THE THURSDAY REPORT

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Happy Holidays from the Law Offices of Gassman, Crotty & Denicolo, P.A.

EDITED BY: ADRIANA OCHSNER

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Article 1

The Biden 3rd Step -
What To Do With The Promissory Note Owed to the Grantor of an Intentionally Defective Grantor Trust

Written By: Alan Gassman, Esq., Brandon Ketron, Esq. and Dakotah Flint

Special thanks to LISI Business Entities Newsletters: LISI Estate Planning Newsletter #2928 (December 21, 2021) at http://www.leimbergservices.com. *Copyright 2021 Leimberg Information Services, Inc. (LISI).*

Forgive or Assign, Keep in Place or Alter the Arrangement (PART 1 OF 2)

Neither a borrower nor a lender be,
Unless it is a low-interest promissory note owed by a trust formed by thee.

The Biden 2-Step is a nickname used by the authors to describe a traditional installment sale to a defective grantor trust where a taxpayer establishes an irrevocable trust that is disregarded for income tax purposes and will not be subject to federal estate tax on his or her death, makes a seed capital gift to the trust, and sells one or more assets to the trust in exchange for a long-term, low-interest promissory note. The taxpayer can then decide to forgive or make a gift of all or a portion of the note, "undo" the sale by repaying the note, or keep the note in place.

The Biden 2-Step was a good fit for many taxpayers in 2021 who were concerned about the proposed estate tax laws and wanted to reduce their taxable estates before new legislation would pass, and be ready to use their estate tax exemptions by forgiving or gifting a note if and when the exemption would be going down. There are no active present bills in the House or the Senate that would otherwise materially affect the estate and gift tax exemption until its scheduled reduction to one-half of its then-applicable level in 2026, although this could change.

The technique allows for the following:

1. Freezing the value of ownership interests and assets that are expected to grow.

2. Allowing for valuation discounts, such as if the assets are held under an LLC and a non-voting membership interest in the LLC is sold to the trust for the note.

3. Allowing the taxpayer to pay the income tax on income that inures to the benefit of the trust, where the payment of the income tax is not considered a gift for gift tax purposes, thus permitting the trust to grow income tax free and further reducing the taxpayer's estate.

4. Allowing the taxpayer to essentially reverse a significant portion of the transaction if they decide they would like to get most of the assets back by simply repaying the promissory note, or transferring assets back to the taxpayer in full or partial satisfaction of the note.

5. The note may be forgiven or transferred as a gift to make use of some or all of the taxpayer's estate tax exemption amount. Incidental benefits include the fact that a long-term, low-interest promissory note received in exchange for assets is not a gift if the face amount of the note equals the value of the assets sold, and the note pays interest at the applicable federal rate, yet the note is generally worth less than the face amount in both the real world and the estate tax world if it is for a fairly long term, and has recently been set at the now low Applicable Federal Rate. This is due to the fact that a willing buyer would not pay the face amount of the note to a willing seller since the interest rate of the note is less than what such buyer could receive in the market.

6. Place the note into an LLC, into joint names with a spouse, under an incomplete gift domestic or foreign asset protection trust, convert it to a self-canceling installment note or private annuity, or proceed with one of the other strategies discussed in this letter.

On August 2020, in LISI Estate Planning Newsletter #2813 Alan Gassman, Jerry Hesch, and Marty Shenkman discussed how the well-established planning technique conventionally known as the Installment Sale to a Defective Grantor Trust can be combined with forgiveness of the note by gift in order to allow for flexibility, given the uncertainty of whether the estate tax exemption amount would be changed. The authors referred to this technique as the "Biden 2-Step," and encouraged practitioners to consider transferring taxpayers' assets into proper entities to facilitate an installment sale, while also selecting, establishing, and possibly refining, irrevocable trusts, and making seed capital gifts, as appropriate, before selling assets and entity interests to such trusts in exchange for long-term low interest promissory notes.

The Biden 2-Step's basic premise was that many taxpayers could not be sure whether they would need to do estate tax planning, but would be in the best position to do so by first queuing up the arrangement by making a sale in exchange for a note. If done sooner than later, taxpayers would have a better chance of being grandfathered to more favorable estate tax laws allowing for valuation discounts and the use of disregarded trusts for income tax purposes (aka grantor trusts). After implementing the Biden 2-Step, the taxpayer would be able to forgive the promissory note—and use a significant portion of his or her $11,700,000 estate tax exemption—immediately after knowing with reasonable certainty that the exemption was going to be reduced.

A YouTube video of Alan, Marty and Jerry discussing the Biden Two Step can be viewed at: https://www.youtube.com/watch?v=4e7utgxtn7A.

As the result of the present situation, many individuals and married couples are now owed large low interest promissory notes by trusts that they have established, and the question becomes whether to (a) continue with the note arrangement, (b) forgive, gift, or sell the note, or (c) enter into a Biden 3rd Step alteration of the arrangement, as described herein.

Reasons to Keep the Note in Place

There are a number of reasons to keep a promissory note in place. These should be evaluated based upon the unique circumstances of each taxpayer, and the possible impact that each reason can have on planning.

1. Continued Flexibility. Keeping the note in place permits the taxpayer to take advantage of one or more of the strategies described herein, when the time is right, based upon future circumstances.

2. Keeping the Note in Place Allows the Taxpayer to Reverse the Transaction, at Least to a Great Extent, Based Upon Relative Values at the Time of Reversal. For example, if the assets grow in value after the sale then the appreciation in value will remain under the trust, but asset interests equal in value to the promissory note can be transferred back to the taxpayer in exchange for cancellation of the note.

3. The Payments May be Needed for Living Expenses, to Pay Taxes and for Other Purposes. The taxpayer may be dependent on or may favor receiving annual interest and possibly principal payments on the note to pay for living expenses, taxes imposed on the note holder attributable to trust income, to make $16,000 per year per person annual exclusion gifts, and to give to charity. While the note may be set to pay interest only, if the note holder wants to receive payments of principal to have more in cash flow, this can be arranged if the Trustee of the borrower trust is agreeable to making prepayments.

4. Lender Relationships. Lenders that have approved the arrangement may prefer that it remain in place.

5. To Grandfather Low Rates. Many notes were implemented at very low interest rates to allow growth above the stated rate to remain outside of the taxpayer's estate. This will become more attractive if and when rates go up in value.

6. The Taxpayer Has Had Enough Planning For Now. Many taxpayers feel that they have been through an ordeal, or at least something less than a completely enjoyable experience in tolerating advisor recommendations and the logistics of putting an installment sale into place. Even asking them to make "another change" may be unappealing, despite our using all of our Dale Carnegie skills, grace and even pleading.

Disadvantages of Keeping a Promissory Note in Place

There are likewise a number of reasons to not keep a promissory note in place, and these will vary from taxpayer to taxpayer and situation to situation.

1. More Control and Personal Financial Security for the Note Holder. The taxpayer may want to keep a large net worth and control where a note would pass during his or her lifetime or upon death. It would be wise to carefully consider spending and possible needs before forgiving or giving away a large asset, not to mention psychological issues that can arise if an individual believes that they may run out of assets during their lifetimes.

2. Possible Loss of the Use of the Increased Federal Estate Tax Exemption. If Congress and the President act retroactively to reduce the exemption, then taxpayers risk losing the ability to use the currently high $11,700,000 estate tax exemption.

Though some advisors are concerned that Congress and the President could act during a taxable year to reduce the estate tax exemption, effective January 1 of that year, this type of conduct would more than enrage affluent financial supporters of both political parties. Both the Bernie Sanders Bill and the September 13, 2021 House of Representatives Ways and Means Committee Bill provided that the reduction in the exemption would not occur until January 1, 2022 (the start of the next taxable year).

Even if a law is passed that will only be perspective (applicable in the future) there will inevitably be many families who will not act before the end of the calendar year, for a number of reasons, including not knowing of the issue, not wanting to re-engage with an estate planner, having dementia, or placing higher priority on other things, like going to holiday parties and getting their cars washed.

3. A Note Arrangement May Cause Issues with Lenders. Many taxpayers transfer income-producing property or assets that are leveraged by debt, so lenders will review loan ratios and trust and debt arrangements to determine how those will impact the financing and financing terms.

