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Comment


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I. INTRODUCTION

Corporate tax planning, in large measure, is a function of several variables. First, tax attorneys must examine recent pronouncements and decisions that could affect current planning techniques. Judicial guidance on the meaning of an Internal Revenue Code ("Code") section, however, may come long after a client completes a transaction.¹

¹ For instance, in Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd, 886 F.2d 728
Second, tax practitioners must constantly analyze the relevant Code sections in structuring transactions. Yet their task is complicated greatly by the flurry of congressional changes. Tax attorneys must continually readjust and restructure their mergers and acquisitions to satisfy the new requirements of the Code.

Third, and most important, tax attorneys must devise strategies to minimize any tax burdens. Because the Code permits various structures for certain corporate acquisitions, in order to best serve his or her client, the tax attorney must seize upon the alternative that accomplishes the desired result with imposition of the least tax, assuming all non-tax considerations are equal. "[T]axpayer ingenuity, although channeled into an effort to reduce or eliminate the incidence of taxation, is ground for neither legal nor moral opprobrium." As Judge Learned Hand so eloquently wrote, "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."

The Internal Revenue Service ("Service") and the courts are leery of many of the intricate and ingenious strategies employed by tax practitioners to reduce or eliminate the incidence of taxation. In certain transactions involving corporate income tax, either a court or the Service will recharacterize the transaction to match the perceived substance or true character of the transaction. Generally, four rules influence the acceptability of recharacterizations of transactions governed by subchapter C of the Code; recharacterizations should be complete, consistent, brief, and direct.

In keeping with the principles of completeness, consistency, brevity, and directness, the courts and the Service employ various judicially-created doctrines to recharacterize or recast corporate taxpayer

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1318 (7th Cir. 1989), the tax court analyzed a transaction that occurred in 1980. Section 311(d) of the Code, as amended by the 1969 Act, governed the transaction. That section, however, was amended in 1982 and 1984, and repealed in 1986.


maneuvers. As courts have reiterated numerous times, the incidence of taxation depends upon the economic substance, and not necessarily the form, of a transaction.\(^7\)

Tax implications that arise from a transaction are not to be determined solely by the form used to transfer legal title. Rather, the transaction must be viewed in its entirety. Each step, from the commencement of the negotiation to the consummation of the deal, must mirror the economic reality of the overall transaction. To do otherwise would be to "exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."\(^9\) If the substance of the transaction conflicts with the form employed, courts will collapse the transactions together to honor the underlying economic reality.

When should the courts respect the form of a transaction? The Tax Court directly addressed the form versus substance issue in Esmark, Inc. v. Commissioner.\(^10\) In that case, the court, in an opinion authored by Judge Cohen, concluded that under Section 311(d) of the Code, a nonrecognition provision, tax consequences would be dictated by form. To disregard the taxpayer's compliance with Section 311(d), the Service must demonstrate that the structure chosen by the taxpayer was a fiction—a subterfuge—that failed to reflect the economic reality of the transaction.\(^11\) In Esmark, the court let the form of the transaction dictate the tax treatment because there was no difference between the form selected by Esmark and the substance alleged by the Service.

The triumph of form over substance has obvious and important ramifications on tax planning for current mergers and acquisitions. This Comment will define briefly the step-transaction doctrine and the alternative tests employed by the courts in invoking the doctrine. Second, this Comment will outline the facts and holding of Esmark. Third, Judge Cohen's decision will be critically analyzed, and past court precedents will be analogized to or distinguished from Esmark. Fourth, this Comment will highlight the statutory and judicial requirements for a Section 355 split-off and recast the Esmark transaction as a tax-free split-off. If Mobil-Esmark type transactions qualify as Section 355 split-offs, the crucial question is whether that result is proper as a matter of tax policy.

\(^7\) The courts have cited to the step-transaction doctrine, sham transaction doctrine, continuity of interest requirements, business purpose doctrine, and various hybrids of the form versus substance arguments. The courts, however, have never been consistent as to which of the several doctrines they purport to rely on in their decisions.

\(^8\) E.g., Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).


\(^10\) 90 T.C. 171 (1988), aff'd, 886 F.2d 1318 (7th Cir. 1989).

\(^11\) Id. at 183.
Oftentimes, a business transaction, especially a complicated acquisition, has no sharp beginning or clearly defined end. In practice, it is often necessary to cut the transaction, usually chronologically, into its constituent elements for tax treatment. If the taxpayer slices the segments too thinly, the objective economic realities of the transaction may not reflect the particular form the taxpayer employed. 

"[T]he simple expedient of drawing up papers [has never been regarded] as controlling for tax purposes when the objective economic realities are to the contrary." If the substance contradicts the form, the tax results may be unduly harsh to the government, the taxpayer, or both.

Consequently, "formal written documents are not rigidly binding." The step-transaction doctrine is, in effect, a corollary of sub-

12. B. BITTKER & J. EUSTICE, supra note 5, ¶ 14.51, at 14-175. For example, the taxpayer may slice a multi-phase transaction into its constituent elements — a stock purchase followed by a redemption.

13. The stock purchase and redemption, however, may more closely resemble an asset sale followed by a nonliquidating distribution to shareholders.


15. B. BITTKER & J. EUSTICE, supra note 5, ¶ 14.51, at 14-175. A transaction may be stepped together regardless whether the practical effect is imposition of, or relief from, taxation. Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d 685, 691 (5th Cir. 1954).

There remains a fundamental question whether, as a matter of tax policy, taxpayers who freely choose the form of their transactions should be permitted to invoke the step-transaction doctrine. Compare Bartels v. Birmingham, 322 U.S. 126 (1944) (taxpayer permitted to disavow form of transaction) with Higgins v. Smith, 308 U.S. 473 (1940) (taxpayer bound by form of transaction). Absent the kind of situation in Rev. Rul. 83-142, 1983-2 C.B. 68, the taxpayer arguably should be limited to the form chosen; a taxpayer should not complain his or her taxes are too great if that form is freely chosen.

 Entirely disallowing taxpayer challenges, however, misplaces the focus of the doctrine. The purpose of the doctrine is to ensure that regardless of the form chosen by the taxpayer, the taxpayer pays the correct amount of tax given the economic reality of the transaction.

Taxpayer challenges, however should be inapplicable under certain circumstances. Because of the overriding need for certainty in tax planning, the step-transaction doctrine should be inapplicable where a taxpayer legitimately has several options available in structuring his transaction but who, through bad advice, chooses a form that produces greater tax than some alternative form.

stance-versus-form arguments. According to the doctrine, a series of formally separate steps may be amalgamated and treated as a single transaction if they are in substance integrated, interdependent, and focused toward a particular end result. The doctrine is a potential weapon in the Service and the courts' arsenal to recharacterize certain taxpayer maneuvers.

A. Judicial Tests

In collapsing certain "steps" together, the courts have employed three alternative tests. No universally accepted test as to when and how the step-transaction doctrine should be applied to a given transaction exists.

1. Binding Commitment Test

Under the binding commitment test, a series of transactions are collapsed if, at the time the first step is entered into, there was a binding commitment to undertake the later step. The binding commitment test is the narrowest alternative of the three tests because a formal commitment, oftentimes reduced to writing, by the parties is required.

Certain corporate reorganizations have been scrutinized under the binding commitment test. The leading case is Commissioner v. Gordon. In that case, Pacific Telephone & Telegraph Co. ("Pacific") devised a plan to generate cash to pay off certain liabilities and meet its capital needs. Under its plan, Pacific, a 90 percent subsidiary of A.T.& T., transferred certain assets to Pacific Northwest Bell Telephone Co. ("Northwest"), a new company, in exchange for all of


17. Invoking the step-transaction doctrine can produce two results. First, the court may conclude that an integrated transaction must not be broken into its constituent steps or, conversely, that the separate steps must be fused together in determining the overall tax implications of the acquisition. In practice, the doctrine is invoked most often at the request of the Service to step together formally separate steps. B. BITTKER & J. EUSTICE, supra note 5, ¶ 14.51, at 14-175.

18. Id. See Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987); Rev. Rul. 79-250, 1979-2 C.B. 156 (substance of each of a series of steps will be recognized and step-transaction doctrine not applied if step has independent economic significance, is not a sham, and was undertaken for a valid business purpose); J. FLEMING, TAX ASPECTS OF BUYING AND SELLING CORPORATE BUSINESSES § 11.02 (1984); Mintz & Plumb, Step Transactions in Corporate Reorganizations, 12 INST. ON FED. TAX'N 247 (1954). But cf. Rev. Rul. 83-142, 1983-2 C.B. 68 (disregard transitory interim steps that would disqualify an otherwise qualified reorganization where steps taken to comply with local law).


Northwest's common stock and debt paper.\textsuperscript{21} Then, in 1961 Pacific transferred approximately 57 percent of its Northwest stock to Pacific shareholders to pass control of Northwest to the parent company, A.T. & T.\textsuperscript{22} Pacific offered the remainder of Northwest common stock to Pacific shareholders in June 1963. This second transaction was similarly structured, except that eight rights plus $16.00 purchased one share of Northwest.

