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From: Steve Leimberg's Estate Planning Newsletter
Subject: Thomas A. Tietz, Louis S. Harrison, Jonathan G. Blattmachr & Martin M. Shenkman on

Smaldino: Lessons to Consider on Structuring and Implementing Estate Planning

"Smaldino, a recent Tax Court decision, provides several important lessons for practitioners to consider about how to approach structuring and implementing estate plans for certain clients, especially for clients that practitioners did planning for during the rush throughout 2020 and 2021, where many clients came to practitioners fearing dramatic changes in the tax laws and who completed planning in a compressed time frame. While Smaldino can be viewed as just another bad fact case (leaving aside the valuation discussions), that would be a mistake. It provides good reminders of formalities that too often are overlooked. Even if harsh changes are not enacted (few of the proposals regarding changes to the estate and gift taxation system were included in the bill just passed by the House), if you have clients in the process of completing planning, you should consider communicating with your clients about heeding the lessons provided in Smaldino."

Thomas A. Tietz, Louis S. Harrison, Jonathan G. Blattmachr and Martin M. Shenkman, provide members with their analysis of Smaldino v. Commissioner.

Thomas Tietz, JD, is an Associate with Shenkman Law. He is experienced in assisting with the implementation of all facets of an estate plan, including the preparation of core documents such as the Last Will and Testament, Health Care Proxy, Durable Power of Attorney, to the more advanced techniques of an Irrevocable Life Insurance Trust, Grantor Retained Annuity Trust, self-settled Trusts, and the implementation of asset transfers to those trusts, depending on the client's needs. In addition to Estate Planning, he assists clients with estate administration, including the organization of the documentation and assets of a decedent for tax filings and disbursement, as well as assisting with corporate work, concentrating on the effects to family entities and businesses in relation to estate planning, including assisting with entity documents and complex entity ownership.

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Here is their commentary:

EXECUTIVE SUMMARY:

Smaldino,[i] a recent Tax Court decision, provides several important lessons for practitioners to consider about how to approach structuring and implementing estate plans for certain clients, especially for clients that practitioners did planning for during the rush throughout 2020 and 2021, where many clients came to practitioners fearing dramatic changes in the tax laws and who completed planning in a compressed time frame. While Smaldino can be viewed as just another bad fact case (leaving aside the valuation discussions), that would be a mistake. It provides good reminders of formalities that too often are overlooked.

Even if harsh changes are not enacted (few of the proposals regarding changes to the estate and gift taxation system were included in the bill just passed by the House[ii]), if you have clients in the process of completing planning, you should consider communicating with your clients about heeding the lessons provided in Smaldino.

For clients who have completed planning in 2020 or 2021 already, practitioners should consider communicating with them to follow up on any items that you may not have been involved in to confirm those steps have been taken, as well as confirming that all steps advisable to the planning have been fully completed. For example, if entity interests were transferred to a trust, the client's corporate counsel may have been involved in that transfer and completing updated governing documents to reflect the change in ownership. Practitioners could request copies of the fully signed versions of those documents if they have not received them. In all events it should be confirmed that prerequisites to transfer contained in the governing documentation were addressed, and that appropriate documentation was completed. Two such issues were raised in the Smaldino case and these will be discussed in more detail below.

Communicating with clients can provide practitioners with a "second look" at implemented transactions, and if an aspect of transactions were not completed properly or fully, practitioners should discuss options with those clients for corrective actions to take soon as feasible. Guiding clients as to how to "clean up" transactions after the fact, rather than waiting for IRS auditors to find issues instead, is essential. While the critical mistake in the Smaldino case cannot be fixed after the fact (this is discussed in more detail below), many planning oversights might benefit from some after the fact corrective efforts.

This article will review the Smaldino case, explain what the taxpayers in that case did "wrong" and the court's response to the actions taken, and how practitioners can advise clients on completing planning in a way that may potentially make it more difficult for the IRS to challenge transactions. Discussions about what practitioners might advise clients to do for some common errors in implementation to "patch up" issues up after the fact, when that is feasible, are included. The Smaldino case can be used as a cautionary tale and a case study to illustrate the good, the bad and the ugly of the estate planning process.

FACTS:
Case Synopsis.

Smaldino includes several steps in an overall transaction which included a gift of interests in a limited liability company (LLC) to a so-called "dynastic trust" (that is a long-term trust for the taxpayer's family), which is a relatively common, albeit sophisticated, estate planning technique that practitioners often recommend for clients to use their estate, gift tax and GST (generation-skipping transfer tax) exemptions.[iii] A condensed version of the steps of the transaction completed by Mr. and Mrs. Smaldino is discussed below.

Establishment and Funding of Family Limited Liability Company.

Mr. Smaldino owned and operated numerous rental properties. He initially established an LLC, Smaldino Investments, LLC ("LLC"), in 2003, as well as a California revocable trust called the Smaldino Family Trust. The LLC went unused until late 2012, when Mr. Smaldino transferred entity interests in 10 different parcels of real estate into the LLC.[iv] The LLC's ownership structure was restated so that there was 10 Class A Voting units and 990 Class B Non-Voting units, all of which were initially held under the Smaldino Family Trust.
While the initial steps completed by the Smaldino family may be considered common entity structure planning by practitioners, there are several thoughts to consider regarding this structure:

1. The structure of having multiple rental properties owned in LLCs is a prudent way to endeavor to minimize a client's personal liability so if a tenant or anyone else, for example, sues the client for harm arising from the property owned by the LLC, the tenant (or other creditor) should only be able, as a general matter, to reach the assets held in the LLCs, not the client's other personal assets.

