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Thoughts Regarding the Application of the Step Transaction Doctrine to the Section 351 Control Requirement and Complex Media, Inc. v. Commissioner

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THOUGHTS REGARDING THE APPLICATION OF THE STEP TRANSACTION DOCTRINE TO THE SECTION 351 CONTROL REQUIREMENT AND *COMPLEX MEDIA, INC. V. COMMISSIONER*

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ABSTRACT

Over thirty years ago, Professor Ronald H. Jensen authored an article in the Virginia Tax Review, titled "Of Form and Substance: Tax Free Incorporations and Other Transactions Under Section 351." Professor Jensen asserted that it was inappropriate to utilize the step transaction doctrine to determine whether the control requirement was met in a purported section 351 transaction, involving a disposition of some, or all, of the transferor's shares even if effected by a binding contract made prior to the contribution.

Professor Jensen concluded that the courts and the Internal Revenue Service (Service) have produced a hodgepodge of intellectually inconsistent decisions and rulings making predictability problematic. There is no doubt of the many inconsistencies rendered by the Service and the courts in addressing the use of the step transaction to determine whether the control test under section 351 has been satisfied when there had been dispositions connected with the initial contribution. Nevertheless, there are sound policy reasons for the application of this judicial canon in certain circumstances and that Professor Jensen's prescription for remedying the problem, i.e., by the complete elimination of the doctrine's utilization in this context, is unwarranted.

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This Article also considers the recent Tax Court decision, Complex Media, Inc. v. Commissioner, *which addresses a different facet of section 351 control. The case involved, inter alia, the taxpayer's successful attempt to invoke the step transaction doctrine to treat as boot, payments made to one of the partners of the transferor. Another aspect of the arrangement, however, is particularly troubling and the reason why discussion of the case is part of this Article examining section 351 control. This concerns the taxpayer's position regarding how the requisite ownership was achieved. The court, at the behest of both parties, reluctantly agreed to include an act, i.e., a merger, in allowing the section to apply when the taxpayer's form arguably did not comport with the statutory requirements. The Service's concurrence to section 351 treatment was apparently motivated by its desire to minimize taxpayer's amortization deductions rather than seeking to achieve a sound policy outcome.*

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INTRODUCTION

Over thirty years ago, Professor Ronald H. Jensen authored an article in the Virginia Tax Review, titled "Of Form and Substance: Tax Free Incorporations and Other Transactions Under Section 351."[1] Professor Jensen asserted that it was inappropriate to utilize the step transaction doctrine to determine whether the control requirement was met in a purported section 351 transaction, involving a disposition of some, or all, of the transferor's shares even if effected by a binding contract made prior to the contribution.[2]

Professor Jensen provided a thorough analysis of decisions by the courts and rulings of the Internal Revenue Service (Service) concerning whether or not the step transaction should be utilized in this context.[3] He also examined the legislative history of a predecessor provision to section 351,[4] as well as made a cogent argument that the mere change in form rationale given by some courts for nonrecognition treatment pursuant to section 351 is tenuous.[5] Professor Jensen concluded that the courts and the Service:

> [H]ave created a patchwork of irreconcilable decisions, inexplicable on the basis of logic or policy and virtually devoid of any explanatory or predictive value. The result has been a series of *ad hoc* decisions distinguishable only on the basis of their factual variations, with little or no explanation as to why such factual variation justifies a particular result.[6]

He asserted that "[t]his lack of a consistent rationale has made both prediction and rational development of the law virtually impossible."[7]

There is no doubt of the many inconsistencies rendered by the Service and the courts in addressing the use of the step transaction to determine whether the control test under section 351 has been satisfied when there had been dispositions connected with the initial contribution.[8] Professor Jensen made a superb case as

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[1] *See* Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions Under Section 351*, 11 VA. TAX REV. 349, 349 (1991).

[2] *Id.* at 417.

[3] *See generally id.*

[4] *See id.* at 381–87.

[5] *See id.* at 375–81.

[6] *Id.* at 355–56.

[7] *Id.* at 356.

[8] *See id.* at 359–67.

to why change is needed in this matter.[9] Nevertheless, there are sound policy reasons for the application of this judicial canon in certain circumstances. Nullifying any role for the step transaction doctrine in this context, is not justified.[10] The Article includes a discussion of some other proposals for addressing the dilemma, including one put forth by tax attorney Stephen S. Bowen in an article written a few years after Professor Jensen's article.[11]

This Article will also consider the recent Tax Court decision, *Complex Media, Inc. v. Commissioner*, which addresses a different facet of section 351 control.[12] The case involved, inter alia, the taxpayer's successful attempt to invoke the step transaction doctrine to treat as boot, payments made to one of the partners of the transferor.[13] Another aspect of the arrangement, however, is particularly troubling and the reason why discussion of the case is part of this Article examining section 351 control. This concerns the taxpayer's position regarding how the requisite ownership was achieved.[14] The court, at the behest of both parties, reluctantly agreed to include an act, i.e., a merger, in allowing the section to apply when the taxpayer's form arguably did not comport with the statutory requirements.[15] The Service's concurrence to section 351 treatment was apparently motivated by its desire to minimize taxpayer's amortization deductions rather than seeking to achieve a sound policy outcome.[16] This type of ephemeral strategy of the Service can lead to what the late renowned tax lawyer and professor Martin Ginsburg characterized as the "law of Moses' rod": "Every stick crafted to beat on the head of a taxpayer will, sooner

[9] *See id.* at 424–26.

[10] *See infra* notes 406–49 and accompanying text.

[11] *See infra* notes 450–96 and accompanying text; Stephen S. Bowen, *The End Result Test*, 72 TAXES 722, 722, 731, 737, 742 (1994).

[12] *See infra* Part I; 121 T.C.M. (CCH) 1089, 22–24 (2021).

[13] *Complex Media, Inc.*, 121 T.C.M. (CCH) at 74–76.

[14] *See infra* notes 77–97 and accompanying text.; *Complex Media, Inc.*, 121 T.C.M. (CCH) at 30–32.

[15] *Complex Media, Inc.*, 121 T.C.M. (CCH) at 30–32.

[16] *Id.* at 31 n.13. The Tax Court noted that the Service's seemingly natural path of trying to tax the transferors for a defective section 351 "would likely have expired by now in the absence of extensions." *Id.* It is also possible that the Service in fact thoroughly analyzed the merger step, explained below, and was comfortable that it should count for determining section 351 control and there was no consideration of the amount of the Taxpayer's amortization deductions. *Id.* It should have explained its reasoning for why section 351 applied in the briefs that it filed with the court.

or later, metamorphose into a large green snake and bite the Commissioner on the hind part."[17]

This Article will begin with a detailed discussion of the *Complex Media* opinion,[18] followed by a concise overview of the step transaction doctrine in general,[19] and close with an analysis of its role in determining control for section 351 purposes when there is a post contribution disposition of transferor's shares connected with the initial transfer.[20] This includes a detailed discussion of Professor Jensen's analysis and recommendation, and some possible alternatives.[21] This Article is certainly, however, not intended to provide the reader an exhaustive analysis of the plethora of decisions and rulings in this area.

I. *COMPLEX MEDIA V. COMMISSIONER*

Complex Media, Inc. v. Commissioner involved asserted deficiencies by the Service with respect to amortization deductions claimed by Complex Media, Inc. (the Taxpayer or petitioner) with respect to intangible assets it acquired in November 2009 in a transaction claimed by the Taxpayer, and stipulated by the Service, to meet the requirements of section 351.[22] Falling under the ambit of section 351 has, inter alia, important implications with respect to whether the initial inside basis to the transferee of the acquired assets reflect the transferor's carryover basis, with adjustments for any gain recognized by the transferor pursuant to section 362(a), or instead equals the contributed assets fair market value under section 1012(a).[23] This determination has important ramifications with respect to the amount of amortization and other cost recovery deductions the transferee taxpayer is entitled to.[24] As the Tax Court explained, in the case of *Complex Media*, "[i]f section 351 did not apply to the transaction, it would be treated as a taxable

[17] Martin Ginsburg, *The National Office Mission*, 27 TAX NOTES 99, 100 (1985).

[18] *See infra* Part I.

[19] *See infra* Section II.A.

[20] *See infra* Section II.B.

[21] *See infra* notes 406–96 and accompanying text.

[22] *See* Complex Media, Inc. v. Comm'r, 121 T.C.M. (CCH) 1089, 6–10, 21–31 (2021).

[23] *See id.* at 21–22, 32, 76.

[24] *See id.* at 21–22.

purchase and sale, and petitioner's bases in any amortizable intangibles would be higher than those it claims."[25]

The *Complex* name was fitting, with the Tax Court acknowledging that "[i]dentifying the issues that remain for decision has proved a challenge, leading to our request that the parties address in supplemental briefs a series of questions ... [but] [o]ur efforts were not entirely successful."[26] The deficiencies at issue relate to the Taxpayer's 2010, 2011, 2012 and 2013 Federal income tax returns.[27]

The most troubling aspect of the decision was the court's reluctant decision for section 351 to apply.[28] One article described the outcome as one where "it appears that there was no factual basis to contend that section 351 applied to the transaction—except that both parties claimed that it did."[29] In this respect, the court was particularly critical of the Service, with the court stating that:

> As far as we can tell, respondent relies entirely on section 351 in support of his position that petitioner's bases in the assets it acquired from CMH [the transferor] were limited by section 362(a) to their bases in CMH's hands. Even so, respondent does not explain in any detail why section 351 applies ....[30]

The Taxpayer too was somewhat evasive as to its assertion as to why the section applied.[31] The Tax Court observed in

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[25] *Id.* at 21. The court detailed the different results from coming within section 351 versus not meeting its requirements in a footnote:

> If petitioner acquired the assets of the transferred business in a taxable purchase and exchange, its basis in the amortizable section 197 intangibles included in the exchange would equal the fair market value of those assets, which, as explained *infra* part IV.D.6., we have determined to be $7,616,852. The 'step-up' in the basis of those assets resulting from the transaction would be $7,578,127 ($7,616,852 value - $38,725 basis to CMH ($12,889 basis in trademarks + $25,836 basis in domain name))—an amount far in excess of the $3 million basis step-up petitioner claimed on its returns.

Id. at 21 n.10.

[26] *Id.* at 21.

[27] *Id.* at 3.

[28] *Id.* at 30–31.

[29] Richard M. Lipton & Brandon King, *Tax Court Decision in Complex Media Involves "Complex" Analysis of Facts, Law, and Step Transaction Doctrine*, 134 J. TAX'N 14, 14 (2021).

[30] *Complex Media, Inc.*, 121 T.C.M. (CCH) at 22.

[31] *See* Petitioner's Opening Brief at 30–34, Complex Media, Inc. v. Comm'r of Internal Revenue, 121 T.C.M. (CCH) 1089 (2021) (No. 13368-15, 19898-17).

this regard that "[i]n its opening brief, petitioner argues at some length for the application of section 351, even though it leaves a potentially critical issue unaddressed."[32]

As explained below, this Article argues that the form of the *Complex Media* transaction at least arguably did not comport with the statutory requirements.[33] The Service's agreement to acquiesce to section 351 treatment was apparently motivated to minimize taxpayer's amortization deductions.[34] It failed in its obligation to try to help shape well-reasoned precedent as to when section 351 control has been met. By challenging such treatment, it would have left it to the Tax Court to conclude the proper course of action rather than to simply acquiesce to the parties' agreement.[35]

By way of background, in May 2002, a print magazine with the title "Complex Magazine" was established by Seth Gerszberg, Marc Ecko and Mr. Ecko's sister as "a vehicle to promote the retail clothing business they had been operating."[36] Online content was later added, "and by 2006, Complex Magazine was aggressively involved on-line through Complex.com which was a network of the most popular advertising sites combined with the magazine content."[37] The business was conducted prior to 2008 by two New Jersey limited liability companies, Complex Media LLC (Media) and Complex Media THC LLC (Media THC).[38] A third New Jersey limited liability company, Complex Media Holdings LLC (CMH) was formed in January 2008, to serve as a holding company for the other limited liability companies.[39] CMH was owned by Gerszberg, Ecko, Richard Antoniello, who had previously been hired to run the magazine and who had added the online context, and Michael Golden, who joined the business later.[40]

While the business "was successful in capitalizing on the increased popularity of online media, the overall business ... experienced financial difficulties because of a decline in the retail

[32] *Complex Media, Inc.*, 121 T.C.M. (CCH) at 22.
[33] *See infra* notes 184–90.
[34] *See supra* note 16 and accompanying text.
[35] *See Complex Media, Inc.*, 121 T.C.M. (CCH) at 29–31, 31 n.13.
[36] Petitioner's Opening Brief, *supra* note 31, at 5.
[37] *Id.* at 6.
[38] *See id.*
[39] *Id.*
[40] *Id.* at 5–6.

clothing business."[41] The need for additional financing prompted the plan at issue in this case.[42] OnNetworks, Inc. (ONI or OnNetworks) was identified as a potential investor.[43] ONI "had raised about $19 million from the issuance of common and preferred stock but lost most of it in pursuit of an unsuccessful business venture."[44] ONI had only about $6.3 million in cash left as of early 2009, which was less than the ONI preferred shareholders' liquidation preference.[45] There developed friction between ONI's preferred shareholders and Gerszberg.[46] A final plan was eventually reached between the parties and was implemented in November 2009.[47] Pursuant to this plan, "a portion of OnNetworks' remaining cash would be used to redeem Mr. Gerszberg's interest in CMH and the remainder used as operating capital for the transferred business."[48]

Through several agreements, all dated on or as of November 25, 2009, the transaction that was the subject of the Tax Court litigation was implemented.[49] These included "the CM & JV Agreement [CMJVA] among petitioner, CMH, OnNetworks, and an acquisition subsidiary of petitioner; an Asset Purchase Agreement between CMH and its two subsidiaries; a Stock Repurchase Agreement between petitioner and CMH; and a Unit Purchase Agreement between CMH and Mr. Gerszberg."[50]

Pursuant to the Asset Purchase Agreement, CMH acquired assets from its two limited liability companies, which included "all 'Intellectual Property' (broadly defined) 'used in or useful to the Business'[,]" but excluded certain specified properties (which encompassed cash, receivables and certain specified contracts).[51] Under the CMJVA, CMH contributed these purchased assets to the Taxpayer.[52] In return, CMH "was entitled to receive 4,999,000

[41] *Id.* at 7.
[42] Complex Media, Inc. v. Comm'r, 121 T.C.M. (CCH) 1089, 5 (2021).
[43] *Id.*
[44] *Id.*
[45] *Id.* at 5–6.
[46] *Id.* at 6.
[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.* at 7, 7 n.2.
[52] *Id.* at 9.

of ... [the Taxpayer's] common stock."[53] Also pursuant to the CMJVA, an acquisition subsidiary of the Taxpayer simultaneously merged into ONI, with ONI surviving, as a subsidiary of the Taxpayer.[54] As discussed in the Tax Court memorandum opinion, the Taxpayer's assertion that the control requirements of section 351 were satisfied was based "on the proposition that the OnNetworks preferred shareholders were transferors in the transaction along with CMH."[55]

The Tax Court pointed out that "[t]he merger of petitioner's acquisition subsidiary into OnNetworks was approved by a shareholder consent executed by one of OnNetworks' common shareholders and six of its preferred shareholders, who together held stock with 67.5% of the voting rights of all of the OnNetworks stock."[56] In the merger, ONI's formerly preferred shareholders received 2,731,808 preferred shares in the Taxpayer,[57] and ONI's former common stock was cancelled without any consideration.[58]

The Tax Court noted that there were inconsistencies with respect to how the Taxpayer and the other parties to the transaction viewed the ONI merger.[59] The CMJVA "expresses the intent of the parties to that agreement that the merger of petitioner's acquisition subsidiary into OnNetworks qualify as a reorganization within the meaning of Section 368(a) of the Code."[60] The Tax Court indicated, however, that "[b]y contrast the description of

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[53] *See id.*

[54] *Id.*

[55] *See id.* at 24.

[56] *Id.* at 9.

[57] *Id.* The 2,731,808 preferred shares in the Taxpayer, owned by the former ONI preferred shareholders "could be converted into 3,122,843 common shares of [the Taxpayer]." *Id.* at 13 n.7.

[58] *Id.* at 10. The Tax Court explained that:

> [f]or the purpose of allocating merger consideration among OnNetworks shareholders, the merger was treated as a liquidation under the terms of OnNetworks' certificate of incorporation because the aggregate merger consideration did not constitute a majority voting interest in petitioner. Because the value of the merger consideration was less than the liquidation preference to which OnNetworks preferred shareholders were entitled, they received all of that consideration.

Id. at 10 n.5.

[59] *See id.* at 10.

[60] *Id.*

the expected Federal income tax consequences of the merger included in the Information Statement prepared in connection with the transaction states: 'In general, the Merger will be treated as a non-taxable transaction to the stockholders under Section 351 of the Code.'"[61]

The Stock Repurchase Agreement "provided for CMH's sale of 1,875,000 of ... [the Taxpayer's] common stock back to ... [the Taxpayer] in exchange for $3 million in cash, with $2.7 million to be paid at closing on November 25, 2009, and an additional payment of $300,000 to be made on January 3, 2011."[62] Gerszberg's interest in CMH was bought out pursuant to the Unit Repurchase Agreement.[63] In redemption of 1,875,000 shares of the Taxpayer's common stock, he received through his ownership in CMH, "an immediate payment of $2.7 million in cash and the partnership's assignment to Mr. Gerszberg of its right to the additional future cash payment."[64]

In terms of tax reporting by the parties, the Form 1065 partnership tax return filed by CMH did not reflect the receipt from the Taxpayer of $2.7 million in cash to redeem Gerszberg's interest.[65] Gerszberg's 2009 Form 1040 does, however, report $4,262,162 of long-term capital gain in connection with the redemption of his interest in CMH, representing the excess of the $2.7 million cash received and a reported negative basis of $1,562,142.[66] His Form 1040 for 2011 reflected as "Other income" the $300,000 received from the Taxpayer.[67] $4,808 was reported as an amortization expense by CMH in 2009.[68] This related to eight trademarks and a domain name.[69] The same $4,808 was reflected in the Taxpayer's returns for the years at issue as a carryover basis from the transfer from CMH,[70] along with

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[61] *Id.*

[62] *Id.* at 11.