The Commissioner asserted deficiencies against certain minority Pacific shareholders, contending that the taxpayers received ordinary income in the amount of the difference between the sum paid to exercise their rights and the fair market value of the stock received. The Court upheld the taxpayers' contention that the 1961 distribution met the requirements of Section 355 of the Code, with the result that no gain or loss had to be recognized on the receipt by them or their exercise of the rights. The Court reasoned that, "[i]f the 1961 distribution played a part in what later proved to be a total divestiture of the Northwest stock, it was not, in 1961, either a total divestiture or a step in a plan of total divestiture."\textsuperscript{23} If the first offering of rights was to be characterized as a "first step," there must have been a binding commitment to total divestiture. The Court, however, found no such binding commitment, stating that it was merely a fortuity that the remainder of the stock had been distributed to shareholders.\textsuperscript{24}

As partially evidenced by Gordon, the principal advantage of the binding commitment test is to promote certainty in the tax planning of shareholders. Under the binding commitment test, a court must objectively determine whether the acquired shareholders were bound by an obligation to sell the shares received in an acquisition.\textsuperscript{25} According to the court in Penrod v. Commissioner,\textsuperscript{26} intent by the shareholders

\begin{enumerate}
\item Id. at 85. Pacific transferred its telephone businesses in Oregon, Washington, and Idaho, retaining its California operations.
\item Under this plan, Pacific distributed to its shareholders transferable rights entitling their holders to purchase Northwest stock at below fair market value. Six rights plus a $16.00 payment purchased one share of Northwest common. Id. at 86.
\item Id. at 97-98.
\item Id. at 96-97. See United States v. Adkins-Phelps, Inc., 400 F.2d 737 (8th Cir. 1968)(where merger agreement placed former target shareholder under no obligation to sell the acquiring company's stock to the other shareholders, her subsequent sale did not destroy the continuity of interest requirement).
\item Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987).
\item Id. In Penrod, petitioners owned stock in a number of corporations that operated McDonald's fast food restaurants in south Florida. In May 1975, petitioner Jack Penrod and McDonald's executed an agreement which transferred ownership and management of the various Penrod corporations to McDonald's in exchange for 106,464 shares of McDonald's unregistered common stock. After registering the McDonald's stock, petitioners sold 90 percent of the stock received. The court concluded that, at the time of the transfer, there was no binding commitment by the Penrods to sell their shares. Id. at 1434. The court also refused to apply the
to sell their shares is immaterial; only an obligation binding the shareholders to sell is considered under the binding commitment test.

The principal advantage of the binding commitment test, however, may also be its greatest weakness. In order to promote certainty in tax planning, the test requires a binding commitment to take the later steps. This requirement, however, is easily manipulable by taxpayers. Many taxpayers, as in Gordon, could devise strategies of total divestiture just short of a binding commitment to that end or, as in Penrod, could take precautions to ensure the sale after the acquisition without making a binding commitment to sell.

2. End-Result Test

In contrast to the narrowness of the binding commitment test, the end-result test is the most far-reaching alternative. Under the end-result test, the step-transaction doctrine applies if the series of formally separate steps are, in essence, "prearranged parts of a single transaction intended from the outset to reach the ultimate result." 27 Unlike the binding commitment test, the end-result test is premised on the parties' actual intent as of the date of the merger or acquisition. 28

Because the test requires a court to make a factual determination as to the taxpayer's intent, the test promotes uncertainty and thus impedes effective tax planning. 29 Courts must second-guess the taxpayer's intent at the outset of the transaction. Such an endeavor is hardly conducive to effective planning.

In direct contrast to the binding commitment test, however, the end-result test is largely flexible. Rather than requiring a party to be bound to take the later steps, the end-result test bases tax consequences on the real substance of the transaction — what the parties intended to accomplish through a series of formally separate steps.

For example, in Heintz v. Commissioner, 30 the taxpayers owned stock in Jack & Heintz, an ammunition manufacturer during World War II. At the war's end, Precision Corp. was formed to acquire Jack & Heintz and to reorganize its production for peacetime. Precision purchased nearly all of the outstanding shares for $5 million in cash and 60,000 shares of $50 par value preferred Precision stock. During the negotiations, the buyer's parties assured the taxpayers that the Precision shares to be received by them as partial payment would be

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27. Id. at 1429 (emphasis added).
28. Id. at 1430. Presumably, the court will determine the subjective intent of the parties as of the date of the merger or acquisition.
29. Id.
sold in a public offering planned for thirty days after the merger. The parties, however, sold their stock for $30 per share at a private sale. In applying the step-transaction doctrine, the court focused upon the taxpayers’ wish to “cash out” their investment in Jack & Heintz, and the acquisition was a step toward that objective. Thus, the court held the reorganization failed the continuity of interest requirement.

3. Interdependence Test

The third alternative is the interdependence test. Whereas the end-result test focuses on the outcome, the interdependence test stresses the relationship between the individual steps. This test asks “whether the individual steps in a series had independent significance or whether they had meaning only as part of the larger transaction.” It focuses upon whether “the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.” Thus, the step-transaction doctrine may be applied whenever it is unlikely that any one step would have been undertaken except in contemplation of the other integrating steps.

Under the interdependence test, the court in Security Industrial Insurance Co. v. United States, examined whether each step had a separate, reasoned economic justification. In denying the corporation and its shareholders “F” reorganization status, the court found the transfers of assets from Southern and Standard to Security were necessary to effectuate the reinsurance agreements with Security. Such complicated interrelationships demonstrated that each step in the transaction led inexorably to the next. Thus, such a symbiotic relationship satisfied the interdependence test for application of the step-

31. Id. at 142-43.
35. Kuper v. Commissioner, 533 F.2d 152, 156 (5th Cir. 1976).
36. 702 F.2d 1234 (5th Cir. 1983).
37. The Security Indus. Ins. Co. transaction occurred prior to congressional amendments to I.R.C. § 368(a)(3)(A), limiting “F” reorganizations to one corporation. Thus, at the time of the transaction an “F” reorganization could legally include more than one corporation.
transaction doctrine.38

B. Critique

Unfortunately, these three tests — binding commitment, end-result, and interdependence — "are notably abstruse — even for such an abstruse field as tax law."39 Because no test is universally accepted, applications of the step-transaction doctrine have been enigmatic.

For example, the Supreme Court's enunciation of the binding commitment test in Gordon, which telescopes several steps into one only if a binding commitment existed as to the second step when the first step was taken, has been limited to the facts of that case. Subsequent decisions have held that Gordon does not contain the slightest indication that the binding commitment requirement is the touchstone of the step transaction doctrine.40 As one court noted, the step transaction doctrine would be a "dead letter if restricted to situations where the parties were bound to take certain steps."41

Thus, courts most often will amalgamate purportedly separate steps into a single transaction if the end-result or the interdependence tests are satisfied. In multi-phase transactions, both the end-result and interdependence tests ensure that the tax consequences of a given transaction turn on substance rather than form.42 In contrast, the binding commitment test may effectively permit taxpayers to evade the step-transaction doctrine merely by abstaining from formal commitments even though that may fly in the face of the parties' actual intent and economic reality.

C. Application

With the theoretical underpinnings of the doctrine in place, this Comment examines the application of the doctrine to various fact patterns. Several landmark cases nicely illustrate when courts are willing to respect the form of the transaction. There are six types of situations when form versus substance analysis will be addressed.43 The first situation is straightforward: a taxpayer's transaction takes a

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38. Id. at 1247. The court also applied the step-transaction doctrine under the end-result test.


41. Id.


43. The following table illustrates the six types of situations in which either the taxpayer or the Service may attempt to use the step-transaction doctrine. For purposes of this table, assume that the form of the transaction is "A". Form "A" refers to the form adopted by the parties, which form may or may not reflect the substance of the transaction. In contrast, "B" represents the economic substance of the transaction if the form ("A") does not represent the substance. However,
particular form and reflects its substance. The form is respected because both form and substance match.

In the second type of situation, form and substance do not match. In *Helvering v. F & R Lazarus & Co.*, a corporate taxpayer succeeded in having its sale-leaseback of certain real property recharacterized as a loan. In the transaction, the taxpayer purported to convey ownership of the real property to the trustee bank. The rent stipulated in the lease was intended as a promise to pay interest on the loan. Thus, the deed was in substance a mortgage executed as security.

The third type of situation involves transactions which may be characterized in substance as either the form adopted by the parties or an alternative form. Because no substance alternative is better than the other, the court should honor the form chosen by the taxpayer. As will be shown, this type of situation is markedly similar to *Esmark, Inc. v. Commissioner*.

In a taxpayer challenge, however, the court should not permit a taxpayer, who through bad advise or otherwise chose a form that produced a greater tax, to argue for a different and less expensive form.

<table>
<thead>
<tr>
<th>Substance of the Transaction</th>
<th>Preferred Substance Alternative</th>
<th>Business Purpose*</th>
<th>Service Challenges Form</th>
<th>Taxpayer Challenges Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>A</td>
<td>N/A</td>
<td>Form</td>
<td>Form</td>
</tr>
<tr>
<td>B</td>
<td>B</td>
<td>N/A</td>
<td>Controls</td>
<td>Controls</td>
</tr>
<tr>
<td>A or B</td>
<td>A or B</td>
<td>N/A</td>
<td>Form</td>
<td>Controls</td>
</tr>
<tr>
<td>A or B</td>
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<td>Controls</td>
</tr>
<tr>
<td>A or B</td>
<td>B</td>
<td>Yes</td>
<td>Form</td>
<td>Controls</td>
</tr>
<tr>
<td>A or B</td>
<td>B</td>
<td>No</td>
<td>Controls</td>
<td>Controls</td>
</tr>
</tbody>
</table>

*B" may or may not be the preferred substance alternative, that is, the best explanation of what in fact occurred.

"B" is not applicable for taxpayer challenges.

