AN ANALYSIS OF THE FACTORS USED BY THE TAX COURT
IN APPLYING THE STEP TRANSACTION DOCTRINE

DISSERTATION

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The step transaction doctrine is one of the judicial doctrines used by the courts to interpret tax law. The doctrine requires that a series of transactions be treated as a single transaction if the transactions share a single, integrated purpose. Many authors believe there is a great deal of uncertainty as to when the doctrine will be applied.

Uncertainty and inconsistency in the application of tax law add to the complexity of the law. One of the most complex areas of tax law is Subchapter C of the Internal Revenue Code, which governs corporate formations, reorganizations, liquidations, distributions, and reorganizations. The purpose of this study was to determine if the step transaction doctrine is being consistently applied by the Tax Court and what variables affect the judges' decision in these cases.

Hierarchical logit analysis was used to derive a full model and two restricted models. The full model was used to determine the predictive power of the variables that were identified and to explain the extent to which the individual variables affect the judges' decisions. One restricted
model was used to test temporal stability. The other was used to test consistency when different issues of tax law are involved. The data source was the sample of step transaction cases involving Subchapter C issues decided by the Tax Court and its predecessor, the Board of Tax Appeals. Eight variables were identified to evaluate the factors discussed in the literature and major court cases involving the doctrine.

Four of the variables were found to be statistically significant. The full model correctly predicted the outcome of 79.5 percent of the cases. The restricted model to test temporal stability correctly predicted the outcome of 86.3 percent of the cases. The restricted model to test the consistency of the decisions relating to a specific topic correctly predicted the outcome of 85.7 percent of the cases.
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CHAPTER I

INTRODUCTION

The step transaction doctrine treats a series of transactions as a single transaction if they have a single, integrated purpose. The doctrine has been administratively and judicially applied in many areas of taxation including corporate acquisitions and reorganizations, transactions between partners and partnerships, like-kind exchanges, and many others. The step transaction issue should be a determination of fact, but a review of cases involving the doctrine leaves most reviewers uncertain as to when the doctrine will be applied.

The courts appear to be using the step transaction doctrine when it appears that, although the taxpayer has complied with the letter of the law, the law is being used in such a way that the taxpayer is taking unfair advantage of the literal interpretation of the statute. In arranging their business affairs in such a way as to incur the smallest possible tax liability, taxpayers are going "too far" and Congressional intent would not be carried out if the courts did not apply the doctrine.

It is almost impossible to write tax law that avoids this problem. The tax statutes are exceedingly complex due
to the process through which they evolve. Congress enacts a tax law to delineate the general imposition of a tax. When possible, the law is written to define its precise application to specific types of transactions which the writers can anticipate. Often, excessive litigation or other problems are encountered in applying the statute. This may make it necessary for Congress to change the existing statutes or add more statutes to define precise application. Tax planning by practitioners contributes to this process.

A particularly complex area of the tax law is the area related to corporate formation, reorganizations, distributions, and liquidations. This general area of taxation is governed by Subchapter C of the Internal Revenue Code. The general theory behind Subchapter C is to allow businesses to restructure their activities without incurring a tax liability and to allow stock to be treated as a capital asset, but to impose a double tax on corporate earnings—once on corporate taxable income at the corporate level, and then upon an individual's taxable income when corporate earnings are distributed to the corporation's shareholders as a dividend or in liquidation. The law as enacted by Congress and interpreted by the Treasury and the courts is exceeded in complexity only by the imaginations of the tax planners trying to minimize their clients' tax liabilities. The step
transaction doctrine is often used by the courts in cases involving Subchapter C issues.

Adam Smith, in his original canons of taxation, states that "certainty...in taxation, is of so great importance, that a very considerable degree of inequality...is not near so great an evil as a very small degree of uncertainty" (2, p. 415). These requirements of a "good" tax structure include not only that everybody pay their "fair share," but that the "tax system should permit fair and nonarbitrary administration and it should be understandable to the taxpayer" (1, p. 235). If the tax law is not consistently applied, it becomes impossible for rational economic decisions to be made because a key ingredient, the tax consequences of a transaction, cannot be determined.

The purpose of this study is to determine if the step transaction doctrine is being consistently applied by the Tax Court and what variables affect the Court's decision in these cases.

The Impact of the Doctrine

It is difficult to evaluate the impact of any aspect of the tax law, but the impact of the common law doctrines may be more difficult to evaluate than other parts of the law. Since these doctrines are used to construct the facts of a case, an evaluation of the doctrines involves evaluating an
An evaluation of the step transaction doctrine is desirable for several reasons. Taxpayers entering into transactions to which the doctrine might be applied need guidance to assess the probability that the doctrine would be applied to them by a court. At a policy level, Congress might wish to study how the application of the doctrine is affecting the enforcement of the laws in accordance with Congressional intent. Others might wish to study the effect of the application to a particular law because of a desire to influence Congress to change the law.

Up to this time, the only method used to evaluate the impact of the step transaction doctrine has been to study precedents established in past litigated cases. This method has centered on differences or similarities in various cases in which the application of the doctrine has been considered.

One of the premises of the present study was that information which would be valuable at a policy level could be obtained through a statistical analysis of litigated cases. Such a study would focus on the variables being used in the application of the doctrine and the consistency of applica-
tion rather than on individual fact situations. With this goal in mind, a statistical analysis of step transaction cases litigated in the Tax Court was planned. Variables believed to be used by the Court in applying the doctrine were drawn from the accounting and law literature, and from landmark cases involving the doctrine.

Statement of the Hypothesis

The hypothesis of this study was that the variables identified from the literature and landmark cases discriminate between those cases where the step transaction doctrine is applied and those cases where the doctrine is not applied. A secondary hypothesis was that application of the doctrine can be refined and applied more consistently to a specific type of transaction than to all types of transactions. A third hypothesis was that the courts have been able to refine their application of the doctrine over time as different uses of the doctrine have been identified and precedents have been set as to how certain transactions should be treated.

Limitations of the Study

This study addressed the issue of whether decisions in Tax Court cases were consistently decided using the variables identified. It did not address the issue of whether the IRS used these variables in selecting cases for audit or
in assessing deficiencies. Currently available data would severely limit any opportunity to extend the observations to all returns examined by the IRS. However, the cases used in this study were a subset of all returns audited by the IRS, and the analysis resulting from this study should provide some insight into the variables used by the IRS.

The cases used for this study were only those cases tried before the Tax Court involving the step transaction doctrine. Tax cases can also be tried in the U. S. District Courts and in the Court of Claims. Thus, any conclusions cannot necessarily be extended to these other courts. In addition, the study included only those cases tried before the Court. Cases where a compromise was reached prior to reaching the Court, for whatever reason, were not included. The effect of excluding these cases is not clear.

It is appropriate to use only Tax Court cases rather than cases tried before all of the courts of original jurisdiction. First, the majority of the tax cases tried are heard in the Tax Court. During the 1970's, sixty-two percent of tax cases were heard in the Tax Court (3). Second, the Tax Court judges are specialists. They hear only tax cases. The judges in the other courts hear cases involving a wide range of issues and cannot concentrate on tax issues. Third, there is only one Tax Court, as opposed to many separate District Courts. This should result in more uni-
form decisions. Because of these three factors, the Tax Court has historically played an important role in the development of tax law. The District Courts and the Court of Claim have played a less important role.

It is possible that the Tax Court has based its decisions on variables not identified in the study. The judge or judges writing the opinion were not identified. Each judge's own personality and biases would surely affect the outcome of a case. The study was also based upon the printed opinions of the Tax Court. These opinions may not reflect the actual proceedings of the Court accurately. The clerk writing the opinion may have felt a need to emphasize certain facts and ignore others in order to support most coherently the conclusion of the court. The written opinions, furthermore, do not make explicit such variables as the skill and expertise of the attorneys involved and the quality of the briefs prepared by these attorneys.

These and any other unidentified variables could not be taken into account in this study.

Preview of the Chapters

Chapter II will provide background for the study, including a discussion of the necessity of common law doctrines in trying tax cases, the consequences of using these doctrines, the effects of complexity and uncertainty sometimes caused by the use of these doctrines, and examples of
the application of the step transaction doctrine. The chapter will end with a discussion of various similar studies in the accounting literature.

Chapter III will discuss the methodology employed in the study. It will include an explanation of how the cases included in the analysis were selected, how the variables selected for analysis were measured, and the statistical procedures used in analyzing the data.

In Chapter IV, the statistical findings will be discussed and interpreted.