[63] *Id.* at 10.

[64] *Id.* at 12.

[65] *See id.* at 14. Neither did it reflect the right to $300,000 of additional payment due January 3, 2011. *See id.* at 11.

[66] *See id.* at 17.

[67] *Id.*

[68] *Id.* at 14.

[69] *See id.*

[70] *Id.*

> an additional $200,000 in respect of an 'intangible asset' acquired on November 25, 2009, with an unadjusted cost or basis of $3 million (equal to the sum of the $2.7 million immediate cash payment and the $300,000 deferred payment petitioner was required to make in the redemption of 1,875,000 of the shares.[71]

The Taxpayer's returns also reflected other deductions for depreciation and amortization.[72] The Taxpayer's and CMH's 2009 tax returns provided disclosures "under section 1.351-3, Income Tax Regs. [that] ... the transferred assets [had] a fair market value of $8 million and an aggregate basis of $237,702."[73]

For the years at issue, the Service had disallowed certain amortization deductions claimed by the Taxpayer.[74] Pursuant to section 197, an item's cost is amortized "ratably over the 15-year period beginning with the month in which such intangible was acquired"[75] if it comes within the statutory definition of "amortizable section 197 intangible."[76] Professors Boris T. Bittker and Lawrence Lokken observed that "[t]his term includes most intangibles acquired in the purchase of a trade or business and a few separately acquired intangibles."[77] The Tax Court explained that "[i]f a section 351 exchange includes a section 197 intangible, the transferee corporation is treated as the transferor shareholder 'with respect to so much of the adjusted basis in the hands

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[71] *Id.* at 14–15.

[72] *See id.* at 15.

[73] *Id.* at 16.

[74] *See id.* at 17.

[75] I.R.C. § 197(a).

[76] I.R.C. § 197(b).

[77] BORIS T. BITTKER & LAWRENCE LOKKEN, FED. TAX'N INCOME, EST.& GIFTS ¶ 23.4.2 (2d/3d ed. 1993–2019, updated Mar. 2021). The Tax Court elaborated that:

> To qualify as "amortizable section 197 intangibles", most section 197 intangibles have to meet three conditions. First, the taxpayer must have acquired the asset after August 10, 1993 (section 197's date of enactment). Sec. 197(c)(1)(A). Second, the taxpayer has to hold the asset in connection with the conduct of a trade or business or other income-producing activity. Sec. 197(c)(1)(B). And third, subject to enumerated exceptions, the asset cannot have been created by the taxpayer. Sec. 197(c)(2). The exclusion for self-created intangibles does not apply to governmental licenses or permits, covenants not to compete, franchises, trademarks, or trade names.

Complex Media, Inc., 121 T.C.M. (CCH) at 19.

of the ... [corporation] as does not exceed the adjusted basis in the hands of the transferor.'"[78] In other words, "[t]he corporation, in effect, steps into the transferor's shoes and can 'continue to amortize its adjusted basis, to the extent it does not exceed the transferor's adjusted basis, ratably over the remainder of the transferor's 15-year amortization period."[79] In addition, "[a]ny increase in the basis of the section 197 intangible allowed by section 362(a) as a result of gain recognized by the shareholder is treated as though the corporation acquired the asset other than in a section 351 exchange (i.e., by purchase)."[80]

The Taxpayer's assertion that section 351 applied presumably was dictated by what was best taxwise for the CMH partners, which was to limit the recognition of realized gain as much as possible by virtue of section 351, and "the duty of consistency."[81] As noted, one might surmise that the Service's seemingly unprincipled position to agree that the transaction came under section 351 was apparently motivated by its goal of limiting the Taxpayer's amortization deductions, under circumstances when assessing the CMH partners for a flawed section 351 transfer was barred by the statute of limitations.[82]

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[78] *Complex Media, Inc.*, 121 T.C.M. (CCH) at 20 (citing § 197(f)(2)(A)).

[79] *Id.*

[80] *Id.* at 21 (citing Reg. § 1.197-2(g)(2)(ii)(B)).

[81] *Id.* at 30–31. In a footnote the Tax Court stated that:

> [W]e cannot rule out the possibility that petitioner's abandonment of its sec. 351 theory would be contrary to factual representations made by CMH or its partners on which the Commissioner relied in determining the partners' tax liabilities for their taxable years ended December 31, 2009. The period of limitations on assessing deficiencies in the partners' tax for those years would likely have expired by now in the absence of extensions. *See sec. 6501(a).* Were petitioner to abandon its claim that the exchange in issue was covered by sec. 351 and, in response, respondent invoked the duty of consistency, we would need to determine whether the economic interests of CMH and petitioner were sufficiently identical for representations made by CMH and its partners to be binding on petitioner. It suffices for present purposes to note that, not only has petitioner consistently argued for the application of sec. 351; it might be prevented from arguing to the contrary.

Id. at 31 n.13.

[82] *See id.* at 21. As noted in an earlier footnote, this might be unfair and the Service could possibly have concluded that the ONI merger satisfied the requisite

Without the possible application of the ONI merger, it was abundantly clear that control requirement for section 351 was not fulfilled.[83] The Tax Court explained that "[t]he 5 million common shares in petitioner that CMH would have held without regard to the immediate redemption of 1,875,000 of those shares would have provided CMH with only about 61.6% of the aggregate voting power of all of control of petitioner immediately after the exchange."[84] Furthermore, the Tax Court, citing *Intermountain Lumber Co. v. Commissioner*,[85] discussed in Section II.B of this Article stated the redemption of the 1,875,000 of the Taxpayer's common stock issued to CMH needed to be considered in determining control, since "CMH was not free to determine whether to keep those 1,875,000 shares."[86] That is, after one gives effect to the Unit Purchase Agreement, "the redemption reduced CMH's share of the aggregate voting power of petitioner's outstanding voting stock from about 61.6% to just over 50% (3,125,000 ÷ (3,125,000 + 3,122,843) = 50.02%)."[87]

The Taxpayer asserted that the ONI merger provided the requisite control.[88] More precisely, the Taxpayer argued that under the CMJVA, the transactions:

> For income tax purposes, [should be treated] as a simultaneous (i) contribution of certain operating assets by CMH to Petitioner in exchange for common stock in Petitioner and (ii) contribution of the outstanding stock of ONI by the preferred stockholders of ONI to Petitioner in exchange for all of the preferred stock of Petitioner.[89]

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control for section 351 to apply. *See supra* note 16 and accompanying text. If so, the Service certainly should have explained this to the Tax Court.

[83] *See Complex Media, Inc.*, 121 T.C.M. at 22–23.

[84] *Id.*; The Tax Court described the calculation of the 61.6% figure as follows: "(5,000,000 ÷ (5,000,000 + 3,122,843 common shares into which petitioner's preferred stock was convertible))." *Id.* at 23.

[85] *See* 65 T.C. 1025, 1034 (1976).

[86] *Complex Media, Inc.*, 121 T.C.M. at 24.

[87] *Id.* at 24. The Taxpayer in fact argued that the redemption should be considered part of the section 351 transaction pursuant to the step transaction doctrine, which provided it with additional amortizable inside basis if boot characterization (as part of a section 351 transaction) was ultimately respected, which it was. *See id.* at 65.

[88] *Id.* at 24.

[89] *Id.* (internal quotation marks omitted).

Under the Taxpayer's theory, which the Tax Court grudgingly acceded to because of the Service's acquiescence, there were "the two transferors, ... CMH and the preferred stockholders of ONI, [which together] owned 100% of the outstanding stock of Petitioner."[90]

The Tax Court spent several pages explaining why the Taxpayer's position that section 351 applied was at least arguably unsound, before it reluctantly acceded to the parties' agreement in this matter.[91] The court concluded this aspect of the case by stating that "[a]lthough we are not convinced that, as a matter of law, petitioner's acquisition of the assets of the transferred business was part of an exchange to which section 351 applies, we will treat it as such in disposing of the cases before us."[92] The Tax Court may have thought this proper because both parties agreed to this treatment.[93] It is certainly, however, worth considering the court's reasoning as to why utilizing the ONI merger to establish the necessary control was, at least, questionable.

The Tax Court stated at the outset of its analysis that "[c]ontrary to petitioner's characterization of the transaction, OnNetworks' preferred shareholders did not actually contribute any property to petitioner."[94] Furthermore, "the stock the OnNetworks preferred shareholders surrendered in the merger was not the same type of stock that petitioner received in the merger."[95] This is because the Taxpayer's shares in ONI were obtained by "conversion in the merger of its common stock in its acquisition subsidiary."[96]

The Tax Court pointed out that "[i]n implicit recognition that it did not actually receive property from the OnNetworks preferred shareholders, petitioner cites Rev. Rul. 67-448, 1967-2 C.B. 144 ...."[97] The Taxpayer's theory was that:

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[90] *Id.* at 25.

[91] *See id.* at 30.

[92] *Id.*

[93] *See id.*

[94] *Id.* at 25. In a footnote the court added that ONI's "preferred shareholders could not have contributed to petitioner 'the outstanding stock' of OnNetworks because they did not own all of that stock. Other shareholders owned common stock in OnNetworks until that stock was canceled in the merger." *Id.* at 25 n.11.

[95] *Id.* at 25.

[96] *See id.*

[97] *Id.*

> Where a parent corporation [i.e., the Taxpayer] forms a transitory merger subsidiary which merges into a target corporation [i.e., ONI], with the target corporation surviving, and the parent corporation then issues its stock to the former shareholders of the target corporation, the transaction is treated as an acquisition by the parent corporation of the stock of the target.[98]

The court indicated that the ruling amounted to a pre-section 368(a)(2)(E) reverse triangular merger that the Service found was qualified as a "B" reorganization, i.e., section 368(a)(1)(B).[99] The Tax Court pointed out, however, that the Taxpayer "fail[ed] to acknowledge potentially material differences between the facts posited in Rev. Rul. 67-448 ... and those of its transaction."[100] The Tax Court explained:

> The ruling [Rev. Rul. 67-448] involved an acquiring corporation, P, that sought to acquire the business of a public utility, Y. Because of Y's status as a regulated entity, its corporate existence had to be maintained—that is, P had to acquire Y's stock rather than its assets. But not all of the Y shareholders were willing to surrender their Y stock to P. So P transferred shares of its voting stock to an acquisition subsidiary, S, in exchange for S stock. S then merged into Y. In the merger, P's stock in S was converted into Y stock. ... The Y stock that P ended up owning was the same type of stock that Y's former shareholders had owned. The ruling gives no indication that Y had more than one class of stock outstanding before the merger. By contrast, the results of the merger by which petitioner acquired OnNetworks cannot be readily explained without acknowledging the role played by petitioner's acquisition subsidiary.... [T]he stock that petitioner ended up with—OnNetworks common stock—was not the type of stock held by those OnNetworks shareholders who participated in the merger. Treating the OnNetworks preferred shareholders as transferors in the exchange in which petitioner acquired the assets of the transferred business would require not only disregarding petitioner's acquisition subsidiary but also treating the OnNetworks preferred stock as being, in substance, common stock.[101]

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[98] *Id.* at 25–26.

[99] *See id.* at 26.

[100] *Id.* at 27.

[101] *Id.* at 26, 28. There were other rulings where the Service held that stock received by transferors should be aggregated with stock received in reorganizations for purpose of determining if the section 351 control requirement was met. *See, e.g.*, Rev. Rul. 68-357, 1968-2 C.B. 144 & Rev. Rul. 76-123, 1976-1 C.B.

Next, the Tax Court criticized an assertion by the Taxpayer that "before the merger of its acquisition subsidiary into OnNetworks, '[t]he ONI Preferred Shareholders ... represented all of ONI's remaining shareholders.'"[102] The Tax Court stated that this "suggestion is factually inaccurate. The common stock of OnNetworks outstanding before the merger was not canceled until the effective time of the merger."[103]

Preemptively, the Tax Court addressed the differences between the Supreme Court decision of *Helvering v. Alabama Asphaltic Limestone Co.*[104] and the case at bar.[105] *Alabama Asphaltic Limestone* addressed whether a transaction qualified as a tax-free reorganization where the taxpayer had acquired assets of an insolvent corporation.[106] The Tax Court pointed out that the Court rejected the Service's argument that this was not a valid reorganization "because the shareholders of the insolvent corporation did not maintain a propriety interest in the taxpayer."[107] The Court reasoned "that the equity interest in the insolvent corporation had shifted, at some point before the transaction in issue, from the corporation's shareholders to its creditors."[108] The Tax Court believed that there were major differences between the transaction it was assessing and that of *Alabama Asphaltic Limestone*.[109]

The Tax Court noted that:

> By contrast, it is not obvious that the decline in value of OnNetworks assets below the liquidation preference of its preferred stock gave its preferred shareholders "effective command" over the disposition of the corporation's property. That the shareholder consent that approved the merger was joined by one of OnNetworks' common shareholders suggests that the corporation's

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94. In Rev. Rul. 84-44, however, the Service held that in a Section 368(a)(1)(D) forward triangular merger, the shares of the entity X being merged into S, a subsidiary of P, "are not taken into account with the P stock received by Y [a transferor of property to P] in determining whether the requirements of section 351 of the Code have been met." 1984-1 C.B. 105.

102 *See Complex Media, Inc.*, 121 T.C.M. (CCH) at 28.

103 *Id.*

104 *See* 315 U.S. 179, 184–85 (1942).

105 *See Complex Media, Inc.*, 121 T.C.M. (CCH) at 26.

106 *Helvering*, 315 U.S. at 180–81.

107 *Complex Media, Inc.*, 121 T.C.M. (CCH) at 29.

108 *Id.*

109 *Id.* (citing Helvering v. Ala. Asphaltic Limestone Co., 315 U.S. 179 (1942)).

> preferred shareholders did not have sufficient voting power, by themselves, to approve the transaction. If the holders of the OnNetworks preferred stock could not have unilaterally approved the merger, or forced a liquidation of the corporation, they would have had less control over the disposition of the corporation's assets than the creditors of the insolvent corporation in *Ala. Asphaltic*.[110]

The Service's concession as to the applicability of the ONI merger in satisfying the section 351 control test precluded the court from providing a definitive decision as to how much deviation in form is permissible.[111] It is submitted that it would have been far better in the interest of sound tax administration had this issue been properly adjudicated.[112] The revenue loss from enhanced amortization deductions by virtue of a stepped-up inside tax basis should not have been the Service's primary concern.

The Tax Court's remaining decision-making, after it assumed section 351 applied, is certainly worth examining. First, the Tax Court categorically rejected the Service's assertion that the Taxpayer had not acquired amortizable assets from CMH.[113] The Tax Court indicated that "[a]ccepting that petitioner acquired the assets of the transferred business in a section 351 exchange, it follows that petitioner stepped into CMH's shoes in regard to the amortization of any amortizable section 197 intangibles included in the transfer."[114] The court later commented that it did "not understand respondent's repeated denials that petitioner acquired amortizable ... intangibles from CMH."[115] It characterized the Service's position as "demonstrably incorrect."[116]

The Tax Court was troubled by the Service's apparent misunderstanding of the facts, stating that its "position [not to treat the Taxpayer as receiving amortizable section 197 intangibles from

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110 *Id.* at 29–30 (citing *Ala. Asphaltic Limestone Co.*, 315 U.S.)

111 *Id.* at 30–31.

112 *See supra* note 16 and accompanying text.

113 *Complex Media, Inc.*, 121 T.C.M. (CCH) at 34.

114 *Id.* at 32.