However, there is contrary authority stating that a taxpayer dissatisfied with the form chosen cannot argue for a different form. *See supra* note 15. Yet that is precisely what the court allowed in *Helvering v. F & R Lazarus*, 308 U.S. 252 (1939). *See infra* text accompanying note 44.

If the taxpayer is dissatisfied with the tax consequences of his chosen form, he should not be allowed to complain about that form if it is one of the preferred substance alternatives. *See supra* note 15. *See also infra* text accompanying note 47.


44. 308 U.S. 252 (1939).
45. 90 T.C. 171 (1988), aff'd, 886 F.2d 1318 (7th Cir. 1989).
The fourth type of situation is similar to the first type of situation, except here the substance of the transaction could also be an alternative form. That alternative form, however, is not the preferred choice. Because the form adopted by the parties is the better alternative, in either an IRS challenge or taxpayer challenge, the taxpayer's form should control the tax consequences.

In the fifth type of situation, the preferred substance alternative is not the form chosen by the taxpayer, but a valid business purpose exists for choosing the taxpayer's form. For example, in Frank Lyon Co. v. United States, the taxpayer originally sought financing for a proposed bank facility by a conventional mortgage loan on the new building; state and federal banking regulations, however, restricted investment in banking premises for any amount in excess of the bank's capital stock or forty percent of its capital stock and surplus. Because the Federal Reserve Bank rejected the taxpayer's plan, the taxpayer structured the transaction as a sale-leaseback. The substance of the transaction, however, more closely resembled a loan than a sale-leaseback. The Court respected the form chosen by the taxpayer, noting that business or regulatory realities and non-tax concerns compelled the taxpayer to cast the transaction as a sale-leaseback.

Finally, the sixth type of situation involves a transaction cast one way even though the preferred substance alternative is different. Unlike the fifth type of situation represented in Frank Lyon, no business purpose exists for choosing the form selected. Commissioner v. Court Holding Co., represents this type of situation. In Court Holding, a corporate taxpayer transferred an apartment building, the corporation's sole asset, in a liquidating distribution to the corporation's two shareholders. The shareholders subsequently sold the apartment building. The U.S. Supreme Court recharacterized the distribution as a sale by the corporation and a distribution of the sale proceeds to its shareholders. Due to the substantial involvement by the corporation in the sale, the substance of the transaction more closely resembled a sale by the corporation. The Court justified its recharacterization on the lack of any business purpose for the selected form, except tax avoidance. If, however, the taxpayer challenges the form in that situation, the taxpayer's chosen form should control. This result prevents the sort of abuse feared by the courts.

III. ESMARK, INC. V. COMMISSIONER

A. Mobil-Esmark Exchange

Against this backdrop of judicial decisions synthesizing the stan-
dards used in the step-transaction doctrine, the Tax Court decided *Esmark, Inc. v. Commissioner.*62 Esmark, Inc. was a large publicly owned holding company,49 trading stock on the New York Stock Exchange ("NYSE"). At the time of the transaction, Esmark conducted business through its five subsidiaries. The five subsidiaries were: (1) Swift & Co., a packager and distributor of fresh meats and processed foods; (2) Estech, Inc., a producer of chemical and industrial products; (3) International Playtex, Inc., a manufacturer and distributor of female hygiene products; (4) STP Corporation, a manufacturer and distributor of automotive products; and (5) Vickers Energy Corporation ("Vickers"), a developer of energy properties and a producer of petroleum products. Historically, however, Esmark has been associated primarily with Swift & Co., its longest standing business.

With respect to the energy division, Vickers, a holding company consisted of its three principal operating subsidiaries: Vickers Petroleum, Inc. ("VPC"), Doric Petroleum, Inc. ("Doric"), and TransOcean Oil, Inc. ("TransOcean").50 The market value of Esmark's energy assets had appreciated greatly.

During 1979 and early 1980, however, Esmark experienced financial problems. Esmark faced a serious liquidity problem due, in large measure, to the sharp rise in crude oil prices, the continued poor performance of Swift & Co., record high short-term interest rates, and an agreement to buy Tridan Corporation assets for $45 million. Esmark management also believed that Esmark shares were greatly undervalued. Shares traded on the NYSE ranged from $23.75 and $35.50 per share during the twelve months prior to April 1980. Management, however, determined that the breakup value of the company's separate assets was between $55 to $71 per share, more than twice the $25.50 per share closing price on April 24, 1980.51 The disparity or spread between the trading value and breakup value, the management feared, made the company ripe for a takeover.

Thus, Esmark needed to generate cash, reduce its long-term debts, and expand its consumer products and chemical subsidiaries. "To capitalize on the current interest in oil-producing property and reserves and to rid itself of an operation that would require huge investments for exploration and development, Esmark announced plans to auction off its entire energy unit."52 In June 1980, the board of directors fi-

49. Before Esmark's restructuring program, approximately 48,000 shareholders held 20,311,000 shares. After restructuring, however, approximately 33,900 shareholders held only 10,083,000 shares. Id. at 179.
50. Id. at 172-73. Pursuant to other agreements, Esmark sold Doric for $26.5 million and VPC for $245 million. Thus, Vickers' sole asset was TransOcean stock.
51. Id. at 173.
nally approved a restructuring program which included closing certain units of Swift & Co., disposing of certain minor businesses, disposing of the entire energy division, and redeeming approximately 50 percent of its stock if the energy segment was sold for cash. Because the energy division was a large ongoing business of Esmark that required large working and investment capital, an accompanying redemption was necessary to avoid making Esmark a prime takeover target.

After deciding that the tender offer/redemption format was the best structure for the transaction, Esmark conducted a bidding contest based on that format. In August 1980, Esmark and Mobil (the winning bidder) entered into a formal exchange agreement. Under the agreement, Mobil agreed to make a best efforts tender offer for 11,918,333 shares (approximately 54 percent) at $60 per share, and Esmark agreed to redeem that stock for 975 shares (97.5 percent) of Vickers stock.54 If Mobil was unable to acquire enough Esmark shares to effect an exchange for 975 Vickers shares, Mobil had an option to purchase the balance of the 975 shares at a price of $733,435.90 per share. On October 3, 1980, Mobil successfully completed the tender offer and exchanged its Esmark shares for the Vickers shares.

Under the tender offer/redemption plan, Esmark contended that the redemption of Mobil's interest would not invite taxation to Esmark on the inherent gain. Esmark complied with the literal requirements in Section 311(d)(2) of the Code that exempted from

53. A tender offer/redemption plan refers to a plan whereby the acquiring corporation purchases a fixed percentage of target's stock equal to the value of the desired target asset. Subsequently the acquiring corporation will exchange its target stock for the target's assets. Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd, 886 F.2d 1318 (7th Cir. 1989).

54. Id. at 177-78. The parties agreed to an exchange rate of 12,224 Esmark shares for one share of Vickers. Esmark also agreed to transfer the remaining 25 shares (2.5 percent) of Vickers stock to Mobil-TransOcean, Mobil's wholly-owned subsidiary-assignee, in exchange for a 10 percent net profits royalty interest in certain non-producing TransOcean properties.

55. I.R.C. § 311(d)(2) (repealed 1986). Section 311(d) formerly provided:

(1) In general. If —

(A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a redemption (to which subpart A applies) of part or all of his stock in such corporation, and

(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation), then a gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution. Subsections (b) and (c) shall not apply to any distribution to which this subsection applies.

(2) Exceptions and Limitations. Paragraph (1) shall not apply to —

(A) a distribution of stock or an obligation of a corporation —

(i) which is engaged in at least one trade or business,

(ii) which has not received property constituting a substantial part of its assets from the distributing corporation, in a transaction to which section 351 applied or as a contribution to capital,
corporate taxation certain distributions of appreciated property of
long-standing subsidiaries with respect to stock. The Service, how-
ever, viewed the transaction differently; it recast the transaction as a
sale of the Vickers stock to Mobil, followed by a redemption of Es-
mark stock for cash. Under the Service's recharacterization, Es-
mark faced a potential long-term gain exceeding $452 million and a
resultant tax liability of approximately $115 million.

The Service did not prevail. The Tax Court dismissed every argu-
ment by the Service to support its position and upheld the taxpayer's
form and characterization. Critical to the Tax Court's analysis were
arguments based on the nature of Mobil's ownership and the step-
transaction doctrine. In order to evaluate the Tax Court's decision
fully, this Comment will carefully analyze each issue.

B. Nature of Mobil's Ownership

As a threshold issue, Esmark had to demonstrate that Mobil was a

within the 5-year period ending on the date of the distribution,
and
(iii) at least 50 percent in value of the outstanding stock of
which is owned by the distributing corporation at any time
within the 9-year period ending one year before the date of the
distribution.

56. Esmark, Inc. v. Commissioner, 90 T.C. 171, 172 (1988), aff'd, 886 F.2d 1318 (7th
Cir. 1989). Pursuant to its procedures, the Service refused to issue an advance
ruling on the transaction. See Rev. Proc. 82-22, 1982-1 C.B. 469.

57. The effect of the transaction at the shareholder level is, of course, a separate issue
from the imposition of tax at the corporate level. If Esmark's form was upheld,
the tendering shareholders would receive capital gains treatment on the ex-
change as if they sold their interests on the open market. If, however, the Ser-
vice's recharacterization was upheld, the tendering non-corporate shareholders
would be subjected to the general distribution rules under I.R.C. § 301. Pursuant
to Section 302, a redeemed shareholder will receive exchange treatment if the
redemption was (1) not essentially equivalent to a dividend, (2) substantially dis-
proportionate with respect to the shareholder, or (3) in complete liquidation of
the shareholder's interest after applying the attribution rules under Section 318.