In the author's experience, lenders typically disregard a promissory note owed by a trust to its Grantor, if both the trust and the Grantor guarantee the indebtedness, but guarantees can cause tax issues, such as if the Grantor of a trust is benefitted by the trust's guarantee.

Moreover, some lenders may have issues with debt owed by the trust to the Grantor, and Trust assets or entity interests being pledged as collateral for the indebtedness, and may ask for subordination of the note, or that the debtor use another lender.

4. Risk of Taxable Income on Death With Note Outstanding

Some authors have taken the position that it is possible that there will be recognition of income on the death of a Grantor, as if the Grantor sold the assets held by the disregarded trust to the trust in exchange for the promissory note before death.

The very well written Bloomberg Portfolio on Grantor Trusts by Professor Rob T. Danforth and Howard Zaritsky indicates that "While it is clear that the death of the Grantor terminates having a Defective Grantor Trust considered to be owned by the Grantor for income tax purposes, the IRS's tendency to attempt to cause the death of the Grantor to be a taxable event does not appear to be supported by case law or any clear statutory guidance."

Professor Danforth and Mr. Zaritsky also provide as follows:

There is no case, regulation or ruling that directly addresses the income tax treatment of the termination of a Grantor Trust status at the Grantor's death, but the IRS's own rulings lead to the inescapable conclusion that death of the Grantor should not be a recognition event for income tax purposes, even when the Trust holds encumbered property with a debt in excess of its adjusted basis. Although this conclusion seems escapable, the IRS may assert a different view.

Some advisors tend to be "opinionated" on issues such as these, believing that one position or the other would apply.[1] None of us have a divining rod, nor is it proper to advise taxpayers to "play the audit lottery anyway" if a taxpayer-friendly position can be taken, but we can educate taxpayers as to risks and the likelihood of success and let them make the decisions. Very few large fortunes were made by not taking risks, and the same may apply for keeping a fortune free from taxes that may be avoided.

5. The Taxpayer Might Unwisely Change Their Mind or be Subject to Undue Influence and Dismantle Part of the Estate Plan. A perfectly happy married couple might enter into promissory note arrangements, with the promissory notes being held by the surviving spouse, who loves the note more than the note holder, and might remarry someone, have dementia, or be subject to undue influence.

If the note did not exist, then all assets held by the Trust may be locked in to pass to the descendants of the original married couple. Now, the note may be gifted to the new spouse, although arguably this is based upon what the surviving spouse desires to have happen. Litigation may ensue, which could batter family relationships.

Strategies to preserve the value of the note for the Grantor and intended heirs or other beneficiaries can include the following, which are further discussed below: (1) making the note non-assignable, which may reduce its value for valuation purposes if this is permitted under State law, (2) converting the note to a nontransferable private annuity that vanishes upon the death of the annuitant, or (3) "wrapping the note in an LLC," and giving the controlling interest in the LLC to an entity other than the Grantor that would help to safeguard management and use of the note within the LLC.

Reasons to Forgive or Gift the Note and Use the Taxpayer's Exemption

1. IRS Audit Considerations. If the taxpayer would prefer not to be audited by the Internal Revenue Service, it would likely make sense to use their exclusion in 2021. There is probably a much lower chance that 2021 gift tax returns will be audited than gifts made in 2022 and thereafter. The IRS only has three years to make changes by reason of the audit of a gift tax return that adequately discloses a gift, and will in all probability be short staffed for the next three years, especially given the significant number of gift tax returns that will be filed for 2021. Because the IRS will likely receive funding to increase their staff in the coming years, 2022 gift tax returns will likely have a greater chance of being audited than 2021 returns given IRS budgets and the number of 2021 gift tax returns being filed.

If there will be a taxable estate, then the chances of audit as the result of the note being disclosed someday on a Form 706 – Estate Tax Return should also be considered. Satisfying or repaying the note now causes it not to be an asset disclosed on the estate tax return, which might cause a higher risk of audit or issues upon audit.

2. Yearly Interest From the Note Adds to the Gross Estate. Although the note is bearing interest at a low rate, interest earned is still added to the taxpayer's estate. For example, a $9,000,000 note bearing interest at 1.5% adds $135,000 per year to the taxpayer's estate (plus growth upon the investments made from the payments received).

3. Notes in Place Still Can Be "Complicated" and Cumbersome. Many taxpayers have a hard time understanding how they can be owed a note that is disregarded for income tax purposes, so they need multiple reminders to make sure that the trustee of the trust makes the note payment to the taxpayer.

Thus, the planner should both (1) remind taxpayers that it is important to follow appropriate formalities and (2) make a spreadsheet and calendar of annual interest payments to remind taxpayers of each payment's due date. Similarly, the taxpayer's certified public accountant and other financial advisors should also be aware of the importance of properly respecting formalities and maintaining financial statement and tax return consistency, which is further complicated by existence of notes.

4. Creditor Claims. Creditors can seize the note, because a note owed to an individual is considered that individual's property. For similar reasons, the note can be taken away by someone asserting undue influence or assigned to a spouse in the event of a divorce.

However, taxpayers should thoroughly consider the implications of such planning. Forgiving or otherwise eliminating the note can be the right move for creditor protection and divorce planning purposes, but not if doing so would be a "fraudulent transfer" for creditor purposes or would invoke the ire of a divorce court judge.

A promissory note owed to a Grantor may be contributed to an "incomplete gift" Asset Protection Trust that will protect the Grantor from creditors, and possibly also from undue influence and the opportunity of the Grantor to change his or her dispositive plans outside of the bounds of conduct that can be permitted under an irrevocable Asset Protection Trust.

Many taxpayers will be well advised to reduce exposure to possible future creditors by placing promissory notes owed to them into limited liability companies that are owned by multiple members, in order to have charging order protection.

Oftentimes, half or more of the voting membership interests of such an LLC will be owned by a separate trust for family members so that a creditor obtaining a judgment against the taxpayer who originally owned the promissory note will not be able to seize the note or take control over payments that are made to the LLC. Such an LLC interest held by the taxpayer may be valued at a significant discount upon death.

While the law of most states provides that a charging order is the sole remedy of a judgment creditor, some states, like Colorado and California, do not.

There is some support for the proposition that the state law where an LLC is formed would be controlling in determining whether a charging order is the sole remedy, but this is far from being firmly established. In 2019, the Iowa Supreme Court found that Iowa law applied to determine whether an LLC ownership interest held by a Florida couple in an Iowa LLC qualified as a tenants by the entireties asset and charging order protection. The Court found that Iowa, and not Florida, law applied.[2]

Also, partial ownership interests in such an LLC can be gifted to irrevocable trusts for children, grandchildren and descendants using the annual exclusion gifts on a discounted basis.

Placing a note under an LLC or family limited partnership with multiple members thus allowing for charging order protection by transferring partial interests for gift tax planning purposes, along with involving family members in management and possibly placing other assets under the same LLC to consolidate holdings can be good business reasons to avoid the application of Internal Revenue Code 2036(a)(2) for estate tax purposes under the bona fide sale exception, and may also facilitate significant discounts, if and when former note holder's interests in the LLC or limited partnership are valued upon death, or transferred or sold during the lifetime of the note holder.

Married couples who live in states that provide creditor protection for tenancy by the entireties assets, which are owed by married spouses, may wish to transfer promissory notes to be held as tenants by the entireties, so that the spouse presently holding a note would not lose the note if there was a creditor action against such spouse.

Where one spouse has made a seed capital gift to an irrevocable trust for the other spouse and/or descendants, and has sold assets that have been subject to valuation discounts in exchange for a note, the transfer of the note into joint names with the spouse who is a beneficiary of the trust might be considered to be evidence to the effect that the gift to the trust that owes the note was actually a transfer by the spouse who receives the note from the original noteholder spouse, or who shares ownership after the original noteholder spouse has placed the note into tenancy by the entireties. There does not appear to be support for the proposition that the transfer of a note after a legitimate installment sale transaction would be evidence to the effect that the recipient or TBE owner spouse has made a transfer to the trust that owes the note, especially if a Wandry assignment, or a King promissory note adjustment clause was used to assure that the value of what was transferred to the trust in exchange for the note was equal in value to the note.