115 *Id.* The Tax Court also pointed out that the Service initially argued that the Taxpayer was not entitled to any amortization deductions "[b]ut the Stipulation of Facts that the parties executed on the day of trial suggests that respondent now accepts that petitioner is entitled to $4,808 of the $204,808 that he initially disallowed." *Id.*

116 *Id.*

CMH] may be explained, in part, by ... [its] apparent confusion about the relevant transaction."[117] The court explained that "[a]lthough respondent consistently refers to the transaction in which petitioner acquired the assets of the transferred business as a 'merger/reorganization,' it was neither."[118] The Tax Court observed that "[c]oncurrently with petitioner's acquisition from CMH of the assets of the transferred business, petitioner's acquisition subsidiary merged into OnNetworks. But those two transactions were distinct."[119] The court further expounded that "[i]n the merger, petitioner exchanged the stock of its acquisition subsidiary for OnNetworks stock. It acquired nothing in the merger from CMH; the partnership did not participate in the merger."[120]

The Tax Court then addressed the Taxpayer's ability to disavow the form of the transaction with respect to the redemption of some of the Taxpayer's shares held by CMH to finance Gerszberg's exit.[121] The court explained that "[u]nder the form of the transaction prescribed by the governing agreements, CMH's transfer of the assets of the transferred business and petitioner's redemption of some of the common shares CMH was entitled to receive for those assets were separate transactions."[122] The Service's position was that the Taxpayer "cannot treat the cash and deferred payment right as boot in the section 351 exchange."[123] Instead of drawing the line with respect to whether section 351 control was met, the Service did so with respect to the Taxpayer's assertion that the redemption of its shares from CMH should be treated as the payment of taxable boot in a section 351 transfer.[124] In challenging boot treatment, the Service asserted that the Taxpayer was "bound by ... the terms of the relevant agreements [and] or the form of the transactions carried out under the agreements."[125] If the Service had succeeded with this argument, which it didn't,[126] the Taxpayer's inside basis would not have

[117] *Id*. at 33.
[118] *Id*.
[119] *Id*.
[120] *Id*. (footnote omitted).
[121] *Id*. at 48.
[122] *Id*. at 36.
[123] *Id*. at 38.
[124] *Id*. at 71.
[125] *Id*. at 38.
[126] *Id*. at 47.

been stepped up to reflect boot income to the transferor.[127] Under this theory, CMH should have reported its receipt of boot.[128]

The Service stated that the CMJVA "provided that the sole consideration to which CMH was entitled in exchange for the transferred assets was 4,999,000 shares of petitioner's common stock, and ... under the Stock Repurchase Agreement, CMH received the $2.7 million cash and $300,000 deferred payment right in redemption of 1,875,000 shares of petitioner's common stock."[129] In other words, the form was two distinct transactions.[130] It was not one in which the Taxpayer "had acquired the assets of the transferred business in exchange for 3,124,000 shares of its common stock and $3 million in current and deferred cash payments."[131] The form "instead [was that] of acquiring those assets for 4,999,000 shares of common stock and then immediately redeeming 1,875,000 of those shares in exchange for the cash payments."[132]

In analyzing how the law applied to the facts in the case, the Tax Court complained that "[b]oth parties have been somewhat casual in distinguishing between a taxpayer's disavowal of the terms of a contract and disavowal of the form of the transactions implemented under those terms."[133] It was particularly critical of the Taxpayer who "insists that it 'is not attempting to in any way vary the terms of the operative agreements ...' [and] alleges that 'there was never any redemption of 1,875,000 shares of Petitioner's common stock.'"[134] The Tax Court commented that "[i]f petitioner means that the transactional form was other than a transfer of assets for stock and an immediate redemption of some of that stock, it is disavowing the terms of the relevant agreements, which clearly provide for those two separate steps."[135]

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[127] *Id.* at 65.
[128] *Id.* at 14.
[129] *Id.* at 38.
[130] *Id.*
[131] *Id.* at 43.
[132] *Id.*
[133] *Id.* at 47.
[134] *Id.*
[135] *Id.* The Tax Court indicated that if instead that the Taxpayer's position was based on "its failure to issue a certificate representing the 4,999,000 common shares it was required to issue and then immediately redeem, that claim, though supported by the record, is irrelevant." *Id.* At an earlier point in the case, the Tax Court noted that the Taxpayer acknowledged it "'envisioned' a redemption of

The court ultimately determined that the Taxpayer was permitted to "invoke the substance-over-form doctrine" to disavow the form of the contracts.[136] In reaching this conclusion, the Tax Court thought that the cases cited by the Service, including the Supreme Court decision, *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, "do not erect an absolute bar to petitioner's disavowal of the form of its transactions."[137] The Tax Court acknowledged that at first glance, language in that case articulating what has "sometimes [been] referred to as the 'non-disavowal principle'",[138] "would, if read in isolation, suggest an absolute prohibition."[139] The language the court was referring to stated that "[w]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not ... and may not enjoy the benefit of some other route he might have chosen to follow but did not."[140] The Tax Court reasoned that if one considered the entire opinion, this sentence "should be interpreted to mean only that a taxpayer's ability to identify an alternative path to a given end result that provides more favorable tax consequences than the path actually taken is not enough to entitle the taxpayer to the desired tax treatment."[141]

In applying the facts of *National Alfalfa* to the case at bar, the Tax Court indicated that the Supreme Court decision "establishes only that petitioner cannot justify the claimed amortization deductions merely by observing that it would have been entitled to a step-up in the bases of the transferred assets had the $2.7 million of cash and $300,000 deferred payment right been boot in the section 351 exchange."[142]

1,875,000 of the shares of common stock that it was required to issue to CMH ... [,]but claims that the redemption 'did not happen.'" *Id.* at 42–43. The Tax Court then chided the Taxpayer that "[n]otwithstanding its claim that the redemption did not actually happen, petitioner devotes considerable attention to the step transaction doctrine, the applicability of which would be irrelevant if, in actual form, the transaction had involved only one step instead of two." *Id.* at 43.

[136] *Id.* at 73.

[137] *Id.* at 48.

[138] *Id.* at 38.

[139] *Id.* at 48.

[140] Comm'r v. Nat'l Alfalfa Dehydrating Milling, 417 U.S. 134, 149 (1974).

[141] *Complex Media, Inc.*, 121 T.C.M. (CCH) at 48.

[142] *Id.* at 51.

A decision that was a major crux of the Service's argument, that the Taxpayer should not be allowed to disavow the form taken, was *Commissioner v. Danielson*.[143] *Danielson* stands for the rule that "a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc."[144]

In its challenge to the applicability of *Danielson*, the Taxpayer argued that its fact pattern "present[ed] none of the concerns underlying the *Danielson* rule and the strong proof test ... [including that] [t]here is no whipsaw potentially requiring the Respondent to litigate against multiple parties."[145] The Tax Court ultimately rejected *Danielson's* applicability, stating that "[t]o the extent that the *Danielson* rule limits a taxpayer's eligibility to disavow the form of its transactions as well as the terms of the contracts that govern those transactions; however, the rule has no application to the cases before us."[146] This is because the Tax Court has "never accepted" this rule and only applies it when the case is appealable to a court subscribing to *Danielson* pursuant to the doctrine of *Golson v. Commissioner*.[147]

Having decided it was not precluded per se from disavowing the form of the transaction when its substance differs, the court next addressed what the Taxpayer "must show to disavow the form of the transactions."[148] The court grappled with the questions as to whether a taxpayer must show more than the Service when it argues the form chosen should be ignored to reflect the economic substance and, "if so, what is the nature and quantum of the required additional showing?"[149]

After it examined the relevant case law, the Tax Court opined that more recent decisions reflect that the Tax Court "has become more hospitable to taxpayers seeking to disavow the form of their transactions."[150] The court, however, concluded that there

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[143] 378 F.2d 771, 775 (3d Cir. 1967).

[144] Comm'r v. Danielson, 378 F.2d 772, 775 (3d Cir. 1967).

[145] *Complex Media, Inc.,* 121 T.C.M. (CCH) at 45–46.

[146] *Id.* at 53.

[147] *Id.*; Golson v. Comm'r, 54 T.C. 742, 758 (1970).

[148] *Complex Media, Inc.*, 121 T.C.M. (CCH) at 55.

[149] *Id.*

[150] *Id.* at 63.

was an additional burden for a taxpayer to do so in comparison to the Service.[151] The Tax Court indicated that this relates "not to the quantum of evidence but instead to its content."[152] Specifically, the Tax Court set forth the following standard to be applied:

> The Commissioner can succeed in disregarding the form of a transaction by showing that the form in which the taxpayer cast the transaction does not reflect its economic substance. For the taxpayer to disavow the form it chose (or at least acquiesced to), it must make that showing and more. In particular, the taxpayer must establish that the form of the transaction was not chosen for the purpose of obtaining tax benefits (to either the taxpayer itself ... or to a counterparty ...) that are inconsistent with those the taxpayer seeks through disregarding that form. When the form that the taxpayer seeks to disavow was chosen for reasons other than providing tax benefits inconsistent with those the taxpayer seeks, the policy concerns articulated in *Danielson* will not be present.[153]

While the Tax Court expressed some concerns with the Taxpayer's arguments, the court focused on:

> Why the parties did not adopt that transactional form to begin with. And the parties had an obvious nontax reason for structuring the transactions as they did: Petitioner could not have paid CMH $2.7 million in cash in exchange for the assets it received from CMH because it did not have any cash until after the exchange.[154]

That is, it needed the cash gained from ONI, and "[o]nly then did petitioner have the wherewithal to pay CMH the cash Mr. Gerszberg apparently demanded for the redemption of his partnership interest."[155] Furthermore, the Tax Court observed that it could have achieved its business objectives and a stepped-up inside basis if it had issued a $3 million note along with the 3,124,000 shares as consideration for CMH's assets.[156]

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[151] *Id*. at 58.
[152] *Id*. at 64.
[153] *Id*.
[154] *Id*. at 72.
[155] *Id*.
[156] *Id*. The Tax Court envisioned that such a note's terms "could have called for repayment of $2.7 million before the close of business on November 25, 2009,

The Tax Court next addressed the application of the step transaction doctrine to link the redemption to the CMH asset transfer.[157] This was not a hard decision for the court.[158] The Tax Court declared that "[i]f the step transaction doctrine has any potency, it necessarily applies to combine a first step that occurs when a preexisting obligation requires the immediate execution of a second step that undoes the first."[159] These steps were clearly mutually interdependent; there would have been no transfer of the CMH assets to the Taxpayer without the payment necessary for Gerszberg's departure from the business.[160] The Tax Court elaborated that this was not an instance where a taxpayer is "asking us to skip, collapse, or rearrange the steps."[161] Furthermore, the Taxpayer was "not even asking to rearrange steps actually taken."[162] The Tax Court "conclude[d] that petitioner should be treated as having acquired the assets of the transferred business in exchange for 3,124,000 shares of its common stock, $2.7 million in cash, and an obligation to make an additional payment of $300,000 on January 3, 2011."[163]

Taxpayer's inside basis, and the resulting amortization deductions, was the next issue dealt with by the Tax Court.[164] First, the Tax Court rejected the Service's assertion that step-up in basis was not permitted because there was no gain reported for the transfer.[165] The Tax Court, in dismissing the Service's argument, stated that "[b]y its plain terms, section 362(a) allows the transferee corporation in a section 351 exchange to increase its bases in transferred assets by 'the amount of gain recognized

and payment of the remaining balance of $300,000 on January 3, 2011." *Id.* The Tax Court speculated that the reason such a structure was not undertaken was because "the prospect of a step-up in corporate asset basis was an afterthought—perhaps arising only when petitioner's accountants began preparing its 2010 return." *Id.* at 73.

[157] *Id.* at 74.

[158] *Id.*

[159] *Id.* at 74–75. For a general discussion of the step transaction test, see *infra* Section II.A.

[160] *Complex Media, Inc.*, 121 T.C.M. (CCH) at 74–75.

[161] *Id.* at 75.

[162] *Id.*

[163] *Id.* at 76.

[164] *Id.* at 76–77.

[165] *Id.* at 77.

to the transferor', without regard to whether the transferor reports that recognized gain."[166] The Tax Court indicated that pursuant to Revenue Ruling 68-55,[167] "cash or other taxable boot should be allocated among the various assets in proportion to their relative fair market values."[168] It did, however, point out that the Taxpayer was not allowed section 197 amortization for the full $3 million.[169] For one, the deferred payment right to the additional $300,000 needed to be discounted to reflect the time value of money.[170] Additionally, some of the basis should be ascribed to assets other than section 197 intangibles.[171]

The Tax Court then addressed the Taxpayer's request that since it had not done an appraisal of the transferred assets at the time of the transaction, the court should "apply the 'principal' established in *Cohan v. Commissioner* ... and 'make an estimate of the proper amortizable step-up in basis for the contributed assets resulting from the 'boot' payment.'"[172] The Service had objected to this on grounds that the Taxpayer "failed to establish a reliable basis for the Court to make an estimated determination."[173] The court determined "that, even without a formal valuation, the record allows us to estimate the relative values of those assets of the transferred business that did and did not qualify as amortizable section 197 intangibles."[174] The Tax Court, however, "disagree[d] with the petitioner that the circumstances do not warrant our bearing against it in estimating the relative values of the transferred assets."[175] The court criticized the Taxpayer for being "[un]prepared to present evidence at trial to establish all facts necessary to justify the full $204,808 of amortization deductions it claimed in respect of intangible assets it acquired from CMH."[176] Because of this, the

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[166] *Id.* (footnote omitted).
[167] Rev. Rul. 68-55, 1968-1 C.B. 140.
[168] *Complex Media, Inc.*, 121 T.C.M. (CCH) at 78.
[169] *Id.* at 80.
[170] *Id.*
[171] *Id.*
[172] *Id.* at 81 (citing Cohan v. Comm'r, 39 F.2d 540, 543–44 (2d Cir. 1930)).
[173] *Id.* at 85.
[174] *Id.* at 87–88.
[175] *Id.* at 88.
[176] *Id.* at 92.

Tax Court "endeavor[ed] to 'bear[ ] heavily' against [P]etitioner in estimating those relative values."[177]

While the Tax Court "accept[ed] petitioner's basic methodology [for determining the basis of its assets] as consistent with, and supported by, the residual method of basis allocation ... [it rejected the Taxpayer's] specific estimates."[178] Among the modifications the Tax Court made to the Taxpayer's proposed inside basis allocations was the court's use of a different discount rate than that advanced by the Taxpayer in valuing the deferred payment right,[179] and its utilizing of the original cost instead of book value for certain fixed assets.[180]

While some might question some aspects of the court's decision to treat the redemption as boot under the circumstances, including the Taxpayer's right to invoke (but not the application of) the step transaction doctrine,[181] this was a very carefully deliberated case where the Tax Court thoroughly analyzed the many issues it had to address.[182] One commentary, however, expressed amazement at its outcomes:

> If most tax practitioners were asked whether a taxpayer could apply the step transaction doctrine against the IRS, most would say that is not easy because a taxpayer must live with the form they chose. If the question arose in a situation in which the taxpayer did not consistently maintain a position concerning how the transaction should be treated, the tax practitioners would likely say "no way." Furthermore, if asked whether a transaction could be viewed as a transfer subject to Section 351 when control was not present immediately after the transaction, most tax practitioners would again say "no way." ... But perhaps the greatest surprise in the opinion in Complex Media was the court's treatment of Danielson.[183]

The most frustrating aspect of the decision was the Service's failure to challenge the section 351 treatment leaving this part of the case undecided.[184] The Tax Court should have been allowed

[177] *Id.* at 93 (citing in part *Cohan*, 39 F.2d at 544).
[178] *Id.*
[179] *Id.* at 94–95.
[180] *Id.* at 96–97.
[181] *See* Lipton & King, *supra* note 29, at 18, 20–21.
[182] *Id.* at 17–18.
[183] *Id.* at 21.
[184] *Id.* at 16.

to decide the issue. It was considerably hampered by the Service's position to acquiesce to the Taxpayer's assertion that the ONI merger counted in meeting the section 351 control requirement.[185] The Service should not have placed minimizing the taxpayer's amortization deductions over attaining the right result.[186]

If a sole transferor, in a purported section 351 transaction, received seventy percent of the transferee's shares, even if from a corporate law standpoint her ability to control the company were not any less than had she owned eighty percent, a court would undoubtedly hold that section 351 was not met.[187] Tax lawyer and prolific commentator Jack Cummings wrote that a "general principle of the federal income tax [is] that the taxpayer is [generally] stuck with its chosen form and its tax consequences."[188] While the ONI merger was certainly not as clear cut as seventy percent control not satisfying section 368(c),[189] the Tax Court's analysis raised the distinct possibility that this too would fail the requisites of the statute if the court had been given the unfettered opportunity to freely reach a judgment.[190]

II. The Role of the Step Transaction Doctrine with Respect to Post Transfer Share Dispositions in a Purported Section 351 Transaction

A. The Step Transaction in General

The judicially developed step transaction doctrine "requires that the interrelated steps of an integrated transaction be analyzed as a whole rather than treated separately."[191] Furthermore, "if a larger transaction is considered to exist the doctrine normally requires the separate transactional steps to be collapsed into—or recast as—an alternative but economically equivalent transaction involving, if not a single step, then presumably fewer

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[185] *Id.* at 17.

[186] Complex Media, Inc. v. Comm'r, 121 T.C.M. (CCH) 1089, 102 (2021).

[187] *See* Lipton & King, *supra* note 29, at 16.

[188] Jasper L. Cummings, Jr., *Section 351 Loss of Control*, 169 Tax Notes Fed. 949, 950 (Nov. 9, 2020).

[189] *Complex Media, Inc.*, 121 T.C.M. (CCH) at 5–6.

[190] *Id.* at 34 n.14.

[191] Bittker & Lokken, *supra* note 77, ¶ 4.3.5.

steps."[192] It has been said to apply, "whenever two or more purported transactions, independent in form are deemed to be so dependent upon each other in substance that they are viewed as elements of one transaction."[193]

The doctrine is often utilized by the courts, and the Service, "to better reflect the economic reality of the taxpayer's actions."[194] On occasion, such as in the *Complex Media* decision, discussed above, the taxpayer has successfully asserted its applicability.[195] It has been utilized frequently "to protect the underlying purpose of statutory provisions."[196] It is in this context, in particular its use with respect to determining if the control requirement of section 351 has been met, that this Article mainly focuses.[197]

The Supreme Court, over eighty years ago, stated that "a given result at the end of a straight path is not made a different result because reached by following a devious path."[198] The Tax Court described this function of the canon as follows:

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[192] *See* Bowen, *supra* note 11, at 723.

[193] *See* Howard J. Rothman et al*., Transfers to Controlled Corporations*, 758-3rd TAX MGMT. PORT. (BNA) ¶ III.F.2.

[194] Jonathan D. Grossberg, *Attacking Tax Shelters: Galloping Toward a Better Step Transaction Doctrine*, 78 LA. L. REV. 369, 369 (2018).

[195] *Complex Media, Inc.*, 121 T.C.M. (CCH) at 74.

[196] *See* Grossberg, *supra* note 194, at 374 (footnote omitted).

[197] *Id.* at 375.

[198] Minn. Tea Co. v. Helvering, 302 U.S. 609, 613 (1938). The Tenth Circuit observed in Associated Wholesale Grocers, Inc. v. United States*,* 927 F.2d 1517, 1522 (10th Cir. 1991) that:

> The step transaction principle derives from the classic tax case *Gregory v. Helvering*, 293 U.S. 465, 79 L. Ed. 596, 55 S. Ct. 266 (1935), and its progeny. In Gregory, the Supreme Court's analysis of the tax effect of a transaction involved 'putting aside ... the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred ....' *Id.* at 469. The analysis revealed a transactional step which the Court characterized as '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,' *id.*, and as 'an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else.' *Id.* at 470. The Court declined to 'exalt artifice above reality' and affirmed the appellate court's holding that there had been no reorganization in the meaning of the statute.