In Rev. Rul. 76-385, 1976-2 C.B. 92, the Service determined a minority share-
holder of a publicly held corporation whose relative stock interest in the redeem-
ing corporation is minimal and who exercises no control over the corporation's
affairs, will qualify under Section 302(b)(1) as not essentially equivalent to a divi-
dend, if the redemption resulted in a meaningful reduction of the shareholder's propor-
tionate interest in the corporation. See United States v. Davis, 397 U.S. 301
(1970); Rev. Rul. 81-289, 1981-2 C. B. 82 (redemption of a shareholder that owned
less than one percent of publicly held corporation did not qualify as not essen-
tially equivalent to a dividend because shareholder's pro rata interest not re-
duced).

Even if no meaningful reduction occurred, redeeming shareholders of a pub-
licly held corporation, such as Esmark, should be afforded exchange treatment
upon tendering their shares. The Esmark shareholders could have sold their
stock through the open market and guaranteed exchange treatment.
shareholder who received a distribution with respect to its stock for purposes of Section 311(a) of the Code. If Mobil was not a shareholder, then Section 311 was inapplicable because Section 311 distributions must be made by reason of the corporation-shareholder relationship. Even though Section 311(d)(2)(B), on which Esmark relied, did not draw any distinction between "historical" and "transitory" shareholders, the Service could disregard Mobil’s ownership of Esmark stock if it was merely incidental to the transaction, that is, the substance of the transaction did not match its form.

As to the nature of Mobil’s ownership, the Tax Court focused on whether Mobil’s ownership was merely transitory, whether Mobil possessed enough ownership attributes to compel a finding that it owned the Esmark shares (albeit for less than a day), and whether Mobil acted as a conduit for the true owner.

1. Prior Precedent

Mobil’s acquisition of Esmark stock followed by a prearranged surrender of that stock in exchange for property suddenly catapulted into the limelight two Tax Court decisions that reached opposite conclusions on the viability of this tax planning technique. In pressing its transitory ownership analysis, the Service stressed the Tax Court decision in *Idol v. Commissioner*. In that case, the sole shareholder of a trucking business needed to generate cash to pay his personal debts. Attempting to withdraw cash from the corporation as capital gain rather than as a dividend, the shareholder sold approximately one-third of his shares. The purchaser redeemed the shares that same day for the corporation’s Detroit franchise and certain equipment. Under the Interstate Commerce Commission (“ICC”) rules on competition,

58. Treas. Reg. § 1.311-2(a) provided that the exceptions and limitations to the application of Section 311(d)(1) contained in Section 311(d)(2) do not broaden “the general nonrecognition provisions of Section 311(a). Thus, for example, if the proceeds of the sale of property in form made by a shareholder, who received such property from a corporation, are imputed to the corporation . . . the exceptions and limitations of Section 311(d)(2) would have no application.”

59. See supra note 55 and accompanying text.

60. *Idol v. Commissioner*, 38 T.C. 444 (1962), aff’d, 319 F.2d 647 (8th Cir. 1963) (prearranged sale of stock coupled with prearranged redemption recast as a sale of assets followed by a distribution); *Standard Linen Serv., Inc. v. Commissioner*, 33 T.C. 1 (1959) (stock purchase and redemption respected).

61. *Idol v. Commissioner*, 38 T.C. 444 (1962), aff’d, 319 F.2d 647 (8th Cir. 1963). The Service also relied on *Helvering v. Bashford*, 302 U.S. 454 (1938) (a corporation that participated in the reorganization of its competitors into a new corporation, of which it became 100 percent owner of preferred shares and 57 percent owner of common shares, held “not a party to a reorganization,” and thus gain on receipt of other property was taxable to it), and *United States v. General Geophysical Co.*, 296 F.2d 86 (5th Cir. 1961) (a corporation that transferred assets to a major shareholder in redemption of stock and then reacquired the same assets denied a step up in basis).
the stock purchase was illegal without ICC approval. The ICC reduced the scope of the franchise being sold and limited the operating rights requested by the purchaser. The parties notified the ICC that the stock purchase was not real and was being done solely to minimize federal income taxes.

In recasting the stock purchase and redemption as a cash sale, the court held the transaction should be treated and taxed as a sale by the corporation of certain of its assets to the purchaser, followed by a dividend distribution of the sales proceeds to the taxpayer. The court stated:

Not only is it plain from the evidence . . . that . . . [the purchaser] had no interest in acquiring any of [the corporation's] stock, but there is no indication here that Idol had any real desire to dispose of any part of his 42 [sic] shares of the corporation's stock. The only reason the transactions were cast in the form of a sale of stock followed by a redemption was the possibility of obtaining favorable tax treatment.

[O]n its face the transitory registration of stock ownership in the name of . . . [the purchaser] followed by registration in the name of . . . [the distributing corporation] and accompanied by a shifting of stock certificates representing 32 shares . . . formally complies with the requirements of a stock redemption . . . and looks like a "complete redemption of all of the stock of the corporation owned by the shareholder." The essential difficulties with this contention result from the absence of record evidence tending to indicate that . . . [the purchaser] not only formally but in substance became the owner, for tax purposes, of 32 shares of . . . [the distributing corporation's] stock, and that the corporation actually intended to and did redeem those shares.62

Conversely, the Tax Court, under an unmistakably similar fact pattern, respected the form of a prearranged sale of stock followed by a redemption in Standard Linen Service, Inc. v. Commissioner.63 In that case, the Model Laundry Co. ("Model") engaged in the laundry and linen supply businesses. Model's wholly-owned subsidiary, Standard Linen Service ("Standard"), operated a separate linen supply business. After Model experienced liquidity problems, several Model shareholders decided to sell their stock (approximately 51 percent of the total outstanding issues) and terminate their investment. A potential purchaser, Alsco, only wished to acquire specific assets used in Model and Standard's linen supply businesses. Motivated in part by tax savings, the Model shareholders desired a stock sale rather than an asset sale. Alsco agreed to acquire Model stock from the shareholders at a price equal to the value of the linen supply assets. Pursuant to their agreement, Model liquidated Standard and redeemed the purchaser's newly acquired stock with the linen supply assets. The exchange occurred on the same day that Alsco acquired the Model stock.


63. 33 T.C. 1 (1959).
In attempting to determine the substance of what occurred, the court noted the transaction accomplished three distinct objectives:

First, those of Model's stockholders who desired to do so were able to dispose of their individual stock interests in the corporation. Second, Model disposed of the linen supply part of its business, thus raising needed capital with which to liquidate existing obligations and underwrite its plans for future expansion of the remaining laundry business. Third, Alsco acquired Model's much wanted linen supply assets, thereby entering the linen supply business. . . . Consequently, the substance of what occurred conceivably can very well differ depending on the position from which the transactions are viewed.64

The court respected the form of the transaction because the taxpayer's form reflected the economic substance of the transaction. The selling shareholders constantly refused to sell anything but stock and the corporation never offered to sell its assets directly. Consequently, the court honored the steps taken, even though Alsco's stock ownership lasted for less than a day.

At first glance, these two decisions seem irreconcilable. In both, the buyer purchased stock and, on the same day, redeemed its stock for certain corporate assets. In Idol, the court recast the transaction and taxed the corporation on any gain from the sale.65 In Standard Linen, however, the court respected the form as a sale of stock followed by a partial liquidation.66

In discussing the apparent conflict between Idol and Standard Linen, the Esmark court determined that Idol was only superficially similar to Standard Linen. Esmark noted that Idol essentially involved an "earnings bailout." In Idol, the sole shareholder used his corporation as his own "personal pocketbook."67 The only corporate change due to the transaction was that the purchaser acquired the needed Detroit franchise and certain business equipment. Idol, however, continued to hold 100 percent of the corporation's stock, and the business remained intact.68

In contrast, the transaction in Standard Linen fundamentally

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64. Id. at 12-13.
65. Additionally, Idol held the distribution of the sale proceeds constituted a dividend to Idol, the sole shareholder. Idol v. Commissioner, 38 T.C. 444, 462 (1962), aff'd, 319 F.2d 647 (8th Cir. 1963). If Idol met one of the requirements of Section 302(b), the redemption would be accorded capital gains treatment. Taxation of the redemption received by Idol, however, is a separate issue from whether the transaction is taxable to the corporation for purposes of this Comment.
66. Because Standard Linen was decided under the 1939 Code, no capital gains tax was imposed on Model for the distribution of appreciated assets.
68. Esmark, Inc. v. Commissioner, 90 T.C. 171, 190 (1988), aff'd, 886 F.2d 1318 (7th Cir. 1989). Before the transaction in Idol, Idol owned 90 shares (100 percent). After the transaction, Idol owned all 58 shares outstanding. The only difference being that the corporation no longer owned the Detroit franchise and certain
changed the ownership of the corporation. As a direct result of the transaction, Model disposed of its entire linen supply business. This disposition served important corporate, as well as shareholder, purposes. With respect to the corporation, Model retired the 45,476 shares received from Alco. Before the transaction, Model had 61,795 shares of stock outstanding; after the transaction, it had reduced its outstanding stock to 16,319 shares. Thus, Model had a valid non-tax motivation in structuring the transaction as it did.

With respect to the Model shareholders who tendered their shares to Alco, they primarily wanted to cash out their investment and not maintain a proprietary interest in the company. Their desire to sell their stock, and not tax savings alone, was the prime reason the transaction took the form it did. As the court concluded, "[r]eal rights and liabilities were created by virtue of the exchanges which . . . cannot be ignored."70

Thus, because Idol did not involve a fundamental shift in the ownership of the corporation, a recharacterization was justifiable. Standard Linen, however, involved the termination or reduction of proprietary interests in the company, and thus a recharacterization was inappropriate.