It may nevertheless be a good idea to leave a reasonable amount of time between having the installment sale that resulted in the note existing and having the noteholder transfer it to the other spouse or tenancy by the entireties, and helpful for these steps to not be part of a single integrated plan. Many planners would recommend that separate steps occur in separate taxable years, but this will not be determinative in that the step transaction doctrine has been applied even where several years have transpired between steps that are pulled together into one aggregated transaction. It is helpful not to discuss or even consider a next step when putting the installment sale into place to limit the argument that there was an intent from the beginning to enter into the separate steps.

5. Valuation Discounts. The amount of the gift made upon forgiveness may be significantly less than the face amount owed on the note. Court cases have confirmed that promissory notes bearing interest at less than the normal fair market value rate will be subject to valuation discounts, as will a part ownership of a promissory note.

An excellent article that details the considerations with respect to the valuation of a note can be found in Bloomberg's Tax Management Estates, Gifts, and Trust Journal. [3]

It may be worthwhile to swap an existing long term low interest note for a shorter term higher interest rate note that would have the same value but a lower face amount. At a later time the replacement note could be gifted so that the gift tax return would show a gift equal to the amount owned on the note, as opposed to the discount that was taken into account when the original note was swapped out.

For example, a $10,000,000 20-year note bearing interest at 1.75% may be worth $8,000,000.

The payee of the note and the Trust that is the obligor may agree to swap the note for an $8,000,000 5-year note bearing interest at 6%, based upon the advice of legal counsel and a valuation expert.

The note may thereafter be forgiven or gifted as an $8,000,000 gift.

The exchange of a $10,000,000 1.75% 20-year note for an $8,000,000 6% interest 5-year note could be disclosed on a gift tax return, so that the IRS would have only three years from the date of the return to assert that a gift as occurred.

6. State Tax Considerations. Taxpayers should also consider and plan for the state estate tax consequences of such notes. Oftentimes, notes retained by a Grantor will be considered to be property for purposes of state estate tax calculations.

For example, New York's estate tax exemption is $5,930,000, but New York has no gift tax. As such, a New York resident may have a net worth upon their death under the $11,700,000 federal estate tax exemption (and won't pay federal estate taxes) and still pay estate taxes to the state of New York because the exemption amounts are not tied together. For example, the New York resident may nevertheless owe $399,440 in New York estate taxes if he or she retains the $10 million promissory note and $1 million worth of other assets. Thus, the New York resident must now make two considerations (1) whether to keep the promissory note in place and (2) whether to move to a place without a state estate tax, such as South Florida, which now has a population well exceeding 6 million and has been referred to as the sixth borough of New York City.[4]

Lawyers who represent individuals from high taxation states who still have "summer homes," or living patterns that may expose them to state and city taxes, should be particularly aware of this risk.

7. Finality. Many taxpayers and advisors might agitate over the fact that they simply are not sure what to do with a note. Thus, eliminating the note can provide better simplicity and give taxpayers a sense of finality and closure.

Third Step Strategies

Part II of this article will be issued soon and will discuss the following in more detail, but readers who are interested in something more than simply leaving the note in place, or forgiving or gifting all or a portion of the note may be interested in alternatives (aka the "third step").

Based on the above discussion, planners can make suggestions on how existing promissory notes and private annuity payment arrangements may be changed to best protect grantors and their families from taxation including but not limited to:

1. Abort the Mission and Leave the Dance Floor.
Some taxpayers may elect to step back, meaning that they wish to reverse the process completely, and only entered the dance floor because they feared the exemption would revert to a lower amount, such as $5,000,000. Now that the exemption amount is not expected to be drastically reduced, at least for the next couple of years, that same individual wants a less complicated plan than the Biden 2-step.

2. Transfer the Note to an Asset Protection Trust.
A note could be transferred to an Asset Protection Trust that is considered to be an "incomplete gift" for federal estate and gift tax purposes by reason of the Grantor having the right to consent before any distribution can be made to any person other than the Grantor, and a testamentary Power of Appointment, which may be exercisable solely in favor of descendants of the Grantor, or perhaps up to 25% to future spouses, charities or other individuals or entities, and 75% solely for the descendants of the Grantor.

While the note would still be includable in the Grantor's estate for estate tax purposes, it would be protected from creditors of the Grantor, assuming that the law of the asset protection jurisdiction is controlling, and also from undue influence and "next spouse" claims as well.

The trust could be drafted so that the Grantor could make the trust a "completed gift trust" by just renouncing her right to consent to distributions and her retained power of appointment, and at that time she will be considered to have made a complete gift of the assets under the trust to the Trustee, without further legal work and transfers being needed.

3. Convert the Note Into an Annuity
Noteholders who live in states that provide creditor protection for annuities may wish to convert the note, in whole or in part, to an annuity right.

4. Use a "Zero'd Out CLAT.
Many clients who are owed large promissory notes may not be aware of the ability to transfer a note or other assets to a Charitable Lead Annuity Trust ("CLAT") during life or upon death to qualify for a 100% estate and/or gift tax charitable deduction while expecting half or more of the assets involved to pass to be held for the benefit of family members after a term of years during which payments are made to one or more charities as determined each year by the family.

5. Safely Gifting the Note – Wandry, Petter, Q-TIP, What's Better?
When there has been an installment sale to a Defective Grantor Trust in exchange for non-voting membership or limited partnership interests, the remaining estate tax exemption of the taxpayer may be in doubt.

Should the taxpayer, therefore, wait until after the statute runs in 2025 before making a gift of any portion of the note? Alternatively, can the taxpayer safely use a formula clause transfer, or a lifetime QTIP Trust arrangement to gift as much of the note as possible without triggering gift tax? The answer is "most likely" with a formula transfer note, and "almost definitely" with a lifetime QTIP.

6. Using the Exemption for a QPRT Instead of Note Reduction.
Other alternative uses of the taxpayer's gift tax exemption may be considered. For example, if the taxpayer's homestead is expected to grow in value or to at least retain its value, and the Grantor is expected to live for longer than the period chosen as the retained use interest, then use of part of the taxpayer's gifting allowance for one or more QPRTs that can own all or a part of the taxpayer's primary residence and one other personal residence, can be the most effective use of gift tax exemption.

7. Give the Note Some SCIN.
Another advantage of keeping the note outstanding is the ability to maintain or convert it to a self-canceling installment note, in whole or in part, so that the death of the Grantor or the Grantor's spouse can cause the note not to be included in the Grantor's estate, without having to use the Grantor's estate tax exemption to reduce or eliminate it.

If the Grantor has a health condition or family history that would cause it to be more probable than not that death would occur before the balloon, then this could be a good strategy.