> The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged.[199]

The step transaction doctrine can also be used by the courts to "change the order of such transaction or steps."[200] Generally, however, the Service may not "generate events which never took place just so an additional tax liability might be asserted."[201]

This judicial canon, "like the ... codified economic substance doctrine, began as a common law effort to avoid results that the courts and the IRS viewed as inappropriate but that seemed to be mandated by a literal application of the statute."[202] It "developed as part of the broader tax concept that substance should prevail over form."[203]

Three different tests of the canon have been applied by the courts and the Service (discussed below) and its utilization for both determining control under section 351, and in general, has been, in certain instances, intellectually inconsistent.[204] Besides the question as to which test or tests are to be utilized in determining whether the step transaction doctrine is applicable, the courts have also shown differing views as to whether the focus should be on "if each step by itself or the whole transaction has economic substance/business purpose."[205] There has also been concern raised that section 7701(o) resulting from the 2010

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[199] Smith v. Comm'r, 78 T.C. 350, 389 (1982).

[200] *See* William W. Chip, *The Economic Substance Doctrine*, 508-2nd TAX MGMT. PORT. (BNA) ¶ III.D.2 (Bureau Nat'l Aff. 2021).

[201] Grove v. Comm'r, 490 F.2d 241, 247–48 (2d Cir. 1973) (citing Sheppard v. U.S., 361 F.2d 972, 978 (Ct. Cl. 1966)).

[202] Philip J. Levine & Britt M. Haxton, *'The End Result Test' Revisited, Part 1*, 149 TAX NOTES 1259, 1260 (2015) (footnote omitted).

[203] *Associated Wholesale Grocers, Inc.*, 927 F.2d at 1521 (citing Am. Potash & Chem. Corp. v. United States, 399 F.2d 194, 207, 185 (Ct. Cl. 1968)).

[204] *See* Grossberg, *supra* note 194, at 369.

[205] Yoram Keinan, *Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification*, 22 AKRON TAX J. 45, 49 (2007).

codification of the economic substance doctrine[206] may "exacerbate ... inconsistency within the step transaction doctrine."[207]

Sometimes courts and the Service have aggressively applied the doctrine, consistent with the following comment from Professors Boris T. Bittker and Lawrence Lokken, that the step transaction doctrine "began as an interpretation of a detailed statutory provision, but it has been a successful cultural imperialist, on which the sun never sets. Its control is especially pronounced in the corporate-shareholder area."[208] In other instances, however the courts have shown considerable reticence.[209]

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[206] Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067–70.

[207] Philip Sancilio, *Note: Clarifying (or is it Codifying?) The "Notably Abstruse": Step Transactions, Economic Substance, and the Tax Code*, 113 COLUM. L. REV. 138, 140 (2013). Sancilio indicated that:

> As wholly judicial creations and functional equivalents, the economic substance and step transaction doctrines generated many varied, overlapping, and frequently conflicting formulations. The definition of the codified economic substance doctrine exacerbates inconsistency within the step transaction doctrine by encompassing some, but not all, of the step transaction doctrine's formulations. Confusion, once mostly confined to judicial dicta, may now govern the application of a statutory framework and the imposition of statutory penalties. Resolving this newly significant inconsistency requires clarifying the interaction and relationship between the two doctrines.

Id. (footnote omitted). Sancilo's recommendation is:

> that the economic substance doctrine should come before the step transaction doctrine; courts must try to apply the codified economic substance doctrine before turning to the step transaction doctrine. Practically, this means that application of the step transaction doctrine requires first finding that the challenged transactions had both economic substance and a business purpose. This condition severely constricts the step transaction doctrine's availability while also clarifying and focusing its function. Thus formulated, the step transaction doctrine acts as a backstop. The doctrine catches cases in which a series of transactions, each of which has some economic substance and a business purpose and would be respected standing alone, combine to generate an unacceptable result.

Id. at 178–79 (footnotes omitted).

[208] *See* BITTKER & LOKKEN, *supra* note 77, ¶ 4.3.5 (footnotes omitted).

[209] *See* Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1524–25 (10th Cir. 1991); Esmark, Inc. v. Comm'r, 90 T.C. 171, 196–97 (1988).

The dissimilarity of use of the doctrine by the courts can be illustrated by briefly examining two decisions where the courts differed as to the doctrine's invocation. In *Esmark, Inc. v. Commissioner*, the taxpayer designed a plan for the disposition of its Vickers energy business that avoided capital gain on the subsidiary's built-in gain.[210] The acquiror, Mobil Oil Corp., was required to participate in "a 'tender offer/redemption' format,"[211] wherein Mobil Oil first bought shares in Esmark that were redeemed for the Vickers shares.[212] The transaction was designed to take advantage of section 311,[213] which then did not tax a distributing corporation on the excess of the fair market value of the property distributed over the corporation's basis in the property before changes made by the Tax Reform Act of 1986 became effective.[214] The Tax Court indicated that "Mobil was willing to accommodate petitioner's tax planning by agreeing to the tender offer/redemption if Mobil received assurances that the tender offer format would not cost Mobil any more than its bid and would not expose Mobil to additional liabilities or costs."[215] Among the arguments made by the Service and rejected by the Tax Court was that the step transaction doctrine was applicable.[216] The Tax Court reasoned that utilization of the step transaction doctrine was improper because the Service "propose[d] to recharacterize the tender offer/redemption as a sale of the Vickers shares to Mobil followed by a self-tender. This recharacterization does not simply combine steps; it invents new ones."[217]

In comparison to *Esmark*, in *Associated Wholesale Grocers, Inc. v. United States* the court thwarted a taxpayer's attempt to recognize a built-in loss in one of its subsidiaries with a transaction that divested the subsidiary's almost entire business was immediately reacquired by the taxpayer pursuant to a preexisting plan with the buyer.[218] In disallowing the loss pursuant to

[210] *Esmark, Inc.*, 90 T.C. at 171.
[211] *Id.* at 175.
[212] *Id.*
[213] *Id.* at 176.
[214] Tax Reform Act of 1986, Pub. L. No. 99-514, § 211, 100 Stat. 2085 (1986).
[215] *Esmark, Inc.*, 90 T.C. at 176.
[216] *Id.* at 196–97.
[217] *Id.* at 196.
[218] 927 F.2d 1517, 1518, 1530 (10th Cir. 1991).

the step transaction doctrine, the Tenth Circuit stated that "[t]he degree of interconnectedness seen here is sufficient under the law to require us to ignore the form of these steps if that form belies the substance of the transaction as a whole."[219]

The courts have applied three different tests for determining if employment of the step transaction doctrine is appropriate: (1) the "binding commitment" test; (2) the "end result" test; and (3) the "mutual interdependence" test (also referred to as simply "interdependence" test).[220] The Court of Appeals for the Tenth Circuit observed that "[m]ore than one test might be appropriate under any given set of circumstances; however, the circumstances need only satisfy one of the tests in order for the step transaction doctrine to operate."[221] Some courts have, however, determined that "more than one of the alternative tests should be satisfied in determining whether the steps ought to be collapsed under the step transaction doctrine."[222] Commentators have noted that "[n]o one test is universally accepted, and historically, step transaction doctrine analysis has depended on the particular facts and circumstances, making it difficult to predict the outcome in many cases."[223] Tax lawyer Stephen S. Bowen opined that "[t]he existence of three step transaction tests implies greater conceptual clarity and distinctiveness than, in fact, exists."[224]

The most rigid test, and the one least often utilized,[225] is the binding commitment test, which requires that the "taxpayer [be] contractually bound to complete all steps when the first in a series of transactions was undertaken."[226] Another way to characterize this test is that "[i]f there were a moment in the series of the transactions during which the parties were not under a binding obligation, the steps cannot be collapsed under this test."[227] It

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[219] *Id.* at 1528.

[220] *See, e.g.*, True v. United States, 190 F.3d 1165, 1174–75 (10th Cir. 1999); Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1522 (10th Cir. 1991).

[221] *True*, 190 F.3d at 1175 (citing *Associated Wholesale Grocers, Inc.*, 927 F.2d at 1527–28).

[222] *See* Chip, *supra* note 200, ¶ III.D.3 (footnote omitted).

[223] *See* Levine & Haxton, *supra* note 202, at 1261.

[224] *See* Bowen, *supra* note 11, at 722–23.

[225] *See* Chip, *supra* note 200, ¶ III.D.3.a (footnote omitted).

[226] *See* BITTKER & LOKKEN, *supra* note 77, ¶ 4.3.5.

[227] *See* Chip, *supra* note 200, ¶ III.D.3.a (footnote omitted).

was first enunciated by the Supreme Court in *Commissioner v. Gordon*.[228] There, the Court stated that "if one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps."[229] According to the Tax Court, "[t]he purpose of the binding commitment test is to promote certainty in tax planning; it is the most rigorous limitation of the step transaction doctrine. It is seldom used and is applicable only where a substantial period of time has passed between the steps that are subject to scrutiny."[230] It has been suggested that the test is appropriate for taxpayers who are seeking to apply the step transaction doctrine.[231]

Another test the courts have employed is the end result test, which appears to be the test used most often.[232] Under this methodology, "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."[233] The Tenth Circuit Court of Appeals explained that "[u]nder this test, if we find the series of closely related steps in a transaction are merely the means to reach a particular result, we will not separate those steps, but instead treat them as a single transaction."[234] The court further observed that "[t]he taxpayer's

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[228] 391 U.S. 83, 96 (1968).

[229] *Id.*

[230] Andantech LLC v. Comm'r, 83 T.C.M. 1476, 1504 (2002), *aff'd* 331 F.3d 972 (D.C. Cir. 2003). Professor Jensen suggested that the reason the binding commitment test has been utilized when there is a significant time span between steps is that "there is a practical need to determine the resulting tax consequences prior to the final step, so the transaction can properly be reported on the taxpayer's annual return." *See* Jensen, *supra* note 1, at 360 (footnote omitted).

[231] *See* Grossberg, *supra* note 194, at 398 ("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, ostensibly the taxpayer only may use the binding commitment test as the basis for its assertion." *Id.* at 398–99 (footnote omitted)).

[232] *See* Chip, *supra* note 200, ¶ III.D.3.b (citing Sec. Indus. Ins. Co. v. U.S., 702 F.2d 1234, 1244 (5th Cir. 1983)).

[233] Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1523 (quoting King Enters., Inc. v. U.S., 418 F.2d 511, 516 (Cl. Ct. 1969)).

[234] True v. United States, 190 F.3d 1165, 1175 (citing Kanawha Gas & Utils. Co. v. Comm'r, 214 F.2d 685, 691 (5th Cir. 1954)).

subjective intent is especially relevant under this test because it allows us to determine whether the taxpayer directed a series of transactions to an intended purpose."[235] In a footnote, the Tenth Circuit in *True v. United States* explained what it meant with respect to taxpayer intent for this purpose:

> We emphasize that under the end result test, our focus is not on the legitimacy of the intended result, but instead on whether the taxpayer undertook multiple steps to achieve a particular result. Thus, if a taxpayer engages in a series of steps that achieve a particular result, he cannot request independent tax recognition of the individual steps unless he shows that at the time he engaged in the individual step, its result was the intended end result in and of itself. If this is not what the taxpayer intended, then we collapse the series of steps and only give tax consideration to the intended end result.[236]

The Fifth Circuit Court of Appeals, in *Security Industrial Insurance Co. v. United States*, described its application of the end result as follows:

> In this case we are faced with a dizzying array of legal maneuvers: OIC's purchases of Southern's and Standard's stock, the reinsurance agreements between Southern, Standard, and Security, the transfers of Southern's and Security's assets through OIC to Security, and, finally, the liquidations of Southern and Security under state law. Yet all these machinations cannot disguise the fact that the intended result of each series of transactions was the acquisition of Southern's and Standard's assets by Security. Security and OIC left a clear and well-documented paper trail to this effect. Security's game plans for acquiring Southern and Standard were identical to the strategy it had pursued for over twenty years: liquidate the rival company and gobble up the assets. Such a plan of acquisition amounts to nothing more than a taxable cash purchase by Security of Southern's and Standard's assets .... Thus these transactions must be viewed in their entireties under the "end result" test of the step transaction doctrine.[237]

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[235] *Id.* (citing Brown v. U.S., 782 F.2d 559, 563 (6th Cir. 1986)).

[236] *Id.* at 1175 n.9.

[237] 702 F.2d 1234, 1246 (5th Cir. 1983) (footnote omitted). The court also found there that the step transaction doctrine applied under the third test, i.e., the mutual interdependence test. *Id.* at 1246–47.

The third test utilized by the courts in determining whether it is proper to apply the step transaction is the mutual interdependence test.[238] The Tax Court stated that "[t]he test is, were the steps taken so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."[239] The Fifth Circuit Court of Appeals in *Security Industrial Insurance Co. v. United States* added that "[t]he 'interdependence' test for applying step transaction analysis asks whether the individual steps in a series had independent significance or whether they had meaning only as part of the larger transaction. This test concentrates on the relationship between the steps, rather than on their 'end result.'"[240] It has been referred to as a "middle version of the step transaction jurisprudence."[241] The Fifth Circuit emphasized that under the mutual interdependence test "we examine this tandem of transactional totalities to determine whether each step had a reasoned economic justification standing alone."[242] The Tax Court in *Andantech L.L.C. v. Commissioner* noted that under this approach "it is useful to compare the transactions in question with those usually expected to occur in otherwise bona fide business settings."[243]

While certainly not conclusive, absent a binding commitment, courts tend to collapse steps more readily when the period between them is relatively short.[244] William Chip contrasted the

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[238] *See* Chip, *supra* note 200, ¶ III.D.3.

[239] Manhattan Bldg. Co. v. Comm'r, 27 T.C. 1032, 1042 (1957) *acq*. 1957-2 C.B.5 (citing Am. Bantam Car Co. v. Comm'r, 11 T.C. 397 (1948)).

[240] 702 F.2d at 1246–47 (citing McDonald's Rests. v. Comm'r, 688 F.2d 520, 524 (7th Cir. 1982)).

[241] *See* Levine & Haxton, *supra* note 202, at 1261.

[242] *Sec. Indus. Ins. Co.*, 702 F.2d at 1247.

[243] 83 T.C.M. 1476, 1505 (2002).

[244] *See* BITTKER & LOKKEN, *supra* note 77, ¶ 4.3.5. Bittker & Lokken observed that "while simultaneity is often the best evidence of interdependence, the step transaction doctrine has been applied to events separated by as much as five years and, on other facts, held inapplicable to events occurring within a period of 30 minutes." *Id.* Noting "[c]ompare Douglas v. CIR, 37 BTA 1122 (1938) (*acq.*) (five-year delay in consummating corporate reorganization resulting from nonassignability of contracts and disputed claims) with Henricksen v. Braicks, 137 F.2d 632 (9th Cir. 1943) (liquidation treated as independent of transfer of assets to new corporation 30 minutes later)." *Id.* at n.93.

results in *Litton Industries v. Commissioner*[245] with that of *Waterman Steamship Corp. v. Commissioner*,[246] both involving distributions made by a target corporation in conjunction with its sale, where the selling shareholder asserted it was entitled to dividend treatment.[247] While the taxpayer prevailed in the former case,[248] in *Waterman Steamship* the payment was treated as consideration for the target under circumstances where "all of the steps took place within one hour and a half."[249]

An example of when the short time between steps led to combining steps in the context of section 351 is *D'Angelo Associates, Inc. v. Commissioner*.[250] There, the Service successfully asserted section 351 should apply to a transaction wherein a dentist had established the company with its shares issued to his wife and minor children for $15,000 in cash.[251] A few days after its incorporation, the dentist and his wife transferred property formally designated as a sale to the company to be leased for use in his dental practice in exchange for, among other things, a $15,000 demand note.[252] In rejecting the company's contention that depreciation of the property should be based on sale treatment, the Tax Court emphasized the transfer was close in time to taxpayer's organization:

> Petitioner has failed to convince us that a sale took place. The events significant to the creation of petitioner occurred almost simultaneously. The formation of petitioner, the transfer of $15,000 cash to petitioner for the issuance of 60 shares of stock, and the transfer of the rental property to petitioner for the return of the $15,000 in cash and the notes all occurred within an interval of less than 10 days. The evidence demonstrates that these steps were integral parts of a plan designed by Dr. D'Angelo to transfer the assets used primarily in his dental practice from individual to corporate ownership.[253]

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[245] *See* 89 T.C. 1086, 1101 (1987).

[246] *See* 430 F.2d 1185, 1185–86 (5th Cir. 1970).

[247] *Litton Indus.*, 89 T.C. at 1086, 1101; *Waterman Steamship Corp.*, 430 F.2d at 1185–86.

[248] *Litton Indus.*, 89 T.C. at 1089, 1100–01.

[249] *See* Chip, *supra* note 200, ¶ III.D.4.

[250] 70 T.C. 121, 136 (1978).

[251] *Id.* at 123 (citation omitted).

[252] *Id.*

[253] *Id.* at 129–30.

Professor Ronald Jensen lamented that "[t]he step transaction doctrine is ... a mixture of inconsistency and ambiguity. Three different tests exist for determining its applicability, but the courts have articulated no standard for determining which test should be applied."[254] Furthermore, Professor Jensen commented that "[e]ven after the appropriate test is chosen, the test can be applied restrictively or expansively, but the courts have not coherently or persuasively explained whether a narrow or broad application is appropriate."[255] He is one of many commentators who have voiced frustration with the canon's application.[256]

Professor Jensen found that, in particular, the "confusion over the proper test for applying the step transaction is itself a source of the inconsistency in cases arising under section 351."[257] A major core of this Article is the application of the step transaction doctrine to determine whether control has been met under section 351 for post contribution share dispositions by the transferor that are connected with the original contribution.[258]

B. The Application of the Step Transaction Doctrine to Determine Whether Control Has Been Met Under Section 351 for Post Contribution Share Dispositions Connected with the Original Contribution

A fundamental requirement for section 351 to pertain is that the transferor or transferors of property to the corporation are in control of that corporation "immediately after the exchange."[259] Professors Boris T. Bittker & James S. Eustice observed in their

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[254] *See* Jensen, *supra* note 1, at 366.

