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Step Transaction Doctrine May Ruin Your Estate Plan

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Apr 27, 2023,05:12pm EDT
https://www.forbes.com/sites/martinshenkman/2023/04/27/step-transaction-doctrine-may-ruin-your-estate-plan/?sh=269fd4e31ab8

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The What Doctrine?

While the step-transaction doctrine might sound arcane it is one of many tax constructs that might well undermine steps you might take to plan your estate to reduce future estate taxes or to protect your hard-earned assets from a malpractice claim. In the simplest of terms, the step-transaction doctrine might be applied to collapse many arguably separate steps of a plan into fewer steps and arrive at a different result than what you intended for your plan. The results can be pretty bad from a tax or legal perspective.

A Plan that Might Violate the Step-Transaction Doctrine

Here's an example of a plan that illustrates the application of the step-transaction doctrine, and might not be what you should do.

Wife is a surgeon and she wants to both protect her assets from a malpractice claim and move them out of her estate before the estate tax exemption (the amount you can bequeath without an estate tax to people other than your spouse and charity which may be unlimited) is reduced by half in 2026. Her husband is a schoolteacher and has few assets in his name. Wife gifts $5 million to husband. The following day the husband creates a trust to benefit his wife and all of their descendants and transfers the same $5 million into that new trust. The step-transaction doctrine would likely be applied to this "plan" and unravel it. The wife will be treated as if she, not the husband made the gift to the trust. That may place those back into her estate and make the reachable by claimants in a malpractice suit. The "plan" was for naught.

A Recent Court Case Unraveled a Plan Based on This Theory

Similar planning was zapped by the Tax Court when the IRS challenged a plan in a recent well-known case. Smaldino v. Comr., T.C. Memo. 2021-127 (November 10, 2021). In Smaldino the husband gave the wife interests in a family limited liability company (LLC) which she purported transferred to a trust for the husband's children from a prior marriage the next day. The court found that it was really the husband that made the transfer to the trust, not the wife. The wife was merely a straw-person or intermediary to facilitate the transfer and she never really owned the interests involved.

Wife is a surgeon and she wants to both protect her assets from a malpractice claim and move them out of her estate before the estate tax exemption is reduced by half in 2026. Her husband is a schoolteacher and has few assets in his name. Wife gifts $6 million to husband in May 2023. The following day the husband deposited the gift into an account that he had had in his name along for many years. Husband hired a new investment advisor who creates a new financial plan, investment policy statement, and reallocates the asset allocation. Husband withdraws funds periodically from this new account and treats the funds as his own. More than six months later, in the new 2024 tax year, the husband hired an estate planning attorney who created a trust for wife and descendants pursuant to a plan he developed with the husband. Husband funded the initial $100,000 gift to the trust from funds he inherited many years ago. Husband has his financial planner create new forecasts and determine through that analysis an amount of money that husband might reasonably gift to the new trust. The financial adviser's analysis suggests $5 million could be gifted and the following month the husband makes the gift.

What Might Have Been Done Right in the Second Plan

While there is no assurance that the IRS or a creditor might try to pierce through the second scenario plan arguing that under the step-transaction theory the wife really funded the trust to benefit herself. But there are some better arguments that the husband's funding of the trust was not part of the same integrated plan of the wife's gift to him. Some of the factors that might help support the plan might include:

· Husband treated the gifted funds as his own in many ways. He reallocated the investments, withdrew and used funds from the gifted money, and commingled the money with an old account of his own.

· Husband hired his own investment advisor to advise him on the funds and the nature of the funds changed dramatically from a cash gift to an investment portfolio.

· The amount the wife gave the husband did not correlate to the amount husband gave the trust.

· The husband did not merely just re-gift the funds wife gave, but he had an independent analysis completed to arrive at the amount that he might gift to a trust for his wife.

· About eight months passed from wife's gift to husband's funding the trust.

· Husband's gift was in a separate tax year from wife's gift.

No Bright Line Rules

Overall, there are many better facts in the second example then in the first example (which was pretty bad from a tax and legal perspective). Will this work to avoid the application of the step-transaction doctrine to unravel the plan? Maybe. There are no definitive rules on what actions are enough to assuredly break the step-transaction doctrine.

Lots Worse Plans Have Been Done

Many plans have facts that are far less compelling then this second example. That doesn't mean that less favorable scenarios may not succeed either. For example, in 2020 and 2021 when most taxpayers and advisers feared imminent, significant and detrimental changes to the estate tax laws, many taxpayers implemented plans where time between steps was nearly non-existent. Those plans were based on the premise that the government could change the tax laws any day so it might be better to get a plan implemented as fast as possible, since any risk of a quickly done plan might outweigh the risk of not getting the planning completed before a change in the tax laws.

Is Six Days Enough?

