The Step Transaction Doctrine

Under the step transaction doctrine, "a series of transactions designed and executed as parts of a unitary plan to achieve an intended result ... will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation." FNMA v. Commissioner, 896 F.2d 580, 586 (D.C. Cir. 1990), cert. denied, 499 U.S. 974 (1991) (citing Kanawha Gas & Utilities Co. v. United States, 214 F.2d 685, 691 (5th Cir. 1954)); see also Minnesota Tea v. Helvering, 302 U.S. 609, 613 (1938) ("[a] given result at the end of a straight path is not made a different result because reached by following a devious path").

Courts have applied three alternative tests in deciding whether to invoke the step transaction doctrine: (1) the "end result" test, under which the transaction will be collapsed if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result, see King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969); (2) the "mutual interdependence" test, which focuses on whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series," Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980), cert denied, 450 U.S. 913 (1981); and (3) the "binding commitment" test, under
which a series of transactions is collapsed if, at the time the first step is entered into, there was a binding commitment to under take the later step. See Commissioner v. Gordon, 391 U.S. 83, 96 (1968).

In this case, the payment by the US OpCos of the full list price of merchandise followed by the repayment to each US OpCo of the difference between the full list price and the negotiated discount price (“the Spread”) qualifies for application of the step transaction doctrine under at least two of the three tests. As stated above, under the end-result test, purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction, each intended from the outset to be taken for the purpose of reaching the ultimate result. In this case, the US OpCos paid the full list price of merchandise only as a component part of a single overall transaction, which included the repayment to each US OpCo of the difference between the full list price and the negotiated discount price. All parties – including the OpCo, the Supplier, and the Parent – knew the precise bottom-line price of each item on the day the order was placed. The Taxpayer has stated that the implementation of its ordering system was largely driven by a desire to reduce costs to the OpCos. Higher volume of centralized ordering would result in deeper discounts; thus, the Taxpayer acted to induce the OpCos to place more centralized orders. To this end, the Taxpayer’s ordering system provided each OpCo with accurate, real-time pricing information to enable the OpCos to compare the benefits of centralized ordering vs. independent purchases. The OpCos understood that their actual COGS would be the Negotiated Discount Price, not the List Price. Thus, the end result test is satisfied.

The mutual interdependence test focuses on whether the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. This test concentrates on the relationship between the steps, rather than on the end result. The inquiry here is whether the US OpCos would have paid full list price for merchandise without assurances that the Spread would be returned to them, thus ensuring that the true price was the Negotiated Discount Price. Again, a large part of the reason for the OpCos’ use of the centralized ordering system was the economies of scale that resulted in greatly reduced prices. Further, the OpCos had the opportunity, which they sometimes exercised, to negotiate their own discounts from suppliers. However, because of the large volume of business transacted by the OpCos as a whole, the centralized price generally reflected deep discounts. The OpCos knew that the Negotiated Discount Price would be the “real” price of any item, and the OpCos planned accordingly. As the Taxpayer argues, the deep discounting that centralized purchasing provided was a key to the success of the OpCos. The OpCos simply would not have paid full list price. Rather, they would have resorted to seeking their own discounts. Thus, the mutual interdependence test is satisfied.

The third test, the binding commitment test, is the most restrictive and generally forbids the use of the Step Transaction Doctrine unless there is a binding commitment to take the later steps. The facts at issue appear to satisfy application of the Step Transaction Doctrine. The Taxpayer provided each of its OpCos with price lists that reflected the
negotiated discounts that had been obtained for group members. The suppliers were legally bound by their agreements with the Taxpayer. Thus, after refunds/rebates, the suppliers received a net price equal to the Negotiated Discount Price. Further, as noted above, OpCo ordering personnel had these price lists in the hands at the time that the orders were placed, and the OpCos acted in reliance on the information provided by the Taxpayer. If the OpCos had not received their promised refund/rebate payments, those OpCos presumably would have legal standing to compel payment.

The Step Transaction Doctrine applies as long as the criteria of one of the tests are satisfied. Under any of the three applicable tests, the US OpCos’ payment of the full list price and the subsequent repayment to the US OpCos of the Spread between the full list price and the negotiated discount price loss must be integrated and treated as a single transaction. Accordingly, the OpCos cannot deduct as COGS the full list price of the merchandise ordered. Rather, they will be limited to the negotiated discount price (i.e., the full list price minus the refund/rebate received).

Please call (202) 622-7530 if you have further questions.