[255] *Id.* at 366–67.

[256] *See, e.g.*, Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365, 413–17 (1988); *see* Bowen, *supra* note 11, at 722; Grossberg, *supra* note 194, at 369, 436.

[257] *See* Jensen*, supra* note 1, at 360.

[258] *See* discussion *infra* Section II.B.

[259] 26 U.S.C. § 351(a). "Control" is defined as follows:

> For purposes of part I (other than section 304), part II, this part, and part V, the term 'control' means the ownership of stock possessing 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.

26 U.S.C. § 368(c).

seminal treatise, *Federal Income Taxation of Corporations & Shareholders*, that "[l]itigation abounds over [this] requirement ... [and this] is one principal application of the so-called 'step transaction doctrine.'"[260] They pointed out that while:

> [t]he doctrine arises in connection with the control requirement comes up in a variety of contexts, but a principal problem is whether the statute is satisfied if the transferors own 80 percent or more of the stock momentarily, but then [their ownership] drops below that benchmark because they sell or give away some of their stock (e.g., to children) or because the corporation issues additional shares to employees, [investors, or others].[261]

A good example of where a court has utilized the step transaction to deny section 351 treatment, and did so correctly, is *Intermountain Lumber Co. v. Commissioner*.[262] There, just as with *D'Angelo Associates*, the transferee taxpayer was the party that argued section 351 had not applied, in order to maximize its inside basis and thus its cost recovery deductions.[263]

Some of the more relevant facts of *Intermountain Lumber Co.* were as follows. After a fire at an existing sawmill owned by Mr. Dee Shook, he and Mr. Milo Wilson, who was both a customer and co-owner with Shook of a separate lumber finishing plant, wanted to replace it with a larger facility.[264] This would enable their finishing plant to operate at full capacity.[265] Shook could not afford the new facility on his own so he "induced Wilson to personally coguarantee [sic] a $200,000 loan to provide financing. In return, Wilson insisted upon an equal voice in rebuilding the sawmill and an opportunity to become an equal shareholder with Shook in the new sawmill."[266]

In May 1964, articles of incorporation for S & W Sawmill, Inc. (S&W) were executed, with "S & W ... derived from the names Shook and Wilson."[267] At the initial shareholders meeting, "Mr.

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[260] *See* BORIS T. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS ¶ 3.09[2] (7th ed. 2015, updated July 2021).

[261] *Id.* (footnote omitted).

[262] 65 T.C. 1025, 1025, 1033–34 (1976).

[263] *Id.*

[264] *Id.* at 1026.

[265] *Id.*

[266] *Id.*

[267] *Id.*

Shook informed the meeting that a separate agreement was being prepared between he and Mr. Wilson providing for the sale of one-half of his stock to Mr. Wilson."[268] In July 1964, Shook transferred his sawmill site and equipment in return for 364 shares in S&W, which constituted all the company's shares except for 4 incorporation shares.[269] At the same time, Shook and Wilson entered into an agreement with Wilson for the purchase of 182 shares of S&W stock from Shook at $500 a share, with prescribed interest for deferred payment, with these shares put in escrow.[270] Simultaneously, Shook executed an irrevocable proxy entitling Wilson to the right to vote his shares for approximately the next 14 months.[271] In August 1964, "S & W borrowed $200,000, in part upon the personal guarantees of Shook, Wilson, and their wives. The loan agreement referred to Shook and Wilson as 'the principal officers and stockholders' of S & W."[272] S & W also agreed at that time "to insure the lives of Shook and Wilson for $100,000 each."[273] In 1967, when S&W was bought by Intermountain Lumber Co., Wilson still owed Shook "$91,000 for 182 shares of S & W ... stock in escrow."[274]

The Tax Court, in holding that section 351 was not satisfied, framed the issue as whether, at the time of the transfer of the property to S & W, Shook was in "control" of the company. That is, did "Shook alone own ... the requisite percentage of shares for control?[275] The court found that:

> Shook and Wilson intended to consummate a sale of the S & W stock, that they never doubted that the sale would be completed, that the sale was an integral part of the incorporation transaction, and that they considered themselves to be coowners [sic] of S & W upon execution of the stock purchase agreement in 1964.[276]

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[268] *Id.*
[269] *Id.* at 1027.
[270] *Id.* at 1027–28.
[271] *Id.* at 1028.
[272] *Id.*
[273] *Id.*
[274] *Id.* at 1029.
[275] *Id.* at 1031.
[276] *Id.* at 1032.

Later in the opinion, the Tax Court reiterated its findings "that Shook, as part of the same transaction by which the shares were acquired (indeed, the agreement for sale was executed before the sawmill was deeded to S & W), had relinquished when he acquired those shares the legal right to determine whether to keep them."[277] He "was under an obligation, upon receipt of the shares, to transfer the stock as he received Wilson's principal payments .... Shook, therefore did not own ... the requisite percentage of stock immediately after the exchange to control the corporation."[278] He lacked the requisite "freedom of action" with respect to 182 shares that were contractually assigned to Wilson.[279]

The Tax Court explained that its holding was consistent with the purpose of section 351:

> We note also that the basic premise of section 351 is to avoid recognition of gain or loss resulting from transfer of property to a corporation which works a change of form only .... Accordingly, if the transferor sells his stock as part of the same transaction, the transaction is taxable because there has been more than a mere change in form.[280]

Another Tax Court step transaction decision regarding this subject was *Manhattan Building Co. v. Commissioner*, where the transferee taxpayer was the party claiming the transfer should be taxable because the control requirement was not met.[281] The case dealt with a predecessor to section 351 and whether the taxpayer making the assignment had the requisite control.[282] In 1922, the original transferor, Mr. Clement O. Miniger had conveyed property to Electric Auto-Lite Company in return for 250,000 shares of common stock and bonds.[283] If one looked no further,

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[277] *Id.* at 1033.

[278] *Id.*

[279] *Id.* at 1031; The Tax Court in *Complex Media* quoted this phrase in its analysis. Complex Media, Inc. v. Comm'r, 121 T.C.M. (CCH) 1089, 23 (2021).

[280] *Intermountain Lumber Co.*, 65 T.C. at 1033–34. Professor Jensen argued that this premise is specious. *See* Jensen, *supra* note 1, at 395–96. The Tax Court also noted that that the Service "abandoned ... [its] contention that Wilson was a transferor of property and therefore a person to also be counted for control under section 351." *Intermountain Lumber Co.*, 65 T.C. at 1031.

[281] Manhattan Bldg. Co. v. Comm'r, 27 T.C. 1032, 1042 (1957).

[282] *Id.*

[283] *Id.* at 1036–37.

the transfer would have met the requirements of the predecessor to section 351.[284] The Tax Court said, however, that the control requirement was not satisfied because "Miniger was under a binding contract to deliver the bonds and 75,000 shares of stock [in Electric Auto-Lite Company] to the underwriters and to return 49,000 shares to the corporation."[285]

The Tax Court observed, in its analysis of whether control was met, that one looks to "whether the transfer of assets to Auto-Lite in exchange for its stock and bonds and the transfer of stock and bonds to the underwriters were mutually interdependent transactions."[286] The test for being mutually interdependent "is, were the steps taken so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."[287] In this case, the requisite interdependence existed because "Miniger could not have completed the purchase of the assets without the cash supplied by the underwriters and could not have had the cash except in exchange for the bonds and stock and could not have secured the bonds and stock except for the assets."[288] As discussed further below, the Treasury and IRS now provide in the regulations[289] essentially that the buyer of the shares from the underwriter in a "qualified underwriting transaction" is deemed to be a co-transferor and the underwriter ignored, thus eliminating the control issue of share dispositions made to an underwriter in circumstances covered by the regulation.[290]

A different result from *Manhattan Building* was reached in an earlier underwriting case, which was cited and distinguished in *Manhattan Building*: *American Bantam Car Co. v. Commissioner*.[291] The case also involved a predecessor to section 351 and the issue of whether the transferor met the necessary control

[284] *Id.* at 1041.

[285] *Id.* at 1042.

[286] *Id.*

[287] *Id.* The Tax Court cited Am. Bantam Car Co. v. Comm'r for this language. 11 T.C. 397, 405 (1948).

[288] *Manhattan Bldg. Co.*, 29 T.C. at 1042.

[289] *See* 26 C.F.R. § 1.351-1(a)(3)(i) (1999).

[290] *Id.*

[291] *Compare Manhattan Bldg. Co.*, 27 T.C. at 1042, *with* Am. Bantam Car Co. v. Comm'r, 11 T.C. 397, 397 (1948).

requirement.[292] As with *Manhattan Building*, the taxpayer transferee was again arguing that it was entitled to fair market value basis on the transfer because gain should have been recognized on the initial contribution.[293] Here, however, the taxpayer was unsuccessful, with the court holding that the original transfer met the control requirements for tax-free treatment.[294]

In that case, a group of individuals, referred to as "the associates," transferred certain properties, subject to liabilities, for 300,000 shares of the American Bantam Car Co.'s common stock.[295] As part of the organizing plan "90,000 shares of petitioner's preference stock would be offered to the public at $10 a share."[296] Furthermore, "the underwriters of such issue of preferred stock were to receive from the associates ... as further compensation for their services as underwriters, certain amounts of the common stock issued to the associates."[297] Additionally, "[a]ll the interested parties orally agreed to the substance of this plan prior to ... [the transfer to American Bantam] though there was no formal written contract between the parties at this time."[298]

A few days after the June 3, 1936 assignment, contracts were entered into between the petitioner and the underwriter as well as between the associates and the underwriter.[299] With respect to the latter, "[i]n substance the associates agreed to deliver [in trust] to the Butler County National Bank & Trust Co. of Butler, Pennsylvania, certificates for 100,000 shares of common stock endorsed in blank for transfer to the underwriters."[300] The underwriter's right to receive these shares was tied to its sale of the preference shares over a period of time.[301]

The Tax Court noted that "[d]uring the year 1936 only 14,757 shares of the preferred stock was [sic] sold by the underwriters."[302] There was a change in underwriters and "[b]etween

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[292] *Am. Bantam Car Co.*, 11 T.C. at 402–03.
[293] *Id.*
[294] *Id.* at 410.
[295] *Id.* at 399.
[296] *Id.*
[297] *Id.*
[298] *Id.*
[299] *Id.* at 400–01.
[300] *Id.* at 401.
[301] *Id.*
[302] *Id.*

October 1936 and October 1937 Grant [the new underwriter] sold 83,618 shares of convertible preferred stock to the public."[303]

In determining that the control requirement was satisfied, the Tax Court noted that "[p]rima facie, when the various steps taken to organize the new corporation and transfer assets to it are considered separately, the associates did have 'control' of the petitioner immediately after the exchange within the statutory definition of the word."[304] The court reasoned that "from June 3 to June 8, 1936, they owned 100 per cent [sic] of all the issued stock, and from June 8, 1936, until October 1937 they owned stock possessing at least 80 per cent of the total combined voting power of all classes of stock."[305] The court ignored the pre-assignment plan, stating that "[o]n June 3, 1936, the associates were issued absolutely and unconditionally 300,000 shares of no par common stock. The resolution of the board of directors of petitioner accepting the associates' offer of the Austin assets attached no strings whatsoever to the issuance of the stock to them."[306]

As to the agreements with the underwriter occurring a few days after the property assignments, the Tax Court stated:

> [o]n June 8 no other common stock had been issued, and a contract regarding possible future assignment of those 300,000 shares already issued was not entered into before that date. No preferred stock had been issued on June 3, nor was a contract for its sale provided until June 8.[307]

According to the court, "[t]he statutory words 'immediately after the exchange' require control for no longer period; in fact, momentary control is sufficient."[308] The Tax Court said not only did the associates have control from June 3 to June 8, even after the agreement with the underwriter "the ownership of the 300,000 shares remained in the associates until such sales were completed."[309] Furthermore, even on "August 16, 1936, [when] the associates deposited all their shares in escrow with the Butler

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[303] *Id.*
[304] *Id.* at 404.
[305] *Id.*
[306] *Id.*
[307] *Id.*
[308] *Id.*
[309] *Id.*

County National Bank & Trust Co. ... they only surrendered possession by the terms of their agreement with the bank and retained all other attributes of ownership."[310]

In the court's judgment, despite the pre-assignment oral plan, "[t]he standard required by the courts to enable them to say that a series of steps are interdependent and thus should be viewed as a single transaction do not exist here."[311] The court was of the opinion that "[t]he understanding with the underwriters for disposing of the preferred stock, however important, was not a sine qua non in the general plan, without which no other step would have been taken."[312] That is, "[w]hile the incorporation and exchange of assets would have been purposeless one without the other, ... both would have been carried out even though the contemplated method of marketing the preferred stock might fail."[313]

The decision reached in *American Bantam Car* was certainly sensible, although the court's dicta about "momentary control is sufficient," while shared by some other courts discussed below,[314] and admittedly consistent with the "immediately after" language in section 351(a),[315] would serve to nullify any role for the step transaction in determining control for section 351 purposes.[316] As discussed below, this is not sound policy.[317] The Treasury/IRS regulatory decision to ignore the underwriter and treat the buyer as a co-transferor in "a qualified underwriting transaction"[318]

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[310] Am. Bantam Car Co. v. Comm'r, 11 T.C. 397, 404 (1948).

[311] *Id.* at 406.

[312] *Id.* (emphasis added).

[313] *Id.* at 406–07.

[314] *Id.* at 404.

[315] I.R.C. § 351(a).

[316] *See Am. Bantam Car Co.*, 11 T.C. at 405.

[317] *See infra* notes 406–49 and accompanying text.

[318] 26 C.F.R. § 1.35101(a)(3)(i). With respect to the impact on control from underwriting transferee shares, 26 C.F.R. § 1.351-1(a)(3)(i) provides that:

> For the purpose of section 351, if a person acquires stock of a corporation from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires stock from the underwriter is treated as transferring cash directly to the corporation in exchange for stock of the corporation and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a corporation issues stock for cash in an underwriting in which either the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory.

eliminates the loss of control issue, and thus removes a barrier to public equity financing.[319] This is certainly practical and (according to at least one commentary) conceptually correct.[320] Professor Jensen, however, disputes the logic for special treatment for underwriting transactions.[321]

Suppose that a taxpayer at the time he transferred his sole proprietorship business to a newly incorporated entity (Newco) for all its shares, was under a binding obligation to sell half of his Newco shares to a non-underwriter. Should this be treated

Id. Prior to being made obsolete by the aforementioned regulation, Rev. Rul. 78-294, distinguished between firm commitment and best-efforts underwriters in analyzing the application of the section 351 control requirement. Rev. Rule 78-294, 1798-2 C.B. 141, *obsoleted by* T.D. 8665, 61 Fed. Reg. 19188 (May 1, 1996). A firm commitment underwriter was someone who received shares in the transferee for cash as part of the asset transfer, intends to sell the shares received, but if unsuccessful was required to retain the shares. Under Rev. Rul. 78-294, the firm commitment underwriter was considered to be a transferor, i.e., part of the original control group. *Id.* The Service also determined in Rev. Rul. 78-294 that the firm commitment underwriter's sale of the shares did not undermine the original transfer, satisfying the section 351 control requirement. *Id.* In the other situation covered by Rev. Rul. 78-294, that of a best-efforts underwriter, the Service characterized the underwriter as an agent of the transferee and unlike the firm commitment underwriter, not part of the control group. *Id.* It was an agent of the transferor. *Id.* Under the facts of the ruling, the public shareholders who bought the shares from the best-efforts underwriter were considered to be part of the control group. *Id.*

[319] *See* David R. Tillinghast & Denise G. Paully, *The Effect of the Collateral Issuance of Stock or Securities on the "Control" Requirement of Section 351*, 37 TAX L. REV. 251, 264 (1982).

[320] *Id.* at 264–65. Written before the promulgation of the section 351 underwriting regulation, Reg. § 1.351-1(a)(3)(I), the authors distinguished a third-party sale by the transferor with the underwriting process as follows:

> In the usual third-party transfer case, the initial transferor exchanges property for stock and then receives cash for that stock from a third party. In the underwriting transaction, however, the underwriter merely acts as a conduit for stock in one direction and cash in the other. The substance of the transaction is a cash payment by the investor to the corporation (reduced, of course, by the underwriter's spread, dealer's commission, and so forth) in exchange for its stock. There is no bail-out and no change of position comparable to those occurring in the third-party transfer cases. Therefore, the investor can appropriately be regarded as a section 351 transferor even when the public offering is integrated with the incorporation transaction.

Id. at 264.

[321] *See* Jensen, *supra* note 1, at 357–58.

as a valid section 351 transaction? What if there was no legal commitment to sell half his Newco shares, but the transfer of the business to Newco was predicated on his sale of half of the Newco shares that he received? Assume he in fact did sell half of the Newco shares a day after the property contribution. In both circumstances, Professor Jensen would argue that the transfers should be good section 351 transactions, nullifying any role for the step transaction doctrine.[322] As will be elaborated upon below, this Article argues that neither contribution should qualify for nonrecognition.[323]

Before focusing on why Professor Jensen came to this conclusion, one needs to understand his generally apt dissatisfaction with some of the decisions and the Service's positions in this area. Professor Jensen's article was critical regarding how the Service and the courts have often addressed the application of the step transaction doctrine in the section 351 context.[324] As noted in this Article's introduction, he wrote that "[i]n their quest to distinguish form from substance in section 351 cases, the courts and the Service have created a patchwork of irreconcilable decisions, inexplicable on the basis of logic or policy and virtually devoid of any explanatory or predictive value."[325] This, Professor Jensen argued, has resulted in a "series of *ad hoc* decisions distinguishable only on the basis of their factual variations, with little or no explanation as to why such factual variation justifies a particular result."[326] He contended that "[t]his lack of a consistent rationale has made both prediction and rational development of the law virtually impossible."[327]

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[322] *See id.* at 358–59.