Chapter V will summarize the findings of previous chapters and discuss some of the implications of these findings. It will conclude with recommendations for future research.
CHAPTER BIBLIOGRAPHY


CHAPTER II

BACKGROUND FOR THE STUDY

Judicial Doctrines for Combating Tax Avoidance

Although the primary source of tax law is the Internal Revenue Code as enacted by Congress, the law is expanded through the Internal Revenue Service's interpretation of Congressional intent and by the courts' arbitration of disagreements between the Service and taxpayers. One issue often before the court is tax avoidance. Tax evasion is an illegal reduction of tax liability, but tax avoidance is a legal reduction of one's tax by using the tax law to one's advantage (16, pp. 3-10 - 3-15).

Since tax avoidance implies the legal means of structuring one's affairs to minimize one's tax liability, it would seem that the only issue to be addressed by the courts would be whether tax evasion has taken place. But the courts have disallowed the tax benefits of a transaction in many cases where it appeared that the only or primary reason for entering into a transaction or structuring a transaction in a certain way was to manipulate the tax consequences of the transaction. However, much tax law is applied with obvious disregard for the motive of the taxpayer entering into the transaction under discussion. Some tax law is even
written with the objective of encouraging taxpayers to enter into transactions because the transactions reduce their tax liabilities. For example, mortgage interest and taxes are routinely allowed as deductions even though the purported reason for enacting the provisions allowing these deductions is to encourage home ownership. It appears there is a point where "too much" tax avoidance is being practiced (8).

Using the tax avoidance motive as a basis for deciding tax law results in many problems.
1. Ignoring motive in some cases and using it as a basis for the decision in other cases seems to be an inconsistent application of an underlying principle of taxation. This results in uncertainty and inconsistency in the application of the tax law (8).
2. Proving a taxpayer's intent is often exceedingly difficult (8).
3. Relying on motive as a basis for deciding a tax issue will tend to cause taxpayers to disavow this motive, encouraging deceit rather than honesty. This is important in a self-assessed taxing system (8).
4. Judges are encouraged to decide issues upon their interpretation of Congressional intent with very little legislative assistance. The result is an extension by the courts of statutory law to the extent that the courts are mandating tax policy rather than the Congress. Again, the
lack of a discernable pattern in the application of the law by various courts results in a great deal of uncertainty in the law (12).

The courts have developed several techniques for dealing with tax avoidance issues. Bittker names three "pervasive judicial doctrines" (1). The form vs. substance argument implies that tax consequences should be based on the substance of the transaction (what it really is) rather than on its form (what it appears to be). The business purpose doctrine would require that a transaction not be given effect for tax purposes unless it serves some purpose other than tax avoidance. The step transaction doctrine requires that an integrated transaction cannot be broken up into separate transactions for tax purposes and, conversely, that separate transactions cannot be treated as one transaction (2, pp. 1-13). There is a great deal of overlap in the application of the three doctrines (1).

The application of the doctrines by the courts usually occurs only in cases where the Service is contending that they should be applied. Only rarely are taxpayers allowed to repudiate the form of a transaction (1).

The doctrines appear in cases as early as the 1920's. But, although the effect of applying the doctrines may be obvious, predicting whether the doctrines will be applied in any but the most obvious situations is difficult (1).
Evolutionary Complexity of Corporate Tax Law

In their preliminary report on their study of the Federal corporate income tax system, the staff of the Senate Finance Committee concluded that the present system of taxation of corporate and shareholder income is unnecessarily complex, with serious abuses and unintended hardships, and considerable manipulation of the law in trying to circumvent the purpose of the statutes as enacted by Congress (15, p. J-1).

In trying to explain how the corporate tax system has reached its present state, Clark describes an evolutionary process. A new rule is prescribed which is followed by a continual process of tax-avoidance efforts. The Internal Revenue Service responds to the new tax avoidance schemes, resulting in more specific and complex rules. Congress and the courts shape the evolution by arbitrating conflicts between taxpayers and the Service (4).

Contemporary corporate tax law is based on a policy of treating corporations a taxable entities separate from their owners. The implementation of this policy has resulted in seven basic decisions or principles which would be considered the basic prescription of legal rules that govern corporate tax law.
1. A separate tax is imposed on corporate income (4).
2. A shareholder-level tax is imposed on corporate income,
generally upon its distribution to shareholders (4).

3. Long-term capital gains are taxed at rates substantially lower than those applicable to ordinary income (4). (Although this was true at the time the cases in the sample were tried, the 1986 tax act repealed the capital gain deduction. The only advantages of classifying a transaction as a capital gain now are the ability to offset capital losses and the reduction of the net proceeds by the taxpayer's basis.)

4. Corporate distributions to shareholders are presumptively treated not as capital gains but as ordinary income, commonly called dividends. Some liquidations also result in ordinary income to the shareholders (4). (Again, the benefits of a transaction being treated as a capital gain have been substantially reduced by the 1986 tax act.)

5. Shareholder dispositions of stock are presumptively treated as dispositions of capital assets (4). (Again, the benefits of this characterization have been substantially reduced by the 1986 tax act.)

6. Corporate distributions in kind shall not create taxable gain or loss to the corporation (4). (The 1984 Reform Act partially eliminated this principle by requiring that the distributing corporation generally recognize gain upon non-liquidating distributions if property. The 1986 Act further eliminated this principle by repealing IRC Sections 336 and
337. Corporations are now taxed in full upon the difference in their basis and the value of assets being distributed in liquidations.)

7. Formal changes in corporate-shareholder relationships that nevertheless involve a substantial continuity of ownership in a business enterprise are not recognized for tax purposes (4). This principle is the result of another basic tax policy that a mere change in the form of doing business should not be treated as a disposition of the business. 

This principle at times seems to be contrary to the separate entity policy. A great deal of litigation has been devoted to determining whether a specific transaction has resulted in a disposition of a shareholder's interest in a business or was a mere change in the form of doing business with no resultant disposition of the shareholder's interest.

Starting from these principles, tax planners have developed a multitude of schemes to reduce taxes, termed "bail-outs" by Clark (4). The basic purposes of some of these schemes can be described as follows.

1. To extract the earnings of corporations not as dividends but as salaries, interest, or other deductible expense (4).
2. To delay extraction of corporate earnings so that the resultant increase in the value of the corporation and its stock can be realized in a capital asset transaction rather than as a dividend (4). (As discussed above, the benefits
of this characterization have been substantially reduced by the 1986 tax act.)

3. To transform corporate distributions that would normally be considered dividends into proceeds that receive capital gains treatment (4). (As discussed above, the benefits of this characterization have been substantially reduced by the 1986 tax act.)

4. To extract the earnings of the corporations in non-taxable reorganizations or liquidations (4). (By repealing IRC Sections 336 and 337, corporations are now taxed in full upon the difference in their basis and the value of assets being distributed in liquidation.)

5. To dispose of ownership in a business in a non-taxable manner (reorganization or liquidation) rather than as a taxable sale (4). (Again, liquidations are no longer non-taxable.)

The resulting counterattack by the Service and arbitration by Congress and the Courts has progressed into "cumulative doctrinal complexity. . .at its most dramatic" (4).

In their report on complexity in the income tax law, the New York State Bar Association notes two direct effects of an overly complex tax law. First, in some instances, a reasonably certain conclusion cannot be determined despite "diligent and expert research." Second, "a reasonably certain conclusion can be determined in other instances only
after an expenditure that is excessive in time and dollars."

These two effects can lead to other reactions by the public that eventually can erode our self-assessed tax system. One obvious reaction is to encourage taxpayers to "play the tax lottery" or, in other words, to adopt questionable positions because they feel they are unlikely to be questioned or penalized (13).

The courts can unnecessarily add to the complexity of the tax law when they practice "judicial legislation." It is necessary for the courts to "fill in the gaps and carve out exceptions" where the literal language of statutes enacted by Congress is not carrying out the general purpose of the statute. But the courts should not "revise the statute to conform to the result which appears desirable in the case before it." A decision should conform as closely as possible to expressed Congressional intent and legislative history and leave any correction of the statute to Congress (13).

Examples of the Application of the Step Transaction Doctrine

The step transaction doctrine could conceivably be applied in almost any area of tax law and has been applied to a wide variety of transactions. One of the areas where it has been used most frequently is in the area of corporate
distributions, liquidations and reorganizations, contributing to the complexity of this area of law. Some examples of applications to Subchapter C issues follow. Obviously, the list is not exhaustive.

