note 5 and accompanying text.

471. Rev. Rul. 2001-46, 2001-2 C.B. 321.

472. *See,* e.g., Linda Z. Swartz, *Multiple Step Acquisitions: Dancing the Tax-Free Tango*, 107 TAX NOTES 609, 612 (2005).

473. *See* Rev. Rul. 2001-46, 2001-2 C.B. 321.

474. For example, if the merger is contingent on a vote of the shareholders of the target company approving the merger or approval by lenders and other counterparties in contracts. *See* PATRICK A. GAUGHAN, MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURING 23–28 (6th ed. 2015).

doctrine if a contractual obligation exists to complete two steps[475] or if a second step is contemplated and anticipated in a contract and will occur absent unanticipated intervening events.

E. Different Tests, Different Results

Under the new test, cases involving unrelated parties, such as *Heintz v. Commissioner*,[476] would be decided in favor of the government rather than the taxpayer.[477] *Heintz* raised the issue of whether the sale was an independent event from the merger that immediately followed.[478] This issue was critical because under the 1939 Code, boot[479] in a reorganization was taxed at ordinary rates rather than capital gain.[480] Therefore, if the whole transaction was a reorganization, the boot would be taxed at a higher rate than if a sale occurred, followed by a reorganization.[481] Although the court was correct that the taxpayers intended to sell from the beginning and, in fact, only accepted the final deal after attempting to negotiate an all cash deal, the court ignored the mutuality involved in characterizing the deal as a reorganization.[482] All of the documents negotiated by the parties contemplated a reorganization that would follow immediately after the receipt by taxpayers of cash and stock of the merged corporation.[483] In fact, taxpayers expressed concerns regarding loss of tax benefits related to net operating loss carrybacks, but the acquirer told them that a reorganization would compensate them for this loss of benefits.[484]

Although courts should acknowledge that the offensive use of the test by taxpayers is permitted, ironically, the definition this Article proposes would result in a denial of the offensive use of the step transaction doctrine and a decision for the government in two of the most famous reported

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475. This contractual obligation may be manifested in one unified contract, in two contracts that reference each other, or in one contract that references another contract.

476. Heintz v. Comm'r, 25 T.C. 132, 133 (1955).

477. *See supra* notes 201–217 and accompanying text.

478. *See Heintz*, 25 T.C. at 133.

479. "Boot is cash, or property other than stock, transferred as part of a reorganization." *See* BITTKER & EUSTICE, *supra* note 263, ¶ 3.05[1].

480. *See Heintz*, 25 T.C. at 133.

481. *See id.*

482. *See id.* at 142.

483. *See id.*

484. *See id.* at 135.

cases, *King Enterprises* and *McDonald's*, in which the taxpayer successfully asserted the step transaction doctrine offensively.[485]

King Enterprises would be decided in favor of the government because there was no mutual expression of intent for a reorganization to occur at the time the sale transaction was completed.[486] In fact, the court acknowledged that the "plan to merge" was "less than announced" even as it asserted that it viewed the plan as "more than inchoate."[487] The court tacitly acknowledged that the documents and testimony presented at trial did not support this conclusion when it stated that "[o]ne gains the impression that the record of intentions is edited."[488] The court supported this supposition by asserting that it was "difficult to believe that sophisticated businessmen arranging a multimillion dollar transaction fraught with tax potentials were so innocent of knowledge of the tax consequences as the testimony purports."[489]

McDonald's would be decided in favor of the government because although the documents permitted the Garb-Stern group to force a registration, a registration never was guaranteed to take place; the Garb-Stern group could have foregone forcing a registration.[490] Although a registration right would be enough under the objective test for the government to assert the step transaction doctrine, it would not be enough for the taxpayer to assert the step transaction doctrine. The taxpayer would have to show that there was a contractual obligation to perform the next step—not simply a manifestation of an intention that the steps should be combined. This requirement is necessary to prevent whipsawing of the IRS.[491] The majority in *McDonald's* asserted that, because the Commissioner would not grant an advanced ruling with regard to this transaction as a reorganization, the Commissioner should not be able to assert that that the transaction is a reorganization after the fact.[492] The court acknowledged that the transfer of shares by the Garb-Stern group was pursuant to a "statutory merger under Delaware corporation law" and that the "Garb-Stern group was not obligated by contract to sell."[493] The intention never could be mutual because the Garb-Stern group always could change its intentions. For

485. King Enters., Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); McDonald's Rests., Inc. v. Comm'r, 688 F.2d 520 (7th Cir. 1982).

486. *See King Enters., Inc.*, 418 F.2d at 519.

487. *Id.*

488. *See id.*

489. *Id.*

490. *See McDonald's Rests., Inc.*, 688 F.2d at 521–22.

491. *See supra* notes 281–283 and accompanying text.