2. Depending on the value of the client's properties and how many different properties there are, many clients might be better served by having each property held in a separate LLC to prevent a "domino" effect of a judgment against one property being able to reach the assets of the other properties held in the LLC. That way, if there is a lawsuit against one property, the others might remain "untouched."

3. While the facts presented in the Smaldino decision do not indicate where the ten parcels of property were located, or if Smaldino Investments, LLC was established in California, practitioners should consider when establishing an LLC where that LLC should be established, as well as any additional filings that should be made, or local or State taxes or expenses that could be incurred, based upon the planning that is being considered. For example, if any of the properties

held in Smaldino Investments, LLC were located outside of California, the practitioners should have considered forming the LLC to do business in the state where the additional parcels were located in. If the plan included establishing a trust in a trust "friendly" state (e.g., Alaska, Nevada, South Dakota) then the practitioner might consider establishing the LLC in the state that the trust will be governed under and have situs in, and then have the LLC authorized to do business in, the state where the real property assets are located. Having the LLC established in the state where the trust will be established may help provide additional or nexus, to the trust-friendly jurisdiction.[v] The Smaldinos pursued less robust planning which some advisers may view as less than optimal.

4. Mr. Smaldino had the LLC interests owned by the revocable trust that he established. This is a planning technique that practitioners can offer to clients to potentially avoid the issue of having to deal with probate for assets held within the revocable trust (which depending on the state, the probate process could be laborious and costly), as well as provide for protecting a client as they age.[vi] However, if the intention of the planning is for the client to transfer interests to an irrevocable trust, transferring those interests to a revocable trust first would create additional steps that would need to be completed before the gift is made by the client, such as changing title to the trustees of the revocable trust and assuring that the revocable trust has adequate gifting provisions to support the later gratuitous transfers. While a client could make transfers directly from a revocable trust to an irrevocable trust, practitioners should consider whether it would be simpler to have those LLC interests held in the personal name of the individual intending to transfer the LLCs (or other assets) to an irrevocable trust, rather than a revocable trust established by that individual. Having a clear understanding of the procession of steps to be taken as part of a client's planning may avoid additional cost and complexity than is needed to achieve a client's goals.

5. Practitioners should consider when establishing client entity structures, or reviewing current entity structures a client has already implemented if there should be any initial foundational aspects that should be addressed before planning itself is commenced.

Establishment of Irrevocable Dynasty Trust and gift by Mr. Smaldino to the Trust.

On December 21, 2012, Mr. Smaldino established the Smaldino 2012 Dynasty Trust ("Trust"), which was established for the benefit of his children and grandchildren. The case noted that the Smaldino family was "blended," with all of Mr. Smaldino's children being from a previous marriage (more on the "current" Mrs. Smaldino below).

In 2013, Mr. Smaldino transferred about 8% of the Class B Non-Voting member interests to the Trust, which is the amount he reflected on his gift tax return. This is an often-used estate planning technique, but there are nuances that might be considered regarding this planning.

1. There has been discussions and proposals regarding the acceleration of the reduction in the estate and gift tax exemption from the current $10 million (inflation adjusted) to $5 million (inflation adjusted), which is currently slated to occur in 2026. Many taxpayers have made gifts to irrevocable trusts to use their exemption in anticipation of that possible reduction. Although the latest proposal passed by the House of Representatives would not reduce the exemption at all;[vii] advising clients on setting up irrevocable trusts and making gifts could still be a prudent planning technique, pending knowledge of what might be included in final legislation.

2. Mr. Smaldino was in a second marriage and his spouse was not included as a beneficiary of the trust he established. For clients who advise counsel that they are in a solid marriage,[viii] using a trust that includes the client's spouse as a beneficiary might be an option to propose to a client, as that preserves access, through the spouse, to the trust assets after the gift. Measures might be taken in any event to address the potential implications of divorce, even if the clients view that as remote. While Mr. Smaldino opted not to include his spouse, a floating spouse clause may have been acceptable and provided more access.

3. It appears that in the Smaldino case there was sufficient wealth to provide separately for children from the prior marriage and for the new spouse, although for most clients that is not the case. Thus, practitioners might have considered further steps for clients that are single, or even for clients who are married, if it makes sense for the clients to have more access to the assets in a trusts they establish for themselves. If the plan includes establishing grantor trusts,[ix] practitioners could offer the clients to have the trusts include express loan provisions so someone can loan the clients/settlors money from the trusts. Other ways to add more access might include naming the clients as a beneficiaries of the trusts they create (self-settled domestic asset protection trusts, "DAPTs"), giving someone the right to add the clients (or a class of individuals that includes the clients) as beneficiaries of the trust the clients create ("Hybrid DAPTs") or giving someone the power to direct the trustees to appoint trust assets to a class that includes the clients (called a special power of appointment trusts, "SPATs").[x]

Gift by Mr. Smaldino to his Wife of LLC Interests.

Mr. Smaldino "purportedly" transferred about 41% of the LLC membership interests to his wife on April 14, 2013. Mrs. Smaldino "purportedly" gifted those same interests to the Dynasty Trust the next day. When a court describes a taxpayer's actions as "purported," it is not a good sign. The Court, suffice it to say, was not impressed with the "validity" of Mr. Smaldino's gift to his wife and her claimed gift the next day to the Dynasty Trust Mr. Smaldino created.