To qualify for non-taxable treatment, the taxpayers incorporating their business or exchanging their stock in a (B) reorganization must own at least eighty percent of certain classes of stock after the transaction (Secs. 351 and 368). In other reorganizations, one requirement for non-taxability is that the original taxpayers of the acquired corporation retain a minimum equity interest in the acquiring corporation. This is referred to as the continuity-of-interest requirement. The taxpayers may have contracted to dispose of their interest after holding the stock for a period of time to comply with the control or continuity-of-interest requirements. If the step transaction doctrine is applied, the non-taxable treatment will be disqualified because the requirement is not met if tested after the last part of the total transaction—the disposition of the stock. In addition, the taxpayers are often allowed to include several transactions leading up to the point where they are required to meet the control requirement. The step transaction doctrine would control which of the several transactions should be included as non-taxable transactions (17, p. 7-33)
In (B) reorganizations, stock of the acquiring corporation must be exchanged solely for stock of the acquired corporation. In the case of a public corporation with widely traded stock, there are likely to be some unrelated sales of stock for cash during the time the reorganization is being consummated unless the reorganization can be completed in one transaction. The step transaction doctrine must be applied to determine whether the cash transactions should disqualify the non-taxable treatment (11).

Prior to the 1984 and 1986 tax acts, complete liquidation of a corporation owned by individuals generally resulted in capital gains to the shareholders and no gain or loss at the corporate level (Sec. 331, 336, 337). A complete liquidation followed by an incorporation of essentially the same business by essentially the same shareholders was often disallowed by the courts as a way to bail out earnings of the corporation at capital gains rates (17, p. 7-33).

Evolution of the Tax Court

The quality and make-up of the Tax Court could also have an effect upon complexity and uncertainty in tax law. If the judges are competent and the Court is properly structured, the quality and consistency of the decisions being written by the Court should be good. This should, in turn,
result in better tax law and less uncertainty in the application of the law.

The Tax Court has also gone through an evolution to become a legislative court. In its original form as the Board of Tax Appeals, it was an agency of the executive branch of the government. Although its name was changed to the "Tax Court of the United States" in 1942, and, for all practical purposes it had been functioning as a court prior to this name change, it did not legally become a court until 1969. A provision of the Tax Reform Act of 1969 contained a provision elevating the court to its present status as a legislative court under article I of the Constitution (5).

Prior to the early 1950's, Tax Court judges were covered by the Civil Service retirement system. These benefits were based upon years of service. Since many judges were appointed from the private sector and were not wealthy, this system encouraged them to remain on the court for financial reasons when health and age considerations would otherwise have encouraged them to retire. In 1952, the average age of judges was over sixty, with three judges over seventy. Some of the judges were very ill but could not afford to retire to make way for those younger and healthier. Legislation was passed in 1953 permitting the judges to retire with pay after eighteen years of service or ten years of service on attainment of age seventy. In addition, during the 1950's,
the judges' salaries were first made identical to the judges in the Federal court system (5, p. 203).

It could be argued that the increased status and financial rewards of the judges' positions and the new retirement system allowing judges to retire for health or age reasons should increase the overall quality and productivity of the court, probably in the late 1950's or the early 1960's.

Legal Research In The Accounting Literature

Traditionally, most tax research has consisted of a case-by-case analysis of cases related to the specific subject matter of concern to the researcher. But recently, researchers have begun to use quantitative techniques to analyze the factors considered by judges in deciding cases related to a specific subject matter. The methods attempt to produce a model of the judicial decisions based upon these input factors.

Robison used probit analysis to analyze Tax Court decisions involving determination of whether or not activities are engaged in for profit. Robison used all profit-motive cases decided by the Tax Court since 1954, including cases later reversed or remanded by higher courts. All business activities were included. He found 219 cases. Three-fourths of the cases were used to build the model, while the other cases were used as a holdout sample. He identified
forty-eight variables, but used factor analysis to reduce the variables to eight scalars to be used as variables in his model (14).

Burns and Groomer used multiple discriminant analysis to develop a discriminant model involving Tax Court decisions that examine whether farming activities are engaged in for profit. They used 151 cases decided by the Tax Court and its predecessor, the Board of Tax Appeals. The cases were all of the cases involving the profit-motive in farming which could be identified. They identified thirty-eight variables in their model (3).

Stewart used logit analysis to determine the factors used by the District Courts and the Court of Claims in determining employment status for tax purposes. He found 148 usable cases. He found that a model built with five variables explained a substantial amount of the variance in the cases (18).

Englebrecht and Rolfe used discriminant analysis to determine the effect of a landmark case upon the determination of dividend equivalence in stock redemptions. They built two models—one using cases decided prior to and one using cases decided after the specific case. They determined that the factors used by the courts had changed. Two variables were used in the first model and three were used
in the second. Fifty-four cases from all of the courts were used (6).

Using simple regression models, Englebrecht and Jamison compared the valuation of property for charitable contribution purposes reached by the Tax Court with the arithmetic mean of the value asserted by the Service and the value reported by the taxpayer. Forty-one cases decided by the Tax Court between 1970 and 1977 were used (7).

Whittington and Whittenburg used discriminant analysis to determine the factors used by the courts to classify capital instruments as debt or equity. They used a sample of seventy cases drawn from a population of 316 cases decided by all courts by 1977. They used a sample of fifty cases to cross-validate the model (19).

Kramer used multiple regression to identify the variables used by the courts to value large blocks of publicly traded stock for tax purposes. She used seventy-five cases from the Tax Court, the District Courts, and the Court of Claims (9).

Madeo used multiple discriminant analysis to determine the factors used by the Tax Court to determine the outcome of accumulated earnings cases. She used fifty-nine cases and found seventeen variables (10).

In summary, researchers have used multiple regression, discriminant analysis, probit analysis and logit analysis to
examine the factors being used in the various courts to decide cases on a variety of subject matters. These techniques appear to be particularly appropriate to the research of tax issues.
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CHAPTER III

METHODOLOGY

The purpose of this study was to determine whether the identified factors effectively discriminate between the cases where the step transaction doctrine was applied by the Tax Court and the cases where the doctrine was not applied. It was hypothesized that there are variables identified in landmark cases and in accounting and legal literature upon which the judges base their decisions. Secondary hypotheses were that the use of the variables should have been refined over the years and that the use of the variables should be more consistent within a narrow subject issue than over a broad range of issues to which the doctrine is applied.

The goals of this chapter are to explain (1) how the cases included in the analysis were selected and collected, (2) how the variables selected for analysis were measured, and (3) the procedure for analyzing the data.

Procedure for Collecting Data

The cases selected for analysis for this study included only the cases where the Tax Court or its predecessor, the Board of Tax Appeals, considered application of the step
transaction doctrine. The decisions of other courts were not included.

Since the doctrine is not codified law, there have been no major changes in Congressional intent affecting the doctrine and there is no evidence heretofore to indicate any fundamental changes is the Court's application of the doctrine. Therefore, all cases, both regular and memorandum, tried since the creation of the Tax Court and through the early 1980's were included. Cases tried before the Board of Tax Appeals, the predecessor of the Tax Court, were also included.

The study used as a sample all Tax Court regular and memorandum cases and Board of Tax Appeals cases involving the application of the step transaction doctrine to corporate formation, redemptions, liquidations, distributions, and reorganizations, hereafter referred to as Subchapter C issues. As discussed earlier, the step transaction doctrine can be, and has been, applied to cases encompassing a variety of issues. Preliminary searches indicated the population of cases involving step transactions to be very large. Using Lexis, almost one hundred Tax Court and Board of Tax Appeals cases were found that contain the phrase "step transaction." Use of a citator revealed a large population of cited cases not containing that specific phrase. There are also several important cases that were
not discovered using Lexis or the citator. Due to the size of the population, it was determined that it would be desirable to use only a segment of the population. Burns and Groomer used only a segment of their population of cases involving the profit motive. They used only cases involving farming, thereby defining a sample of the cases involving the profit motive (4).

In addition, it might be difficult to define variables in such a way as to handle diverse issues. The factors determining mutual intent might be very relevant in corporate reorganizations but might be totally irrelevant in tax straddle issues. Thus the factors can be more precisely defined using only corporate cases.

Using Lexis, all cases containing the phrase "step transaction doctrine" were identified. Cases cited in these original cases were identified using the Prentice-Hall Citator. The original cases and the cited cases were screened by reading the headnote at the beginning of the text of the case which briefly describes the issues decided in the cases. Where it was obvious that the case did not involve both the step transaction doctrine and a Subchapter C issue, the case was discarded. In those cases where it was obvious that the case involved the application of the doctrine to a Subchapter C issue, the case was used in the analysis. In many instances, the headnote did not clearly indicate
whether the issues decided included an application of the doctrine to a Subchapter C issue. In those instances, it was necessary to read the complete case to determine if it would be appropriate to include the case in the analysis.