[323] *See id.* at 381.

[324] *See id.* at 355–56.

[325] *Id.*; *see also supra* note 6 and accompanying text.

[326] Jensen, *supra* note 1, at 355–56.

[327] *Id.* at 356. Professor Jensen asserted that:

> The confusion and inconsistencies in section 351 cases described above stem from a basic misunderstanding of the function of the step transaction doctrine. Courts have viewed the doctrine as an instrument for perceiving reality, that is, for determining what really took place. The courts typically employ the doctrine to ascertain "what really happened," and then apply the relevant legal principles to the facts thus determined. This approach misses the true nature of the step transaction doctrine. Legal doctrines are not, and by their nature cannot be, devices for determining reality. They do not add to our ability to discern

Professor Jensen provided a hypothetical fact pattern wherein father F wants to incorporate his sole proprietorship and at the same time gift seventy-five percent of the business to his son S.[328] F takes back seventy-five percent of the shares in Newco and twenty-five percent are immediately given to S.[329] In a variation of this hypothetical, he posits that as a matter of convenience S's shares go directly from Newco to him.[330] He compared the result in these cases with those where F has a binding obligation to sell his shares to a third party, who is not an underwriter.[331] He asked why these fact patterns should conceptually have contrary results vis-a-vis control.[332] He wrote:

> The similarities between the binding obligation case and the gift case would seemingly dictate the same result: the control requirement was unsatisfied. F's ownership of a controlling stock interest was just as fleeting as was the transferor's controlling stock interest in the binding obligation case; arguably more so, since F was never record owner of a controlling stock interest. Certainly it was no more permanent. Further, in both cases, the loss of control was predetermined and may be fairly characterized as part and parcel of the overall transaction. Nevertheless, the courts and the Service have with only rare exception treated the gift cases as satisfying the control requirement.[333]

Focusing for a moment on his first gift hypothetical, the distinction with a binding obligation is that the transferor retained "freedom of action."[334] Professor Jensen recognized this but believed that "this purported distinction hardly justifies the differing tax treatments."[335] Among his arguments was the idea

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> the facts. Rather, legal doctrines, including the step transaction doctrine, are means of determining legal consequences. A necessary corollary of this observation is that the proper scope and limits of the doctrine must ultimately be grounded in the policy the law seeks to implement.

Id. at 372 (footnotes omitted).

[328] *See id.* at 356.

[329] *See id.*

[330] *See id.*

[331] *See id.*

[332] *See id.*

[333] *Id.* (footnote omitted).

[334] *See, e.g.*, Intermountain Lumber Co. v. Comm'r, 65 T.C. 1025, 1031–32 (1976).

[335] *See* Jensen, *supra* note 1, at 358.

that "it is anomalous to make tax treatment turn on a person's technical legal rights which he or she has no intention of exercising when the point of the exercise is to tax the transaction on its substance and not its form."[336] As to Professor Jensen's hypothetical variation, wherein F never actually received the shares, the failure to conform to the form of the statute should arguably result in an invalid section 351 transaction,[337] although there is conflicting authority discussed below.[338]

Some of the relevant authorities addressing control when there is a disposition of shares through a gift are as follows. In *Wilgard Realty Co., Inc v. Commissioner*, the transferor to a newly formed corporation, "intended when the transfer was made to give away about three-fourths of the stock he received and did so on the same day."[339] In holding that the control requirement was met despite both the planned and effected divestiture of most of the transferee stock at the time of the contribution, the Second Circuit reasoned:

> Though it was plainly enough Mr. Chamberlin's [the transferor] intention to create the petitioner and to transfer his property to it for its stock and the assumption of his liability on the two mortgages in order to provide him with stock to give as he did to his relatives, he was under no obligation to make the gift. There is neither claim nor proof that he was bound to carry out his intention to give any of it away when he received the stock or that he was not free at any time up to the very moment he gave it away to change his mind and use it for any lawful purpose .... In the absence of any restriction upon his freedom of action after he acquired the stock, he had "immediately after the exchange" as much control of the petitioner as if he had not before made up his mind to give away most of his stock and with it consequently his control. And that is equally true whether the transaction is viewed as a whole or as a series of separate steps.[340]

In *Stanton v. United States*, a case not involving section 351 but rather whether a transaction met the control requirements

[336] *Id.* at 358–59.
[337] *Id.* at 356.
[338] Wilgard Realty Co. v. Comm'r, 127 F.2d 514, 515–16 (2d Cir. 1942), *cert. denied*, 317 U.S. 655 (1942).
[339] *Id.* at 515.
[340] *Id.* at 516.

for a section 368(a)(1)(D) reorganization, control was found to be met where the transferor designated forty-nine percent of the shares to go to his wife as a gift.[341] In determining that the control requirement had been satisfied, despite the fact that forty-nine percent of the shares went directly to transferor's wife, the court indicated "that at the time of the transfer of the operating assets ... to the new enterprise Stanton had the absolute right to designate who would receive all the stock."[342]

In *D'Angelo Associates*, discussed above, in which the Service successfully argued section 351 applied, the Tax Court, like in *Stanton*, held that the control requisite was met even though shares were directly issued "in the names of their children."[343] The Tax Court held that "[t]he loss of control of petitioner resulting from the gift of stock does not preclude the application of section 351(a), which requires that the transferors be in control of the transferee corporation 'immediately after the exchange.'"[344] The court stated that "[t]his requirement is satisfied where, as here, the transferors transfer by gift the stock they were entitled to receive in exchange for the property they transferred to the corporation, regardless of whether such disposition was planned before or after acquiring control."[345] The court reasoned that "[t]he issuance of the stock by petitioner to the D'Angelo children is the direct consequence of 'the absolute right' of Dr. and Mrs. D'Angelo to designate who would receive all of the stock."[346]

Contrast the result in *Stanton* and *D'Angelo Associates* with *Fahs v. Florida Machine & Foundry Co*.[347] In *Fahs*, a "father and son entered into an agreement whereby the son would eventually receive a one-half interest in the business, if he remained with it and continued to operate the plant."[348] Three years later, "[i]n pursuance of this agreement, the Florida Machine and

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[341] 512 F.2d 13, 15, 17 (3d Cir. 1975).

[342] *Id.* at 17.

[343] *See* D'Angelo Assoc. v. Comm'r, 70 T.C. 121, 131–32 (1978); *see also supra* notes 250–53 and accompanying text.

[344] *D'Angelo Assoc.*, 70 T.C. at 132.

[345] *Id.*

[346] *Id.*

[347] *Compare* Fahs v. Fla. Mach. & Foundry Co., 168 F.2d 957, 959 (5th Cir. 1948), *with Stanton*, 512 F.2d at 18, *and D'Angelo Assoc.*, 70 T.C. at 132–33.

[348] *Fahs*, 168 F.2d at 958.

Foundry Company, the taxpayer, was organized and incorporated ... [with] all of the assets of the business which [the father] then owned individually ... [transferred] for stock in the corporation."[349] In the transaction "[t]he father received 1181 shares and his son 1176 shares, the father thereby retaining only a bare majority of the stock issued."[350] The Fifth Circuit found control was not met.[351] In *Stanton*, the Third Circuit attempted to distinguish *Fahs* because the transferor there "did not at the time of the transfer have the absolute right to designate who would receive all the stock in the transferee."[352]

A somewhat similar case to *Fahs* was the Tax Court decision, *Mojonnier & Sons, Inc. v. Commissioner*.[353] In *Mojonnier*, the court found the control requirements of a precursor to section 351 were not satisfied and therefore the transferee taxpayer was entitled to fair market value basis in the assigned property.[354] The transferors owned less than eighty percent of the transferee after the assignment with other shares going directly to other individuals, including the transferors' son and a son-in-law, both of whom received their shares in connection with their work in the business.[355] Although the court emphasized that these were not gifts,[356] what was key to the outcome was that the shares were "not issued to the transferors and then conveyed by them to members of their family, but was issued directly to the members of the family in accordance with the plan and offer of F. E. Mojonnier [a transferor]."[357] As such, "the transferors were never the owners

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[349] *Id.*

[350] *Id.*

[351] The government had argued that "the son ... by virtue of the agreement with his father in 1921, acquired an equitable one-half interest in the land involved, which thereafter placed him and his father, as joint transferors, in 'control' of taxpayer immediately after the transfer." *Id.* at 959. This contention was rejected by the court. *Id.*

[352] 512 F.2d at 18.

[353] 12 T.C. 837, 848–49 (1949).

[354] *Id.* at 849, 851.

[355] *Id.* at 840, 849.

[356] *Id.* at 848. The Service's theory was "that in substance the transaction was a transfer of the entire business by the transferors in exchange for all of the stock and thereafter a series of gifts by them to members of their family." *Id.*

[357] *Id.* at 850.

or holders of a sufficient amount of stock to place them in 'control' of the corporation."[358]

The conflict in the case law with respect to Professor Jensen's gift hypothetical variation where the shares go directly from the transferee corporation to S certainly evidence lack of consistency and thus predictability.[359] Even his initial hypothetical is not entirely free from doubt, as evidenced by Revenue Ruling 55-36,[360] cited by Professor Jensen.[361] Revenue Ruling 55-36 was another preplanned gift case involving a predecessor to section 351.[362] The Service ruled that this gain would be recognized in the initial assignment by an individual taxpayer when the donee liquidated the transferee as part of the plan.[363] The Service stated that "in the instant case the transaction served no corporate business purpose for the transfer of the stock of X Corporation [the transferred property] to the Z Corporation [the transferee corporation]."[364] Furthermore, "[t]he Z Corporation did not engage in the conduct of any trade or business and did not remain in existence, except for a brief time as was necessary to implement the donation of X Corporation's stock to the Y Corporation."[365] It determined that "the individual shareholder was not in control of the Z Corporation within the meaning of section 112(h) of such Code, since his ownership of the stock was only transitory and the object of the plan was to place control in the hands of the Y Corporation."[366] While the ruling can be distinguished from Professor Jensen's initial hypothetical because transferee was liquidated, it leaves open the possibility the result might be the same had transferee remained in existence because "his ownership of the stock was [still] only transitory and the object of the plan was to place control in the hands of the Y Corporation."[367] While the result would likely have been

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[358] *Id.*
[359] *See* Jensen, *supra* note 1, at 355–56.
[360] Rev. Rul. 55-36, 1955-1 C.B. 340, 340.
[361] *See* Jensen, *supra* note 1, at 367.
[362] Rev. Rul. 55-36, 1955-1 C.B. 340, 341.
[363] *Id.* at 341–42.
[364] *Id.* at 341.
[365] *Id.*
[366] *Id.*
[367] *Id.*

different had corporation Z, the transferee, remained in existence, the ruling still serves to undermine the notion that section 351 and its predecessor are not subject to the step transaction doctrine in gift scenarios because the transferor had freedom to not make the gift.[368]

Professor Jensen was also critical of the treatment of underwriting transactions.[369] He poses a hypothetical that, simultaneously with a transfer of property to a Newco, eighty percent of Newco shares are distributed to a firm commitment underwriter for cash.[370] He wrote:

> U's [the firm commitment underwriter] intentionally transitory ownership of stock should preclude nonrecognition. It is the height of artificiality to treat the transaction as complete for tax purposes upon U's purchase of the stock when the only reason for U's purchase of the stock was to immediately resell it to the public at a profit. U's controlling stock ownership was transitory; disposition of the stock was preplanned; and practical commercial necessity compelled U to dispose of the stock as quickly as possible, that is, its need to make its profit and

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[368] While not a gift situation, the idea that steps should not be collapsed so long as the transferor had legal freedom of action not to engage in a transaction where control was lost was also undercut by an earlier ruling, Rev. Rul. 54-96, 1954-1 C.B. 111, 112. In that ruling, X corporation, which had engaged in two lines of business, transferred one of its businesses to Y corporation "and as a part of a prearranged plan, transferred all of the stock of Y to the Z Corporation, an unrelated corporation that has been engaged in business for many years, in exchange for which Z issued to X 20 percent of Z's voting stock." *Id.* at 111. The Service stated that "[t]he two steps of the transaction described above were part of a prearranged integrated plan and may [therefore] not be considered independently of each other for Federal income tax purposes." *Id.* at 112. Therefore, the Service ruled that:

> [s]ince as a result of the whole transaction the X Corporation was not in control of the Y Corporation after transferring a part of its assets to that corporation, the transaction did not constitute a reorganization as defined in section 112(g)(1)(D), nor did it constitute a tax-free transfer under section 122(b)(5).

Id. A similar analysis and conclusion was reached in Rev. Rul. 70-140, 1970-1 C.B. 73, 73–74.

[369] *See* Jensen, *supra* note 1, at 357–59. He focused on Revenue Ruling 78-294, 1978-2 C.B. 141 because at the time of his article, Reg. § 1.351-1(a)(3)(I) had not yet been promulgated and the ruling made obsolete, but his rationale should not be affected by the foregoing.

[370] *Id.* at 357.

> to terminate its exposure to the possibility of adverse market price fluctuations.[371]

He pointed out that it does not make sense to permit section 351 treatment to stay intact with the underwriter transaction but not when the transferor is under a binding obligation to dispose of the shares to another third party.[372] While his assertion is certainly not unreasonable, as noted above, at least one commentary offered a rationale for treating underwriting differently from third party sales.[373] In any event the effect of the regulation, as well as prior guidance, is to avoid thwarting a newly formed corporation from going public.[374] Perhaps, however, it might have been better conceptually had Congress addressed underwriting by amending section 351.

Professor Jensen contended that "[t]he lack of any clearly articulated rationale [for deciding whether or not to use the step transaction doctrine in determining section 351 control] makes it difficult to resolve novel questions and to develop a coherent and consistent body of law."[375] He cited the diverse reasonings given by the courts in cases dealing with options to purchase transferee shares as an illustration.[376] He posited a fact pattern wherein an individual incorporates his sole proprietorship "but who prior to the transfer had given an enforceable option to another to buy the stock."[377] Professor Jensen then referred to the various justifications given by the courts in deciding cases of this sort including freedom of action, transitory nature of the transferor's control, and interdependence.[378] His point about conflicting rationalizations

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[371] *Id.* at 358.
[372] *Id.*
[373] *See* Tillinghast & Paully, *supra* note 319, at 264.
[374] *Id.*
[375] *See* Jensen, *supra* note 1, at 371.
[376] *Id.* at 371–72.
[377] *Id.* at 371.
[378] *Id.* Professor Jensen's discussion of this was as follows:

> If the relevant factor is freedom of action, presumably the transferor would fail the control requirement, since he did not have complete freedom of action over the shares at the time of the transfer. Alternatively, if the crucial question is whether the prospective purchaser is bound to buy the transferor's

for decisions with respect to options and elsewhere is certainly fair.[379] While there are many cases correctly holding, in the opinion of this Article, that the mere granting of the option in circumstances where exercise is not a foregone conclusion does not affect control, there is also some contrary authority.[380]

Another ruling Professor Jensen cited for intellectual inconsistencies, with respect to the application of step transaction doctrine when determining section 351 control, is Revenue Ruling

> stock, a mere option would not destroy the transferor's control since an optionee has no obligation to exercise the option. If the relevant inquiry is the transitory nature of the transferor's control, the answer might turn on when the option could be exercised, or possibly when in fact it was exercised. If interdependence is the key, then presumably one would need to know whether exercise of the option was essential to the successful completion of the plan. Each of these factors has been articulated at one time or another in section 351 cases. Because the courts lack a coherent unifying rationale, however, they are unable to determine the significance and the relative importance of these factors.

Id. at 371–72 (footnotes omitted).

[379] *See id.* at 359–60, 367–69, 412.