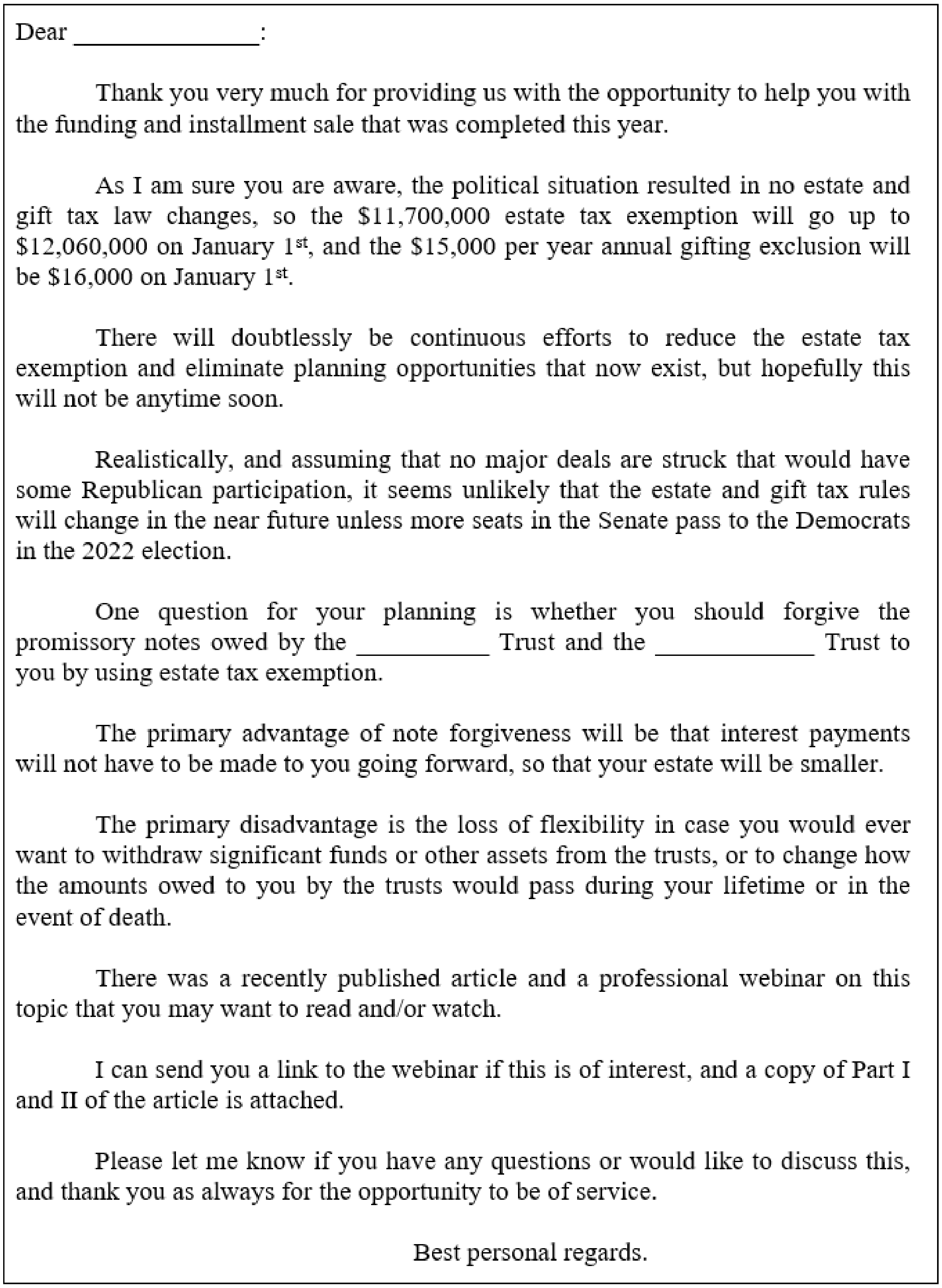
Conclusion

Taxpayers who have taken the first step in selling assets to disregarded trusts in exchange for promissory notes have many opportunities and possibilities to consider in determining whether to terminate or have the note repaid.

For estate tax planning purposes, the best result may be facilitated by forgiving the note, but not always.

Practical concerns such as marital rights, creditor protection, and whether a commitment should be made.

The following is a recent **sample letter** that may be used to pass these considerations along to your clients:



Dear _______________:

Thank you very much for providing us with the opportunity to help you with the funding and installment sale that was completed this year.

As I am sure you are aware, the political situation resulted in no estate and gift tax law changes, so the $11,700,000 estate tax exemption will go up to $12,060,000 on January 1st, and the $15,000 per year annual gifting exclusion will be $16,000 on January 1st.

There will doubtlessly be continuous efforts to reduce the estate tax exemption and eliminate planning opportunities that now exist, but hopefully this will not be anytime soon.

Realistically, and assuming that no major deals are struck that would have some Republican participation, it seems unlikely that the estate and gift tax rules will change in the near future unless more seats in the Senate pass to the Democrats in the 2022 election.

One question for your planning is whether you should forgive the promissory notes owed by the ___________ Trust and the _____________ Trust to you by using estate tax exemption.

The primary advantage of note forgiveness will be that interest payments will not have to be made to you going forward, so that your estate will be smaller.

The primary disadvantage is the loss of flexibility in case you would ever want to withdraw significant funds or other assets from the trusts, or to change how the amounts owed to you by the trusts would pass during your lifetime or in the event of death.

There was a recently published article and a professional webinar on this topic that you may want to read and/or watch.

I can send you a link to the webinar if this is of interest, and a copy of Part I and II of the article is attached.

Please let me know if you have any questions or would like to discuss this, and thank you as always for the opportunity to be of service.

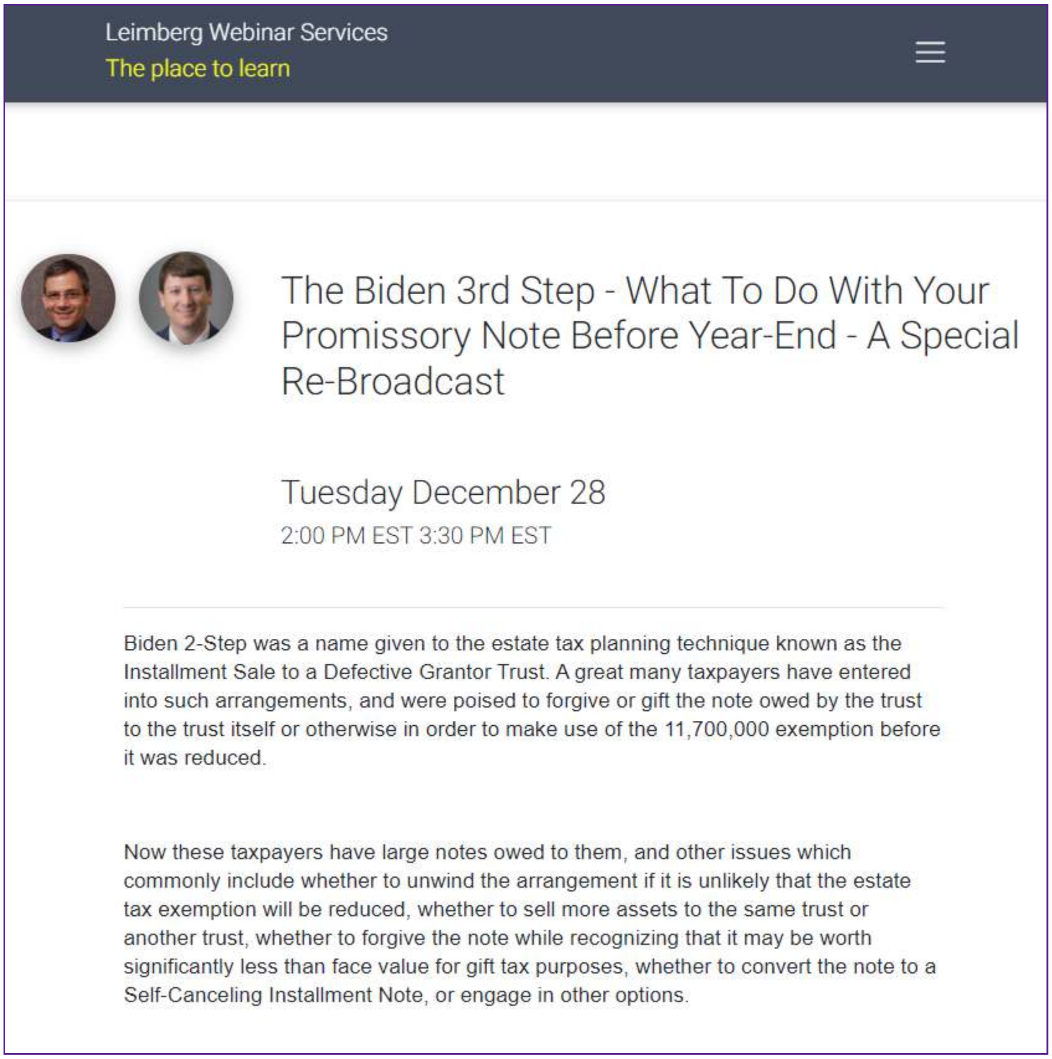
Best personal regards.

Want to learn more?

Join Alan and Brandon for a 90-minute video on this topic.

Leimberg Webinar Services on Tuesday, Dec 28, 2021.