One hundred, twenty-five cases were selected for analysis. These cases represent all of the cases tried in the Tax Court or the Board of Tax Appeals from the inception of the Board of Tax Appeals through late 1985. Of these cases, fifty-five were appealed. However in only eight of the cases appealed, Earnest Becher (2), Burton & Co. (5), Capital Sales (6), Hubert Howard (11), McDonald's (15), Gerald Redding (22), Reef Corp. (23), and C. E. Reeves (24), the Circuit Court of Appeals reversed the Tax Court's decision as it applied to the doctrine. Although the parties attempted to appeal many of the cases to the Supreme Court, certiori was granted in only one case, Court Holding Company (9). In that case, the Supreme Court upheld the Tax Court's original decision.

In the analysis of the cases, the cases that were reversed by the Circuit Court of Appeals were not included in the general model. The eight cases represent only about six percent of the cases and should not significantly affect the model. The general model was then used to predict the outcome of these eight cases.
Missing data did not present a substantial problem in the analysis. Most of the operational variables were stated in such a way that the question could always be answered "yes" or "no". Since the purpose of the study was to determine whether a variable was being used by the court, most of the questions began with the phrase "Was there evidence of or did the judges expressly believe. . .?" The two questions which were not stated in this manner contained very few missing responses. One question, the time between the first step in a transaction and the last step in the transaction, could be closely estimated in all but two cases. The amount of the deficiency assessed by the IRS is always included at the beginning of the case. However, since this number may apply to only the step transaction doctrine issue or it may apply to several issues being decided by the court in that case, the variable should be of little significance.

Measurement

A review of the accounting and law literature was conducted to determine the variables that are commonly used by the courts to determine the application of the step transaction doctrine. Since there is no codified law or regulations relating to the doctrine, the variables discussed in the literature are drawn from various court cases. In most of the articles reviewed, four variables or some
combination of two or three of these four variables are discussed (7, 16, 17, 18).

1. Timing of the transactions—A short period of time between transactions may imply that the steps should be viewed as a whole and a long period of time may imply the converse. Although it appears that this is generally true, there are many instances where the opposite has been true. In several cases, a period of several years did not prevent the application of the step transaction doctrine. In other cases, the doctrine was not applied even though only hours lapsed between the transactions (25). Although most tax planning articles will suggest that a reasonable time period between transactions will help to avoid the doctrine, they never assume that this time lapse alone will insure that transactions will not be stepped together (14).

2. Binding commitment—A legal document which requires all parties to enter into all steps of a contemplated transactions would appear to require the application of the step transaction doctrine. In at least one instance, a binding contract is required in order for the doctrine to be applied. In applying Code Section 355, the courts have decided that for subsequent transactions to be grouped with an earlier transaction for the purpose of finding whether control had been transferred, there must be a binding agreement to take the later steps. However, in other cases,
the existence of a binding contract has not been sufficient
evidence to require the application of the doctrine. In a
"Type A" reorganization case the court did not apply the
binding commitment test.

"Clearly, the step transactions doctrine would
be a dead letter if restricted to situations where
the parties were bound to take certain steps. The
document derives vitality, rather, from its
application where the form of a transaction does
not require a particular further step be taken;
but, once taken, the substance of the transaction
reveals that the ultimate result was intended from
the outset" (13).

The Tax Court applied the binding commitment test in another
case where it decided there was an "A" reorganization even
though the former shareholders entered into an agreement to
sell their acquired stock six months after the merger but
were not bound to do so (25).

3. Interdependence of steps--The courts have often stepped
together one or more transactions when the Court was felt
that one step would have been fruitless without another or
that the legal relationship between the steps would make it
unreasonable to enter into one of the steps unless the
complete series of transactions was completed (25). The
document will usually be applied when the steps are so
interdependent that, if any one step were missing, the
others would not have been taken, and that separation of the
steps would defeat their purpose and the intention of the
parties (17). Although this idea may seem straight-forward,
its application to actual situations is difficult. It is often difficult to determine from the written opinion whether the steps were so interdependent as to require application of the doctrine. It may be even more difficult to determine before a transaction is completed whether a Court will decide that the steps are interdependent.

4. Intention of the parties--Some courts have applied the doctrine when the result of a series of transactions was intended from the outset (20). Other courts have looked to the results desired by the taxpayers, and applied the step transaction doctrine to all transactions that played a part in achieving that end result (25). It appears that if the parties had a preconceived plan involving a series of transactions to achieve a particular end result, the Courts will be likely to apply the doctrine. However, it is often quite difficult, after the transaction has been completed, to determine with any accuracy the intention of the parties at the outset. A great deal of the evidence presented in these cases was evidence to support or deny the contention that a preconceived plan existed.

In addition to these four variables that are commonly discussed, some other factors were found that could have some effect upon the Court's decision.

The existence of a tax avoidance motive is not only part of the issue being decided by the Court, it is also one
of the facts presented as evidence by the IRS in many of these cases. In Court Holding, the taxpayers had entered into an agreement to sell assets of their corporation. While at the lawyer's office for the purpose of effecting the sale, they were advised by the lawyer to restructure the sale to avoid taxes at the corporate level. The fact that they restructured the sale after learning of the adverse tax consequences of the original agreement led the Court to infer that avoiding taxes was the only motive for restructuring a transaction. The Court determined that the taxpayers were engaging in excessive avoidance and the transaction should be treated as it was originally structured (9).

The existence of an intervening event between two transactions that substantially changes the economic effect of entering into the second transaction should reduce the probability that the step transaction doctrine will be applied. In Bruce vs. Helvering, a stockholder sold stock for cash early in the day. Later that day, he received an offer to exchange his stock in a reorganization. Since he had no knowledge of the reorganization when the cash sale was made, the two transactions were not stepped together (2). Examples of other intervening events would be a substantial change in the value of stock or other property,
death of significant party to a transaction, and changes in
the demand for a product due to a specific event.

There is a tendency in the literature to believe that
the Courts will apply the doctrine only when the IRS is
arguing that it should be applied. Since the taxpayer
structured a transaction in a certain way, it has been
argued that tax effect should be given to the form the
taxpayer adopted. This would prevent the taxpayer from
arguing that the doctrine should be applied to a series of
steps (17, p. 248). Since there are some obvious ex-
ceptions to this argument (12), this variable was included.

One interesting variable would be some measure of the
size of the economic effect of applying the doctrine. The
only information reported in Tax Court cases that approxi-
mates such a measure is the deficiency assessed by IRS.
There are some obvious limitations in this information.
There are often more than one issue involved in a case, but
the deficiency is only a total number for all issues
involved. In addition, the deficiency is only for the years
at issue. The decision of the Court may affect subsequent
years which are not included in the deficiency assessed.
Despite these weaknesses, the deficiency assessed by the IRS
was included as a variable.

Operationally defined, the variables that were used to
score the cases and construct the model follow.
1. In days, how much time passed between the first step(s) and the last step(s)? (DAYS) Response—ordered categorical.

2. Was there a binding contractual obligation to enter into all of the steps before the first step was completed? (CONTRACT) Response—Yes or No.

3. Was there evidence of or did the judges expressly believe that it would have been economically unreasonable to enter into some of the steps if the other steps had not been completed because some of the steps, standing alone, had no business purpose? (INTERDEPENDENCE) Response—Yes or No.

4. Was there evidence of or did the judges expressly believe that the series of transactions were part of a preconceived plan leading to a specific end result? (PLAN) Response—Yes or No.

5. Was there evidence of, or did the judges expressly believe, the parties rearranged the transaction after they learned of the adverse consequences of structuring the transactions another way? Or, was there evidence of or did the judges expressly believe that, although the transaction was not rearranged at a late stage to avoid adverse tax consequences, the taxpayers had tax advice in the early stages of setting up the transaction and the tax consequences were a major factor in structuring the transaction? (MOTIVE) Response—Yes or No.
6. Was there a lack of an intervening event after the first step(s) but before later step(s) that substantially changed the economic risk of entering into the later transaction(s)? (EVENT) Response--Yes or No.

7. Who was arguing that the transaction(s) should be re-characterized using the step transaction doctrine? (ARGUER) Response--IRS or Taxpayer.

8. Deficiency proposed by the IRS. (DOLLARS) Response--Ordered Categorical.

Procedure for Analyzing Data

The dependent variable to be used in this study will be dichotomous. That is, it will be assigned one of two responses. When the question is asked, "Were one or more steps treated as one transaction?" or the converse "Did the court refuse to treat one or more steps in a series of transactions as separate transactions?" only two responses are possible: yes or no. This binary response limits the possible statistical methods which can be used effectively.