492. *McDonald's Rests., Inc*., 688 F.2d at 528 (7th Cir. 1982).

493. *Id.* at 522.

example, if the McDonald's stock price went up, the Garb-Stern group may have chosen to hold the stock rather than sell. Furthermore, the first expected registration, which did not take place, was in June—two months after the closing and plenty of time for price swings in McDonald's shares, which could change whether the Garb-Stern group actually sold its stock.[494]

III. BROADER THEMES AND OPEN QUESTIONS: BORROWING ACROSS AREAS OF LAW AND ALIGNING THEORY WITH PRACTICE

This Article provides a view into two broader themes that can be explored fruitfully in future work. Both of these themes tie into promoting predictability and the rule of law by promoting consistent outcomes that can provide advance notice of the law to affected persons.[495] The first theme is that tax law can benefit from drawing on doctrines in other areas of law when those areas of law are addressing the same types of transactions and subject matter as tax law. The second theme is that tax law and taxpayers benefit from the alignment of judicial doctrine and its application.

Tax law often has been viewed as separate from other areas of law.[496] This is true both in the oft-stated idea that the federal income tax consequences of actions may be different than the state law consequences and in the creation of different doctrines both for statutory interpretation and for validity of regulations.[497] Tax law is not as unique as it seems, however.

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494. *See id.*

495. Predictability is an important theme within the rule of law. *See* Timothy A.O. Endicott, *The Impossibility of the Rule of Law*, 19 OXFORD J. LEG. ST. 1, 3 (1999) (noting, although ultimately complicating, that there is broad agreement on three important characteristics of the rule of law: (1) constraint on the rulers; (2) consistency in application; and (3) certainty of outcomes); Jeremy Waldron, *Is the Rule of Law an Essentially Contested Concept (in Florida)?*, 21 LAW & PHIL. 137, 153–64 (2002) (arguing that the rule of law always has been a contested concept and had complexity but noting certain basic commonalities among those who attempt to define the concept, including the importance of consistency and effective guidance); Jeremy Waldron, *The Concept and the Rule of Law*, 43 GA. L. REV. 1, 6 (2008) (discussing certainty and predictability as broadly accepted characteristics of the rule of law).

496. Paul L. Caron, *Tax Myopia, or Mamas Don't Let Your Babies Grow Up to be Tax Lawyers*, 13 VA. TAX REV. 517, 518 (1994).

497. Professors Nancy Staudt, Lee Epstein, Peter Wiedenbeck, and Rene Lindstadt analyzed every tax case decided by the Supreme Court since Congress adopted modern tax laws in 1909 to provide a descriptive mapping of statutory interpretation in disputes over the meaning of the Internal Revenue Code. *See*

Nancy Staudt et al., *Judging Statutes: Interpretive Regimes*, 38 LOY. L.A. L. REV. 1909, 1911 (2005). Their study aimed to "identify[] the various rationales deployed by the justices as well [as] assess[] some commonly-held beliefs about trends in statutory interpretation over time." *Id.* After identifying all the Supreme Court cases mentioning the word "tax" and retaining only those that involved the interpretation of a federal tax statute, the authors were left with 922 distinct cases—or 991 Code provisions—decided from 1912 to 2000. *Id.* at 1926–29. Because both intentionalism and purposivism emphasize the process leading to a statute's creation, the authors identified decisions that relied on either approach by looking for the use of certain evidence, which was produced during the law-making process. *Id.* at 1939–40. The authors found that in nearly half the cases, the Court invoked legislative history, which included congressional record, congressional bills, committee reports, congressional/committee hearings, and congressional studies and analyses. *Id.* at 1940–41. Among those components of legislative history, committee reports clearly dominated. *Id.* at 1941. This finding comported with "the Court's own rhetoric and with other studies." *Id.*; *see* William N. Eskridge, Jr., *The New Textualism*, 37 UCLA L. REV. 621, 636 (1990) (deeming committee reports as "most authoritative" under the "hierarchy of [legislative history] sources"); Stephanie Wald, *The Use of Legislative History in Statutory Interpretation Cases in the 1992 U.S. Supreme Court Term; Scalia Rails But Legislative History Remains on Track*, 23 SW. U. L. REV. 47, 47 (1993) (maintaining the Court "continues to look at legislative history in cases where the meaning of a federal statute is at issue"); *see also* Comm'r v. Soliman, 506 U.S. 168, 173–74 (1993) (Kennedy, J.) (citing committee reports to illustrate the intent of the Code section for determining whether an office in a taxpayer's home qualified as his "principal place of business"). Judicial decisions in tax regularly cite to policy rationales, something that would not meet with favor from textualists. *See* Staudt et al., *supra*, at 1957–60 (noting and tracking the Court's reliance upon policy rationales, such as administrability, economic growth and stability, revenue raising concerns, etc.); Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567 (1965) (discussing pervasive tax policies such as adequacy of revenue, practicality, equality, and economic stability by detailing the judicial, legislative, and administrative history of the federal income tax). William N. Eskridge, Jr., *The New Textualism*, 37 UCLA L. REV. 621, 648 (1990) (describing textualism as a judicial philosophy whose underlying premise is that "major policy decisions should be made by the popularly elected branches of government" rather than courts); *see also* Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44, 53–57 (2011) (holding that the deferential standard of *Chevron U.S.A., Inc. v. Nat. Res. Def. Council*, 467 U.S. 837 (1984) applied in the tax area and the standard of *Nat'l Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472 (1979), which is unique to tax law, did not apply). Prior to the decision in *Mayo Foundation*, the Court had cited to both *Chevron* and *National Muffler Dealers* in tax cases. *See Mayo Found.*, 562 U.S. at 53–57. In *Mayo Foundation*, the Court made explicit that *Chevron* was the appropriate standard and tax should be like other areas of law