After distinguishing Idol from Standard Linen, the Esmark court distinguished itself from Idol and subsequently compared itself to Standard Linen. In stressing the similarities between Mobil-Esmark's exchange and Alco-Model's exchange, the Esmark court stated:

In this case and in Standard Linen, but not in Idol, the transaction substantially changed the ownership of the corporation. In this case and in Standard Linen, again in contrast to Idol, the transaction resulted in the disposition of an entire line of business. Finally, in this case and in Standard Linen, unlike in Idol, the transaction served important corporate, as well as shareholder, purposes.71

In both Standard Linen and Esmark, the corporations significantly contracted their businesses; Model no longer was in the linen supply business, and Esmark no longer owned an energy business. Additionally, a large percentage of shareholders terminated their interests in the companies by surrendering their shares of their own volition in a public tender.72

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70. Id. at 14.
72. In Standard Linen, approximately 51 percent of the shareholders tendered, while in Esmark approximately 54 percent tendered.
2. Potential Distinctions

Although the Esmark court concluded that the Mobil-Esmark exchange resembled the Alsco-Model exchange, several possible problems still lurk in the background for taxpayers seeking to structure Mobil-Esmark type transactions. First and foremost, a Mobil-Esmark type transaction is taxable at the corporate level because Congress amended Section 311(d), removing the nonrecognition exemption that protected the distributing corporation.\textsuperscript{73}

Second, the impetus for the transaction is a controlling factor in the court's analysis of whether to recharacterize the transaction as a sale of assets. Paramount to the result in Standard Linen was the court's reasoning that the underlying purpose that gave rise to the transaction — the shareholders' desire to terminate their interests or the corporation's intent to dispose of assets — controls the tax consequences. If the corporation initiated the transaction, the Service could recharacterize the transaction as a sale of assets by the corporation regardless whether the subsequent redemption qualified for capital gains treatment under Section 302.\textsuperscript{74} If, however, the court determined that the shareholders' desire to sell their shares was the critical factor in shaping the transaction, then no corporate tax should be imposed.\textsuperscript{75}

The Esmark shareholders, unlike the shareholders in Standard Linen, did not participate in the transaction other than to tender their shares. Esmark unveiled the tender offer plan to its shareholders only after Mobil won the bidding to acquire TransOcean. Esmark faced a liquidity crisis and unilaterally decided to sell Vickers. The shareholders' desire to terminate their interests did not arise until after the tender offer was initiated with Esmark management's blessings. Thus, Esmark's corporate objective to sell its energy assets may have been sufficient to support the Service's recharacterization.

The third concern involves the distinction between Idol and Standard Linen. Prior to Revenue Ruling 80-221,\textsuperscript{76} the Service publicly accepted the fundamental change in ownership theory, justifying the differing results in Idol and Standard Linen.\textsuperscript{77} In 1980, however, the Service noted additional factors justifying its recharacterization in

\textsuperscript{73} See supra note 55.
\textsuperscript{74} For a discussion on Section 302 exchange treatment, see supra note 57. In Waltham Netoco Theatres, Inc. v. Commissioner, 401 F.2d 333 (1st Cir. 1968), the court found the requisite corporate intention to sell assets, and thus imposed a corporate tax on the distributing corporation.
\textsuperscript{75} Standard Linen Serv., Inc. v. Commissioner, 33 T.C. 1, 13-14 (1959). See also Master Eagle Assoc., Inc. v. United States, 81-1 U.S. Tax Cas. (CCH) ¶ 9171 (S.D.N.Y. 1981).
Idol. In Revenue Ruling 80-221, the Service recharacterized a stock purchase followed by a redemption as a sale of assets. In that ruling, the seller's proportionate interest in the corporation remained identical. Thus, the suggested rationale for recharacterizing the transaction in Idol was present. The Service, however, held that the transaction was structured as a stock purchase primarily for tax avoidance purposes, and that the buyer's stock ownership was transitory, was never intended to represent a normal shareholder interest, and involved only a right to receive the desired assets in the immediate future.

If these other factors justify the opposite results in Idol and Standard Linen, and not the shift in ownership of the entity, Mobil-Esmark type transactions are still subject to attack because such transactions arguably are structured for tax avoidance purposes. As the Esmark court noted, "The expected tax benefits were . . . the most important reason for selection of the tender offer/redemption format."78 Thus, under the Service's rationale, Esmark's tax avoidance purposes justified the recharacterization, even though a structural change in ownership occurred.

Besides tax savings, the Tax Court found valid business purposes for the form of the transaction. First, as previously mentioned, Esmark rid itself of a large ongoing energy business that required large sums of capital, and redeemed approximately 50 percent of its shares. Second, a stock purchase maximized shareholders' returns; Esmark never ruled out a cash sale if that would net the highest return for shareholders.79 Third, because a third party tendered rather than a self-tender, Esmark eliminated its requirement to obtain a fair price for the tender.80

A fourth possible problem for taxpayers structuring Mobil-Esmark type transaction is whether an agreement to exchange was in place before the tender offer. In these instances, the Service concluded that, on facts similar to Standard Linen and Esmark, the transaction would be recharacterized as a sale of the subsidiary (or its assets) by the parent corporation for cash followed by a redemption of shareholders.81

79. Id. at 177.
80. In a self-tender, Esmark would be duty-bound to pay a fair price to its tendering shareholders. See generally Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (in a cash-out merger the parent must disclose all critical information pertaining to what it considers a fair price). Otherwise the minority shareholders may receive their appraisal rights. In the case of a third party tender, no such requirement exists. One commentator dismissed this business purpose as believable but of little importance, concluding that a fairness opinion would be considerably less than the $115 million in taxes saved. Sheppard, supra note 67, at 1168.
In that ruling, which was issued after litigation in *Esmark* began, the Service disregarded the acquiring company's shareholder status. Under the Service's analysis, the acquirer agreed to purchase the parent's shares as a means of settling its obligation with the parent company and not within the corporation-shareholder relationship.

In *Esmark*, Mobil and Esmark formally agreed before the tender offer that Mobil would acquire enough Esmark shares to effect an exchange for 975 Vickers shares. Although Esmark and Mobil's formal exchange agreement would justify a recharacterization under Revenue Ruling 83-38, the *Esmark* court rejected that argument, emphasizing the similarity with *Standard Linen*'s exchange and the Service's longstanding acquiescence at the time of the transaction.82

3. **Mobil’s Attributes of Ownership**

The court also quickly dismissed the Service’s argument that Mobil lacked the attributes of ownership, posing a rhetorical question: "if not Mobil, then who?"83 The tendering public shareholders surrendered all incidents of ownership upon the closing of the tender offer; they could no longer vote their shares, receive dividends, or sell to anyone else. The court concluded that only Mobil enjoyed the right to receive dividends, one of the most important attributes of stock ownership.84 Thus, Mobil truly owned the Esmark shares and was not merely an intermediary, a conduit for the true owner.

C. **Step Transactions**

After concluding that Mobil’s ownership was real and substantial, and not merely transitory, the court turned its attention to the step-transaction doctrine. In its inquiry, the court addressed whether the doctrine — however applied to the Mobil-Esmark exchange — could compel disregarding Mobil’s ownership of the Esmark shares. If applicable, the doctrine would treat "a series of formally separate ‘steps’ as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."85

83. Zonona, *Form Over Substance*, N.Y.L.J., July 21, 1988, at 5, col. 2. Specifically, the court said, “In claiming that Mobil was not a shareholder upon purchasing petitioner’s shares pursuant to the tender offer, respondent fails to identify anyone other than Mobil as the ‘true owner’ of the shares.” *Esmark, Inc. v. Commissioner*, 90 T.C. 171, 193 (1988), aff’d, 886 F.2d 1318 (7th Cir. 1989).
84. If, however, one treats the Esmark stock held momentarily by Mobil as being reacquired by Esmark, then the right to receive dividends adds nothing to the analysis. Furthermore, even if Mobil had the right to receive dividends, the parties timed the transaction so precisely to avoid having to deal with that problem. 85. *Esmark, Inc. v. Commissioner*, 90 T.C. 171, 195 (1988), aff’d, 886 F.2d 1318 (7th Cir. 1989)(quoting Penrod v. Commissioner, 88 T.C. 1415, 1423 (1987)). See B. BITTKER & J. EUSTICE, supra note 5, ¶ 14.51, at 14-175.
The *Esmark* court acknowledged that Mobil's tender offer was merely a part of an overall plan; neither Esmark nor the Service disputed this characterization. However, "[t]he existence of an overall plan does not alone ... justify application of the step-transaction doctrine." 86 Whether invoked under the binding commitment, 87 end-result, 88 or interdependence 89 tests, the doctrine "combines a series of individually meaningless steps into a single transaction." 90

The court addressed whether the Mobil-Esmark exchange included any meaningless or unnecessary steps. If it did, the court could collapse them together to honor the economic realities of the transaction. The court, however, found no meaningless steps. Mobil's cash tender offer was not a meaningless step because Mobil's stock ownership was real and not transitory.