The independent variables will be of two types. Most of the variables will have unordered, binary responses (yes or no), or three responses (yes, no or missing). However, two of the variables--the time between the first and last steps in number of days and the amount of the deficiency proposed by IRS--are ordered, categorical responses.
Multiple linear regression, multiple discriminate analysis, probit analysis, and logit analysis have been used in the legal research cited above. Logit appears to be the method of choice for the present study.

Multiple discriminant analysis is based on the assumptions that the independent variables are normally distributed and the variance-covariance matrices of the variables are the same for both populations (10). In the present study, these assumptions will be violated, resulting in distortions in tests of significance and classifications.

There are several problems related to using the ordinary least squares multiple regression model when dealing with binary-response dependent variables.

1. The error terms are not homoscedastic. The value of the error term depends upon the observation, rather than having a constant variance. Thus the ordinary least squares method will result in inefficient estimates and imprecise predictions.

2. The distribution of the error terms will not be normal. The result is that tests of significance will be unreliable.

3. The model can result in probability predictions outside the range of zero to one. This is the most intractable problem (19, p. 356).

In addition, the use of a linear function may not be acceptable in dealing with a binary variable. It is pos-
sible that when one variable exceeds some threshold level, changes in the other variables would have little or no effect upon the judge, but when that variable is small, changes in the other variables would have significant impact. A linear model could not capture this effect (21, p. 249).

Both probit and logit analysis are applicable when a threshold theory would be applicable. Threshold theory would imply an attempt to discover the values at which a set of independent variables would reach a threshold, causing a brick to break or a judge to apply a principle. The models' strength lies in the fact that they transform unbounded predictions of the dependent variable into a transformation bounded by zero to one. Probit is dependent upon the assumption that the threshold values of the linear combination of independent variables are normally distributed, and is based upon a cumulative normal distribution (21, p. 245).

The logit model statistically is very similar to the probit model, but the logit model is based upon a cumulative logistic distribution. The distributions are very similar, but the computations involved in the logit model are simpler, making it the method of choice for this study (19, p. 366).

The dependent variable can be expressed as a logistic function of the time variable by creating a frequency dis-
tribution based upon the dependent variable and the time variable. This is a probability function. The transformed logistic response function can be fitted by making the logistic transformation on the sample proportions. This transformation is called the logistic transformation of the probability function and is a linear function. The probability function is bounded by zero and one, eliminating the most difficult problem of using regression analysis with a binary response function (19, p. 360).

Since the transformation is a linear function, a model can be constructed with multiple regression using the binary dependent variable, the logit transformation for the time variable, and dummy variables for the other independent variables. However, as discussed above, the error terms are still not homoscedastic and are not normally distributed. These problems related to the ordinary least squares method of multiple regression result in inefficient estimates, imprecise predictions and unreliable tests of significance. Thus, maximum likelihood estimators (MLE) are often used to estimate the logit parameters. With large to moderately large samples MLE have the same properties as least squares estimates. These properties include unbiasedness (the estimates are centered around the true value on average), efficiency (no other unbiased estimator has lower sampling
variance), and normality (hypotheses can be tested and inferences drawn) (1, p. 54).

The LOGIST procedure employed in the Statistical Analysis System was used to analyze the data. The procedure fits the logistic multiple regression model to a single binary dependent variable using maximum-likelihood estimates. The procedure computes test statistics for assessing lack of fit of the model. In the first phase of the analysis, a general model was fit using all of the cases selected for analysis. This program uses maximum-likelihood estimators.

Some of the general tests of goodness of fit and significance are discussed in the following paragraphs. The SAS program reports these statistics.

Individual coefficient estimates and estimates of the associated standard errors are reported. As with ordinary least square regression, a t-statistic is used to test the null hypothesis that a coefficient is 0.

In ordinary least squares multiple regression, an F statistic is used to test the hypothesis that all coefficients except the intercept are zero. The test used in logit analysis produces a statistic called the likelihood ratio statistic: \( c = -2 \log(L(0)/L(1)) \) where \( L(1) \) is the value of the likelihood function for the full model as fitted and \( L(0) \) is the maximum value of the likelihood function if all
coefficients except the intercept are 0. This statistic approximately follows a chi-square distribution (1, p. 55).

Another measure commonly of interest is $R^2$, the coefficient of determination. $R^2$ can be interpreted to represent the variance in the dependent variable "explained" by the dependent variables. There is no comparable statistic in logit analysis. Several measures of goodness of fit have been considered as substitutes for the $R^2$. The predictive ability of a model and a "pseudo" $R^2$ are two such measures.

The predictive ability of a model may be measured using Logit as follows. In understanding a logit probability model, the assumption is made that there exists an index $I_i$ which measures an individual's feeling toward an action. (In the instant case, the individual will be the Tax Court and the action will be to apply the step transaction doctrine.) If properly chosen, $I_i$ will be defined so that the higher its value, the greater the likelihood that the individual will take the action. The assumption is also made that there is a critical value $I^*$ which allows us to describe an explicit criterion for predicting whether the action will be taken.

If $I_i > I^*$, apply the step transaction doctrine

If $I_i \leq I^*$, do not apply the step transaction doctrine

where $I_i = a + b_1x_{i1} + b_2x_{i2} \ldots b_jx_{ij}$
The logit model is based on the cumulative logistic probability function:

\[ p_i = f(I_i) = \frac{1}{1 + e^{-I_i}} \]

where \( p_i \) represents the probability that an individual will make a certain choice given knowledge of a set of \( x_i \)'s (21, p. 246). The model was used to predict the outcome of each case and compared to the actual outcome. The percentage of correct predictions acts as a measure of the predictive ability of the model.

Several pseudo \( R^2 \) measures have been developed. They are generally based on a chi-square distribution. The measure reported by the SAS program is:

\[ R^2 = \frac{(\text{model chi-square} - 2p)}{(-2L(0))} \]

where \( p \) is the number of variables in the model and \( L(0) \) is the same as defined above. One unusual attribute of this measure is that it does not necessarily increase in magnitude when a variable is added to the model, contrary to the behavior of \( R^2 \) in ordinary least squares multiple regression.

In addition to measuring the overall explanatory power of the independent variables in a model, \( R^2 \) can also be used to make inferences concerning the amount of variance explained by each independent variable. The most common method of analyzing the individual variables' contribution to the explanatory power of the method is one of several stepwise
regression procedures. In each of these procedures, partial models are fit which include less variables than the full model. In a sequence specified by some computational criteria, a series of partial models are fit, starting with one independent variable, then adding one independent variable with each new model until all of the independent variables are included. (Backward elimination procedures complete this procedure in reverse.) $R^2$ is computed for each step in the procedure, with the difference in $R^2$ for any specific model and the model preceding it representing the incremental $R^2$ attributable to the independent variable just added (or deleted). Due to the interrelationships between the independent variables, different sequences will usually result in different incremental $R^2$ for any specific independent variable.

Hierarchical analysis is a superior method of analyzing the explanatory power of the individual independent variables. As with the stepwise procedures, a series of partial models are fit, with each succeeding model containing at least one more independent variable than the preceding model. The increased in $R^2$ for each model is attributable to the independent variable(s) introduced in that model. However, in hierarchical analysis, the sequence is determined in advance, based on causal relationships that are posited a priori. The sequence would be based on the cri-
teria that each variable should be entered only after other variables that may be a cause of the variable has been entered. This leads to an ordering of the variables that reflects their presumed causal priority. In other words, no independent variable entered later should be a presumptive cause of an independent variable entered earlier. Consequently, the incremental $R^2$ obtained from adding any specific variable in uniquely attributable to that variable and cannot be considered a secondary effect of some other variable being entered at some other point in the analysis (8, p. 120).

The following diagram reflects the cause-effect relationships posited in this study.

Fig. 1 - Hierarchy of variables
This resulted in the following sequence.

1. DOLLARS
2. EVENT
3. DAYS
4. ARGUER
5. MOTIVE
6. INTERDEPENDENCE
7. PLAN
8. CONTRACT

In the second phase of the analysis, a restricted model deleting observations before 1965 was fit and compared to the general model. The purpose of this phase of the analysis was to determine if the application of the doctrine has changed as time passes. If the doctrine has been refined and the quality of the Tax Court is improving, the application of the doctrine should become more consistent over time.