[380] *See, e.g.*, Rothman et al., *supra* note 193, at 29; In Harder v. Comm'r, 17 T.C.M.(CCH) 494, 497 (1958), the taxpayer had on January 2, 1952 transferred his sole proprietorship to a newly formed corporation for all its stock but "[s]imultaneously ... a five-party agreement ... was entered into between Harder [the transferor and certain parties including three individuals] ... and petitioner corporation ...." *Id.* These individuals were given on or after July 3, 1952, "'the right to purchase' from Harder [the transferor] shares of stock in the corporation in certain designated portions set forth in the agreement." *Id.* Even though the exercise of the right would have brought transferor under the control threshold under a predecessor provision to section 351, the court found the transfer to meet the statutory requirements. *Id.* at 499. A comparable result was reached in National Bellas Hess, Inc. v. Comm'r, 20 T.C. 636, 648 (1953), *aff'd*, 220 F.2d 415 (8th Cir. 1955). There, the transferor "was obligated to grant to the employee-organizers an option to purchase the 300,000 shares." *Id.* at 646–47. The Tax Court continued, "[w]e think it is significant that the predecessor was not obligated to do more than grant an option. It had not entered into a contract of sale or in any way divested itself of ownership." *Id.* at 647. In comparison, the Ninth Circuit determined in Barker v. United States, 200 F.2d 223, 229 (9th Cir. 1952), that the transferor did not have the necessary control by virtue of granting options. The court said that the transferor "had relinquished the right to dispose of the shares as they wished. Such a restriction upon their freedom of action deprived the Lawrence Barker Interests of unrestricted control of the stock." *Id.*

54-96.[381] Corporation X, which engaged in two separate businesses, first transferred one of those businesses to a newly formed corporation Y in exchange for its stock and then "as part of a prearranged plan, transferred all of the stock of Y to Z Corporation, an unrelated corporation ... in exchange for ... 20 percent of Z's voting stock."[382] Because "[t]he two steps of the transaction ... were part of a prearranged integrated plan" the control requirement was not met under a precursor to section 351.[383] Professor Jensen pointed out that there was "no indication [in the ruling] that the transferor-corporation was legally bound at the time of the transfer to engage in the subsequent stock-for-stock swap although that was its plan."[384] Professor Jensen complained that the ruling "cannot be squared" with the position not to invoke the doctrine in general with respect to preplanned gifts and transfers to underwriters.[385] His point is valid, although the treatment with respect to underwriters is sui generis.[386]

To briefly digress from Professor Jensen's assessment of the irreconcilable decisions and rulings in this area, sixteen years after Revenue Ruling 54-96, the Service issued a very similar ruling, albeit this time there was a binding commitment to swap the transferor's interest in the transferee and not just a preexisting integrated plan.[387] In Revenue Ruling 70-140, an individual, A, owned all the outstanding stock of X corporation.[388] He "also operated a similar business in the form of a sole proprietorship" and a third party Y was interested in acquiring both businesses, with its voting stock used as the consideration.[389] The Service indicated that

> [p]ursuant to an agreement between A and Y, an unrelated corporation, A transferred all the assets of the sole proprietorship to X in exchange for additional shares of X stock. A then transferred

[381] *See* Jensen, *supra* note 1, at 367–68.
[382] Rev. Rul. 54-96, 1954-1 C.B. 111, 111.
[383] *Id.* at 112.
[384] *See* Jensen, *supra* note 1, at 367.
[385] *Id.* at 367–68.
[386] *See* Tillinghast & Paully, *supra* note 319, at 264.
[387] Rev. Rul. 70-140, 1970-1 C.B. 73, 73.
[388] *Id.*
[389] *Id.*

> all his X stock to Y solely in exchange for voting common stock of Y, which was widely held.[390]

The Service held that the transfer of the sole proprietorship did not qualify under section 351.[391] The ruling was discussed in an article by Steven Bowen, also discussed in Section II.B of this Article.[392]

Bowen agreed with the result (as would presumably many commentators with the notable exception of Professor Jensen), since A was not in control of X due to the binding contract with Y.[393] Bowen pointed out, however, that the Service's reasoning "took a somewhat different approach."[394] The Service stated that "[t]he two steps of the transaction described above were part of a prearranged integrated plan and may not be considered independently of each other for Federal income tax purposes."[395] Furthermore,

> [t]he receipt by A of the additional stock of X in exchange for the sole proprietorship assets is transitory and without substance for tax purposes since it is apparent that the assets of the sole proprietorship were transferred to X for the purpose of enabling Y to acquire such assets without the recognition of gain to A.[396]

The Service ruled that A was taxed on the realized gain on the transfer of the sole proprietorship to X, but "[t]he exchange by A of all the outstanding stock of X, solely for voting common stock of Y, other than the Y stock received in payment for the sole proprietorship assets, is a reorganization within the meaning of section 368(a)(1)(B) of the Code."[397]

Thirty-three years later, the Service issued Revenue Ruling 2003-51 which distinguished Revenue Ruling 70-140, and permitted section 351 treatment, despite loss of control pursuant to a binding contract, albeit in a very limited circumstance.[398] The facts of the ruling were as follows: W is a domestic corporation

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[390] *Id.*
[391] *Id.*
[392] *See* Bowen, *supra* note 11, at 738; *supra* Section II.B.
[393] *See* Bowen, *supra* note 11, at 738–39.
[394] *Id.* at 738.
[395] Rev. Rul. 70-140, 1970-1 C.B. 73, 73.
[396] *Id.*
[397] *Id.* at 73–74.
[398] Rev. Rul. 2003-51, 2003-1 C.B. 938, 940.

that conducts businesses A (fair market value $40x), B (fair market value $30x) and C (fair market value $30x).[399] An unrelated domestic corporation X engages in business A, which it does through its wholly owned domestic subsidiary Y.[400] Y's fair market value is $30x.[401] To achieve W and X's objective to consolidate their respective A businesses, the parties enter into a binding agreement with the following steps.[402] W transfers its A business to newly formed corporation Z, in return for all the Z shares (first transfer).[403] Immediately thereafter, W transfers all its Z shares to Y in return for additional Y shares (second transfer).[404] "Simultaneous[ly] with the second transfer, X contributes $30x to Y" in exchange for additional Y shares (third transfer). This results in W and X owning respectively forty percent and sixty percent of Y.[405] Finally, after the second and third transfers, Y contributes $30x and the assets in its A business to Z (fourth transfer).[406] The ruling indicated that "[v]iewed separately, each of the first transfer, the combined second and third transfer, and the fourth transfer qualifies as a transfer described in [section] 351."[407] The issue posed by that ruling was:

> Whether a transfer of assets to a corporation (the "first corporation") in exchange for an amount of stock in the first corporation constituting control satisfies the control requirement of [section] 351 of the Internal Revenue Code if, pursuant to a binding agreement entered into by the transferor with a third party prior to the exchange, the transferor transfers the stock of the first corporation to another corporation (the "second corporation") simultaneously with the transfer of assets by the third party to the second corporation, and immediately thereafter, the transferor and the third party are in control of the second corporation.[408]

The Service ruled that under these circumstances the first transfer satisfied the section 351 control requirements, that is the

[399] *Id.* at 938.
[400] *Id.*
[401] *Id.*
[402] *Id.*
[403] *Id.*
[404] *Id.*
[405] *Id.*
[406] *Id.*
[407] *Id.*
[408] *Id.*

second transfer, although undertaken pursuant to a prearranged agreement, did not cause the first transfer to fail to meet the section 351 control requirements.[409] In reaching this result the Service reasoned that "[t]reating a transfer of property that is followed by a nontaxable disposition of the stock received as a transfer described in [section] 351 is not necessarily inconsistent with the purpose of [section] 351."[410] That purpose being "to facilitate the rearrangement of the transferor's interest in its property."[411] The Service indicated that "[a]ccordingly, the control requirement may be satisfied in such a case, even if the stock received is transferred pursuant to a binding commitment in place upon the transfer of the property in exchange for stock."[412]

The Service distinguished Revenue Ruling 70-140 stating that in that fact pattern "there was no alternative form of transaction that would have qualified for nonrecognition treatment."[413] In contrast to Revenue Ruling 70-140, the Service indicated that here:

> W's transfer of the business A assets to Z was not necessary for W and X to combine their business A assets in a holding company structure in a manner that would have qualified for nonrecognition of gain or loss under [section] 351. A transfer of W's business A assets to Y in exchange for Y stock as part of a plan that included X's transfer of $30x to Y in exchange for Y stock, and Y's transfer of the business A assets and $30x to Z in exchange for all of the Z stock, would have qualified as successive transfers described in [section] 351.[414]

Jack Cummings indicated that one might interpret Revenue Ruling 2003-51 as follows:

> Whenever (1) the potentially decontrolling event is a nonrecognition transaction, and (2) the property exchanged with the corporation might have been transferred in a nonrecognition transaction with the transferee of the stock, then (3) the step transaction doctrine will not be applied to prevent the shareholders from having control in the first purported section 351

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[409] *Id.* at 940.
[410] *Id.*
[411] *Id.*
[412] *Id.*
[413] *Id.*
[414] *Id.*

> exchange, "immediately after." "Might have been" does not require any finding of actual practicality.[415]

While the foregoing was a departure from the discussion of Professor Jensen's article, it does serve to illustrate that the application of the step transaction doctrine to the section 351 control requirement has engendered considerable confusion.[416] Another problem Professor Jensen had with the approach often taken by the courts and the Service was that he thought it was inconsistent with the intent of Congress in enacting the antecedent to section 351.[417] Professor Jensen believed "that Congress enacted the 80% requirement to prevent existing corporations with readily marketable stock from using their stock to buy goods and supplies on a tax free basis to their vendors."[418] In other words,

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[415] *See* Cummings, *supra* note 188, at 950; Cummings cautioned, however, that "the ruling doesn't imply the existence of a general principle that the taxpayer wins if it could have gotten the tax result it wanted by doing the transaction another way." *Id*. Furthermore, Cummings stated that "there is no principled reason for the IRS to create a could-have-done-it-another-way basis for this particular the [section] 351 ruling." *Id.* at 951. Cummings was critical of some of the theories espoused as to the Service's intellectual basis for the ruling. *Id.* at 952. For example, he cited the comment that the ruling is consistent with the fact "that the Service has long respected cascading section 351 exchanges." Jerrod G. Blanchard, Jr., *The Ghost of Kimbell-Diamond: The Current State of the Law Pertaining to Multi-Step Corporate Transactions,* 71 TAX LAW. 445, 483 (2018) (footnote omitted). Cummings writes that

> Cascading 351's don't explain Rev. Rul. 2003-51. Cascading 351s never violated the words of the code. Section 351 doesn't require that the corporation retain the contributed property. The step transaction doctrine as applied to 'control immediately after' hasn't been applied to the different question of the double drop of property. The shareholder of the top corporation never owned stock of the second-tier corporation, and it made no step transaction sense to hypothesize a drop directly to that lower-tier subsidiary. In contrast there is a problem with decontrol because section 351 requires control 'immediately after,' and the courts and the IRS routinely have applied step transaction concepts to that requirement. Therefore, the allowance of cascading 351s is not relevant to a decision not to apply the step transaction doctrine to a decontrolling transfer of stock.

Id. at 952–53 (footnote omitted).

[416] *See supra* Section II.B; *supra* note 415 and accompanying text.

[417] *See* Jensen, *supra* note 1, at 397–98.

[418] *Id.* at 398.

according to Professor Jensen, "the 80% control requirement prevents a supplier, for example, from selling supplies to a corporation without recognizing income or gain simply by accepting the corporation's stock in lieu of cash."[419]

Professor Jensen asserted that "[d]espite the paucity of legislative history, strong circumstantial evidence exists for rejecting the contention that the 80% control requirement was intended to limit nonrecognition to mere changes in the form of the transferor's investment."[420] He suggested that "the legislative history shows that Congress was not obsessed with restricting nonrecognition to transactions involving mere changes in the form of the taxpayer's investment."[421] Instead, according to Professor Jensen, "its primary purpose in 1921 was to facilitate desirable business readjustments and to avoid recognition of gain where there was no realization of a cash profit."[422]

He also questioned the rationale provided in *Intermountain Lumber* and elsewhere that section 351's:

> [B]asic premise ... is to avoid recognition of gain or loss resulting from transfer of property to a corporation which works a change in form only .... Accordingly, if the transferor sells his stock as part of the same transaction, the transaction is taxable because there has been more than a mere change of form.[423]

Professor Jensen argued that if ten unrelated individuals transfer diverse properties to a Newco to be used in its manufacturing business, this is a good section 351 transaction for these individuals "[y]et by no stretch of the imagination can it be described as a mere change in form of each investor's respective investment."[424] Another example that he cited, as to why a premise that section 351 is based on no change in form is faulty is a fact pattern in Revenue Ruling 79-194, wherein Z and a group of investors form Newco, with Z receiving eighty percent of its stock, and "[p]ursuant

[419] *Id.*

[420] *Id.* at 387–88 (footnote omitted).

[421] *Id.* at 393.

[422] *Id.*

[423] *Id.* at 376 (footnote omitted) (quoting Intermountain Lumber Co. v. Comm'r, 65 T.C. 1025, 1033–34 (1976)).

[424] *Id.* at 377.

to ... [a binding] agreement Z sold an amount of its Newco stock ... to bring its ownership down to 49[%]."[425] The Service found the control requirements of section 351 were met stating that "[t]he fact that there was a shift in ownership of stock among the transferors after their exchanges with Newco does not affect the application of section 351(a)."[426] Professor Jensen contended that this, and in other examples he referred to, established "that radical changes can occur in the relationship of the transferor to the transferred assets in a transaction, and yet the transaction may still qualify for nonrecognition under section 351. This casts serious doubt upon validity of the mere change of form rationale of the control requirement."[427]

Professor Jensen summarized his criticism of the utilization of the step transaction doctrine for determining if section 351 control has been satisfied as follows:

> [I]n certain instances, a transferor's divestiture of control shortly after the transfer pursuant to a preconceived plan disqualifies the transaction under section 351 while in others it does not. Neither the courts nor the Service have articulated a persuasive rationale explaining these apparently inconsistent applications of the step transaction doctrine. Indeed, there was no reasoned justification for application of the step transaction doctrine to section 351 in the first place.[428]

He also pointed to the "express language adopted by Congress which demands only that the transferor have control of the corporation immediately after the exchange."[429] He acknowledged that "it is sometimes appropriate to deviate from the literal language of the statute when necessary to effectuate a statute's policy."[430] He asserted, however, that in this case "deviation from the literal language furthers no discernible policy but defeats

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[425] Rev. Rul. 79-194, 1979-1 C.B. 145, 145; *see* Jensen, *supra* note 1, at 380–81.

[426] Rev. Rul. 79-194, 1979-1 C.B. 145, 146.

[427] Jensen, *supra* note 1, at 381.

[428] *Id.* at 368. Another criticism Professor Jensen had was that "[c]ourts purporting to apply the [mutual interdependence] test outside the section 351 context have been much more ready to find that events are interdependent than when applying the test within the section 351 context." *Id.* at 362 (footnote omitted).

[429] *Id.* at 394.

[430] *Id.* at 394–95.

the most reasonable interpretation of the policies underlying section 351."[431]

Professor Jensen contended that the conclusion from the foregoing is the complete removal of any role for the step transaction doctrine in determining whether control under section 351 was fulfilled.[432] He argued that the policy behind section 351 is not well served if the loss of control, even if caused by a binding obligation, results in all the realized gain being recognized.[433] Under his proposed statutory interpretation, section 351 control will be deemed to have been met "so long as the transferor[s] own at least eighty percent of the stock immediately after the exchange, even if the transferor[s] thereafter divest themselves of control pursuant to a preexisting binding agreement."[434] Under his proposal, if transferor received eighty percent of transferee subject to a binding obligation to sell five percent to a third party only the five percent actually sold would result in gain recognition.[435] He explained that:

> In every case where the courts have applied the doctrine (e.g., the binding obligation cases), the transferor technically complied with the statute, that is, the transferor for some finite period of time owned 80% of the corporation's stock. Thus, the only reason for not according nonrecognition under section 351 would be that to do so would frustrate a policy of the statute, and the only policy reason offered for deviating from the literal language of the statute was the mere change of form rationale. Upon analysis we found that rationale to be unsatisfactory and thus did not justify deviation from the statute's literal language. Accordingly, there is no occasion to use the step transaction doctrine here since there simply is no policy to vindicate.[436]

In sum, Professor Jensen claimed that his recommended construction of section 351 control is consistent with the statutory language,[437] avoids Draconian penalties,[438] is harmonious with both

[431] *Id.* at 395.
[432] *Id.* at 424.
[433] *Id.* at 421.
[434] *Id.* at 408.
[435] *Id.*
[436] *Id.* at 417.
[437] *Id.* at 394.

Congressional objectives to facilitate business readjustments,[439] and taxing only those having liquid wherewithal to pay.[440]

Another commentator echoed Professor Jensen's view that no post transfer event should result in a loss of control for section 351 purposes.[441] This observer advocated that "[t]he Treasury should ... adopt a regulation reversing the judicial application of the step transaction doctrine to the post-incorporation sale."[442] He believed that "[t]he sale of some portion of an investment in the wake of the incorporation will give rise to recognition on that portion of the interest actually disposed of. The interests of fair and efficient taxation demand no more."[443]

Professor Jensen's criticism with the inconsistent application, and in many cases a lack of a coherent rationale, for whether the step transaction doctrine should be used in determining control for section 351 purposes by the courts and the Service is warranted.[444] Furthermore, this Article is in accord with Professor

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[438] *Id.* at 395.

[439] *Id.* at 394.

[440] *Id.* Interestingly and somewhat paradoxically Professor Jensen is a strong advocate of applying the step transaction expansively "to determine whether to integrate the initial transfer of property for stock with the transferor's subsequent sale of his stock when applying the boot provisions of section 351(b)." *Id.* at 417. He would even go as far as to utilize the end result in analyzing when the steps should be combined for this purpose. *Id.* Professor Jensen's reasoning is as follows:

> The basic premise here is that Congress has prescribed the tax consequences flowing from an incorporation of business. The parties should not be able to evade those consequences by manipulating the formal structure of the transaction. Since the step transaction is a means of implementing policy, it should be used to prevent such evasion. Note that here the policy being vindicated is not some semi-mystical concept of the purpose of the statute such as the mere change of form rationale, but rather the explicit tax consequences spelled out by Congress for incorporating transactions. The policy is clear, and the step transaction doctrine being an instrument for implementing policy should be used.

Id. at 417–18.

[441] *See* Note, *Losing Control: Toward a New Understanding of the Taxation of Post-Incorporation Stock Sales*, 108 HARV. L. REV. 1661, 1678 n.71 (1995) [hereinafter *Losing Control*].

[442] *Id.*

[443] *Id.* at 1678 (footnote omitted).

[444] *See* Jensen, *supra* note 1, at 367.

Jensen that a justification for section 351 treatment grounded upon the preservation of form is tenuous conceptually and not defensible from the legislative history of a predecessor provision.[445] Nevertheless, his proposed prescription for addressing serious glitches with the doctrine's utilization does not warrant its complete abandonment in determining section 351 control.[446] Moreover, some of the underpinnings for Professor Jensen's conclusion that in effect from both a textualist and intentionalist approach, there is no support for utilizing the step transaction doctrine to determine whether control for section 351 purposes is affected by the disposition of shares by a transferor post contribution, appear to be flawed.[447]

Turning first to his comment that "[i]t is remarkable that the courts felt no need to justify a result [i.e., applying the step transaction doctrine to deny nonrecognition upon a post contribution event] clearly at odds with the language of the statute."[448] While as Professor Jensen points out, there are a number of cases, in addition to the dicta in *American Bantam Car* discussed above,[449] interpreting section 351's predecessor as providing literally that momentary ownership suffices,[450] it is certainly questionable that if a transferor is legally bound, for example, to deliver the shares she receives at closing whether she in fact met the literal language in the statute.[451] There is also a valid argument, despite the "immediately after" language in section 351(a), that the literal requirement has been fulfilled when the transferor's freedom of action with respect to the shares is otherwise substantially restricted.[452] In other words, someone should arguably not be deemed to have ownership for this purpose when the benefit of such ownership is limited to receiving a prescribed payment for the shares in question or in certain circumstances where such ownership is fleeting and ephemeral.[453]

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445 *Compare Losing Control*, *supra* note 441, at 1661, *with* Jensen, *supra* note 1, at 387–88.