REGISTER HERE



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The Biden 3rd Step - What To Do With Your Promissory Note Before Year-End - A Special Re-Broadcast

Tuesday December 28

2:00 PM EST 3:30 PM EST

Biden 2-Step was a name given to the estate tax planning technique known as the Installment Sale to a Defective Grantor Trust. A great many taxpayers have entered into such arrangements, and were poised to forgive or gift the note owed by the trust to the trust itself or otherwise in order to make use of the 11,700,000 exemption before it was reduced.

Now these taxpayers have large notes owed to them, and other issues which commonly include whether to unwind the arrangement if it is unlikely that the estate tax exemption will be reduced, whether to sell more assets to the same trust or another trust, whether to forgive the note while recognizing that it may be worth significantly less than face value for gift tax purposes, whether to convert the note to a Self-Canceling Installment Note, or engage in other options.

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[1] Ladies and Gentlemen, I have suffered from my music now it is your turn!

All the prophets of doom

Can always find room

In a world full of worry and fear

Tip cigarettes,

And chemistry sets,

And Rudolph, the Red-Nosed Reindeer.

From Monty Python's parody of a Bob Dylan Song. Monty Python Live! At City Center – Track 13 (1976) https://www.youtube.com/watch?v=qfTIGMCeuDE

(Brandon Ketron officially disclaims any participation in the selection or preparation of this footnote)

[2] Wells Fargo Equip. Fin. v. Retterath 2019 WL 1574686.

While some have commented that this decision was "corny" we are not aware of a kernel of contrary authority.

[3]Michael S. Strauss and Jerome M. Hesch, A Noteworthy Dichotomy: Valuation of Intrafamily Notes for Transfer Tax Purposes, 45 Bloomberg Tax Management Estates, Gifts, and Trust Journal 4 (Jan. 2020).

[4] New York City has 5 Boroughs, bring Manhattan, Brooklyn, the Bronx, Queens, and Staten Island. New York's Primary Airports are John F. Kennedy and LaGuardia. Islip (the name has since been changed to Long Island MacArthur Airport) is must less crowded but is a 2 hour cab from Manhattan.

This is Part 1 of this article.

Stay tuned for Part 2 in our next Thursday Report.

Article 2

New Stark Law - Don't Be Caught Naked

Written By: Alan Gassman, Esq. and Irine Plantenberg Korte

Memorandum to Physician Clients and Advisors
January 1, 2022 Deadline to Amend Physician Compensation Plans
for New Stark Law Changes

The following article is based upon our understanding of hundreds of pages of regulations, preambles and explanations.

There is a good chance that something we say in this article will not be absolutely correct. We will be updating this article in the future (stay tuned!).

As most physicians and physician advisors relating to group medical practices are aware, the Stark Law was amended in 2020 to change how compensation arrangements within group medical practices must be arranged in order to be able to bill Medicare for Designated Health Services (DHS).

The newly promulgated rule described below will not be effective until January 1, 2022.

The primary focus and impact on the Stark Law for group medical practices is the way that doctors working in the practice can be compensated with reference to their referrals or work on Designated Health Services.

For example, a doctor in a practice that bills Medicare cannot be compensated, directly or indirectly, based upon his or her referrals of patients to receive such Designated Health Services, except to the extent attributable to a reading fee or physician service that may be billed globally with the Designated Health Service.

Designated Health Services are as follows:

a. Clinical laboratory services

b. Physical therapy, occupational therapy, and outpatient speech-language pathology services

c. Radiology and certain other imaging services.

d. Durable medical equipment and supplies.

e. Parenteral and enteral nutrients, equipment, and supplies.

f. Prosthetics, orthotics, and prosthetic devices and supplies.

g. Home health services.

h. Outpatient prescription drugs.

i. Inpatient and outpatient hospital services.

The new rule will apparently apply to DHS income from services that are performed after 2021. For example, in January of 2022 practices will receive payment for many 2021 DHS, which may be distributed based upon the prior rules, while revenues received from 2022 DHS can be distributed under the new rules. It is somewhat difficult to draft documents and administer monies based upon the year that services were rendered, but some practices may elect to do so, while most will likely apply the new rules to all 2022 revenues, regardless of what year services were rendered.

Under the new rules, which will be effective on January 1, 2022, the main changes reflect that:

Change #1: Overall profits from DHS can be shared, not a percentage of revenues.

Doctors can be compensated based on overall profits from DHS when properly arranged, but not gross revenues.

Some practices currently have compensation arrangements where each doctor in the practice receives a certain percentage of all revenues derived from one or more DHS, such as each doctor in a five doctor practice receiving 10% of revenues derived from ultrasounds given in the practice.

Effective January 1, 2022, the doctors will only be able to be compensated for DHS based upon net "overall profits" attributable thereto. These profits must be divided in a reasonable and verifiable manner not directly related to the volume or value of a physician's referrals for DHS.

Additionally, these profits must be aggregated prior to any payment to physicians (doing away with the practice's ability to allocate distributions differently for each kind of DHS).

Regulations are surprisingly sparse for what the definition of "overall profits" will be. Comments to the proposed rule even identified the lack of direction to which the response again identified the necessity for calculation of overall profits to not be based on volume or value.

There are entire textbooks and graduate schools courses on the concept of "cost accounting" and how direct and indirect costs are allocated to separate and related businesses and endeavors.

The entire treatment of the term "overall profits" in the new regulations is as follows:

> § 411.352 - Group Practice. ...
>
> (ii) Overall profits means the profits derived from all the designated health services of any component of the group that consists of at least five physicians, which may include all physicians in the group. If there are fewer than five physicians in the group, overall profits means the profits derived from all the designated health services of the group.
>
> (iii) Overall profits must be divided in a reasonable and verifiable manner. The share of overall profits will be deemed not to directly relate to the volume or value of referrals if one of the following conditions is met:
>
> (A) Overall profits are divided per capita (for example, per member of the group or per physician in the group)
>
> (B) Overall profits are distributed based on the distribution of the group's revenues attributed to services that are not designated health services and would not be considered designated health services if they were payable by Medicare.
>
> (C) Revenues derived from designated health services constitute less than 5 percent of the group's total revenues, and the portion of those revenues distributed to each physician in the group constitutes 5

> percent or less of his or her total compensation from the group.

The entire treatment of “overall profits” under the preamble and explanation is as follows:

> ...overall profits means “the profits derived from all the designated health services.” Thus, the profits from all the designated health services of any component of the group that consists of at least five physicians...must be aggregated before distribution. To illustrate, suppose a physician practice provides both clinical laboratory services and diagnostic imaging services—both designated health services—to its patients in a centralized building ... or a location that qualifies as a ‘‘same building’’.... If the practice wishes to qualify as a group practice, it may not distribute the profits from clinical laboratory services to one subset of its physicians and distribute the profits from diagnostic imaging to a different subset of its physicians.
>
> We are cognizant that under the requirement...the overhead expenses of, and income from, a practice must be distributed according to methods that are determined before the receipt of payment for those services giving rise to the overhead expenses or producing the income.

This new rule will cause a significant hardship for many practices, because the definition and calculation of “overall profits” can be somewhat complicated, especially since the compensation arrangements are typically planned prospectively.

Most medical practices develop compensation arrangements yearly, which is why the final rule does not go into effect until January 1, 2022, even though it was issued January 19, 2021.

For example, an ultrasound machine may be owned by the practice, but can be depreciated whereby its cost is amortized over a period of time, such as seven years.

Alternatively, an ultrasound machine might be leased from an unrelated third party, so that the lease payment would be a cost of operation.
An ultrasound technician might spend 35% of his time doing ultrasound work in the practice, and 65% of his time doing other things.

The ultrasound tech’s compensation costs includes not only salary, but employment taxes, insurances, Workers’ Compensation and pension contributions.

The ultrasound machine may occupy a room in the practice that uses air conditioning and electricity, so rent, electricity, office insurances and janitorial expenses would need to be allocated as costs in the determination of net profit.

In addition, the billing department of the practice bills and tracks receipts and does follow-up work that must also be taken into account.

Many practices will wonder if it is even worth the expenses of keeping track of “overall profits” when such profits are not required to be distributed to the physicians. However, the vagueness found within these definitions may be good news for medical practices that would like to make the calculation of net profits simpler than what might otherwise apply.