The bottom line was the Court recharacterized the claimed gift Mr. Smaldino made to his wife, followed by her gift to the Dynasty Trust, as if Mr. Smaldino himself had made the gift directly to the Dynasty Trust. This nullified the supposed transfer by Mrs. Smaldino. The result was an adverse and costly tax result for Mr. Smaldino. Several of the concerns raised by the Court include the fact that Mrs. Smaldino held the interests only for a day,[xi] transferred the same exact interests she received as a gift to the Dynasty Trust, and the family and their advisers skipped numerous steps that should have been followed to corroborate that they respected the transaction. The effect of these various points caused the Court to conclude that the family did not respect the transaction, resulting in the adverse tax result. The Court also seemed to feel that Mr. Smaldino as a CPA perhaps "should have known better." Each of these factors, and how practitioners can approach them to provide a stronger argument of respecting the transaction than the Smaldino family did, should be considered.

Intent When Transferring Assets is Important.

Mrs. Smaldino testified that before the purported transfer in question 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 examination whether she could have changed her mind if she had wanted to, she responded: "No, because I believe in fairness." Several lessons that practitioners should consider:

1. Mrs. Smaldino's testimony undermined the position the family presented to the IRS. Practitioners should communicate with clients to help them understand the transactions they engage in, as well as the substance and form of the transactions.[xii]

2. Mrs. Smaldino's testimony that she had no intent to hold the equity interest contradicted the purported substance of the transaction that was presented by her supposedly accepting ownership of the interests. Too often clients become impatient with planning, don't want to devote the time or effort to understanding their transactions, or want to minimize professional fees and thus avoid the meetings or memoranda necessary to their better understanding the transactions. Practitioners should be cautious in allowing clients to take such short-cuts. Estate planning transactions often include a significant portion of a client's total net worth, and practitioners can help protect themselves, as well as their clients, by ensuring that each of the formalities and steps of a transaction are completed, and that the client understands the reasoning behind completing those steps along the way. Clients may not need to understand every technicality of a plan, but they must understand the big picture of what the planning is doing for them. Had Mrs. Smaldino understood the plan better, perhaps her responses would have been different.
Reporting Spousal Gifts on a Gift Tax Return.

When clients make taxable gifts, a United States Gift Tax Return (Form 709) needs to be filed with the IRS to report the gifts made. While a gift to a US citizen spouse is not a taxable event (to the extent qualifying for the gift tax marital deduction),[xiii] and the client therefore does not need to report such a gift on a Form 709, perhaps, as in the Smaldino case, practitioners should discuss the pros and cons of reporting that gift anyway on the Form 709.[xiv] Reporting that gift could potentially provide additional evidence of respecting the transfer and the process of the planning. Mr. Smaldino on his Federal gift tax return reported his direct taxable gift to the Dynasty Trust but he did not report any gift to Mrs. Smaldino. While it may not be required to report inter-spousal gifts, it may be advisable for the practitioners to recommend to the client to do so to fully reflect the transactions involved. This may also help support the argument that the transaction to the client's spouse is being respected. However, had Mrs. Smaldino actually received and had time to treat the interest as her asset, this would have been a more beneficial act than gift tax reporting.

Engaging Clients in Planning:

One of the many challenges that practitioners face when proposing planning to clients is framing it in a way that they can understand, as well as gauging the "appetite" that certain clients may have for the potential planning, and their ability to both implement and follow up on (administer) the planning. A well-crafted and drafted trust, with a proper plan for assets to be transferred to that trust (either via gift or sale, or a combination of both), can be foiled by a lack of follow through on the numerous steps that need to be taken after the plan is enacted to support and maintain that

plan. Several points from the Smaldino case highlight the tight rope that practitioners walk when assisting clients in planning:

1. Mr. Smaldino was certified public accountant (CPA) and even had worked as a CPA. Mrs. Smaldino had a master's degree in economics, so she too should have had the sophistication to have some understanding of the planning they pursued. In addition, the family's real estate portfolio was worth about $80 million, so the family operated a sophisticated real estate empire.

2. As a CPA, Mr. Smaldino should have well-understood the need for legal and tax formalities and Mrs. Smaldino should have understood the business/economic shortcomings of the plan. Also, with wealth of the level involved in this case, the family can and should have had a collaborative team of capable advisers (lawyers, accountants, wealth advisers, etc.) that worked together to assure that their estate plan was properly planned, drafted and implemented.

3. The Smaldino's had a combination of sophistication and wealth that should have resulted in a well-crafted and implemented plan, yet as the case shows that did not happen. Practitioners should be careful in gauging clients and their ability to complete planning, and offer options based upon their discussions with the clients. Even for client with smaller estates, or who may be less sophisticated, if the clients understand that employing a team of professionals can provide them with better outcomes, they may be a better fit for advanced planning. Even if clients' estate is much smaller than that in the Smaldino case, taking shortcuts and forgoing formalities is never a winning strategy.

4. When Mr. Smaldino was 69, a health scare motivated him to get his estate planning in order. In fact, the Court noted that the LLC was formed in 2003 but it remained inactive until late 2012. The Smaldino's started the process and perhaps got busy with "life" and only may have revisited planning when health concerns became pressing. No clients should wait for health emergencies (or similar external events) to begin planning. All clients need plans that work for their wealth level and other circumstances.

5. Waiting, as in the case of the Smaldino's, is not only a bad idea, but that might have been a contributing factor to the rushed planning that led to a step transaction issue in the case. Practitioners who are under time pressure to complete planning, either from events such as possible tax changes or client health scares, should be mindful of avoiding being swept up in the moment, take a step back and ensure that all needed steps are being taken.[xv]

Respecting the Formalities of Entities and Trusts.

It is fundamental for much of legal and tax planning that, in order for creditors, the IRS, or others to respect legal structures clients establish as real, the clients themselves should first respect the formalities and maintenance of their separate legal entities.