The court also analyzed Esmark's objectives and options in structuring the transaction to determine whether any meaningless steps were taken. Esmark had two objectives: disposing of its energy division and redeeming approximately 54 percent of its stock. To accomplish these goals, Esmark had three alternatives available. First, Esmark could have distributed Vickers stock to its shareholders in exchange for their shares; the shareholders then could have sold the Vickers stock for cash to interested buyers. 91 Second, Esmark could have sold its Vickers stock for cash and then distributed the proceeds to its shareholders in exchange for their stock. 92 Using a third alter-

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88. Penrod v. Commissioner, 88 T.C. 1415, 1429-30 (1987). *See supra* text accompanying notes 26-29. In *Esmark*, the end-result test was met because Esmark was motivated largely by tax savings.
89. Security Indus. Ins. Co. v. United States, 702 F.2d 1234, 1246 (5th Cir. 1983). *See supra* text accompanying notes 32-38. In *Esmark*, the various steps in Mobil's purchase were mutually interdependent because Esmark would never have agreed to have Mobil as a shareholder if it would assert the normal rights of a 54 percent shareholder.
91. *Id.* at 195-96. Similar plans were used in United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950)(a closely held corporation distributed electric transmission and distribution equipment to its shareholders who in turn sold the equipment to a willing cooperative) and Commissioner v. Court Holding Co., 324 U.S. 331 (1945)(closely held corporation made liquidating distribution to its two shareholders who subsequently conveyed the apartment building to a purchaser).
92. *Esmark*, Inc. v. Commissioner, 90 T.C. 171, 196 (1988), aff'd, 886 F.2d 1318 (7th Cir. 1989). This alternative, however, posed several problems; Mobil may not have been the successful bidder, and a cash sale would result in Esmark being taxed on the exchange of highly appreciated property.
Mobil acquired Esmark stock in a cash tender offer and immediately exchanged such stock for the Vickers stock. After outlining the three routes that Esmark had available, the court considered whether any one route was more direct than any other. In other words, did any one route better explain the substance of what occurred? If any one route was more direct, more consistent, more complete, or more succinct, the court could recast the transaction to match its perceived substance. If, however, no single route was preferred, the court should honor the form chosen.

In Esmark, each alternative required two steps, and each step involved two of the three interested parties. The first alternative required a distribution to shareholders followed by a cash sale to Mobil. The second alternative required a stock sale to Mobil followed by a distribution of the proceeds to its shareholders in exchange for Esmark stock. The third alternative required a stock purchase and a redemption of that stock for Vickers stock. Each alternative left Esmark, its shareholders, and the purchaser in the same relative positions. Thus, the court concluded that no single route better explained the substance of what occurred; neither the form used by Esmark nor the other alternatives were preferred. Because the parties could have completed the transaction in any of the three forms and still have achieved the same economic result, Esmark was entitled to choose the path that resulted in the least tax.

Additionally, the Service's recharacterization of the Mobil-Esmark exchange sought not only to combine steps, but to invent new ones. By characterizing the transaction as a sale of Vickers to Mobil followed by a self-tender, the Service attempted to create steps not taken under the tender offer/redemption format.

Inventing new steps, however, is not generally appropriate in the application of the step-transaction doctrine. In Grove v. Commissioner, a taxpayer donated stock in his construction company to his alma mater. The taxpayer's gift contained four conditions.

93. Levmore, supra note 5, at 1020.
94. In terms of the table listing the six types of situations in which form versus substance arguments arise, see supra note 43, Esmark represents the third type with only one minor modification. There were three substance alternatives rather than two. In determining whether all three forms achieved the same economic result, the amount of tax savings in using the third alternative as opposed to the other two is not included. The focus here is on what properties were transferred and to whom.
95. According to the Service, however, its characterization did combine formally separate steps. The Service argued the transaction was in fact a purchase by Mobil of Vickers stock from Esmark (one transaction) rather than a purchase of Esmark stock by Mobil followed by redemption of the Esmark stock (two transactions). That characterization, however, fell on deaf ears in the Tax Court litigation. Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd, 886 F.2d 1318 (7th Cir. 1989).
96. 490 F.2d 241 (2d Cir. 1973).
tions: (1) the corporation could not agree to any obligation to redeem shares held by the donee; (2) if the donee disposed of the shares, any proceeds had to be invested and managed by an established professional firm; (3) the donor, or his wife if she survived him, retained an interest in the income from the gift for life; and (4) the donee agreed to give the corporation the right of first refusal in purchasing the shares. Grove made similar donations over the next thirteen years. The corporation typically redeemed the donee's shares one year after the donation.

The Service, however, viewed the transaction differently. It recast the transaction as a redemption of Grove's, not the donee's shares, followed by a cash gift to the donee. In rejecting the Service's recharacterization, the Court stated:

We are not so naive as to believe that tax considerations played no role in Grove's planning. But foresight and planning do not transform a non-taxable event into one that is taxable. Were we to adopt the Commissioner's view, we would be required to recast two actual transactions — a gift by Grove to . . . [donee] and a redemption from . . . [donee] by the Corporation — into two completely fictional transactions — a redemption from Grove by the Corporation and a gift by Grove to . . . [donee]. [W]e can discover no basis for elevating the Commissioner's "form" over that employed by the taxpayer in good faith. "Useful as the step transaction may be in the interpretation of equivocal contracts and ambiguous events, it cannot generate events which never took place just so an additional tax liability might be asserted."

Recognizing that inventing new steps would be improper, the Esmark court refused to apply the step-transaction doctrine. The Mobil-Esmark exchange involved no meaningless or unnecessary steps. Each step had independent economic significance, creating substantial rights and liabilities that could not be ignored. Application of the step-transaction doctrine to the Mobil-Esmark exchange would not only have combined steps, but would have invented new fictional steps.

IV. MOBIL-ESMARK TYPE TRANSACTIONS AND SECTION 355

In 1980, Esmark completed its transaction with Mobil, relying on Section 311(d)(2)(B) to provide nonrecognition treatment. Subsequent congressional amendments have preempted much of the creative tax planning that led to the enactment of Section 311(d). Consequently, many may wonder whether tax-free Mobil-Esmark type transactions have been statutorily eliminated. Taxpayers seeking to structure Mobil-Esmark type transactions may still have one possi-

97. Under the Service's characterization, the redemption proceeds would be taxable as ordinary income to Grove. Under the taxpayer's view, amounts paid by the corporation to redeem the donated shares from the school were not taxed upon distribution. Id. at 246.
98. Id. at 247-48 (quoting Sheppard v. United States, 361 F.2d 972, 978 (Ct. Cl. 1966)).
bility available. A Mobil-Esmark type transaction might qualify as a nontaxable "split-off"99 to which Section 355 of the Code applies. In order to determine whether a transaction qualifies as a Section 355 split-off, one must examine the statutory and judicial requirements for a split-off, especially in light of the repeal of the General Utilities doctrine.100 Only after a proper statutory foundation is laid may one determine whether a Mobil-Esmark type transaction qualifies for such nonrecognition treatment.

A. Section 355 Requirements

1. Statutory Requirements

Section 355 of the Code101 generally permits the tax-free distribu-

99. A split-off refers to an exchange of the stock of a controlled corporation with some or all shareholders for some or all of their stock of the distributing corporation; such an exchange may be pro rata among the shareholders. B. BITTKER & J. EUSTICE, supra note 5, § 13.01; Walter, Spin-offs, Split-offs and Split-ups in Two Step Acquisitions and Dispositions, 66 TAXES 970, 972 (1988).

100. The General Utilities doctrine is named after General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). This doctrine was later codified in Sections 311 and 336 of the 1954 Code. Before the amendments in the Tax Reform Act of 1986, the General Utilities doctrine allowed corporations to distribute appreciated assets without recognition of gain in certain circumstances. The 1986 amendments, however, provide that nearly all distributions of appreciated assets will trigger corporate level gain recognition. The recognition provisions in Section 311(b) nearly swallow the nonrecognition rule in Section 311(a).


(a) Effect on Distributrees.

(1) General Rule. If —

(A) a corporation (referred to in this section as the distributing corporation') —

(i) distributes to a shareholder, with respect to his stock, ... solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b)(relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes —

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 388(c) ...
tion by one corporation (the distributing corporation) of stock or securities in another corporation (the controlled corporation) to shareholders with respect to their stock or security holders in exchange for their securities, provided that the distribution is not principally a device for distributing earnings and profits to shareholders. Although Section 355 is directed to the tax treatment of the distributee shareholders in certain corporate divisions, the repeal of the General Utilities doctrine and the inversion of the tax rates have switched the focus from the tax treatment of the distributee shareholders to the distributing corporation. Because Section 355 permits nonrecognition treatment to shareholders in transactions that fit its requirements, the section is a powerful tool for creative tax planners in avoiding the dire consequences of General Utilities repeal.

Section 355 expressly requires that four conditions be satisfied for non-recognition treatment. First, a corporation must distribute stock of a subsidiary which the distributing corporation controlled immediately prior to the distribution to a shareholder with respect to his stock. Second, either all of the stock of the subsidiary must be distrib-

102. Redding v. Commissioner, 630 F.2d 1169 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981)(distribution not with respect to stock because some stock rights were exercised by persons who were not stockholders of the distributing corporation); Commissioner v. Baan, 382 F.2d 485 (9th Cir. 1967)(transfer of stock of transferor's subsidiary to transferor's shareholders on their exercise of stock rights held as not being a distribution by transferor with respect to its stock); cf. Rev. Rul. 83-142, 1983-2 C.B. 68 (upstream sale of stock of second-tier subsidiary, followed by an immediate cash dividend to parent corporation disregarded and transaction held in substance a Section 355 distribution of stock).