The subject matter of tax is the subject matter of other areas of law: the meaning of contractual terms; the effect of a corporate merger; and the rights of partners in relation to each other, among other things. These events have meaning in other areas of law as well as in tax law. Ownership rights confer not only the right to a stream of income but also the right to use property.[498] This view of tax as exceptional limits the tools available to tax scholars, practitioners, and judges when faced with difficult interpretive questions.[499]

The second theme, the importance of aligning the articulation of judicial doctrines with their application, is demonstrated in the area of assertion of the application of judicial doctrines by the taxpayer.[500] The traditional understanding has been that such application is highly limited.[501] This understanding, however, is empirically questionable and in some cases has been limitedly abandoned by the IRS.[502] These two facts should raise the question of whether the theory needs to be changed. There are also possibly other areas, including other judicial doctrines[503] and general anti-abuse rules, where rules are applied differently than how they are articulated. Because judicial decisions and Treasury Regulations often state these rules in overly broad terms, the misalignment of the description of doctrine and its application render necessary a reexamination of the descriptive contours of these doctrines.[504] This misalignment might even

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with regard to the Court's respect for agency expertise. *See id*. at 56 ("We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other [non-tax] regulations.").

498. *See* Edward H. Ziegler, *Partial Taking Claims, Ownership Rights in Land and Urban Planning Practice: The Emerging Dichotomy Between Uncompensated Regulation and Compensable Benefit Extradition under the Fifth Amendment Takings Clause*, 22 J. LAND RESOURCES & ENVTL. L. 1, 18 (2002) (denying economically viable use of land is a taking because it infringes on the right to use property).

499. *See* Alice G. Abreu & Richard K. Greenstein, *Tax as Everylaw: Interpretation, Enforcement, and the Legitimacy of the IRS*, 69 TAX LAW. 493, 501 (2016) ("Our central claim is that when tax is viewed as objectively exceptional—that is, when tax is thought to be fundamentally different in kind from other fields of law—it is deprived of the analytical tools and vocabulary commonplace in other fields of law.").

500. *See supra* Part I.C.1.

501. *See supra* Part I.C.1.

502. *See* Schneider, *supra* note 358, at 39–40.

503. *See id.*

504. *See* John M. Breen, *Statutory Interpretation and the Lessons of Llewellyn*, 33 LOYOLA L.A. L. REV. 263 (2000) (discussing Karl Llewellyn's distinction

be cured by looking to other areas of law for more precise definitions, as this Article advocates with respect to the definition of the step transaction doctrine tests.

The alignment of judicial doctrine and its application is an important part of the rule of law. If courts articulate a test—whether characterized as a rule or a standard—but apply it differently than its articulation, then predictability is decreased and the rule of law is damaged accordingly.[505] Lawyers and clients should not have to study every case in an area to understand a thousand unstated exceptions to a test lacking any articulated exceptions. This misalignment of judicial doctrine and its application increases transaction costs and decreases predictability. It also harms the public image of justice.

CONCLUSION

Courts can achieve greater clarity by reconceptualizing the step transaction doctrine as consisting of two tests: an objective test for arms-length transactions and an economic reality test for related-party transactions. These new tests would provide greater predictability for taxpayers—and the IRS—while still protecting the public treasury. By finding inspiration and guidance for the objective test in contract law, this Article also reinforces the argument that tax law is an inseparable part of law as a whole. By demonstrating that the objective test should be available to taxpayers in at least some circumstances, this Article demonstrates the benefit of aligning theory with practice.

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between "pseudo" rules and "real rules." "Pseudo" rules are the court's articulation of doctrine whereas "real rules" are "descriptions of the 'practices of courts.'") (citations omitted).

505. *See supra* note 495.