In the third phase of the analysis, a restricted model using cases related to corporate reorganizations was fit and compared to the general model. The cases related to corporate reorganizations represent the largest group of cases related to a specific Code Section within the total group of cases selected for analysis. The purpose of this phase of the analysis was to determine if the application of the
doctrine is more consistent as applied to cases relating to the same topic.
CHAPTER BIBLIOGRAPHY


CHAPTER 4

ANALYSIS AND INTERPRETATION OF THE FINDINGS

The purpose of the analysis was to determine whether the variables could differentiate between the cases where the step transaction doctrine was applied and those where the doctrine was not applied. Hierarchical logit analysis was performed on all cases except those reversed by a higher court, on all cases including those reversed by a higher court, on only those cases decided after 1965, and on only those cases involving IRC Section 368. The results of these analyses will be presented and interpreted in this chapter.

Analysis of the Findings

The General Model

The general model derived by the logit program was based upon 117 cases which did not include decisions reversed by a higher court. In forty-seven of the cases, the Tax Court held that the step transaction doctrine should not be applied and in seventy cases, the Court held that the doctrine should be applied. Table I presents basic statistics for the variables. The first variable, Dollars, had limited dispersion. The mean minus the standard deviation results in a negative number.
TABLE I
SUMMARY OF BASIC STATISTICS
FULL MODEL USING ALL CASES

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dollars</td>
<td>3,129,536</td>
<td>600</td>
<td>199,498,560</td>
<td>18,813,352</td>
</tr>
<tr>
<td>Days</td>
<td>208.308</td>
<td>0</td>
<td>3,650</td>
<td>514.023</td>
</tr>
<tr>
<td>Event</td>
<td>0.82906</td>
<td>0</td>
<td>1</td>
<td>0.37808</td>
</tr>
<tr>
<td>Arguer</td>
<td>0.60256</td>
<td>0</td>
<td>1</td>
<td>0.48485</td>
</tr>
<tr>
<td>Motive</td>
<td>0.34188</td>
<td>0</td>
<td>1</td>
<td>0.47638</td>
</tr>
<tr>
<td>Interdependence</td>
<td>0.46581</td>
<td>0</td>
<td>1</td>
<td>0.49882</td>
</tr>
<tr>
<td>Plan</td>
<td>0.82051</td>
<td>0</td>
<td>1</td>
<td>0.38541</td>
</tr>
<tr>
<td>Contract</td>
<td>0.16239</td>
<td>0</td>
<td>1</td>
<td>0.36452</td>
</tr>
</tbody>
</table>

The coefficients derived by the program and the statistics related to the various statistics are summarized in Table II. This model represents only the statistics after

TABLE II
FULL MODEL

<table>
<thead>
<tr>
<th>Variable</th>
<th>Beta</th>
<th>Standard Error</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>-3.34832168</td>
<td>1.01588310</td>
<td>0.0010</td>
</tr>
<tr>
<td>Dollars</td>
<td>0.00000000</td>
<td>0.00000002</td>
<td>0.9422</td>
</tr>
<tr>
<td>Event</td>
<td>0.79447281</td>
<td>0.69989996</td>
<td>0.2563</td>
</tr>
<tr>
<td>Days</td>
<td>0.00002345</td>
<td>0.00049119</td>
<td>0.9619</td>
</tr>
<tr>
<td>Arguer</td>
<td>0.14751579</td>
<td>0.52917451</td>
<td>0.7804</td>
</tr>
<tr>
<td>Motive</td>
<td>0.58791522</td>
<td>0.55358410</td>
<td>0.2882</td>
</tr>
<tr>
<td>Interdependence</td>
<td>2.27080082</td>
<td>0.57066134</td>
<td>0.0001</td>
</tr>
<tr>
<td>Plan</td>
<td>2.19915594</td>
<td>0.85496596</td>
<td>0.0101</td>
</tr>
<tr>
<td>Contract</td>
<td>0.65103903</td>
<td>0.89989635</td>
<td>0.4694</td>
</tr>
</tbody>
</table>
all variables have been entered and does not contain information related to the effect of each variable as entered in a hierarchical sequence.

In order to analyze the explanatory power added to the model by the individual variables, a hierarchical sequencing procedure was employed. Based on the cause-effect diagram presented in Chapter 3, the variables were added in the order as presented in Table III. The table also includes the portion of the variance explained by the model as each variable is introduced and the probability of a Type I error.

### TABLE III

**INCREASE IN R² AS EACH VARIABLE IS ADDED**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Increase In R²</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dollars</td>
<td>.00000</td>
<td>.6078</td>
</tr>
<tr>
<td>Event</td>
<td>.03312</td>
<td>.0045</td>
</tr>
<tr>
<td>Days</td>
<td>.00000</td>
<td>.5867</td>
</tr>
<tr>
<td>Arguer</td>
<td>.00000</td>
<td>.4458</td>
</tr>
<tr>
<td>Motive</td>
<td>.01472</td>
<td>.0251</td>
</tr>
<tr>
<td>Interdependence</td>
<td>.18913</td>
<td>.0000</td>
</tr>
<tr>
<td>Plan</td>
<td>.04771</td>
<td>.0083</td>
</tr>
<tr>
<td>Contract</td>
<td>.00000</td>
<td>.4694</td>
</tr>
</tbody>
</table>

Four variables were found to be statistically significant. Interdependence of the steps was the most significant. An intervening event and the existence of a plan were less significant but were significant at a the .01
level. The obvious existence of a tax avoidance motive was significant but only at the .0251 level of significance.

The marginal probability of the doctrine being applied if the response to any particular variable was 0 (no) or if the response was 1 (yes) was computed by using the mean of the variables not being considered and replacing the variable in question with 0 to determine the probability of the doctrine being applied if the variable in question was 0 and replacing the variable in question with 1 to determine the probability of the doctrine being applied if the variable in question was 1. This number was then transformed back into a probability by using the formula \( P = \text{antilog} \left( \frac{x}{1+x} \right) \). These probabilities were computed for the four significant variables and are presented in Table IV.

TABLE IV
SUMMARY OF PROBABILITIES OF STEP TRANSACTION BEING APPLIED

<table>
<thead>
<tr>
<th>Variable</th>
<th>Probability (Response = 0)</th>
<th>Probability (Response = 1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Event</td>
<td>15%</td>
<td>79%</td>
</tr>
<tr>
<td>Motive</td>
<td>55%</td>
<td>92%</td>
</tr>
<tr>
<td>Interdependence</td>
<td>19%</td>
<td>98%</td>
</tr>
<tr>
<td>Plan</td>
<td>7%</td>
<td>87%</td>
</tr>
</tbody>
</table>

The model was able to correctly classify the cases as to whether or not the step transaction doctrine would be
applied in 79.5 percent of the cases. Table V details the classification of the cases.

**TABLE V**

CLASSIFICATION TABLE--FULL MODEL USING ALL CASES EXCEPT THOSE REVERSED

<table>
<thead>
<tr>
<th>Predicted</th>
<th>Applied</th>
<th>Not Applied</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Actual</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Applied</td>
<td>56</td>
<td>14</td>
<td>70</td>
</tr>
<tr>
<td>Not Applied</td>
<td>10</td>
<td>37</td>
<td>47</td>
</tr>
<tr>
<td>Total</td>
<td>66</td>
<td>51</td>
<td>117</td>
</tr>
</tbody>
</table>

A similar table was generated using the original 117 cases plus 8 cases in which a higher court reversed the

**TABLE VI**

CLASSIFICATION TABLE--FULL MODEL USING ALL CASES INCLUDING THOSE REVERSED

<table>
<thead>
<tr>
<th>Predicted</th>
<th>Applied</th>
<th>Not Applied</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Actual</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Applied</td>
<td>58</td>
<td>15</td>
<td>73</td>
</tr>
<tr>
<td>Not Applied</td>
<td>13</td>
<td>39</td>
<td>52</td>
</tr>
<tr>
<td>Total</td>
<td>71</td>
<td>54</td>
<td>125</td>
</tr>
</tbody>
</table>
findings of the Tax Court. The model predicted the correct outcome in only 77.6 percent of the cases when these cases were added. For four of the eight cases added, the model correctly predicted the Tax Court's findings. Table VI details the results.

Although the model was effective in predicting the outcome of the cases, the variables used in building the model were able to explain only about 27 percent of the variance. The likelihood ratio for the model was 57.35. The critical value of chi-square with 8 degrees of freedom at a .1 significance level is only 1.65 so the null hypothesis that all variables except the intercept are 0 is rejected.

**Restricted Model—Time**

The logit program derived a restricted model using the cases decided after 1965. Fifty-one cases were included in the model. This model correctly predicted the outcome of 86.3 percent of the cases. Table VII presents the prediction results of the model.