446 *Losing Control*, *supra* note 441, at 1671.

447 *See* Jensen, *supra* note 1, at 369.

448 *See id.*

449 Am. Bantam Car Co. v. Comm'r, 11 T.C. 397, 404 (1948); *see supra* notes 291–313.

450 *See* Jensen, *supra* note 1, at 369–71.

451 *Id.* at 371–72.

452 *See id.* at 370.

453 *See id.*

In terms of the intent of the statute, let's accept Professor Jensen's scholarly research that "[the] primary purpose in 1921 was to facilitate desirable business readjustments and to avoid recognition of gain where there was no realization of a cash profit."[454] If Congress since then shared Professor Jensen's indignation with utilizing the doctrine to determine control under section 351 and its predecessors,[455] why didn't it revise the statute to preclude its use when section 351 was first enacted or in the many decades since that time?[456] Perhaps Congress has, and had, concerns about according nonrecognition in circumstances where ownership is transitory and/or where the original transfer would not have occurred but for an interdependent disposition of sufficient shares to bring the transferor or transferors under the eighty percent threshold.[457]

With respect to Professor Jensen's extreme remedy, there should be wariness with throwing decades of decisions and rulings in this area into the trash bin where many, albeit certainly not all, appear to be conceptually sound.[458] There is significant authority to the effect that at least under certain circumstances "[i]f the disposition is integrated with the initial section 351 exchange, the requirement of control immediately after the exchange is not satisfied, in essence because the transferors' stock ownership is viewed as too transitory to be counted toward control."[459] It is submitted that the optimal course of action to address at least some of Professor Jensen's concerns is for the Service and the courts to adopt a more uniform approach to when to employ the step transaction doctrine to determine if section 351 control has been met.

The Tax Court in *Intermountain Lumber o*bserved that:

> A determination of "ownership," as that term is used in section 368(c) and for purposes of control under section 351, depends upon the obligations and freedom of action of the transferee with respect to the stock when he acquired it from the corporation.

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[454] *Id.* at 393.
[455] *Id.*
[456] *See* 26 U.S.C. § 351 (note the lack of relevant amendment).
[457] *See* Jensen, *supra* note 1, at 380.
[458] *See id.* at 393.
[459] *See id.* at 252.

> Such traditional ownership attributes as legal title, voting rights, and possession of stock certificates are not conclusive. If the transferee, as part of the transaction by which the shares were acquired, has irrevocably foregone or relinquished at that time the legal right to determine whether to keep the shares, ownership in such shares is lacking for purposes of section 351.[460]

Just because the *Intermountain Lumber* Tax Court statement that "the basic premise of section 351 is to avoid recognition of gain or loss resulting from transfer of property to a corporation which works a change of form only"[461] is of questionable validity, does not mean the decision and the rest of the court's reasoning including the above quoted passage should be nullified. In short, Professor Jensen has provided a superb analysis identifying the problems with the decision to utilize or not utilize the canon for determining if control was met under section 351,[462] and his remedy would achieve transparency and consistency,[463] but it would not make for sound tax policy.[464] There are other recommendations put forth by practitioners and scholars with respect to the utilization of the step transaction doctrine that merit consideration in the section 351 control context.[465]

Steven Bowen, while not addressing section 351 control per se, put forward ideas for restricting when courts and the Service should utilize the step transaction doctrine.[466] Bowen, in effect, asserted that in a multistep corporate stock transaction where there is a binding commitment, and in some circumstances when there is mutual interdependence of the steps, the utilization of the canon is generally proper.[467] With respect to the use of the mutual interdependence test to collapse steps, he suggested there be "some form of economic compulsion ... [that] makes the completion of the later steps likely, if not a foregone conclusion—e.g., because a later step eliminates any exposure to an

[460] Intermountain Lumber Co. v. Comm'r, 65 T.C. 1025, 1031 (1976).
[461] *Id.* at 1033.
[462] *See* Jensen, *supra* note 1, at 381.
[463] *See id.* at 426.
[464] *See supra* text accompanying note 458.
[465] *See Losing Control*, *supra* note 441, at 1677–78.
[466] Bowen, *supra* note 11, at 722.
[467] *See id.* at 727.

unacceptable risk of loss attributable to the first step."[468] He recommended that economic compulsion "be narrowly construed, so as to avoid the open-endedness characteristic of the end result test."[469] Bowen asserted that "economic compulsion" could have application in circumstances of "actual or threatened lawsuits and foreclosures and various rights and obligations set forth in unrelated or collateral agreements."[470] He reasoned that "[a] mutual interdependence test that rests principally on economic significance as opposed to taxpayer intent may be viewed perhaps as a variation of the binding commitment test."[471]

Bowen believed that "the end result test in corporate stock transactions ... be sharply curtailed if not prohibited."[472] He expressed wariness of a court deciding whether to invoke the doctrine based on a determination of "the parties' intentions [that are] deduced from particular facts and circumstances."[473] Bowen contended that "the fruitfulness—or fruitlessness—of formally separate transactions should be judged on the basis of their particular economic consequences and that economically meaningful transactions should be respected, generally without regard to what the parties 'hoped' or intended to achieve."[474] Eliminating or at least substantially curtailing the utilization of the end result test for determining section 351 control would certainly provide more certainty and consistency for decisions in this area.[475]

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[468] *Id.* Grossberg, however, argued that

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

Grossberg, *supra* note 194, at 403–04.

[469] Bowen, *supra* note 11, at 727.

[470] *Id.* (footnotes omitted). Bowen advocated that economic compulsion "should not include such things as market forces, which are generally applicable, or ... the likely consequences of potentially applicable federal income tax rules." *Id.*

[471] *Id.*

[472] *Id.* at 722 (footnote omitted).

[473] *Id.* at 723.

[474] *Id.*

[475] *See* Jensen, *supra* note 1, at 426.

At the same time, the doctrine would continue to play a necessary role.[476]

One example Bowen cited to explain his position on when mutual interdependence should be deemed or not deemed to exist for section 351 control purposes was the Tax Court decision of *Weikel v. Commissioner*.[477] In that case, a dentist transferred an amalgam patent and some other assets to a newly formed corporation (D) for its shares in November 1973.[478] It was done so, at the suggestion of Johnson & Johnson (J&J),[479] which had expressed interest in a possible joint venture with the taxpayer.[480] By the time of the contribution, there was an oral tentative understanding between the taxpayer and a representative from J&J of some key terms,[481] but there was no definitive signed agreement until January 1974 which provided for an exchange of J&J stock for D stock.[482] The issue was whether the purported section 351 followed by a "B" reorganization should be respected or stepped together as a taxable sale of assets, the latter being how J&J treated the transaction.[483]

The taxpayer prevailed which Bowen believed was the correct result.[484] Bowen was, nevertheless, critical[485] of the Tax Court's comment that "[u]nder the interdependence test it is clear that petitioners intended to incorporate whether or not they finalized an agreement with J&J for an exchange of stock."[486] He was, however, complimentary[487] of the Tax Court's statement that its mission was to "determine whether the incorporation of ... [D] was an event with an independent economic substance."[488] According to Bowen, this latter statement "is the purpose of the mutual interdependences test ... [and] not on what he may or may not have

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476 *See id.*
477 Weikel v. Comm'r, 51 T.C.M.(CCH) 432, 438 (1986).
478 *Id.* at 435.
479 *Id.* at 434.
480 *Id.*
481 *Id.* at 436.
482 *Id.*
483 *Id.* at 437.
484 *See* Bowen, *supra* note 11, at 739.
485 *Id.*
486 *Weikel*, 51 T.C.M.(CCH) at 440.
487 *See* Bowen, *supra* note 11, at 739.
488 *Weikel*, 51 T.C.M.(CCH) at 439.

intended to achieve."[489] Bowen asserted that in applying the mutual interdependence what should have mattered to the Tax Court was simply that:

> [The taxpayer] incorporated ... [D] at a time when he had no agreement with ... [J&J] or any other prospective purchaser. The patent was in corporate solution .... [The Taxpayer] could not have retrieved it without incurring (at that time) a shareholder level tax; and ... [the Taxpayer] owned ... D's] stock with all the attendant benefits and burdens of ownership.[490]

Some other commentators believe Bowen went too far in imposing restrictions on the step transaction doctrine.[491] Philip J. Levine and Britt M. Haxton expressed the view that "contrary to the thesis of the Bowen article, no one step transaction test should apply in every situation or to every code provision and that, for better or worse, each case must be evaluated individually to determine whether application of the step transaction doctrine is appropriate."[492] While Bowen's proposal might serve to unnecessarily handcuff the Service, Levine and Haxton's case by case methodology doesn't appear to adequately address the plethora of intellectual inconsistencies in this area.[493]

Another commentator, Jonathan D. Grossberg, who like Levine and Haxton as well as Bowen, addressed the step transaction in general, rather than specifically its function with satisfying control under section 351, noted that the end result test "has been the subject of much criticism because it is so malleable."[494] The determination of whether a taxpayer intended to take succeeding steps has "create[d] ... problems of fairness, notice and certainty."[495] Professor Joshua D. Rosenberg articulated his objection to the use of the end result as follows:

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[489] *See* Bowen, *supra* note 11, at 739.

[490] *Id.*

[491] *See* Levine & Haxton, *supra* note 202, at 1260 (arguing that Bowen's position is too restrictive).

[492] *Id.*

[493] *Compare* Bowen, *supra* note 11, at 722 (arguing for the elimination of the end result test from the step transaction doctrine), *with* Levine & Haxton, *supra* note 202, at 1260 (arguing for a case-by-case application of the end result test).

[494] *See* Grossberg, *supra* note 194, at 409–10 (footnote omitted).

[495] *Id.* at 411.

> [W]hile 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. If all that is required to join two separate exchanges together is that 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. For example, imagine that A forms a corporation in 1987. At the time, A intends to make the corporation successful and to have it go public in 1990. A also intends to purchase Treasury bonds in 1988 and to sell short some stock in an unrelated enterprise in 1987. All of these purchases and sales are planned to maximize A's profit potential and to minimize his risk; yet to suggest that these events are a single "transaction" would be absurd.[496]

As to relying solely, or mainly, on a binding commitment test, Grossberg suggested it is easily preventable by taxpayers in that they "need only to avoid obligating themselves in writing to take later steps."[497] He also expressed concern with the mutual interdependence test because it "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."[498] Professor Grossberg proposed that as an alternative to the current three tests that:

> [C]ourts 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

[496] *See* Rosenberg, *supra* note 256, at 407.
[497] *See* Grossberg, *supra* note 194, at 414 (footnote omitted).
[498] *Id.* (footnote omitted).

> person in the position of the other party would have. 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."[499]

Certainly, increased objectivity in determining when steps should be collapsed would, as Grossberg indicated, serve to "promote ... predictability and certainty .... 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."[500] In short it "promotes the predictable administration of the tax law."[501]

Grossberg indicated that with related parties there is a need for a different test because they "can rely on unwritten understandings ... [and] 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."[502] In related party circumstances, he envisioned that the economic reality test he proposed "would determine reasoned economic justification by looking to the behavior exhibited by businesses engaged in similar arms-length transactions."[503] Thus, "[i]f businesses engaged in arms-length transactions would never engage in the intermediate, challenged steps, the steps probably do not have reasoned economic justification."[504]

Although he ultimately advocated replacing all three tests,[505] Professor Rosenberg opined that with respect to the mutual interdependence test, while "[i]t will not do for all the cases,"[506] the application of the "test to nonrecognition exchanges is fairly straightforward."[507] He reasoned that:

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[499] *Id.* at 376 (footnotes omitted).
[500] *Id.* at 415 (footnote omitted).
[501] *Id.* at 423.
[502] *Id.* at 417 (footnote omitted).
[503] *Id.* at 417–18 (footnote omitted).
[504] *Id.* at 418.
[505] *See* Rosenberg, *supra* note 256, at 413–17.
[506] *Id.* at 411 (quoting Randolph Paul & Phillip Zimet, *Step Transactions*, *in* SELECTED STUDIES IN FEDERAL TAXATION 200, 252 (1938)).
[507] Rosenberg, *supra* note 256, at 411.

> Most exchanges, and almost all nonrecognition transactions, generate no tax savings. A nonrecognition exchange merely results in no current taxation of accrued appreciation in the exchanged assets, a result identical to that imposed upon simple retention of the asset. As a result, the tax savings generated by a single nonrecognition transaction could never entirely motivate that transaction. The taxpayer must either have some business purpose (i.e., the desire to exchange assets), some other tax goal which will be accomplished by the nonrecognition exchange, or some tax purpose which can be accomplished only by combining the first nonrecognition exchange with a second exchange. In the last case, the two (or more) exchanges necessary to achieve the single tax purpose will be integrated and treated as a single transaction.[508]

Perhaps it is not quite so clear cut. Returning to the dentist/taxpayer with the amalgam patent in *Weikel* where the Tax Court chose not to collapse steps upon his contributing the amalgam business, including the patent, to a newly incorporated entity.[509] There was no binding agreement and there was evidence that he would have contributed the business to a Newco even without a likely forthcoming transaction with J&J, so the decision was both conceptually sound and somewhat relatively easy to predict.[510] Nevertheless, a sophisticated taxpayer, J&J, thought, or at least took a tax return position, that this was not the outcome.[511] Furthermore, how would the case be decided if there was still no binding agreement with J&J at the time of the contribution, but there is no evidence taxpayer would have taken this step, but for an imminent tax-free acquisition of a Newco with J&J? Is it enough, as Bowen seemed to suggest, that the shareholder had "all the attendant benefits and burdens of ownership" and that the patent now in corporate solution could not have been distributed back to the dentist without incurring tax to Newco?[512] What if there was evidence of an economic compulsion at the time of the contribution to transfer some, or all, of those shares? Presumably, this might, very well, change the result to not collapse steps.[513]

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508 *Id.* (footnotes omitted).

509 *See supra* text accompanying notes 483–84; Weikel v. Comm'r, 51 T.C.M.(CCH) 432, 437 (1986).

510 *Weikel*, 51 T.C.M.(CCH) at 439–40.

511 *See id.* at 438.

512 *See* Bowen, *supra* note 11, at 739.

513 *Weikel*, 51 T.C.M.(CCH) at 439–40.

Whatever modifications are adopted to provide more uniformity of the utilization of the step transaction doctrine with respect to section 351 control, there will undoubtedly still leave some uncertainty. Bowen, as well as Grossberg and others, have proposed some interesting and useful ideas.[514] This includes eliminating or curtailing the use of the end result test and its focus on what the parties hoped or intended to achieve.[515] The mutual interdependence test generally incorporating economic justification is another idea worth considering.[516]

In sum, there are proposed methodologies to the utilization of the step transaction doctrine in this context that if uniformly applied by the Service and the courts, can ameliorate many, but not all, of the contradictions identified by Professor Jensen, without the abolition of an important tool necessary to ensure the statute operates in a proper manner.[517] This leads to this Article's final point.

Professor Jensen was dismissive of courts that find control was not satisfied in cases where the transferor's disposition of shares was connected to the initial contribution and its ownership reflected "fleeting, ephemeral control."[518] He rejected use of the step transaction doctrine in such circumstances because there was "no discernable policy exists for limiting nonrecognition."[519] He ignored the fact that only including shares for control purposes where the shareholder has the benefits and burdens of ownership and maintains freedom of action of the shares is, in and of itself a sound policy objective.[520]

Conclusion

There should be reasonable, transparent and intellectually consistent boundaries as to when the step transaction doctrine should apply for purposes of determining control in a section 351 transaction.[521] Professor Jensen provided a superb analysis clearly

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[514] *See* Bowen, *supra* note 11, at 722, 727; Grossberg, *supra* note 194, at 369.
[515] *See* Bowen, *supra* note 11, at 722.
[516] *Id.* at 727.
[517] *See* Jensen, *supra* note 1, at 358–59, 365–66, 368, 370–71.
[518] *See id.* at 372.
[519] *Id.* at 374.
[520] *Id.* at 372–74.
[521] Bowen, *supra* note 11, at 722; Grossberg, *supra* note 194, at 376.

identifying the contradictions by the Service and the courts with the decision as to when to utilize the canon for determining if control was met under section 351.[522] His proposed solution, that of complete nullification of the doctrine in determining section 351 control, however, is unwarranted and not sound policy.[523] There are legitimate concerns about according nonrecognition in certain circumstances where ownership is transitory and/or where the original transfer would not have occurred but for an interdependent disposition of sufficient shares to bring the transferor or transferors under the eighty percent threshold.[524] In many of these situations, in substance statutory form has not been satisfied.[525] The step transaction doctrine should remain an important device by the courts, the Service, and in some cases by taxpayers, but tests for utilization should be revised to reduce inconsistency.[526]

Satisfying statutory form should have been central to *Complex Media*.[527] There were compelling issues raised by the Tax Court on the ONI merger casting doubt on whether the form in this case satisfied section 351.[528] A step should still not count for meeting the section 351 control requirement where the form chosen by the taxpayer does not comport with the statutory requirements. The Service should have allowed the court to render a judgment as to whether the form here sufficed.

[522] *See* Jensen, *supra* note 1, at 358–59, 365–66, 368, 370–71.
[523] *Id.* at 425–26.
[524] *See supra* text accompanying notes 455–59.
[525] Complex Media, Inc. v. Comm'r, 121 T.C.M. (CCH) 1089, 30–31 (2021).
[526] *See* Grossberg, *supra* note 194, at 411.
[527] *Complex Media, Inc.*, 121 T.C.M. (CCH) at 30–31.
[528] *Id.* at 25.