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No. 92/69

TO COUNTY ASSESSORS:

STEP TRANSACTION DOCTRINE

Shuwa Investments Corp. v. County of Los Angeles
(1991) 1 Cal.App.4th 1635

This letter clarifies the position of the State Board of Equalization on the step transaction doctrine in light of the December 1991 decision of the California Court of Appeal in Shuwa Investments Corp. v. County of Los Angeles.

One of the basic foundations of tax law is the principle that the substance rather than the form of a transaction is controlling. Without this basic principle, all tax laws could be easily frustrated or avoided. The step transaction doctrine is the result of the application of this basic principle to certain multiple step transactions. The doctrine was developed by the federal courts to prevent taxpayers from avoiding federal income tax through the use of a series of transactions which, in form, individually and in sequence either avoid or limit the tax consequences of the taxpayer's actions. When applying the doctrine, the courts have looked through the form of these transactions to their true substance and have ignored some of the steps ("collapsed" or "stepped" them into a single transaction) for tax purposes. Thus, when the propriety and necessity for a multi-phase transaction is challenged, the step transaction doctrine has been applied to determine whether the transaction should be treated as a single whole or whether each step of the transaction may stand alone.

The leading case in this area is Gregory v. Helvering (1935) 293 U.S. 465. See also: Commissioner of Internal Revenue v. Court Holding Co. (1945) 324 U.S. 331. While the doctrine was developed and is primarily utilized in the federal courts, the concept has been recognized by the California courts in various contexts. See W. E. Hall Co. v. Franchise Tax Board (1968) 260 Cal.App.2d 179.

Since the adoption in 1978 of Proposition 13 and the enactment of various provisions of the Revenue and Taxation Code relating to change in ownership, the step transaction doctrine has been recognized by both the California Legislature and the California courts. The first acknowledgment of the

need to confront potential step transactions taken by taxpayers in order to escape reappraisal is found at page 27 of the Assembly Revenue and Taxation Committee Report, "Property Tax Assessment," dated October 29, 1979. In 1987, when implementing the exclusion from change in ownership for certain parent/child transfers of real property (Proposition 58), the Legislature expressly stated that "Except as provided herein, nothing in this section shall be construed as an expression of intent on the part of the Legislature disapproving in principle the appropriate application of the substance-over-form or step transaction doctrine." (Section 2, Chapter 48, Statutes of 1987; Assembly Bill 47.)

It has been the position of the Board's staff, since as early as 1981, that the step transaction doctrine is applicable to real property transfers involving change in ownership issues. In recent years, the staff has generally advised that where a taxpayer utilizes a series of transfers or steps to effect a transfer which might otherwise have been accomplished by fewer transfers or steps, it is recommended that the county assessor disregard any steps in the transaction which the assessor concludes are not supported by a business purpose other than avoiding higher property taxes. Under this formulation, the ultimate decision as to the application of the step transaction doctrine was left to the discretion of the county assessor. As explained below, this statement no longer reflects the position of the Board.

The first reported instance of a California court applying the step transaction doctrine in a change in ownership situation occurred in Aden v. Lynch which was decided by the California Court of Appeals on May 31, 1990 (220 Cal.App.3d 1429). This case involved the transfer of an apartment house owned by a corporation in which two shareholders each owned 50 percent of the shares. The corporation transferred a one-half interest in the property to each shareholder and, on the same day, one shareholder purchased the interest of the other. Applying the step transaction theory, the county reassessed 100 percent of the property on the ground that the transactions were, in substance, a transfer of the property from the corporation to one stockholder. Based upon testimony that the stockholder wished to acquire the property free of any corporate liabilities, the trial court found there was an independent business purpose for the steps taken and that the step transaction doctrine did not apply. The court of appeals sustained the trial court, finding that the step transaction doctrine did not apply unless there was no valid economic or business purpose for the step sought to be disregarded. It concluded that as long as there was a valid economic or business purpose it was unimportant that one motive was the reduction of taxes. This decision has no precedent value, however, because it was ordered decertified for publication by the California Supreme Court on August 16, 1990. As a result, the court's views regarding the protective effect of an economic or business purpose are not legal precedent.

Fortunately, the court of appeals decision in Shuwa is now final and provides, for the first time, guidance on the application of the step transaction doctrine to property tax change in ownership issues. This case involved the question of whether the acquisition of the ARCO Plaza office complex in downtown Los Angeles resulted in a 50 percent change in ownership, as contended by the taxpayer, or a 100 percent change in ownership, as contended by the county. Applying the step transaction doctrine, the court agreed with the county.

ARCO Plaza was owned by a partnership in which ARCO and the Bank of America were equal partners. In July of 1986 Shuwa offered to buy 100 percent of the property. ARCO refused because of unfavorable income tax consequences, indicating that it would only sell its partnership interest. The parties then executed a letter of intent for Shuwa to purchase all of the partnership interests. The letter also indicated an intent to minimize the property tax change in ownership effects. The parties then entered into a sale agreement reflecting a three-step transaction in which (1) ARCO would sell its partnership interest to Shuwa; (2) the Bank of America and Shuwa, as equal partners, would liquidate the partnership and each receive a 50 percent interest in the property; and (3) the Bank of America would sell its 50 percent interest in the property to Shuwa. This three-step transaction was carried out on September 15-16 and Shuwa paid a total of $620,000,000. Both the assessment appeals board and the trial court sustained the 100 percent reassessment of the property by the county.

The court of appeals recognized that if each one of the three steps was separately analyzed and allowed to stand alone, there would be only a 50 percent change in ownership. Applying the step transaction doctrine, however, the court concluded that the substance of the transaction was the acquisition of the ARCO Plaza property by Shuwa, a 100 percent change in ownership.