103. Rev. Rul. 76-175, 1976-1 C.B. 92; Rev. Rul. 70-271, 1970-1 C.B. 166. If the distribution is not made with respect to its stock or stock and securities, the transaction will be characterized by that status. See, e.g., Rev. Rul 77-20, 1977-1 C.B. 91 (excess of value of distributed stock over value of stock surrendered by shareholder-landlord constituted rent owed by distributing corporation to shareholder).

104. Although there is no comprehensive definition of the term "earnings and profits" in the Code or regulations, Section 312 of the Code contains numerous rules for determining the effect of particular transactions on the computation of earnings and profits. In most cases, earnings and profits correspond to the earned surplus account representing the amount of retained profits from operation, and reflecting nonoperating profits and losses. Fed. Taxes 2d (P-H) ¶ 17.343 (1988). In other cases, the earned surplus amount will differ from the amount of earnings and profits for tax purposes due to the effect of Section 312 of the Code. Id.

105. Under Section 311(a), as amended in 1986, a distributing corporation does not recognize gain or loss on a nonliquidating distribution of property with respect to its stock. The Section 311(a) nonrecognition rule is limited by Section 311(b)(1) with respect to gain for distributions to which subpart A (I.R.C. §§ 301-307) applies. Because Section 355 is not within the scope of the Section 311(b)(1) limitation, the general nonrecognition rule of Section 311(a) applies to spin-offs (an analog to dividends) and split-offs (an analog to nonliquidating redemptions) under Section 355. B. BITTKER & J. EUSTICE, supra note 5, ¶ 13.12, at 13-44.
uted or an amount of stock constituting control (within the meaning of Section 368(c))\(^{106}\) must be distributed, and the distributing corporation must establish that the retention of the nondistributed stock was not for tax avoidance purposes.\(^{107}\) Third, the transaction must not be used principally as a device for the distribution of earnings and profits.\(^{108}\) Fourth, both the distributing corporation and the controlled corporation must have been engaged in an active trade or business for five years before the date of the distribution.\(^{109}\)

2. Continuity of Interest Test

Besides the express requirements of Section 355, a two-step transaction must satisfy the continuity of interest requirement in order to qualify under the section. There are generally two possible sources for the continuity of interest requirement: Section 368 of the Code,\(^{110}\) if a Section 355 transaction is viewed as a reorganization; or the device clause in Section 355 itself.\(^{111}\) Currently tax theorists and commentators view the continuity of interest requirement as a useful protection

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106. I.R.C. § 368(c) generally requires that the distributing corporation own at least 80 percent of the total combined voting power and at least 80 percent of the total number of shares of all other classes of stock of the controlled corporation.

107. Under Section 355(a)(2), the distribution need not be pro-rata to the shareholders.

108. The device clause normally prohibits the distributee in a spin-off from immediately reselling the spun-off stock pursuant to a plan. The device clause, however, is premised on a significant difference between the rates on ordinary income and capital gains. Because there is largely no difference between ordinary income and capital gains treatment currently, the importance of the device clause as a defense against an earnings and profits bailout is significantly diminished. See Walter, supra note 99, at 971; Simon & Simmons, The Future of Section 355, 40 TAX NOTES 291, 299 (July 18, 1988).


110. Walter, supra note 99, at 973. Viewing a Section 355 transaction as a reorganization, however, may be problematic. A Section 355 transaction need not be a reorganization, and continuity of interest is not a requirement in all types of reorganizations, such as recapitalizations under I.R.C. § 368(a)(1)(E)(1982), see Rev. Rul. 77-415, 1977-2 C.B. § 111; Rev. Rul. 77-479, 1977-2 C.B. 119, and distributions under former I.R.C. § 311(d)(repealed 1986), see supra note 55. Typically, two-step transactions under Section 355 closely resemble a recapitalization: both involve the reshuffling of an existing business or businesses without the injection of assets or operations from another corporation. Walter, supra note 99, at 973. See also Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 202-03 (1942).

111. Walter, supra note 99, at 973; Sheppard, Section 355 and Continuity of Interest, 39 TAX NOTES 911, 912 (May 23, 1988). The device clause in Section 355 arguably does not support a continuity of interest requirement because the device clause was designed to protect against corporations bailing out earnings at capital gains rates. B. Bittker & J. Eustice, supra note 5, ¶ 13.02[2]-[3]. Capital gains preference, however, has been eliminated from the Code.
against an end-run around the repeal of the General Utilities doctrine. In existing regulations, the Service has indicated that:

Section 355 applies to a separation that affects only readjustment of continuing interests in the property of the distributing and controlled corporations. In this regard section 355 requires that one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation.

Thus, the Service has granted nonrecognition treatment to Section 355 spin-offs based on the fact that the shareholder's interest in the underlying assets remains in corporate solution, albeit in different percentages and in a different form.

To ensure that the shareholder's interest remains in corporate solution, the Service prohibits immediate sale of the subsidiary stock, relying on the restrictions in the device clause. Additionally, under the 1988 amendments to Section 355, a corporation which acquires control of the distributing corporation must be engaged in the active conduct of a trade or business for a period of five years from the date it received the parent's stock in a taxable transaction. Thus, the distributee corporation which acquires control of the target corporation must hold the target stock for five years before the Section 355 transaction in order to satisfy the continuity of interest requirement.

If, however, the distributing corporation does not acquire control of the target corporation in a taxable transaction, the issue becomes whether a similar five-year holding period applies. Prior to 1990, as a general rule, the purchaser must wait approximately two years before "spinning off" a controlled subsidiary.

112. Walter, supra note 99, at 975. See also Simon & Simmons, supra note 108. The Treasury currently is drafting regulations pursuant to its authority under Section 337(d) of the Code to prevent end-runs around General Utilities repeal.


114. Id. at § 1.355-2(d)(1).


116. Sheppard, Spin Cycle: Whither Section 355?, 38 TAX NOTES 109, 109 (Jan. 11, 1988). A shareholder with two years of stock ownership in the distributing corporation prior to the Section 355 exchange was considered a historic shareholder for continuity of interest purposes. Schler, Avoiding the Technical Requirements of New Section 355, 38 TAX NOTES 417, 417 (Jan. 25, 1988).

In certain circumstances prior to 1990, the distributing corporation may not have waited two years before receiving stock in the target's subsidiary in a Section 355 exchange. The statute only required a holding period in case of a controlling interest in the target corporation. Prior to the 1990 amendments, the distributee could purchase stock in a target and immediately effectuate a Section 355 spin-off or split-off of the desired subsidiary. For example, a purchaser could acquire approximately 60 percent of the target corporation stock, with no change in the remaining shareholders, and be immediately redeemed out without violat-
In 1990, Congress addressed whether a holding period of less than five years is sufficient in situations involving a less than controlling interest in the target. In amending Section 355(d), Congress statutorily requires a holding period of at least five years if immediately following the literal requirements of Section 355. *Id. But cf.* Sheppard, *supra,* at 111 (“In th[at] case it is hard to see how the corporation making the distribution can argue a business purpose for doing so, even if satiating a raider holds up as a business purpose. . . . It is likewise difficult to see how the investor can argue that the distribution is not a device for avoiding dividend treatment.”).

117. The 1990 revisions were part of the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11321(c), 1991 U.S. CONG. & ADMIN. NEWS (104 Stat.) 1162 (to be codified at I.R.C. § 355(d)). Section 355(d), in pertinent part, provides:

(d) Recognition of Gain on Certain Distributions of Stock or Securities in Controlled Corporation.—

(1) In general. In the case of a disqualified distribution, any stock or securities in the controlled corporation shall not be treated as qualified property for purposes of subsection (c)(2) of this section or section 361(c)(2).

(2) Disqualified distribution.—For purposes of this subsection, the term “disqualified distribution” means any distribution to which this section (or so much of section 356 as relates to this section) applies if, immediately after the distribution—

(A) any person holds disqualified stock in the distributing corporation which constitutes a 50-percent or greater interest in such corporation, or

(B) any person holds disqualified stock in the controlled corporation (or, if stock of more than 1 controlled corporation is distributed, in any controlled corporation) which constitutes a 50-percent or greater interest in such corporation.

(3) Disqualified stock.—For purposes of this subsection, the term “disqualified stock” means—

(A) any stock in the distributing corporation acquired by purchase after October 9, 1990, and during the 5-year period ending on the date of the distribution, and

(B) any stock in any controlled corporation—

(i) acquired by purchase after October 9, 1990, and during the 5-year period ending on the date of the distribution, or

(ii) received in the distribution to the extent attributable to distributions on—

(I) stock described in subparagraph (A), or

(II) any securities in the distributing corporation acquired by purchase after October 9, 1990, and during the 5-year period ending on the date of the distribution.

(4) 50-Percent or greater interest.—For purposes of this subsection, the term “50-percent or greater interest” means stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock.

(5) Purchase.—For purposes of this subsection—

(A) In general—Except as otherwise provided in this paragraph, the term “purchase” means any acquisition but only if—

(i) the basis of the property acquired in the hands of the acquirer is not determined (I) in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or (II) under section 1014(a), and
(ii) the property is not acquired in an exchange to which section 351, 354, 355, or 356 applies.

(B) Certain section 351 exchanges treated as purchases—The term "purchase" includes any acquisition of property in an exchange to which section 351 applies to the extent such property is acquired in exchange for—

(i) any cash or cash item,
(ii) any marketable stock or security, or
(iii) any debt of the transferor.