In addition to being able to predict the outcome of the cases better than the full model, the restricted model also explained more of the variance of the dependent variable. The restricted model explained about 32 percent of the variance.
### TABLE VII

CLASSIFICATION TABLE—RESTRICTED MODEL
USING CASES DECIDED AFTER 1965

<table>
<thead>
<tr>
<th>Actual</th>
<th>Predicted</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Applied</td>
<td>Not Applied</td>
<td>Total</td>
</tr>
<tr>
<td>Applied</td>
<td>26</td>
<td>2</td>
<td>28</td>
</tr>
<tr>
<td>Not Applied</td>
<td>5</td>
<td>18</td>
<td>23</td>
</tr>
<tr>
<td>Total</td>
<td>31</td>
<td>20</td>
<td>51</td>
</tr>
</tbody>
</table>

**Restricted Model—Topic**

Another restricted model was derived by the logit program using only the cases involving IRC Section 368 which relates to corporate reorganizations. Forty-two cases were

### TABLE VIII

CLASSIFICATION TABLE--RESTRICTED MODEL
USING CASES INVOLVING SECTION 368

<table>
<thead>
<tr>
<th>Actual</th>
<th>Predicted</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
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included. (This was the largest group of cases related to any specific section.) This model was able to correctly predict 85.7 percent of the case outcomes. Table VIII presents the results of this analysis.

Although this restricted model had greater predictive ability than the general model, it was only able to explain about 23 percent of the variance in the dependent variable.

Interpretation of the Findings

The Individual Variables

Although the variables were able to discriminate between the cases where the step transaction doctrine was applied and those where it was not applied much better than expected, only four of the eight variables identified as possible discriminators were found to be statistically significant. Two of these variables, interdependence and plan, are commonly discussed in the literature and cases. The other two variables, event and motive, are not commonly recognized as factors that will be considered in determining the application of the doctrine.

The time between the first and last steps of a series of transactions is always discussed when analyzing the possible application of the step transaction doctrine. Logic would dictate that the longer the time period between the two steps, the less likely the two transactions are related.
However, this variable was not found to be statistically significant. The only plausible explanation is that the IRS has gone through a prescreening process, eliminating those cases where time plays a significant role in the application of the doctrine. In other words, if the whole population of transactions entered into by taxpayers were examined, time might be a significant factor in determining whether or not a group of transactions are stepped together. But most of these transactions never reach the Tax Court because one of three things happen. First, the time variable probably dictates to a great degree the way that taxpayers report transactions. Transactions occurring within a small time span are treated as one transaction, but when a long period of time passes between transactions, they are treated as separate transactions. Unless the other variables prove contrary to this treatment, the doctrine has been applied correctly based upon the time variable. Secondly, the IRS probably uses the same criteria to initially evaluate transactions. Unless the other variables provide to the contrary, a short time period will dictate that the doctrine be applied, and a long time period between transactions will dictate that the doctrine not be applied. And third, where the taxpayer and the IRS disagree about the treatment, the appeals process within the IRS may further screen out those cases where time is the significant factor. Only those
cases where the other variables are important will make it through the administrative proceedings to the Tax Court.

The existence of a contract is apparently too strict a requirement to enter into the decision process of most transactions, as this variable also proved to be statistically insignificant. The literature is clear that the existence of a contract involving a series of transactions will be strong evidence in favor of applying the doctrine, but the lack of a contract is not strong evidence against applying the doctrine. Again, it is possible that a pre-screening process has eliminated those cases where it is fairly obvious that the doctrine should be applied because there was a binding, legal contract to enter into all of the steps of one, interrelated transaction. If this is true, the only cases that will make it to the Tax Court are those cases where there was not a written contract but the other variables require the application of the doctrine, or those cases where some ambiguity in the contract make the application of the doctrine open to question.

Although it is often argued that the taxpayer is bound by his/her documentation and thus cannot argue that the substance of a transaction should override its form, this variable was also found to have little statistical significance. Although this result may be somewhat surprising, its interpretation is straightforward. The court will de-
cide these cases based on the other variables and will pay little attention to which party is arguing that the doctrine should be applied.

The deficiency assessed by the IRS was also found to be statistically insignificant. This result is not surprising when this variable is critically examined. The deficiency does not represent the economic effect of applying the step transaction doctrine. The deficiency is for all issues being decided by the court for a specific year. In some cases, the only issue is whether the doctrine should be applied, but for many cases, there are many other issues. There is not enough information given in the text of the cases to determine the amount of the deficiency related to the application of the step transaction doctrine. In addition, the effect of the application of the doctrine often goes far beyond the specific year in question. For example, if the depreciable basis of an asset or assets is the question being addressed, the deficiency proposed by the IRS will be the effect of the depreciation deduction only for the year in question. The true economic effect of the application of the doctrine would have to include an analysis of the present value of the future differences in tax liabilities for the life of the assets in question. The texts of the cases examined did not provide enough
information to evaluate the true economic effect of the application of the doctrine.

The existence of a tax avoidance motive was one of the variables that were statistically significant. This result is somewhat surprising. It could be argued that the tax avoidance motive is the issue before the court and not an evidential fact used in the decision. The cases would not have reached the Tax Court unless the IRS believed that tax avoidance was the motive for the taxpayer treating a transaction in a certain. Once the IRS believes that a transaction is being treated improperly in order to avoid taxes, a case must be made as to why the treatment is improper. Court Holding Company and its progeny clearly imply that the tax avoidance motive in itself is not reason to govern the tax treatment of a transaction. However, the court apparently is influenced when the tax avoidance motive is very apparent.

The marginal probabilities related to this variable are consistent with this result. When the tax avoidance motive is not obvious, the probability of the doctrine being applied is 55 percent. However, if the motive is obvious, the probability of the doctrine being applied jumps to 92 percent.

The existence of an intervening event was also a statistically significant variable. As might be expected, the
existence of an intervening event that significantly affects the economic effects of entering into later steps of a transaction would seem to be strong evidence against applying the doctrine. The lack of such event did not appear to be evidence for not applying the doctrine. In the majority of the cases used, there was no intervening event and the cases were decided upon the other facts of the case.

Again, an analysis of the mean probabilities supports this argument. The probability that the court will apply the doctrine was only 15 percent when there was an intervening event that changed the economic consequences of entering into the later steps, but the probability that the doctrine would be applied was 79 percent when there was no such event.

The existence of a preconceived plan and the economic interdependence of the steps were also statistically significant. Due to the subjective nature of the determination of whether these two situations exist, it is not surprising that these factors have the most effect upon the Tax Court's decisions. In nearly all of the cases, the taxpayer has presented a large number of facts supporting his/her contention that the doctrine should or should not be applied. The IRS has presented an equally large number of facts to support the opposite contention. All of these facts must be evaluated in order to determine whether there really was a
preconceived plan and whether the steps were economically interdependent. It appears that an objective appraisal based on consistent guidelines is difficult because each set of facts is different and must be analyzed in light of the parties conflicting objectives. It can be readily understood why these are the issues being decided by the court. These issues are so complex that they cannot be prescreened in the same manner as the variables discussed above. Both the taxpayer and the IRS officials believe their interpretation of the situation is valid, and in these complex situations where large numbers of tax dollars are involved, the issue must be decided by an impartial third party. The subjective nature of these decisions makes this process appear to be inconsistent based upon a reading of a sample of cases. It is difficult to predict whether or not the court will decide that a preconceived plan existed, or that the steps were economically interdependent, based on any set of complex facts.

An analysis of the mean probabilities related to these two variables is again consistent with other results. There was a 87 percent probability that the doctrine would be applied if there was evidence of a preconceived plan and only a 7 percent probability of application if there was no evidence of a plan. There was an 98 percent probability that the doctrine would be applied if the steps appeared to
be economically interdependent but only an 19 percent proba-
bility when the contrary was apparent. The large differ-
ences in probabilities based on the response to these two
variables again indicates their substantial effect on the
court's decision.

**Variance Explained by the Significant Factors**

The analysis of the variance in the dependent variable
explained by the independent variables is consistent with
the analysis of the individual variables. The four vari-
ables that were statistically significant were also the only
variables whose addition to the model resulted in an in-
crease in $R^2$. The greatest increase resulted from the
addition of the interdependence of the steps. The exis-
tence of a plan resulted in about a 5 percent increase in
explained variance. The existence of an intervening event
resulted in a 3 percent increase and an obvious tax
avoidance motive resulted in only a 1 percent increase.

**The Restricted Models**

The classification tables for the models imply that the
restricted models were able to discriminate better than the
full model. The full model correctly classified only 79.5
percent of the cases correctly whereas the time model cor-
rectly classified 86.3 percent of the cases and the Sec. 368
model correctly classified 85.7 percent of the cases. A
chi-square test was computed to determine if the differences in the classification tables was statistically significant. Chi-square using the full model and the time model was 17. Chi-square using the full model and the Sec. 368 model was 59. With 3 degrees of freedom, in both cases the hypothesis that the classification tables were not significantly different would be rejected.