In its review of the step transaction doctrine, the court noted that the commentators have attempted to reduce the many court decisions on this subject to several bright line tests in order to determine whether the step transaction doctrine is applicable. Citing authority which suggests that different tests may be applicable in different contexts, the court applied three "relevant" tests to the transactions in this case and concluded that under each test the three transfers should be "stepped" together to reveal what actually occurred, the acquisition by Shuwa of 100 percent of the ARCO Plaza.

The three tests applied were:

(1) The "end result test" (whether the reported separate transactions were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result).

2) The "interdependence test" (whether on a reasonable interpretation of objective facts the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series).

(3) The "binding commitment test" (whether there is a binding commitment to take all steps if the first step is taken).

The court emphasized that in applying these tests, the step transaction doctrine is only a judicial device expressing the familiar principle that in applying tax laws the substance rather than the form of the transaction is controlling.

Shuwa argued that the step transaction doctrine should not be applied in this case because independent business considerations, apart from avoidance of property tax, motivated the transactions. In rejecting this argument, the court expressed serious doubt as to whether an independent business reason may protect a transfer from the step transaction doctrine. For example, the court questioned (without deciding) whether avoidance of additional federal income tax liability may be a legitimate business purpose and, in footnote 17, it is noted that the law is unclear as to the relationship between the step transaction doctrine and the business purpose requirement. It quoted a statement that no case has been found holding that the existence of a business purpose precludes the application of the step transaction doctrine. The court concluded by stating "We cannot describe with precision exactly which combination of business exigencies would justify upholding form over substance, but we do know this is not such a case."

The various documents prepared by the attorneys for the parties to this transaction painted such a clear picture that the court had little trouble determining what the true substance of the transaction was. Further, the court seemed convinced that to allow Shuwa to acquire this $620 million property without a 100 percent reappraisal would violate the intent of the change in ownership statutes. It should be recognized that many transactions are not so well documented and the true substance is not so clear. It remains to be seen how the courts will deal with those transactions in light of the Shuwa decision.

Shuwa applied three tests in making its determination and concluded that all three were satisfied under the facts before the court. Unfortunately, the decision does not make clear whether the step transaction doctrine may be applied if only one of the tests is satisfied, if two out of three tests is satisfied, or whether all three tests must be satisfied. The only indication of the court's thinking on this issue seems to be the reference to an authority suggesting that different tests are applicable in different contexts. This suggests that not all of the three tests need to be applied in each case in order to establish a basis for the step transactions doctrine.

Perhaps the most significant aspect of the Shuwa decision is the rejection of the argument that the step transaction doctrine should not be applied because each of the steps was supported by independent business considerations apart from property tax avoidance. The court's analysis, including its statement regarding the question of whether avoidance of federal income taxes is a legitimate business purpose and the footnote quotation stating that no case holds that the existence of a business purpose precludes application of the step transaction doctrine, suggests that an independent business purpose does not provide protection against the application of the step transaction doctrine. These statements are, of course, clearly inconsistent with the traditional position of the Board's staff as described above. In light of the court's statement, it is no longer appropriate to recognize business purpose as a protection against the step transaction doctrine where the substance of the transaction falls within the intent of the statute. The decision does not address the issue of what role business purpose may play where the substance is not as clearly established as it was in this case. That issue must, apparently, await further judicial clarification.

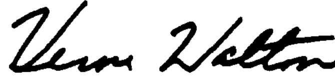
The lessons of the Shuwa decision seem to be that first, and foremost, the substance of the transaction rather than its form is controlling for tax purposes when the substance demonstrates a transaction which falls within the intent of the taxing statute. If the true substance of the transaction is clear, its tax effect cannot be avoided simply by the fact that the taxpayer is able to demonstrate an independent business purpose for each of the individual steps. Finally, the assessor may be assisted in his analysis of the transaction by applying one or more of the three analytical tests described in the Shuwa decision.

There is an exception to the rule that substance over from controls. Substance over form does not apply when a taxpayer selects a form which results in a change in ownership consistent with the apparent legislative intent of the statutes. In footnote 13 of the Shuwa decision, the court rejected the taxpayer's argument that each of the individual steps of the transactions should be allowed to stand on its own based upon a number of recent appellate court decisions which have declined to accept taxpayer arguments that the change in ownership consequences should be determined by the substance rather than the form of the transaction. In those cases, the courts refused to look beyond the individual steps of the transactions to ultimate control in determining whether a change in ownership has occurred. The court noted that, in these cases, giving the precise statutory language its full effect as applied to the form of the transaction resulted in a finding of change in ownership and subjected the property to reappraisal. Thus, when the form chosen by the taxpayer results in reappraisal, the language of the statute will be given full effect. Arguments that the true substance of the transaction avoids reappraisal have not been accepted because they are not consistent with the apparent intent of the statute.

It is the position of the Board, therefore, that future step transaction decisions should be made by assessors based upon all of the facts of each transaction. If those facts demonstrate that in substance a change in ownership occurred, then the transaction should be treated accordingly. The existence of independent business purposes for the various steps will not prevent the application of the step transaction doctrine. Finally, the assessor may be aided in determining what the true substance of the transaction was by applying the (1) end result test, (2) interdependence test, and/or (3) binding commitment test, as set forth in the Shuwa decision.

If you have any questions concerning the application of the step transaction doctrine, please contact our Real Property Technical Services Unit at (916) 445-4982.

Sincerely,



Verne Walton, Chief
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