(C) Carryover basis transactions.—If—

(i) any person acquires property from another person who acquired such property by purchase (as determined under this paragraph with regard to this subparagraph), and
(ii) the adjusted basis of such property in the hands of such acquirer is determined in whole or in part by reference to the adjusted basis of such property in the hands of such other person,

such acquirer shall be treated as having acquired such property by purchase on the date it was so acquired by such other person.

(6) Special rule where substantial diminution of risk.—

(A) In general.—If this paragraph applies to any stock or securities for any period, the running of any 5-year period set forth in subparagraph (A) or (B) of paragraph (3)(whichever applies) shall be suspended during such period.

(B) Property to which suspension applies.—This paragraph applies to any stock or securities for any period during which the holder's risk of loss with respect to such stock or securities, or with respect to any portion of the activities of the corporation, is (directly or indirectly) substantially diminished by—

(i) an option,
(ii) a sale,
(iii) any special class of stock, or
(iv) any other device or transaction.

(7) Aggregation rules.—

(A) In general.—For purposes of this subsection, a person and all persons related to such person (within the meaning of 267(b) or 707(b)(1)) shall be treated as one person.

(B) Persons acting pursuant to plans or arrangements.—If two or more persons act pursuant to a plan or arrangement with respect to acquisitions of stock or securities in the distributing corporation or controlled corporation, such person shall be treated as one person for purposes of this subsection.

(8) Attribution from entities.—

(A) In general.—Paragraph (2) of section 318(a) shall apply in determining whether a person holds stock or securities in any corporation (determined by substituting "10 percent" for "50 percent" in subparagraph (C) of such paragraph (2) and by treating any reference to stock as including a reference to securities).

(B) Deemed purchase rule.—If—

(i) any person acquires by purchase any interest in any entity, and
(ii) such person is treated under subparagraph (A) as holding any stock or securities by reason of holding such interests,

such stock or securities shall be treated as acquired by purchase by such person on the later of the date of the purchase of the interest in such
est in the distributing corporation or a distributed subsidiary that is attributable to stock or securities that were acquired by purchase within the preceding five-year period. 118 Section 355(d)(6) suspends the five-year holding period whenever the holder's risk of loss with respect to such stock or securities, or with respect to any portion of the activities of the corporation, is (directly or indirectly) substantially diminished by an option, a short sale, any special class of stock (the so-called alphabet stock), or any other device or transaction.

3. Business Purpose Test

Additionally, there must be a valid business purpose, other than tax avoidance, for both the distribution of the controlled corporation stock to the distributee shareholders and the separation of the businesses. 119 Since Gregory v. Helvering, 120 both the Service and the courts have applied this concept in a rigorous manner, fearing that the corporation could use Section 355 to bail out earnings. To protect against a Gregory-type bailout, the regulations under Section 355 provide that a distribution will not meet the business purpose test if the business purpose can be achieved by another nontaxable transaction that does not involve a distribution of stock of a controlled corporation "and which is neither impractical nor unduly expensive." 121 The cases and regulations provide examples illustrating the requirement that there be a business purpose for the distribution as well as for the separation of the businesses. Although the Service requires that there must be a corporate business purpose and that a shareholder purpose will not suffice, 122 the courts' position may be unclear. 123 Recent examples of valid corporate business purposes include: (1) enhancing a

118. The 50 percent or greater interest test in Section 355(d) means stock or securities possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of all shares of all classes of stock. I.R.C. § 355(d)(4). Whether disqualified stock constitutes a 50-percent or greater interest is determined immediately following the distribution of stock (whether to that shareholder, or to other shareholders). In applying the 50-percent or greater test, all stock that the shareholder (including related parties) acquires after the effective date of the provision by purchase (or that is attributable to distributions on stock or securities acquired after the effective date by purchase), as that term is defined for purposes of this provision, is taken into consideration. Fed. Taxes 2d (P-H) § 3551, at 25,162-E (1990).

119. This requirement is reflected in the regulations, Treas. Reg. § 1.355-2(b)(3)(1990); the rulings, Rev. Rul. 69-460, 1969-2 C.B. 51; and the cases, see, e.g., Bonsale v. Commissioner, 317 F.2d 61 (2d Cir. 1963); Gada v. United States, 460 F. Supp. 859 (D. Conn. 1978).

120. 293 U.S. 465 (1935).


122. Treas. Regs. § 1.355-2(b)(2)(1990). However, a shareholder purpose which is "nearly coextensive with a corporate business purpose as to preclude any distinct-
corporation’s access to additional funds by borrowing or raising equity capital;124 (2) distributions to enable a key employee to acquire an equity interest in the operation of one or more of the corporation’s businesses;125 (3) facilitating a merger of the distributing or controlled corporation;126 and (4) reducing regulatory burdens.127

Although the regulations provide that qualifying either the distributing corporation or controlled corporation to make a Subchapter S election is not a proper business purpose presumably because the objective is tax avoidance,128 the regulations do not address whether preserving an existing S election is a valid corporate business purpose.129

B. Mobil-Esmark’s Exchange: Section 355 Split-off?

Assuming that all relevant businesses have been conducted for five years, that a valid business purpose for the exchange exists,130 and that the parties can avoid the step-transaction doctrine, the Mobil-Esmark exchange may qualify as a tax-free split-off under Section 355.131 The critical issue is whether the formal exchange agreement whereby Esmark was obligated to redeem Mobil’s shares the same day as the tender offer constitutes a prohibited device for the distribution of earnings or, alternatively, a violation of the continuity of interest requirement.

Under the factors listed in Revenue Ruling 83-38,132 the Service would attack the exchange for its tax avoidance purposes. The Service

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123. See Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir. 1962)(shareholder purpose may justify a spin-off even when there is no corporate business purpose).


126. E.g., King v. Commissioner, 458 F.2d 245 (6th Cir. 1972); Rev. Rul. 78-251, 1978-1 C.B. 89.


129. The Service recently refused to rule in one situation involving a spin-off designed to preserve an existing S election. Faber, supra note 125, at 881.

130. In Esmark, Inc. v. Commissioner, 90 T.C. 171, 192 (1988), aff’d, 886 F.2d 1318 (7th Cir. 1989), the court noted that the transaction served several important corporate, as well as shareholder, purposes. Esmark generated needed capital by significantly contracting its businesses, and a significant percentage of shareholders forever terminated their interests in the company.

131. If, however, Esmark flunks the requirements under Section 355, the corporation would be forced to recognize gain on the transaction under Section 311(b). It would have to recognize gain equal to the difference between its basis in the subsidiary stock distributed and the fair market value of such stock.

132. 1983-1 C.B. 76.
would allege that such tax avoidance purposes constitute a prohibited device for the distribution of earnings. Furthermore, the Service would contend that the existence of a formal exchange agreement violates the continuity of interest requirement; Mobil held Esmark for less than a day which is substantially less than the five-year holding period required by Section 355(d) for less than controlling interests. Thus, Mobil in order to effectuate a Section 355 split-off would be required to hold its Esmark shares for at least five years.

Although a split-off is theoretically possible, it is important to consider whether a split-off is a viable business option. If Mobil would have been required to hold its Esmark stock for the full five years before the Section 355 transaction occurred, the exchange may never have proceeded. Esmark would never have consented to Mobil acquiring 54 percent of Esmark shares if Mobil would have been able to exercise its majority shareholder rights for five years. Esmark would have been held captive by Mobil’s board of directors. Conversely, Mobil would have been in an awkward position because it did not want to buy into the management of a large holding company such as Esmark. Mobil only wanted to acquire Vickers’ assets in corporate solution. Thus, a five-year marriage between Mobil and Esmark would have been unacceptable to both parties.

In a smaller transaction, however, a five-year holding period may not pose a complete barrier to the consummation of the transaction. The distributing corporation may not be as sensitive to a new majority shareholder, and the acquiring corporation may not be as reluctant to assume majority shareholder duties for the five-year period. Thus, a union of smaller corporations or, in the alternative, similarly sized corporations on a smaller scale of ownership may make a better fit.

The distributing corporation may avoid the five-year holding period in Section 355(d) by acquiring less than a 50-percent interest in the target corporation. In those cases, a holding period of at least two years may be sufficient in order to qualify for tax-free treatment under Section 355.133

V. CONCLUSION

The Service and the courts repeatedly recharacterize certain taxpayer maneuvers to honor the underlying economic reality of the transaction. The step-transaction doctrine is a corollary of substance versus form arguments. The doctrine will treat a series of formally separate steps as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result. The doctrine will combine steps, but it should never be used to invent new steps.

133. See supra note 116.
The court in *Esmark* correctly refused to apply the step-transaction doctrine. Although the substantive result may at first blush seem incorrect, the court's decision is theoretically sound. Whenever a transaction satisfies the literal requirements of the Code and accepted judicial doctrine, the statute must be given full force and effect, even though that result may not have been contemplated by Congress or the Treasury. In such a situation, the form of the transaction should dictate the tax treatment. Otherwise, the value of certainty in the "art" of tax planning, in Judge Cohen's words, is irretrievably lost.

Although the nonrecognition provision used in *Esmark* was eliminated in 1986, Mobil-Esmark type transactions may qualify as a tax-free split-off under Section 355 of the Code. In order to qualify under Section 355, the acquiring corporation may be required to hold its stock in the distributing corporation for at least five years. Such a holding period may pose problems to both corporations.

Heartened by the spirit of the *Esmark* decision, tax practitioners may offer creative tax planning opportunities to their corporate clients if the transaction complies with the literal requirements of the Code. Perhaps *Esmark* represents the triumph of form over substance if all the literal requirements of the Code are satisfied.

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