Perhaps, the classic example is that of clients establishing corporations or limited liability companies in which to operate their businesses. A traditional purpose of doing so is to insulate personal assets from business creditors. Yet, if clients ignore the formalities and reality of the entities (for example, by commingling personal and business funds, using business assets

personally such as by having the clients' spouses' personal use cars owned by the businesses, and so forth), the courts and IRS will be loath to respect the entity. This is such a common issue that the phrase "piercing the corporate veil" is used to describe the legal theory of breaking through entities form to reach the clients personal assets as if the entities did not exist.

When evaluating the actions taken by the Smaldino's, they did not do well in regard to respecting the formalities of their entity, regarding the gift Mr. Smaldino tried to claim he made to his wife. Adhering to the formalities of the operating agreement restrictions would not have taken much effort,[xvi] Mr. Smaldino as trustee of the Dynasty Trust and as manager of the LLC could have given written consent for the admission of Mrs. Smaldino as a member, showing adherence to the formalities required by the operating agreement of the entity.[xvii]

The lessons of this particular piece of the saga are simple, but quite important and central to defending the structure of a plan that includes numerous different legal entities. One must adhere to the legal requirements for a gift and any other estate planning transaction. Practitioners should document for any aspects they are involved in and instruct clients to document and retain that documentation for steps the practitioner may not be assisting with, what actions have been taken, and documents prepared, in compliance with the various requirements each of the legal entities involved may have. This should be documented in such a way that a third party (IRS, court, bank, etc.) can be clearly shown the steps taken as part of the plan.

For any clients that have engaged in estate planning in the past, communicating with those clients on the need to confirm that all formalities for their various entities, trusts and plans, similar to the concepts that arose in Smaldino but tailored to clients' unique planning structure, have been addressed. If it is determined that steps have been missed or not properly documented, practitioners should recommend to the clients that they should consult with the entire planning team to determine what steps, if any, can be taken to ameliorate the situation.[xviii]

Considerations for Documentation in Transactions.

The Court in Smaldino listed the legal documents that the Smaldino's proffered in the case.[xix] There are several lessons to consider from the analysis provided by the Court.

Dating of Legal Documents.

The legal document used to transfer the LLC interests from Mr. Smaldino to Mrs. Smaldino said that it was "Effective: April 14, 2013" but it did not include a section for each individual signing the document to indicate when that individual actually signed it.

1. There is nothing inherently wrong with indicating a date a document should be effective (as long as the effective date is not contradictory to the facts). However, legal documents could indicate the date they were actually signed even if there is a different effective date. Having a transaction present a clear timeline of how steps proceeded may help prevent an alternative, and adverse to the client, sequence of events being asserted during an audit or other challenge.

2. The problem with dates of legal documents in the Smaldino case was significant. The effective date of Mrs. Smaldino's gift to the Dynasty Trust was a mere one day after the transfer of the interests in the LLC to her by Mr. Smaldino.

3. The Court felt that the taxpayers were disingenuous in regard to the dates of the documents. The Court noted that the appraisal report that valued the LLC was dated August 22, 2013. The Court believed that the documents were actually signed after the appraisal, months after their effective dates.[xx]

4. The fact that key documents did not reflect dates that they were signed lead the Court to suspect that they were really signed much later than their claimed effective date, several months later when the family got the appraisal they needed to consummate the transfer. Worse yet, consider that in the Smaldino situation, if the documents were actually signed long after the supposed gift to Mrs. Smaldino, she could not have had any opportunity to exercise her ownership over the LLC interests Mr. Smaldino gave her. According to the Court's position, by the time the family signed the legal documents, the effective dates already had the Dynasty Trust owning the LLC interests.[xxi] The inability for Mrs. Smaldino to exercise any control over the LLC interests she was purported to have received undermines the planning steps the family attempted to take and contributed to the adverse result for the family. Practitioners should focus on the accuracy of the timing and dating of legal documentation and that clients understand the effects that failures to follow dating sequences in transactions can have.

Consider Varying the Value of Transfers in Each Phase of a Transaction.

The value of LLC interests that Mr. Smaldino transferred to Mrs. Smaldino were about equal to her then available Federal estate and gift tax exemption. That was then the same value which Mrs. Smaldino purportedly transferred to the trust as her gift the following day.

It would have been advisable not to have consummated the transaction with similar amounts/interest on each leg. It may have been wiser for Mr. Smaldino to have transferred a larger LLC interest to Mrs. Smaldino so that his gift to her, and her gift to the trust were, not identical, but of course, that would have meant she would really own a portion of the LLC. Perhaps, he should have also transferred additional assets to her which she might not have transferred to the trust for his descendants. Practitioners should consider discussing with clients how to vary the transfers made in each phase of a transaction. Consider the following:

1. Varying the types of assets transferred in each phase. Consider if Mrs. Smaldino instead of transferring the same LLC interests she had just received from Mr. Smaldino to the trust, she had transferred a portion of the LLC interests, retained a slice of those LLC interests, and then gifted cash and/or marketable securities to make up the difference for the LLC interests she retained in her own name. This would then cause Mrs. Smaldino to continue to be a member of the LLC, even after the transfers are completed, while still having the same value of transfers made to the Dynasty Trust. Could this have changed the analysis provided by the Court?

2. After each transfer of LLC membership interests there should have had been a signing of updated governing documents (e.g., operating agreement or perhaps a joinder agreement) to reflect the changes in membership interests. Pro-rata distributions from the LLC to each of the members could have been made during even a short period that Mrs. Smaldino held interests.
Substance Over Form Can Undermine Legal Documents.

