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Lessons from *Smaldino v. Commissioner*: The consequences of rushed planning

Market Trend: The “step transaction” doctrine is alive and well. In the foot-race to beat potential tax law changes, families often miss the forest from the trees. Here the IRS shows it will carefully review prearranged transfers using a straw man. The economic realities and entity formalities must be respected in the execution of a gift transaction.

Synopsis: On November 10, 2021, the Tax Court rendered its decision in the case of *Smaldino v. Commissioner*, which involved a purported gift of LLC interests by Mr. Smaldino to his wife, followed by a purported gift of the same LLC interests, the very next day, from Mrs. Smaldino to a dynasty trust for the sole benefit of Mr. Smaldino’s children from a prior marriage. The Court found a series of ignored formalities, and that as a practical matter there was never a time when Mrs. Smaldino would have been able to effectively exercise any ownership rights with respect to the LLC interests “given” to her. The Court held that Mr. Smaldino never effectively transferred any LLC interest to Mrs. Smaldino, and consequently the dynasty trust received its entire LLC interest from Mr. Smaldino, creating a taxable event.

Take Aways: This case is more about what it doesn’t say. Slow down and take your time. Do not wait until the last minute to effect complex or even seemingly simple gifting transactions. The Golden Rule of tax planning: treat each step of a transaction how you would want the IRS to treat it. The requisite formalities must be followed for each step of a multi-step transfer to ensure that the step is respected. Optics matter, and the donee needs to truly own the interest they are gifting.

The *Smaldino* case provides valuable lessons on structuring and implementing multi-step gifts. The case stresses the importance of formalities. The lessons from the *Smaldino* case are especially relevant coming off of 2021 where numerous transactions were completed on a compressed timeline because of potential, looming tax legislation and will continue to be relevant as we approach the sunsetting of the federal estate tax exemption on December 31, 2025.

What Really Went Wrong in Samldino

The Court noted that, "[i]t is well established that the substance of a transaction, rather than the form in which it is cast, determines the tax consequences unless it appears from an examination of the statute and its purpose that form was intended to govern." Using this "substance over form" analysis, the Court looked at the LLC operating agreement requirements for the transfer of membership interests, the timing of the transaction, the intent of the parties, as well as the income tax returns of the LLC. This analysis was a functional extension of the "step transaction" doctrine as the Court looked at arguments to compress the steps and treat the entire gift as made by Mr. Smaldino.

The pertinent facts in *Smaldino* include:

- Mr. Smaldino placed 10 Southern California rental properties into Smaldino Investments, LLC ("LLC"), which he owned through his revocable trust.

- In 2013, he transferred about 8% of LLC class B member interests to the Smaldino 2012 Dynasty Trust (the "Dynasty Trust"), an irrevocable trust for the benefit of his children and grandchildren (from a prior marriage).

- Around the same time, Mr. Smaldino transferred about 41% of the LLC class B member interests to his wife, who retransferred them to the Dynasty Trust the very next day.

- On his 2013 Federal gift tax return, Mr. Smaldino reported a taxable gift to the Dynasty Trust of $1,031,882, described as "INTEREST IN SMALDINO INVESTMENTS, LLC." He did not elect to split the gift.

- On her 2013 Federal gift tax return, Mrs. Smaldino reported a taxable gift to the Dynasty Trust of $5,249,118, described as "INTEREST IN SMALDINO INVESTMENTS, LLC." She did not elect to split the gift.

The Court noted that the transfer of LLC membership interests to Mrs. Smaldino should not be respected.

The So-Called Transfer

- Nothing in the record suggests that Mrs. Smaldino ever executed any instrument adopting the terms and provisions of the LLC operating agreement or otherwise suggests that under the terms of the operating agreement she would have received anything more than an assignee's interest in the LLC as a result of the so-called transfer.

- The record does not suggest that Mr. Smaldino, in his capacity as trustee of the Dynasty Trust or manager of the LLC, gave express or implied consent for the admission of Mrs. Smaldino as a LLC member.

- The ownership schedule of the operating agreement of the LLC was never amended to show that Mrs. Smaldino held any membership interest.

Intent

Mr. Smaldino testified that he intended for the properties in the LLC to be divided among his children, as beneficiaries of the Dynasty Trust, and that Mrs. Smaldino would receive a larger share of assets that were "outside the LLC." Mrs. Smaldino testified that before the purported transfer she had already made "a commitment, promise" to her husband and family that she would transfer the LLC units to the Dynasty Trust. When asked on direct examination whether she could have changed her mind if she had wanted to, she responded, "[n]o, because I believe in fairness."

