The 'Step-Transaction' Doctrine

Take-Away: The IRS's assertion of the *step-transaction* doctrine is a tax trap that can be planned for, and around, with forethought and attention to details.

Background: Estate planning usually involves the transfer of asset at some point in time. However, sometimes the IRS will not respect the transfer of assets, or more accurately will seek to impose the gift tax on a transfer that otherwise would be sheltered from the gift tax by the transferor's applicable exemption amount. One 'tool' the IRS uses to impose the federal gift tax is the *step-transaction* doctrine. In effect, the IRS will compress several steps related to the transfer of assets, finding them to be prearranged and interdependent resulting in the transferor being treated as having made a larger taxable gift than would otherwise appear on the face of the transaction(s.)

Example: An example of the *step-transaction* doctrine is the 2021 Tax Court decision, *Smaldino v. Commissioner. Tax Court Memo, 2021-127 (2021),* which was summarized 3 years ago in a prior missive. Mr. Smaldino owned substantial wealth in his own name. His second wife only held title to assets jointly with her husband. Their estate planning goal was for them to make lifetime gifts fully using both of their then, combined, available applicable exemption amounts to shelter the lifetime gifts from federal gift taxation. Mr. Smaldino gave Mrs. Smaldino interests in a family limited liability company (FLLC). His gift to his wife was sheltered by the unlimited marital deduction. However, the very next day Mrs. Smaldino transferred those gifted FLLC units to a trust that Mr. Smaldino had established for his children from a prior marriage. The IRS claimed that the *step-transaction* applied to the gifts by Mrs. Smaldino, the result of which was that Mrs. Smaldino's gift was treated as having been made by Mr. Smaldino. The Tax Court agreed with the IRS. The Court found that Mrs. Smaldino did not make the gifts; rather, it was more appropriate to treat Mr. Smaldino as having made the taxable gifts to the trust for his children. Accordingly, since Mr. Smaldino had already used his available applicable exemption amount when he transferred his own FLLC units to the trust for his children, he was held to have made a taxable gift to the trust (his wife acting as his agent) which resulting in a large federal gift tax liability that had to be paid since he had fully used his own applicable exemption amount when he funded the trust with his own FLLC units.

Interdependent Steps: When applying the *step-transaction* doctrine, the federal courts often conclude that the steps involved were both prearranged and interdependent. In *Linton v United States, 638 F. Supp. 1277 (W.D. Wash), reversed in part at 630 F.2d 1211 (9th Circuit, 2011),* the Court looked at an LLC that was funded with several assets, where LLC units were gifted the very same day to a trust. The Court noted that the transferors would not have undertaken the initial step of funding the LLC without the subsequent integrated act of gifting the LLC units to the trust. From these facts, the Court found that there were *no real economic risks during the time between the steps,* which entitled the Court to recast the transferor's plan.

SLATs: We know that there is a lot of interest in spousal lifetime access trusts (or SLATs) these days. Maybe less so now that the election is behind us and Republicans control the federal government. With that caveat in mind, the *step-transaction* doctrine can still impact non-reciprocal SLATs funded by spouses, especially when one spouse gifts assets to the other, and the other spouse then gifts those assets to a SLAT for the transferor's lifetime benefit. Note that the *step transaction* doctrine is not the same thing as the *reciprocal trust* doctrine we have covered in the past-they are different, but the negative result can be the same.

If the *step-transaction* doctrine is applied to the steps of the intra-spousal gift, followed by the funding of a SLAT for the original transferor's lifetime benefit, three negative consequences could result:

(i) the original transferor may end up paying a gift tax if he/she had previously fully used their applicable exemption amount (as in *Smaldino*);

(ii) the SLAT created for the transferor's benefit could be classified as a self-settled trust, thus exposing its assets to creditor claims of the transferor-spouse; and

(iii) the IRS could claim that IRC 2036 applies to that SLAT, treating it as a lifetime gift to a trust with a retained interest by the transferor, which will then cause the SLAT's assets to be included in the transferor's-SLAT beneficiary's gross estate at death.

Planning Steps: To avoid the IRS applying the *step-transaction* some precautionary plans should be considered whether in funding a SLAT or any other irrevocable trust when assets originally came as a gift to the subsequent transferor/settlor.

1. **Create Time Intervals:** Put some time between the separate steps, so that each step can stand independently on its own. This addresses the 'test' the *Linton* court applied which is that there should be *significant economic consequences* associated with each step, meaning each step could stand alone as the *final step,* without the need for further steps. For example, with a SLAT, it would be best to have the intra-spousal gift occur in one calendar year and the funding of the SLAT occur in a following calendar year so the time between the 'steps' is substantial, and not the same day (*Linton*) or the next day (*Smaldino.*)

2. **Change the Nature of the Transferred Assets:** Commingle the gifted/transferred assets with other assets owned by the transferee, so the same 'assets' are not in each of the transfer-steps. The nature of the asset can change from the initial gift/transfer to the following transfer of assets to the trust. The volatility of the underlying assets thus changes with the nature of the assets. Accordingly, there is genuine economic risk between the two steps, a fact which has been relied on by courts in the past to decline to apply the *step-transaction* doctrine. See *Holman v. Commissioner, 130 Tax Court 12 (May 27, 2008.)* In short, differentiate the character of the funds from those that were originally received.

3. **Manifest Control:** The transferee of the gifted property should take steps that manifest his/her own control of the property before the second transfer/gift is made. Perhaps the subject of the gift is invested with other assets in the transferee's portfolio. Or the transferee initially places the gifted assets in an LLC, and then later transfers LLC units to the trust.

4. **Adhere to Organizational Formalities:** Stick to formalities. If a gift of LLC units is made, the LLC's operating agreement should be promptly amended to reflect the new member of the LLC, even if the LLC units are later to be gifted by the 'new' LLC member. This was an important omission in the *Smaldino* decision

that the Tax Court pointed out, where the Court felt comfortable concluding that Mrs. Smaldino was acting as her husband's agent (and not using her own available applicable exemption amount.)

5. **Consistency in Tax Reporting:** One of the facts the Court seized on in *Smaldino* was that no K-1 was ever issued to Mrs. Smaldino, even though she was technically an LLC member (albeit for only one day.) If time is intentionally created in between the steps involved and an income asset is the subject of the transfers , the transferee should receive and report his/her share of the income, and not be skipped over.

6. **Avoid Circularity:** If the transferor gifts a specific percentage of an asset or entity, e.g., 37% of LLC units, the transferee's later gift/transfer to the trust should be a different percentage. If cash is the subject of the first transfer, avoid using the same amount of cash when the trust is funded in the second transfer, or better yet, invest the cash in a stock portfolio, and then use the portfolio as the subject of the second transfer.

Conclusion: When thinking about any transfer tax strategy that uses a lifetime gift, whether it is to a SLAT or any other transfer to an irrevocable trust, the potential assertion of the *step-transaction* doctrine always needs to be in the back of the mind of the planner and his/her clients. It can be avoided with advance planning, yet it is more apt to occur if there is haste in putting the plan in place. Time and following formalities are the best protection from the *step-transaction* doctrine.

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