

# Step Transaction Issues for Gifts and Sales of Closely Held Business Interests

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## 1. What is the step transaction doctrine?

- One of several court developed anti-avoidance doctrines applicable as a judicial remedy [business purpose doctrine/substance over form doctrine/sham transaction doctrine/economic substance doctrine].
- The anti-avoidance doctrines allow courts to prevent the true nature of a transaction from being masked by formalisms, which exist strictly for the purpose of altering tax liabilities.

## 2. What is the concern?

- Valuation discounts on minority blocks of LLC or FLP units transferred to family members or trusts will be reduced dramatically if the IRS is able to use the step transaction doctrine to collapse the step's undertaken in such transactions

## 3. The step transaction doctrine is a variation of the substance over form doctrine.

- Taxpayer seeks to get from point A point D and does so while stopping at points B and C. The unnecessary stops at points B and C are purely to achieve tax consequences which necessarily differ from those achieved from the direct path of A to D.
- Courts may disregard or rearrange the steps taken by the taxpayer when she claims benefits unintended by Congress by structuring the transaction in such a manner that serves no economic purpose other than tax savings.
- As a general principle, courts hold that separate steps are to be treated as a single transaction if such steps are in fact interdependent and integrated to achieve a particular result. But if the substance does not differ from its form, then the step transaction doctrine will not be applied.
- Courts apply three alternative tests to determine the applicability of a step transaction doctrine: Binding Commitment Test, End Result Test, and Mutual Interdependence Test.
- Some courts have held that if any of the three tests are satisfied the step transaction applies.

#### 4. Binding Commitment Test.

- Binding Commitment Test is comprised of a finding that the parties are committed to honor a specific result at the outset; the taxpayer is committed to pursue successive steps when the first step is entered into.
- In the court's view, the set of transactions are more properly understood as one, and the court therefore collapses the series of transactions.
- This is the least frequently invoked test given that it is the narrowest in scope of the three tests.

#### 5. End Result Test.

- The End Result Test is based upon the intent of the parties at the time of the transaction.
- In other words, was the set of separate transactions prearranged elements and actually part of a single transaction, fashioned to achieve the specific end result?
- This is the broadest and most flexible of the Step Transaction Tests.

#### 6. The Mutual Interdependence Test.

- The focus is on the relationship of the steps and not necessarily the result.
- This test considers whether the steps are so interdependent that they are meaningless unless all of the steps occur. Would a reasonable interpretation of the facts show that the steps are so intertwined that the legal relations created by one transaction would have been worthless without a completion of this series of transactions?
- This involves viewing the economic substance of the steps, much like in the End Result Test.

#### 7. Step Transaction Doctrine cases to consider:

- *Pierre v. Comm'r*, T.C. Memo 2010-106
- *Heckerman v. US*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009)
- *Gross v. Comm'r*, T.C. Memo 2008-221
- *Holman v. Comm'r*, 130 T.C. 12 (2008) ?
- *Senda v. Comm'r*, 433 F.3d 1044 (8<sup>th</sup> Cir. 2006)
- *Jones v. Comm'r*, 116 T.C. 121 (2001)
- *Shepherd v. Comm'r*, 115 T.C. 376 (2000)

8. *Linton v. US*, 630 F.3d 1211 (9<sup>th</sup> Cir. January 21, 2011).

- The US District Court for the Western District of Washington applied all three of the step transaction doctrine tests and held that the formation of the LLC and gifts of the LLC interests were so related that the grantors had made indirect gifts of the underlying assets, as opposed to direct gifts of the LLC interests.
- The key to the appeal was the order of the transactions, in creating and funding the LLC and then making conveyances of the LLC interests. If the taxpayers first contributed assets to the LLC and then, after some time had passed, conveyed the LLC interests to the trusts for taxpayers' children, the gifts would have been discounted for lack of marketability and/or minority interests. But, if the contributions to the LLC postdated the transfer of the LLC interests, the gifts would be indirect gifts of the contributed assets and not discountable.
- On appeal, the Ninth Circuit held that because the record was muddled and subject to various inferences as to the operative date of the gift, the IRS was not entitled to summary judgment. In fact, the Ninth Circuit held that the transactions failed to meet any of the three step transaction doctrine tests.

9. What do we need to be aware of?

- Estate planners need to be aware of the time factors. Establishing an entity and the subsequent transfer of entity interest should be separated by "some" time. How much time is appropriate? It should be enough time that there is a "real economic risk" of a change in asset value. This will be a very fact sensitive analysis and would likely depend on the nature of the asset.
- Some commentators have argued that the measuring stick should be an actual change in value. The time allowed should be enough that the original appraisals are no longer usable. Indeed some commentators argue that the failure to get second appraisals could undercut the taxpayers' position that the transactions are in fact independent of one another.
- Apart from fluctuations in price, we should also look to factors like changes in asset structures and holdings, and risk of loss occurring between the steps. To know exactly how much change in these elements is sufficient, we'll have to wait for future cases to come in.