The Court did not believe that Mr. Smaldino ever intended Mrs. Smaldino to be a member of the LLC, i.e., it was not a real gift; he just wanted access to her exemption before the law changed.

Income Tax

While Mrs. Smaldino was the purported owner of the membership interests for only one day, the Court noted that on the LLC's 2013 partnership tax return, Mrs. Smaldino was not even reported as being a (tax) partner at any time. Why should the Court respect a transfer that no one else did?

What the Court Held

The Court concluded that Mr. Smaldino never effectively transferred any membership interest in the LLC to Mrs. Smaldino and consequently the Dynasty Trust received its entire 49% of the class B membership interests as a gift from Mr. Smaldino.[1]

Lessons to be Learned

Smaldino provides practitioners a roadmap to avoid the application of the "substance over form" doctrine in completing a multi-step gift.

Entity Formalities. It is imperative that clients follow the formalities in an entity's governing documents when conducting estate planning transactions.

Timing. Timing is very important when conducting an estate planning strategy. For instance, in Smaldino, the recipient spouse should have retained the transferred assets long enough to show economic ownership. There is no magic number for how long the donee spouse must hold the property, but one day is clearly too short.

Income Tax. The documentation that the lawyers draft needs to match what is reported on the income tax returns. This requires coordination between advisors.

[1] The Court also ruled on the valuation of the 49% Class B Member Interest, but such holding is outside the scope of this article.

Breadcrumbs. Avoid correspondence that provides a negative color to the program.

The Impact of Smaldino

The lasting impact of *Smaldino* will be in the following contexts:

Blended Families. In *Smaldino*, the Dynasty Trust was for the benefit of Mr. Smaldino's descendants from a prior marriage. This made Mrs. Smaldino's use of (nearly) all her exemption suspicious. Optics matter: Mrs. Smaldino was making a gift to "his" kids.

- In the context of a blended family where the donee spouse is not the parent of the children benefited by a gift, the use of gift-splitting may be preferential. Probably a big miss.

SLATs. A Spousal Lifetime Access Trust ("SLAT") allows one spouse to establish a trust for the benefit of the other spouse (and descendants). In the *Smaldino* case, the IRS victory resulted in a gift tax liability; however, the result could be more severe with a SLAT.

> **Example 1**: Assume the same facts as *Smaldino*, except that the Dynasty Trust was a SLAT for the benefit of Mr. Smaldino and his children. Once the IRS recharacterized the transfer as an indirect gift made by Mr. Smaldino, the transfer would result in an irrevocable gift to a trust for his own benefit. Generally, this would either invalidate the trust and/or cause estate tax inclusion of the purportedly transferred assets.[2]

The extent of this problem can be amplified with the inclusion of life insurance in a SLAT (or any other trust with an inherent *Smaldino* problem).

> **Example 2**: Same facts as Example 1, except prior to an IRS challenge, the Dynasty Trust purchases a $20 million life insurance policy on the life of Mrs. Smaldino. The IRS then challenges the gift to the Dynasty Trust and determines that Mr. Smaldino, in fact, made an indirect gift to a trust for his benefit. Not only the initial gift, but also a large life insurance policy, is likely includible in Mr. Smaldino's estate.

Observation: SLATS and Dynasty Trusts are usually first or second to die ILITs. Before acquiring life insurance in an existing SLAT or Dynasty Trust, it might pay to understand the funding behind it.

Additional Caveat Regarding Community Property: When dealing with assets that are or may be community property (California, Texas), it is advisable to enter into a transmutation agreement to ensure the assets are titled as desired to complete the transaction. This additional step may require even more time to effectuate a proper gifting strategy. Again, timing the event is critical.

[2] There are currently nineteen states that allow for some form of self-settled domestic asset protection trusts. A discussion of such statutes is beyond the scope of this article.

Take Aways

Slow down and take your time. Taxpayers must respect the form and the substance of each step of their transactions. Entity formalities must be followed, and each step must have economic substance to ensure that the step is respected. If you or your clients are planning on making large multi-step transfers prior to the sunset of the increased exemption in 2025, do not wait until the last minute, it is advisable to start the process now.

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