These results indicate that the court is becoming more consistent in its application of the step transaction doctrine, and that it is more consistent in applying the doctrine to cases involving a specific code section—in this instance Sec. 368.

Summary

The findings indicate that the variables discussed in the literature and leading court cases can discriminate between the cases where the step transaction doctrine will be applied and the cases where the step transaction doctrine will not be applied. However, the percentage of the cases that these variables can correctly predict is somewhat less than desirable—between 79 percent and 86 percent. The percentages do indicate that there is a greater level of consistency in the application of the doctrine than might be expected after reading a few of the cases. The uncertainty encountered lies in the nature of the two variables that are most significant. Determining whether a preconceived plan
existed or whether the steps were economically interdependent based on a voluminous number of facts is difficult. A priori, it is difficult to evaluate the probability that judges will decide that one or both of these conditions exist.

The findings also indicated that the court's application of the doctrine is becoming more predictable as time passes. The model derived with cases tried after 1965 was a better predictor than the model derived with all cases.

The findings also indicated that the court's application of the doctrine is more predictable as applied to a specific topic. The model derived with cases involving Code Section 368 was a better predictor than the model derived using all cases.

It was somewhat surprising that only two of the variables commonly discussed in the literature were found to be statistically significant while two other factors not usually discussed were found to be significant to a smaller degree.
CHAPTER V

SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

In Chapter I, three hypotheses were proposed. The first hypothesis stated that the variables identified could discriminate between cases where the step transaction doctrine would be applied and those cases where the doctrine would not be applied. The second hypothesis stated that the variables would discriminate better when the sample used was restricted to cases involving one specific type of transaction rather than to a broad range of transactions. The third hypothesis stated that the variables would discriminate better when the sample used was restricted to cases decided after 1965, implying that the doctrine has been refined over time.

In Chapter II, the use of common law doctrines was discussed. The step transaction doctrine is one of the doctrines used to construct the facts of a tax case. The courts have found it necessary to apply this doctrine when the taxpayer's primary motive for arranging a transaction in a specific way is tax avoidance. When a taxpayer's tax planning results in compliance with the law as written but circumvention of Congressional intent, judges have found it
necessary to use the doctrines to correctly interpret the taxpayer's actions.

One of the most complex areas of tax law is the area related to corporate distributions, liquidations, and reorganizations. These transactions often result in large tax liabilities. Corporations also tend to have more financial resources at their disposal than other segments of society. Consequently, corporations tend to spend a great deal of time and money structuring transactions in such a way as to minimize their tax liabilities. The IRS responds to this tax planning, resulting in a great deal of litigation where the corporations and the IRS cannot reach agreement. The resulting complexity is an inherent problem of our tax structure.

Chapter II goes on to discuss the evolution of the Tax Court. The Court has evolved from an agency to a legislative court, with accompanying improvements in the status and compensation of the judges. Consequently, the quality of the decisions being made by the judges should have improved over time.

Chapter II ends with a summary of the legal research being published in the accounting literature. This study is similar to the research described.

Chapter III explains the methodology used in this study. The sample consisted of all the cases where the Tax
Court or the Board of Tax appeals considered the application of the step transaction doctrine to an issue involving corporation distributions, liquidations, or reorganizations. The variables were selected using accounting and law literature since there is no codified law, regulations, or IRS guidelines related to the doctrine. Logit analysis was used to analyze the data. The procedure fits the logistic multiple regression model to a single binary dependent variable using maximum-likelihood estimates. A hierarchical procedure was used to determine the sequence in which the variables were added to the model. This allowed for a straight-forward interpretation of the explanatory power of each variable.

In Chapter IV, the findings were analyzed and interpreted. The full model derived by the logit procedure was able to correctly predict the outcome of 79.5 percent of the cases. The restricted model using cases decided after 1965 correctly predicted the outcome of 86.3 percent of the cases. The restricted model using only the cases related to corporate reorganizations correctly predicted the outcome of 85.7 percent of the cases.

Four variables were found to be statistically significant. Interdependence of the steps and the existence of a plan are commonly discussed as factors to be used in determining whether the doctrine will be applied. Thus is it not
surprising that these variables were significant. However, two variables that are not commonly believed to be important in the application of the doctrine were also statistically significant. The existence of an intervening event and an obvious tax avoidance motive were also significant the analysis. The two variables are rarely discussed in the literature as factors to be considered in the application of the doctrine.

Conclusions

Since the step transaction doctrine is a common law doctrine, there is no codified law, regulations, or IRS guidelines to assist the researcher in determining what circumstances will cause the IRS and, eventually, the Courts to apply the doctrine. Law and accounting literature and the text of court cases are the only sources of information regarding the doctrine. These sources usually suggest that four factors should be considered in setting up a transaction that might possibly be considered a step transaction. The factors are the time period between steps, the existence of a binding contract, the interdependence of the steps, and the existence of a plan.

This study found that four variables were statistically significant in predicting the outcome of cases where the application of the step transaction doctrine was considered. However, only two of these variables were included in the
variables commonly discussed in the literature and leading court cases. The interdependence of the steps and the existence of a plan were important variables in the analysis, but the time period between steps and the existence of a binding contract did not significantly influence the model derived in the study. It is possible that these factors are important at a lower level. It may be that taxpayers characterize transactions and that the IRS screens transactions using time and the existence of a contract. Consequently, these factors could be important in determining whether the doctrine is applied, but not at the Tax Court level.

In addition, two other variables were found to be significant in the analysis. The existence of an intervening event and an obvious tax avoidance motive were statistically significant, but these two variables are usually not included in a discussion of the variables that should be considered when predicting the application of the step transaction doctrine.

The uncertainty that most researchers experience when trying to predict the application of the step transaction doctrine may be a function of nature of at least two of these significant variables. Although it may be obvious that the judges will tend to apply the doctrine when the steps are interdependent or when there is obviously a preconceived plan to enter into all of the steps, it is dif-
ficult to determine when the judges believe one or both of these two situations exist. It is often not obvious what factors the judges will use in determining whether a series of steps are interdependent. The same is true of a preconceived plan. At the Tax Court level, a taxpayer trying to avoid the application of the doctrine will attempt to prove that a preconceived plan did not exist. The factors considered by the judges in making this determination are not obvious. Consequently, although the variables considered by the judges in determining the application of the doctrine have been determined by this study, it is still very difficult to predict the application of the doctrine.

The tax policy implications of this study are not obvious. If would be possible for Congress to set guidelines as to whether or not the doctrine would be applied based upon the time that passed between the steps. This sort of guideline has been legislated once in the form of old Sec. 334(b)(2). Under that section, if a subsidiary was acquired and liquidated within a two-year period, the parent's basis in the assets of the subsidiary was the same as the parent's basis in the stock of the subsidiary. This section has since been repealed. It appears that Congress does not intend that the application of the doctrine be based upon the time variable.
The time variable is the only variable that does not involve a great deal of subjectivity. The four variables found in this study to be the variables important in applying the doctrine are always or often very subjective in nature. Legislating objective guidelines in the form of codified law or regulations would be very difficult. Thus, it is unlikely that Congress will attempt to deal with this issue at the legislative level. It will probably continue to be dealt with at the judicial level.

Recommendations

The methodology in this study has been used to examine several topics. Many more subjects could be examined in much the same manner.

The sample cases in the study were limited to those cases tried before the Tax Court and related to corporate distributions, liquidations, and reorganizations. The study could be expanded to include the District Courts and The Court of Claims. The sample used could also include or be entirely comprised of cases involving other subjects. Two example would be like-kind exchanges and partnership transactions.

Probably the most interesting extension of this study would be to remove some of the limitations. For example, a sample of all transactions entered into by taxpayers that might be step transactions could be examined to determine
how the variables affect the characterization of the transactions at that level. This information would be so difficult to obtain that such a project would probably be impossible.

It would also be helpful to have more information than that contained in the published opinion of the Tax Court. Being able to examine the Court's records and other documentation related to the cases might provide a great deal of information not biased by the person writing the opinion. Again, this information would be very difficult, if not impossible, to obtain.
APPENDIX

TABLE IX
DATA USED IN LOGIT ANALYSIS

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<tr>
<th>Case</th>
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*Missing data

**"DAY"--days, "CON"--contract, "INT"--interdependence, "PLA"--plan, "MOT"--motive, "EVE"--event, "ARG"--arguer, "DOL"--dollars
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