CELEBRATING 55 YEARS

Step transaction doctrine and how it applies to 1031 exchanges - by Lynne Bagby

May 27, 2022 - Spotlights

Lynne Bagby

As taxpayers across the country, including New England, continue to review their investment real estate portfolios, many often decide that participating in a 1031 exchange for tax deferral when selling and buying their real property is a beneficial action for them to take. However, sometimes the taxpayer's plans present obstacles that must be considered in situations presented below when taking advantage of this tax code, so care must be taken when preparing for the sale, purchase and use of Section 1031.

The step transaction doctrine is a common law principle and is part of the general tax concept that substance should control over form. In using this doctrine, a series of separate transactions is recharacterized as a single transaction for tax purposes. The doctrine is applied to prevent tax abuse; and is often used in combination with other doctrines such as the business purpose doctrine.

The step transaction doctrine applies in cases when a taxpayer wants to get from point A to point D and does so by taking otherwise unnecessary steps at points B and C. The entire purpose of steps B and C is to achieve a tax consequence differing from the tax consequence of a direct path from A to D. In these situations, courts may disregard the intervening steps and collapse the path taken by a taxpayer and instead focus on the intended economic result. Under the doctrine, "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus linking together all interdependent steps with legal or business significance, rather than looking at each step in isolation, federal tax liability may be based on a realistic view of the entire transaction." are three tests for applying the step transaction doctrine: (1) the mutual interdependence test, (2) the end result (or, intent) test, and (3) the binding commitment test.

The "Mutual Interdependence Test": Under the mutual interdependence test, a series of transactional steps will be collapsed if the steps are so interdependent that the legal relationship created by one step would have been fruitless without completion of the entire series of steps. This test looks at the relationship between the steps. In other words, the question is whether or not the transactional steps are so interdependent that none of the transactional steps would have happened without the other transactional steps occurring.

The mutual interdependence test generally applies to transactions that are between related parties. To reduce the risk of attack under the mutual interdependence test, each transactional step should have its own independent business purpose and substance independent of the other steps.

The "End Result Test (or Intent Test)": Under this test, purportedly separate transactions will be amalgamated into a single transaction when it appears they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result. A prerequisite to the application of the end result test is proof of an agreement or understanding between the transacting parties to bring about the ultimate result. The step transaction doctrine can apply under the end result test only if the taxpayer intended a sole outcome when entering into a series of transactions and if no other outcome can be discerned.

Courts have taken the position that step transaction doctrine may not apply under the end result test where the form of the ultimate transaction is not known at the time of entering into the initial transaction. Each step, on its own, should have economic significance and risk to withstand attack by the courts.

The “Binding Commitment Test”: The step transaction doctrine will apply under this test if, at the time of the first transactional step, there was a binding commitment to undertake a later step and a substantial period of time has passed between the transactional steps under evaluation. The analysis under this test typically considers whether there’s documentary evidence of such a commitment.

For tax planning, the taxpayers who want to bolster their position that a series of transactions are independent transactions to withstand a potential attack involving the step transaction doctrine should consider some of the factors below and seek advice from tax and legal advisors.

• Each transaction should have independent economic substance and accomplish its own separate business purpose.

• There should not be any agreement or mutual understanding with other taxpayers regarding the final result of a prearranged and coordinated plan.

• There should not be a commitment at the time of the first transaction to complete other transactions later on.

• A taxpayer should not attempt to disguise the ultimate economic objective through multiple transactions.

• Each transaction should have separate significance, risk, and economic substance.

• A transaction should not involve only related parties.

Finally, a taxpayer should be aware that there is always the possibility a court will consider a series of transactions occurring over a short period of time as a single economic transaction involving a series of multiple steps. A taxpayer should review any proposed transaction or series of transactions with their tax and/or legal advisors.

Lynne Bagby, CES is the New England division manager for Asset Preservation, Inc., Boston, Mass.