Change #2: Physician compensation on DHS profits must be calculated equally.

Any medical group that bases physician compensation on DHS profits must do so by allocating all DHS profits using the same formula, which must be established in advance and not take into account the volume or value of referrals. Many medical practices have divided income or revenues for one or more DHS’s in different ways.

For example, if one physician in the group produces 65% of the professional service fees and the other physician produces 35% of the professional fees, the ultimate distribution of x-ray revenues for the practice may be based upon 65%/35%, while ultrasound profits might be divided equally.

The new rule would require that all DHS profits (including the above-referenced x-ray and ultrasound profits) would have to be allocated based upon one method of determination.

An example applying current practices, revenue from a blood lab might be shared 90% equally among the primary care doctors in a multi-specialty practice, and 10% equally among the surgeons, while physical therapy revenues might be shared 80% among the surgeons and 20% among the primary care doctors.

Under the new rule, this practice will have to share the overall profits from all DHS in the same proportion for each physician within each pod of five or more physicians, or the entire practice if no pods are designated. Pods of five physicians can be designated when the group practice contains ten or more physicians, and each pod may use a different formula or method of determining the DHS profit sharing. An entity may not compensate a physician based directly or indirectly on the volume or value of that physician's referrals.

For medical practices having fewer than ten doctors, this means that the profits of DHS that are shared must all be shared in accordance with the same formula. Referring back to the above example, the surgeons may receive 60% of all DHS overall profits for physical therapy and blood lab in equal shares, and the primary care doctors may receive 40% of all such DHS items in equal shares.

In contrast, if the group practice described above consisted of five surgeons and four primary care doctors, and they add another doctor of any specialty, they can have five doctors who share DHS profits in one way and five doctors who share DHS profits in another way.

If this example group added another surgeon, and therefore had six surgeons and four primary care doctors, they could allow five of the surgeons to share in the DHS profits in one method, and the four primary care doctors and one surgeon to share in the DHS profits another method.

This might mean that the surgeons share equally 80% of the physical therapy and 20% of blood lab DHS profits, and the mixed-physician pod share 20% of the physical therapy and 80% of the blood lab DHS profits.

Unfortunately, there cannot be a pod of less than five doctors, so one surgeon in the above example will have to be treated differently than the others to comply with these rules.

Pods do not have to be based on any specific criteria, and eligibility standards may be utilized to develop the pods as desired by the medical group. Eligibility standards may be based on whether the physician is an owner, employee or independent contractor, or how long the physician has been with the group.

The above conclusion is based upon the following excerpt from the preamble to the final rule:

> [A] physician in a group practice may be paid a share of overall profits of the group practice, provided that the share is not determined in any manner that is directly related to the volume or value of referrals by the physician. We have long interpreted "is directly related to" ... to mean "takes into account[.]"

Change #3: Only Medicare DHS profits are subject to Stark Law.

The Stark Law rules do not apply to Medicaid or Medicare Advantage/HMO plans, TRICARE or other federal programs.

It was widely assumed by conservative health care lawyers and other advisors that the Stark Law applied to federal programs other than Medicare, but the new regulations clarify that this is not the case.

This will have a large impact on medical groups located in states that do not regulate compensation for Designated Health Services.

The vast majority of our physician clients are in Florida, subjecting them to Florida's Patient Self-Referral Act, which is very similar to the Stark Law. Florida's act has the same list of Designated Health Services, except that x-ray is excluded from the list.

Florida physician practices may therefore wish to distribute x-ray revenues or profits to the referring physician, if health care counsel is comfortable that such allocation does not breach any Medicare or Florida "anti-kickback" or "patient brokering" rules.

In the preamble to the finalized rule, the above conclusion was explained as follows:

> "We believe that the inclusion of this [Medicaid] reference unnecessarily complicates the regulation.... This is because the definition of "designated health services" includes only those services payable in

> whole or in part by Medicare...
>
> For consistency with the definitions and regulations we proposed (and are finalizing here), we [are eliminating] the references to Medicaid in the definition of “overall profits."

This explicit shift away from application to all federally funded payor systems will likely cause Florida providers to change their allocation of x-ray technical component revenue or profit from non-Medicare beneficiaries to be allocated to the referring physician in a medical practice.

Change #4: Value-based exceptions may be utilized for innovative group practice arrangements.

Revenues and profits from Designated Health Services rendered for patients under “value-based” activities will not be subject to the Stark Law limitation.

Apparently, there will be some contractual or medical facility or hospital-related cost and quality assurance programs that physician groups may become involved with such as clinically integrated networks, where insurance carriers monitor costs and outcomes, and may share cost-savings with medical groups.

The new regulations recognize that these arrangements present less risk of abuse and will permit doctors who are in these arrangements to be credited with net profits from designated health services that they recommend, under certain circumstance which are not at all well defined.

This exemption does not appear to be available to the vast majority of medical groups but may present a good opportunity when the smoke clears on what this really is, and how a doctor would be part of this type of arrangement while treating medicare patients.

The regulations confirm that this situation is complex, as follows:

> For example, a shared savings payment distributed by an entity to a downstream physician who joined with other providers and suppliers to achieve the savings represents the physician’s agreed upon share of such savings rather than a payment for specific items or services furnished by the physician to the entity (or on the entity’s behalf). And, when payments are made to encourage a physician to adhere to a redesigned care protocol, such payments are made, in part, in consideration of the physician refraining from following or altering his or her past patient care practices rather than for direct patient care items or services provided by the physician.

Value-based arrangements are explained in several definitions that have been added as of the promulgation of the new rule taking effect; these terms might be included by health care lawyers, but they seem very confusing to us, and consist of the following:

> a. Value-based activity – an activity that is reasonably designed to achieve the value-based purpose of the value-based enterprise;
>
> b. Value-based arrangement – an arrangement for the provision of at least one value-based activity for a target patient population
>
> c. Value-based enterprise (VBE) – two or more participants that collaborate to achieve a purpose, within a value-based arrangement, having an accountable body or person, and records such arrangement with a “governing document” that describes the moving parts thereto;
>
> d. Value-based purpose – this definition contains many prongs to achieve; coordination and management of care of a target patient population, improving quality of care for that population, reducing costs or growth of expenditures and operational oversight for a value-based enterprise, or transitioning from volume-based care models to quality of care and control of costs care models for a target patient population
>
> e. VBE participant – an individual or entity that engages in one or more value-based activities as a part of a VBE; and
>
> f. Target patient population – an identified population selected by the VBE or its participants based on criteria, set out in writing, that is used to further the value-based purpose(s).

Value-based arrangements share a foundation with value-based healthcare delivery: patient care coordination and management.

For example, if a patient undergoes a surgical procedure that requires follow-up after discharge by a physician and the performing surgical center, and the surgical center has a value-based purpose of maintaining coordination of care, then the physician's follow-up is considered to be a value-based activity. The compensation the physician receives would be from a value-based arrangement.

In an interest to allow for VBE participants to remain innovative in development of value-based delivery of services, CMS directly states that an activity would qualify as a value-based activity when the activity is "reasonably designed to achieve at least one value-based purpose of the value-based enterprise."

There is no requirement that a value-based purpose is achieved, only a good faith belief that the activity would achieve such purpose, to be protected under the applicable exception.

Change #5: Better guidance on exceptions for "Incident To" services.

An "Incident To" service is a service provided under the direct supervision of a doctor.

The final rule discusses "incident to" services within the § 411.352 as follows:

> [Compensation] may directly relate to the volume or value of DHS referrals by the physician if the referrals are for service "incident to" the physician's personally performed services.

While an "incident to" service might be considered to be a DHS, the regulations recognize that when a doctor has to be intricately involved in supervising a particular procedure, test, or other service performed by another physician or non-physician practitioner (NPP), the supervising physician may be compensated as if the service were not a DHS. An "incident to" compensation payment may relate directly to the volume or value of the physician's referrals.

A physician's compensation for "incident to" services is not calculated in the same manner that any other compensation from DHS is calculated. "Incident to" services are paid to a physician in what is commonly known as a productivity bonus.