Having properly drafted and executed legal documentation is critical for clients to enhance the likelihood of their plans succeeding, but it may not suffice to win a challenge by the IRS. Mr. Smaldino did in fact sign a certificate of assignment transferring interests in the LLC to Mrs. Smaldino.[xxii] The courts don't consider legal papers as controlling for tax purposes when the objective economic realities are to contrary to the content of those documents.[xxiii] The circumstances surrounding the writing must show that the writing was meant to be effective.[xxiv] In Smaldino, the facts belied the legal document. Through the assignment from Mr. Smaldino to Mrs. Smaldino, she legally only held the LLC interests for a day. In addition, there were no additional legal documents or actions taken to support that assignment. Mrs. Smaldino never signed an operating agreement, never received a distribution, was not listed as an owner on the LLC income tax return, and acknowledged in testimony that she had no intent of retaining the interests.

The courts have often recognized that the tax consequences of transactions involving nominees or straw parties must be determined with regard to the true beneficial interests involved. Transactions which do not vary, control or change the flow of economic benefits are to be dismissed from consideration.[xxv] In Smaldino, there was no economic consequence to Mrs. Smaldino holding interests in the LLC for one day before regifting them to the ultimate donee, the Dynasty Trust. That lack of economic reality, coupled by all the missed formalities, made the court conclude that Mrs. Smaldino was no more than a "straw person" passing the interests on as Mr. Smaldino wished. There are a several general tax principals which applied in the Smaldino case, and which practitioners should consider in planning transactions, as well as consider cautioning clients about as potential risks for transactions.

Substance Over Form: The substance of transactions, rather than the form in which they have been cast, can determine the tax consequences from those transactions. This is an important touchstone for practitioners to evaluate all planning against. The courts have used substance over form principles to recharacterize multistep property transfers among related parties as indirect gifts between the persons who were determined to be, in substance, the actual donors and donees. In the Smaldino case, the court applied the doctrine of substance over form to disregard petitioner's purported transfer of the LLC member interests to Mrs. Smaldino and her purported retransfer of those same interests to the Dynasty Trust a day later because the court found their actions were part of a prearranged plan between all the parties involved to effectuate the transfer of the ownership of the LLC from Mr. Smaldino to the Dynasty Trust.[xxvi]

Related Party Transactions: The court notes that heightened scrutiny is appropriate for cases, such as in Smaldino, where all the parties to the transactions in question are related.[xxvii] The courts have viewed family transactions as affording much opportunity for deception and that therefore those transactions should be subject to close scrutiny. Estate planning transactions are invariably between related parties, so communicating to clients that greater caution and care in

assuring that the substance of the transaction does not compromise the intended results, specifically through the steps taken (and implemented properly) and the documentation prepared is important.

Marital Deduction Doesn't Supersede Substance Over Form. Mr. Smaldino tried to argue that because the tax law permitted him to make a gift to his wife that gift should be permitted and the substance over form doctrine should not apply.[xxviii] The Court responded that the marital deduction rules do not supersede the substance over form doctrine, and under that doctrine Mr. Smaldino's actions were ineffective to transfer membership interests in the LLC to Mrs. Smaldino.[xxix]

Therefore, the Court sided with the IRS in concluding that Mr. Smaldino, in substance, made all the gifts to the Dynasty Trust. Practitioners might use this example to communicate to clients that the marital deduction is not a cure-all for defective transactions, and that the various phases of the transactions must be completed properly to afford a better chance for the planning to be successful. For example, in funding the many spousal lifetime access trusts ("SLATs") and other irrevocable trusts created and funded on a rushed basis in 2020 and 2021, if assets were retitled between spouses prior to the donee spouse making a gift, the issue in the Smaldino case may be present and the marital deduction argument advanced in Smaldino won't be effective.

Steps to Consider for Transactions.

Practitioners should consider advising clients on steps that they can take to reduce the chance of a court collapsing the phases of the transaction like the Smaldino family experienced. Consider the following:

1. Mrs. Smaldino only held the interests in the LLC for a day. It would have been preferable to have more time pass between the date of the gift and the gift from the spouse to another entity. Some commentators recommend a minimum of 30 days, some say 60+, many agree the more time the better. Tax Court cases in related areas have respected timelines less than 30 days. Throughout 2020 and 2021 many clients feared imminent, even retroactive, tax changes. So, waiting was an anathema to getting planning done before unknown effective dates of new rules (which may never happen). Practitioners completed transactions at a pace that was deemed needed based upon the facts they had at hand. Will that environment change how a court might view transactions done close in time? Perhaps not, but at least there are objective external circumstances that practitioners can point to as the reason for compressed planning if it is later challenged.

2. Varying the transfer amounts so the client's spouse retains interests in his or her name after the gift to the trust is made may be preferable and create a difference between the two phases of the transaction, potentially increasing the difficulty of the "straw man" argument found in Smaldino.

3. During the period Mrs. Smaldino held the LLC interests, there might have been a distribution to confirm the reality of her economic ownership. In other client circumstances, a pro-rata distribution from entities may support arguments of economic substance during donee spouses'.

4. Perhaps, other actions may have occurred during the period of her ownership, e.g., her voting in accordance with the governing documents on an important matter,[xxx] to demonstrate real ownership.

5. The court in Smaldino notes that there was no amended and restated operating agreement signed while Mrs. Smaldino was owner of the LLC interests. When donees receive an interest in entities, they should sign governing legal documentations agreeing to be bound by them. That should have been done in Smaldino to evidence the reality of Mrs. Smaldino's interests. Similarly, when after her later transfer of interests to the Dynasty Trust, another amended and restated operating agreement should have been signed reflecting her as owner.[xxxi]

6. For any clients that have completed planning, if practitioners did not handle updating the governing documents for all entities involved in the planning themselves, the practitioner should communicate to the clients to confirm the clients' corporate counsel created amended and restated governing documents (operating agreements for LLCs, shareholders' agreements for corporations, or partnership agreements for partnerships). If amended documents were not prepared for each of the phases of the transactions, practitioners should encourage clients to do so now, being certain (also as noted in Smaldino) to have the documents dated as of the date they were executed, even if made effective as of the date of the transfer being documented. While dating a document as effective as of a prior date (even in a prior year) is not ideal, it might still demonstrate respect for the formalities of the entities involved.