In a famous tax case, Thomas Holman, 130 TC No. 12, 5/27/08, the court found that holding stock for a mere six days, in one step along the planning path, was enough time for the tax plan to work. In really simplified terms the parents transferred Dell stock to a family limited partnership ("FLP"). About six days later they gifted part of the partnership interests to a trust and argued that the value of the FLP interests should be discounted from the value of the underlying stock value. If the Dell stock the contributed to the FLP was worth $1 million, and they gifted 20% of the FLP, they did not value the 20% FLP interest at 20% x $1M = $200,000. Rather they valued it at $100,000 after a 50% discount.) The IRS applied the step-transaction argument that the parents really made direct gifts of the Dell stock to their children's trust. This argument is based on the FLP not being real and rather just being a-way-station on the path from the parents to the trust so that not only would the FLP be ignored, but the reduction in value the parents claimed would be as well. If the gifts are considered indirect gifts of the Dell stock, instead of gifts of FLP. The IRS reasoning in their attack was that the step-transaction doctrine provides that if a series of steps in a transaction are so integrated and interdependent, economic reality may be better reflected by collapsing the various steps into a single step. The court, in a resounding taxpayer victory, determined that during the six day time period that the FLP held the Dell stock from the time stock was contributed to the FLP, until the date the parents gifted FLP interests to the trust, created an economic risk that the value could change because publicly trading stock is volatile.

While few tax experts might suggest that a six day period is sufficient when you are planning a transaction, the lessons of the Hollman case are valuable.

Take Home Message For Your Planning

But the take home message is that when you engage in estate or asset protection planning, or other types of tax planning, where there are many steps involved from the first step in the plan to the last steps, consideration should be given, to the extent feasible, to addressing (really deflecting or refuting) the step-transaction doctrine.

With this background, the following discussion will explore in some more depth some of the nuances and concepts of the step transaction doctrine.

Linton Case

The court in the Linton case found that the taxpayers crafted a scheme that consisted of pre-arranged parts of a single tax plan. The court found those steps were interdependent. The Court did not believe that the taxpayers would have undertaken the initial steps in the plan without the later and integrated acts. The Linton court did not find real economic risks of a change in asset values during the time between steps. Linton v. US, 638 F. Supp. 2d, 1277 (W.D. Wash. 2009).

Three Factors That Might Affect Applicability of the Step-Transaction Doctrine

If the steps in the plan have to "lien" on each other to stand, they are interdependent. In other words, would the client do step 3 if steps 2 and 5 were not also done. If the answer is no, then there might be an issue. This might be referred to as a "mutual interdependence test." To analyze a plan from this lens, consider each step that might be incorporated into the plan. Try to determine whether specific steps are meaningless unless all the other steps in the plan happen.

What would happen if the plan stopped at an interim step and was not completed. So, if there are four steps in the plan, and you stopped the plan mid-stream at step 2, not getting to steps 3 or 4, what would happen? If the IRS shows that the various steps are really pre-arranged parts of a single plan that are intended from the beginning to achieve a particular end result. Thus, this factor is referred to by some as the "end result test."

Can you stop the plan at step for and skip steps 5 and 6? If you have contractual or other obligations to complete all 6 steps it might appear that you are locked in to completing every step of the plan. Each step is thus a fait accompli. So, if you have a binding commitment from the beginning of the plan to undertake each following step in the plan. This type of challenge may be easier for the IRS to pursue if all of the various steps in the plan occurred in close time proximity. Penrod v. Comr. 88 T.C. 1415 (1987). This test is thus referred to by some as the "binding commitment test."

Some Step-Transaction Planning Lessons

The step transaction challenge might be an issue for many transactions. As general suggestions consider some of the following:

· The longer the time span between each step or phase of a plan, the more likely that each planning step may stand independently on its own. But time alone should not be the sole factor considered. Other factors might negate the application of this doctrine.

· Ideally there should be some, and if possible significant, economic implications to each step of the plan. If one spouse transfers assets to the other spouse, while the second spouse holds the asset there should be a meaningful risk of economic consequences during that period of ownership. If interests in an LLC are transferred a distribution might be made from the entity while that recipient holds the interests.

· To the extent feasible each step in the plan should be able to serve as the final step of the plan. There should ideally be no requirement or even need to proceed to later steps.

· The recipient of a transfer should exercise control, to the extent feasible over the asset received.

· Carefully adhere to all the legal formalities the plan would seem to suggest. For example, interests in an entity, such as an LLC, are transferred from one person to another, then to another entity and finally to a trust. The LLC should have a new operating agreement that could be amended and restated and signed at each transfer confirming the new owner after that particular step.

· Carefully adhere to all the tax formalities the plan would seem to suggest. Again, assume that interests in an entity, such as an LLC, are transferred from one person to another, then to another entity and finally to a trust. The LLC, assuming that it is taxed as a partnership for income tax purposes, should issue a K-1 to each owner properly reflecting the number of days each owned an interest in that LLC during the year. Sorensen v. Commissioner, Tax Ct. Dkt. Nos. 24797-18, 24798-18, 20284-19, 20285-19 (decision entered Aug. 22, 2022).

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