"Incident to" services are, therefore, relative to the personal productivity of the physician, and not subject to the regulation under Stark Law.

Examples of "Incident To" services that will not be considered DHS for purposes of the Stark Law (meaning that the doctor can receive a productivity bonus as if this was personal service income generated by him or her) are as follows:

> a. Physician assigned supervision of chemotherapy suite (as required by Medicare), even without physician's knowledge, considered "incident to" patient's treatment and physician received compensation for chemotherapy suite coverage. (*U.S. ex. rel. Lockyer v. Hawaii Pacific Health, 490 F.Supp.2d 1062 (D.Hawaii, 2007*).
>
> b. Physician ordered blood lab work that was completed by another practitioner (or NPP) within the same group, and physician is permitted to receive compensation for remaining in the office to indirectly supervise DHS incident to other care by physician.
>
> c. One physician ordered chemotherapy for a patient; another physician was supervising in the chemotherapy suite during the patient's treatment. The second physician may receive compensation for DHS "incident to" their action in supervision.

There are several other instances of "incident to" services that do not have anything to do with the new Stark Law and issued a final rule that has been excluded from our discussion.

The many changes coming into effect on January 1, 2022 after issuance of the final rule on January 19, 2021 may cause group practices to scramble here at year-end to develop appropriate formulas and designations for Stark Law compliance.

Main ideas to focus on, as discussed, are the changes in the manner of calculating and allocation of overall profits (as opposed to revenues generally) and the specificity of such within the group(s) of physicians in each practice. This may be offset by the explicit exclusion of non-Medicare government-funded payor program (Medicaid, TriCare, etc.).

As previously indicated, this article may contain our interpretation that may not be absolutely correct. We encourage you to check back with us for further updates!

Article 3

The Ballad of Louis P. Smaldino

Written By: Matthew Giovenco, with a little help from Alan Gassman

'Twas the night before Christmas, all through the Smaldino house,
Not a creature was stirring, not even a mouse;
The ownership units of the LLC had been listed on his return with care,
In hopes that a tax-free gift was there;

The children were nestled all snug in their beds;
While visions of their very own rental properties danced in their heads,
And Mama in her 'kerchief, and him in his cap,
Had just settled down for a long winter's nap—

When out on the lawn there arose such clatter,
An IRS auditor, hopes and dreams to shatter;
Away to the door, Smaldino flew like a flash,
To find out that his empire now had a bad rash.

In 2013, that IRS auditor said,
The tax law should have been better read,

Because that taxpayer named Louis Smaldino[1]
Unsuccessfully swang for the fences like The Great Bambino[2]

He had tried using many tax avoidance tactics,
And the IRS despised his mathematics:
He had used over $4,000,000 of his $5,200,000 estate tax exemption;
His wife had not used any of hers, which got his attention.

He had 10 rental properties in California
And put them into an LLC, but let us warn ya
The LLC was owned by him in the end,
And his second wife was a very true friend

He hired an appraiser who determined a 36% discount,
Through which Smaldino planned his mount.
He transferred 8% in trust for his kids and 41% to his wife,[3]
Who transferred it immediately to the kids' trust—love is blyth;[4]

His gift tax return reported the 8%, but did not report the marital gift,
A blunder that got the IRS miffed.
Smaldino thought he had a way, gave his attorney a whistle,
And away to Tax Court they flew, hoping to avoid dismissal.

The IRS applied the "Step Transaction Doctrine"[5]
And said that Smaldino made a 49% gift therein—
His gift tax return was thus a bit lean-a,
And Mr. Smaldino's tax deficiency made the IRS mean-a.[6]

In fact the Tax Court held that his wife made no gift at all,[7]
Because she agreed to transfer it immediately based on a plan from last fall;
The court found a lack of LLC paperwork less than commendable[8]
But the fact that no penalties were imposed is quite memorable.

The end result for Mr. Smaldino was a very large gift,[9]

The looming gift tax may cause a tiff;
But the tax code might allow Mr. Smaldino to act again,
By having Mrs. Smaldino now file a gift split for the win.

A $7.8 million dollar gift the Tax Court found,
At that amount, Mr. Smaldino frowned,
But the clever advisors may have an idea,
To split the gift with the Mrs. Smaldino, oh my, Mamma Mia![10]

A split of the gift by the clever CPA and his wife,
That $7.8 million dollar gift swiftly halved by a knife,
Now the gift hath turned to $3.9 million dollars by each,
To reduce the gift tax payment well within reach.

$10 million dollars[11] of property was removed from Mr. Smaldino's estate,
So the IRS lost 60% of the estate tax revenue at the 40% rate,[12]
And please don't forget that the estate tax is tax-exclusive,
The calculation of which can be quite elusive.

If I leave my children $10,000,000 on death,
They will pay $4,000,000 at most, at most, 9 months after my final breath.
However, if 3 years before death and $4,000,000 by lifetime transfer I shift;
If my exclusion has been totally used, I will pay $1,600,000 in taxes on that gift.

Then I die with $4,400,000 above and beyond my other assets instead $1,000,000 times ten—
My heirs will be happy because the $1,600,000 doesn't get taxed again;
So paying gift taxes can be your descendants' best friend,
Just make sure it is 3 years before your life does end.[13]

Mr. Smaldino was the officer of a successful business,
And took a gamble with lots of riches;
Although he lost the audit lottery,
He is not without tax savings that can buy a lot of pottery.

Of course, there are many lessons to learn,

Perhaps even better ways to minimize taxes on what you earn,

But don’t be exactly like Mr. Smaldino,

And take the chances that would work better in Reno.

Allow your tax advisor to make a bid,

And hopefully, your high taxes they will rid;

Decide with your advisors in advance what to do,

And more likely you can have a better result, and not catch the “audit adjustments flu.”

And for the tax experts out there,

In addition to the footnotes, which may be more than you can bear;

Please understand the *step transaction doctrine*,

Because surviving it will take much more than 30 days and oxygen.

The court in *Senda* says this doctrine is impliedly included in the gift tax statute,

Where formally distinct steps are classified as one same root;

The entire transaction, the court looks,

Rather than each separate entry in the taxpayer’s books.[14]

In Holman v. our good friend the Commish,[15]

Tax avoidance was the retired Dell employee’s wish:

He funded a partnership with Dell stock and after 6 days elapsed,

He transferred a partnership interest reporting a discount, alas.

The IRS claimed that no discount applied,

But the Tax Court said the Holman was not in a pickle, on rye,

6 days was long enough between funding and gifting:

Thus, Mr. Holman found a good way for shifting.

This whole concept is rather confusing,

And a tax issue that some of you may find amusing;

A way to ensure that a gift is discounted,

Even if it’s made shortly after an entity is with volatile stock funded.

What is written above may be quippy and smart,
There is an important lesson you should take to heart:
The *Holman* situation is separate and apart,
From the step transaction doctrine, which is somewhat science and somewhat art.

Don’t think that 30 days will avoid the doctrine,
Or your client will quickly run out of oxygen,
The Tax Court and the IRS will explain without reluctance
That they “hate hate hate”[16] transactions that lack economic substance.[17]
This is different than the normal case law on step transactions—
Timing and intent could cause 6 months or even 6 years to elicit the same reaction[18];
The case of *Whiteley v. Commisioner* is another example,[19]
Where the IRS left a taxpayer in shambles.

A transaction occurred 7 days after the first step,
The Tax Court and IRS deemed the taxpayers inept;
The time between transactions in this case didn’t matter,
Which caused the taxpayers’ heads to shatter.

The Tax Court will focus on rights retained by the grantor,
And the IRS has a very strong hammer,
Be careful not to leave strings attached,
Lest you subject yourself to an estate tax.