Entity Records and Tax Returns Should Reflect the Phases of the Transaction.

In Smaldino, the LLC filed its initial partnership income tax return (Form 1065), U.S. Return of Partnership Income. On the Schedules K-1, Partner's Share of Income, Deductions, Credits, etc., attached to the Form 1065, the LLC listed Mr. Smaldino as a 51% partner, and the Dynasty Trust as a 49% partner for the entire tax year. Mrs. Smaldino was not listed as a partner for any part of the tax year. Thus, the income tax returns did not reflect a partial year ownership (1 day) for Mrs. Smaldino, which was contradictory to the position the taxpayers' tried to argue.[xxxii]

It is imperative that all tax reporting (income and gift tax returns), legal documents (assignments, operating agreements, etc.), economics (e.g., distributions), third party documents (trust records) be consistent with the position the clients intend to achieve. Often clients do not want to involve their counsel in communicating with the CPAs preparing tax returns for entities and trusts, believing that attorneys roles are completed once the documents for transactions are signed. Practitioners should caution clients as to the critical role that these documents can play in supporting the positions taken in the transactions, and how the planning teams should be involved in the transactions, from inception to implementation to reporting.

Approaching Timing Phases of a Transaction.

Mrs. Smaldino held onto the LLC interests she received as a gift from Mr. Smaldino for a mere day. The Court found that length was not enough time for the gift to her to be real. The myriad of other factors and issues in the steps taken and the documents created discussed above played a role in the Court's decision.

But leaving those other factors aside, how long is long enough to hold on to an asset before retransferring it? What should practitioners recommend to clients, or discuss with them regarding the timing between phases of a transaction? Practitioners will need to carefully communicate with clients the various concerns, advantages and disadvantages to how long to hold assets in spouses' names to defray the various challenges the IRS can argue to collapse transactions. Practitioners may need to consider providing different suggestions to clients based on the facts of the case, as the kind of assets being transferred could affect what is a sufficient amount of time between phases. In the Holman[xxxiii] case, the Court accepted six days as sufficient time between phases of a plan. In Holman, the IRS also argued that the gift should be viewed as an indirect gift, applying the step transaction doctrine in that instance. The facts are as follows:

1. The Holmans formed and funded a partnership with Dell Computer Corp. stock, then six days later made gifts of the partnership interests.

2. The IRS asserted that the formation and funding of the partnership, and later gifts of partnership interests, should be treated as occurring simultaneously. The IRS argued that the transactions (funding and later gift) were interdependent. The brief separation in time between formation and funding and the subsequent gift served no purpose other than to avoid making an indirect gift of the partnership interests.[xxxiv]

3. But the Court reasoned that the Holmans bore a real economic risk of a change in value of the underlying Dell stock and hence of the partnership for the six days that separated the transfer of Dell shares to the partnership.[xxxv] So, the Court refused to treat the formation and funding of the partnership, and the later gifts as being a single event under the step transaction doctrine.

4. So, considering this decision in Holman, is one day too short and six days just enough? The reality is it depends. Even if the taxpayers succeeded with a mere six days in Holman, it is unlikely any tax adviser would recommend such a short time between different steps in a plan. However, considering the fear of potential imminent and massive tax changes that has pervaded planning in 2020 and 2021, many clients may have chosen not to let much time pass at all between phases of a transaction.

5. One of the common themes that can be identified between Smaldino and Holman is economic substance. The courts want to see that there was the potential for real and meaningful economic impact during the time period any person or entity held interests, or they may not respect the purported form of that transaction as it was structured.

Conclusion.

Many tax advisers might dismiss the Smaldino case as "bad facts-bad law." That would be a mistake. Some of the oversights in the Smaldino case are common issues that arise in many transactions and could be caused by clients not involving their professional planning teams in the administration of their plans after implementation. Too often clients will take actions without even understanding that it is the kind of action they should ask their team how to address with before taking.

Instead of dismissing the Smaldino case, practitioners should glean lessons about how to communicate with clients regarding common issues that may need to be reviewed to address in existing estate planning transactions, and how to structure new estate planning to reduce the potential for the of issues found in Smaldino from occurring. Smaldino is really a lesson about the danger of clients not wanting to dot the "i's" or cross the "t's." It is about the danger of frenetic estate tax planning and the need for not rushing projects, no matter what proposed tax bills may provide.

While there certainly were bad facts in the Smaldino case, there is no bright line as to how many issues can occur with a plan before they may cause clients' planning to fail. How many any issues need to be identified by an IRS auditor during a challenge will weaken the client's argument and contribute to a potential adverse outcome for the client. Consider communicating to clients that it is better to be cautious and confirm their planning is in order, that it adheres to legal and tax formalities, and that the underlying economics support the tax objectives they endeavoring to achieve.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

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CITATIONS:

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[i] Smaldino V. Commissioner Of Internal Revenue, T.C. Memo. 2021-127, November 10, 2021

[ii] The bill may face additional changes in the Senate, and then potentially additional changes in a House and Senate conference if the bill is modified but passes the Senate. So, it is unclear whether any of the previous proposals that have been discussed that would affect estate planning will be re-introduced into a future version of the legislation.

[iii] Paul Hood and Robert Keebler in their article "Smaldino v. Commissioner: Danger at the Intersection of Blended Families and Taxable Gifts" provided an in-depth review of the Smaldino case, including a timeline of the planning steps taken, which was published as Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2920.

[iv] It is interesting to note that it appears that Mr. Smaldino began estate planning in 2003, but did not take significant strides to complete that planning until late in 2012. While a significant portion of the planning the Smaldino family completed was in 2013, the planning team may have begun the process and drafted documentation in 2012. That year is somewhat similar to the situation practitioners have been facing in 2020 and 2021 in that there was a massive crush of work completed in a short span of time, so many steps that Mr. Smaldino took (or should have taken) may have been compressed or missed by the planning team due to that fact. This further highlights how planning conceived or completed under pressure should be followed up upon later to see if any portion of the planning was either missed or not implemented correctly.
[v]Regarding nexus to a particular state, there is no bright line rule regarding what are sufficient ties to the state in order to establish jurisdiction in that state and allow the trust to avail itself of those trust-friendly statutes. Often, a less trust friendly state will attempt to apply their laws to a trust even if it specifically designates it is governed under a different jurisdiction. For example, Florida in In re Rensin, 600 B.R. 870 (S.D. Fla. 2019), applied Florida law to an offshore trust established in Belize, allowing a Florida creditor to reach the assets held in the trust. For a further analysis of the Rensin case, see the commentary by Alan Gassman, Martin M. Shenkman & Wesley Dickson in Steve Leimberg's Asset Protection Planning Email Newsletter – Archive Message #390 (August 26, 2019).
[vi] A revocable trust is one of many techniques practitioners could offer to clients to protect clients as they age. However, these techniques are not just for older clients, they can also be employed by "vulnerable" clients, which means clients that do not have a robust support structure of friends and family around them to help in case a client cannot perform actions themselves. See Estate Planning for the Chronically Ill, Aging and Otherwise Vulnerable or Isolated Client, by Martin M. Shenkman, Probate & Property, May/June 2016, pages 23-29 for additional considerations on this topic.
[vii] As discussed previously in this article, there is no way to be certain whether the proposal to reduce exemption, as well as other estate and gift taxation proposals, will be included in the legislation ultimately passed.
[viii] Practitioners should consider cautioning clients regarding the matrimonial concerns of establishing an irrevocable trust and how planning might affect their rights, especially in case of a divorce. Providing clients with cautions regarding, as a few examples, loss of an elective share for assets transferred to a trust, loss of beneficiary status on divorce if a "floating spouse" clause is used (that is where the spouse is benefitted from the trust but spouse means the person to whom the grantor is or was married at the time in question), the grantor having to pay income tax on income for the trust if it is a grantor trust, etc. may help protect the practitioner if an issue comes to light after planning is completed.
[ix] For a "Non-Grantor" trust (that is, one of which the income, deductions and credits of the trust are not attributed for income tax purposes to the grantor) the ability for a client to access the funds in their own trust are limited in comparison to a grantor trust. Caution should be exercised in structuring a non-grantor trust and providing access to funds for the grantor, as many of the powers discussed directly cause grantor trust status. As one example, if the client's spouse is included as a beneficiary, in order for the trust to be a non-grantor trust it will require that the spouse only receive distributions with the consent of an adverse party. There are many other considerations not discussed in this article regarding planning with non-grantor trusts.
[x] Practitioners should be aware that when discussing a domestic asset protection trusts (DAPTs), Hybrid DAPTs (where the grantor is not an initial beneficiary but is part of a class of possible

beneficiaries that may be added later) and special power of appointment trusts (SPATs) techniques that different commentators have different views of these techniques. For a description of a SPAT, see O'Connor et al. in the February 2019 issue of Estate Planning. Some commentators suggest that a hybrid-DAPT might potentially be subject to self-settled trust categorization, and challenged in a non-DAPT jurisdiction. Others disagree, especially before the settlor is added back (baring proving an implied agreement). A SPAT, by definition, is not self-settled (see commentary to Section 505 of the Uniform Trust Code). However, practitioners should consider the fact that almost any type of irrevocable trust might be challenged on the basis of an implied agreement with a powerholder, fiduciary or other person.

[xi] While the interests were transferred by Mrs. Smaldino to the Dynasty Trust the day after she received them, there was additional discussion in the case regarding if she ever had dominion over the assets at all, due to the fact that the transfer documents were not dated when signed, causing the court to question whether they were signed before April 15, 2013 at all. See discussion later in this article.

[xii] Providing a clear synopsis of the transaction that is being completed to the client in writing also allows practitioners to protect themselves, as it makes it harder for a client after a transaction is completed to argue to the practitioner that they did not understand the transaction that was taking place.

[xiii] Practitioners should be cautious of determining the citizenship of both the client and the client's spouse before any gifts are made between spouses. While there is an unlimited marital deduction allowed for transfers to one's US Citizen spouse, there is no unlimited marital deduction when transferring assets to one's spouse who is not a US citizen. Before completing any planning, practitioners should consider inquiring about citizenship of anyone involved in the planning, including powerholders being named in the trusts (which could also potentially classify the trust as a foreign trust, causing additional reporting requirements). Note also that if the gift is to as so-called QTIP trust, described in Section 2523(f), a timely filed return, with the election to have it qualify for the marital deduction, must be made to secure the gift tax marital deduction.

[xiv] The instructions to Form 709 provide: "Gifts to your spouse. You must file a gift tax return if you made any gift to your spouse of a terminable interest that does not meet the exception described in Life estate with power of appointment, later, or if your spouse is not a U.S. citizen and the total gifts you made to your spouse during the year exceed $157,000. You must also file a gift tax return to make the qualified terminable interest property (QTIP) election described under Line 12. Election Out of QTIP Treatment of Annuities, later. Except as described earlier, you do not have to file a gift tax return to report gifts to your spouse regardless of the amount of these gifts and regardless of whether the gifts are present or future interests."

[xv] Similarly, clients that waited until mid-2021 to plan for (still) possible tax law changes no doubt rushed (or are still rushing) through the planning process, thereby making the planning more stressful and more likely to have issues missed or items not addressed and, therefore, the planning is less likely to succeed. Practitioners should communicate with clients to help them learn the lesson the Smaldino case presents and make planning, not just for their estates, but all of the clients' financial and legal matters, a habit to pursue in increments on a regular basis.

[xvi] The Court in Smaldino specifically stated "The record does not suggest that petitioner, in his dual roles as trustee of the Smaldino Family Trust and as manager of the LLC, gave express or implied consent for the admission of Mrs. Smaldino as a member in disregard of the operating agreement's restrictions. To the contrary, the record shows that on April 15, 2013—a day after he purportedly transferred the LLC member interests to Mrs. Smaldino—petitioner executed an

amendment to the LLC operating agreement (providing for guaranteed payments to himself) which identified the Smaldino Family Trust as the LLC's 'SOLE MEMBER'."

[xvii] The Court further notes that "The LLC's operating agreement was never amended to account for any transfer of units to Mrs. Smaldino. However, exhibit A of the operating agreement was amended 'as of April 15, 2013' to show the Dynasty Trust as holding a 49% ownership interest in the LLC." Practitioners should consider whether the failure to adhere to formalities for the gift to Mrs. Smaldino, and then adherence to the formalities for the transfer to the Dynasty Trust, may have hurt the Smaldinos case.

[xviii] While taking corrective action subsequent to implementation of a transaction may not be ideal, and might not help on an IRS audit, attempting corrective action could potentially help show good faith in the transactions completed and change the tone of an audit.

[xix] The Court took special care to list the sequence of documents signed, and the date included on each of those documents. Practitioners should take this as a cautionary tale that their documentation will be scrutinized to a significant degree if a challenge is ever raised to a transaction.

[xx] The Court stated that "On the basis of all the evidence in the record we find it more likely than not that the undated certificates of assignment and associated operating agreement amendment were executed no earlier than August 22, 2013." By not having a date when the clients signed the assignments and operating agreement, the Smaldino family provided the Court with the ability to view the transaction in a different light than they may have intended.

[xxi] The Court noted 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 any LLC membership interests."

[xxii] The Court said that this was "a factor to be considered, [but it] is not controlling."

[xxiii] Kerr v. Commissioner, 113 T.C. 449, 464 (1999).

[xxiv] Linton v. United States, 630 F.3d 1211, 1218-1219 (9th Cir. 2011).

[xxv] Snyder v. Commissioner, 66 T.C. 785, 791 (1976).

[xxvi] The court held "… we agree with respondent that in substance the Dynasty Trust received all its membership interests from petitioner."

[xxvii] The court quotes several cases for this doctrine: "See Brown v. United States, 329 F.3d 664, 673 (9th Cir. 2003); Kuney v. Frank, 308 F.2d 719, 721 (9th Cir. 1962) ('Transactions between persons in a close family group, whether or not involving partnership interests, afford much opportunity for deception and should be subject to close scrutiny.' (quoting H.R. Rept. No. 82-586, at 33 (1951), 1951-2 C.B. 357, 381)); Estate of Bongard v. Commissioner, 124 T.C. 95, 119 (2005) ('A transaction between family members is * * * subjected to heightened scrutiny to ensure that it is not a sham or disguised gift.')"

[xxviii] Mr. Smaldino referenced Code Section 2523(a) regarding the unlimited marital deduction in making this argument.

[xxix] The court noted "Pursuant to its terms, however, section 2523(a) applies in the first instance only if the donor 'transfers * * * an interest in property' to his or her spouse. For the reasons discussed below, we conclude that petitioner's actions were ineffective to transfer membership interests in the LLC to Mrs. Smaldino."

[xxx] While this point may require additional planning regarding the structure and phases of the transaction, allowing the spouse to exercise this level of control over the interests while holding them is a point practitioners can suggest to clients to see if anything is happening as part of their business during the time planning will be taking place. Even if nothing is done regarding this,

communicating this fact can help clients understand the kinds of steps that should be taken as part of structuring an estate plan.

[xxxi] Note that in the Smaldino case the operating agreement reflecting the ownership of the LLC interests by the Dynasty Trust was prepared, which compounds the issue of no operating agreement being prepared reflecting Mrs. Smaldino as the owner for a period of time. Practitioners should be careful to caution clients about completing all phases of the documentation for a transaction, as having some, but not all, of the governing documents reflecting ownership could end up harmful instead of helpful.

[xxxii] Also note that the Dynasty Trust was incorrectly listed as having owned the 49% interest in the LLC for the entire year, while it should have been a partial year from April 15th, 2013 onward. There did not appear to be an indication of when the 8% interest Mr. Smaldino transferred personally to the Dynasty Trust was completed, but if that was during 2013 the Schedule K-1s should have reflected the Dynasty Trust owning an 8% interest for a period of the year, which then increased to 49% for the rest of the year after April 15th.

[xxxiii] Holman v. Commissioner, (2008) 130 TC 170 (2008). aff'd, 601 F.3d 763 (8th Cir. 2010).

[xxxiv] Treas. Reg. Sec. 25.2511-1(h)(1).

[xxxv] Consider whether a similar decision would have been made if the partnership was funded with a less volatile asset. A publicly traded company can have its value vary significantly in just a few days, which is less likely to be able to be argued with a privately held company, or real estate, or cash.