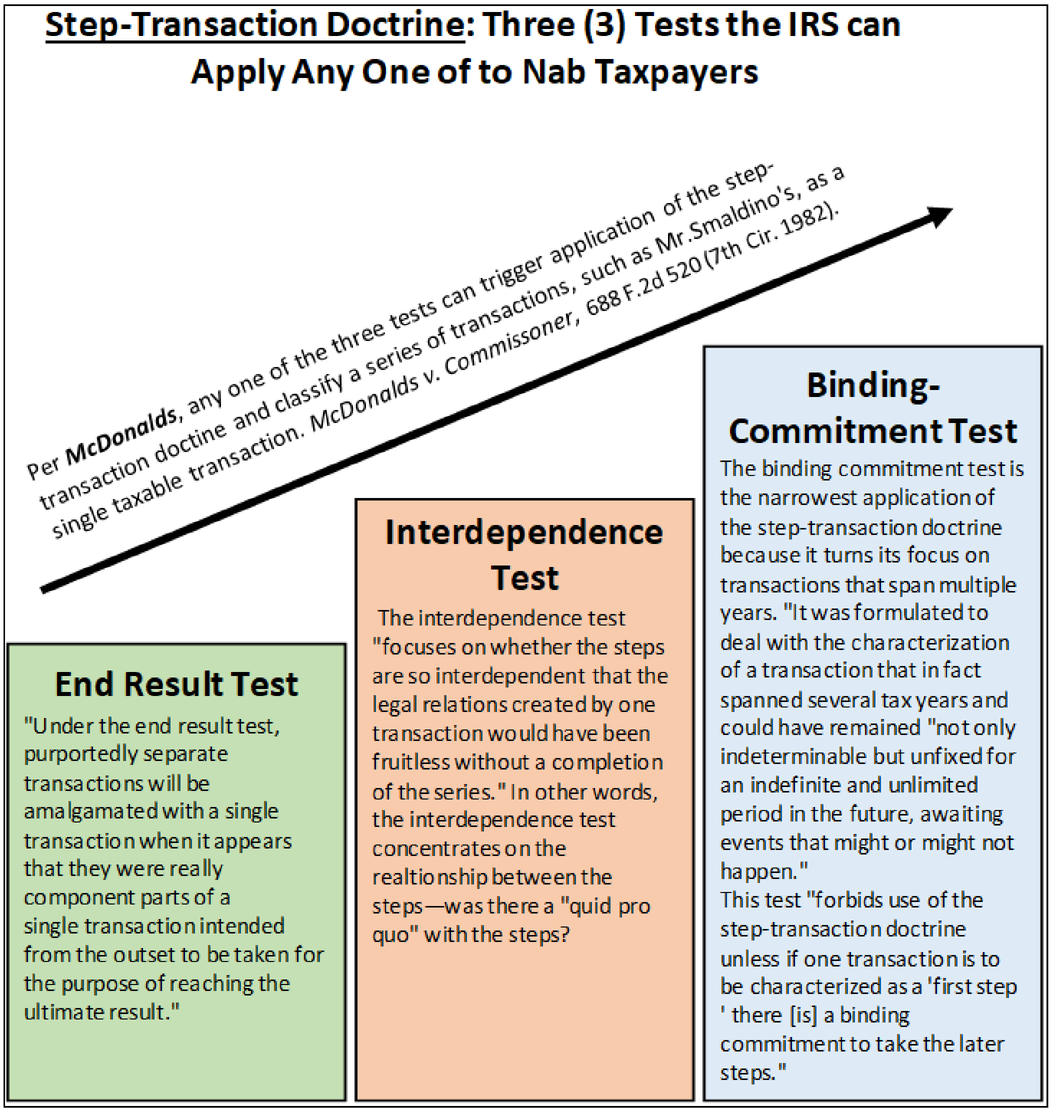
Assets resulting from a gift,
May be taxed to the donor under IRC section 2036,
Where the grantor is still considered to be the owner;
And thus from his estate, the assets not gone-r.[20]

In a plan to fund a SLAT, funds must actually come from the non-beneficiary spouse,
Even if you try and tiptoe like a mouse;
Because if the IRS thinks it came indirectly from the grantor,
Expect estate taxation despite your best banter.

This may bring you to tears,
That not 6 or 7 days but even if there are steps separated by 3 years,
A court challenge of the transaction can cause the gavel to drop,
And the step transaction doctrine can put your plan to a stop.[21]

And there are variations of the step transaction doctrine that you will see,
Three arrows in the quiver that fill the IRS with glee,
The end result test, the interdependence, and the binding commitment test
Cause the IRS to beat their chest.

'Twas the night before Christmas, as you sit in your house,
Reading this poem, your head a madhouse;
The chart below might help you make sense,[22]
So hopefully your confusion is past tense.



Step-Transaction Doctrine: Three (3) Tests the IRS can Apply Any One of to Nab Taxpayers

Per ***McDonalds***, any one of the three tests can trigger application of the step-transaction doctine and classify a series of transactions, such as Mr.Smaldino's, as a single taxable transaction. *McDonalds v. Commissoner*, 688 F.2d 520 (7th Cir. 1982).

End Result Test

"Under the end result test, purportedly separate transactions will be amalgamated with a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."

Interdependence Test

The 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." In other words, the interdependence test concentrates on the realtionship between the steps—was there a "quid pro quo" with the steps?

Binding-Commitment Test

The binding commitment test is the narrowest application of the step-transaction doctrine because it turns its focus on transactions that span multiple years. "It was formulated to deal with the characterization of a transaction that in fact spanned several tax years and could have remained "not only indeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen."
This test "forbids use of the step-transaction doctrine unless if one transaction is to be characterized as a 'first step ' there [is] a binding commitment to take the later steps."

Under any test, the doctrine acts to make any transaction difficult,
If in substance they are integrated, interdependent, and aimed at a particular result;[23]
The courts will look at each test,
And see which one is better than the rest.

With the binding commitment test, after a taxpayer takes a first step,
If a contract or other commitment makes him take a later step,
Those transactions must be combined,
At least that’s how the U.S. Supreme Court opined.[24]

Second, courts might look at the end result,
To throw “clever” taxpayers into a state of tumult.
Classifies as single, a series of formally separate transactions,

Intended from the outset to be a part of the same interaction.

Third, courts look at test of interdependence,
Which is when a transaction has anything but independence;
Because based on a reasonable interpretation of objective facts,
Transactions are so interrelated and would not work without a specific series of acts.

Under any one test devised,
Even if the taxpayers tried.
The transactions may be stepped together;
Leaving the taxpayer to wish for better weather.

The IRS looks at substance over form,
At least that appears to be the norm.
Taxpayers are encouraged to take legally permissible means to their maxes,
So long there is another reason to avoid paying taxes.

We are presently at a loss for words with a better combination,
Mr. Smaldino or his advisors messed up the documentation.[25]
Nevertheless, a discount of Thirty-Six (36) percent,
Is where a lot of taxpayers would like to have went.

Mr. Smaldino thought he'd made Santa’s list,
But instead it turned out that he got the IRS pissed;
But those of us that do the tax planning right,
Can enjoy a happy Christmas, and to all a good night.

WE HOPE THAT THIS HELPS YOU HELP OTHERS.

EVEN IF THEY GIFT VIA WIVES WHO ARE NOT THEIR CHILDREN’S MOTHERS.

[1] Louis P. Smaldino, CPA was 69-years old in 2012, and married Agustina Smaldino in 2006. *Smaldino v. Commissioner*, No. 5437-18, 2021 Tax Ct. Memo LEXIS 168 (T.C. Nov. 10, 2021). Mr. Smaldino had 6 children and 10 grandchildren by his prior marriage. *Id*. He owned 10 rental properties, and formed Smaldino Investments, LLC in 2003, but it was inactive until 2012. He placed the 10 properties under Smaldino Investments, LLC (LLC), which he owned through a revocable trust. *Id*. In 2013 he transferred about 8% of the LLC class B member interests to the Smaldino 2012 Dynasty Trust (Dynasty Trust), an irrevocable trust that he had created a few months earlier for the benefit of his children and grandchildren. At *a*round the same time he purportedly transferred about 41% of the LLC class B member interests to Agustina, who purportedly retransferred them to the Dynasty Trust the next day. *Id.*

[2] George Herman "Babe" Ruth, also known as The Great Bambino and The Sultan of Swat, was an iconic American Baseball player known for his ability to swing for the fences, finishing his career with a record-setting 714 career home runs. *Babe Ruth*, Wikipedia (last updated Dec. 12, 2021), https://en.wikipedia.org/wiki/Babe_Ruth. No baseball player has ever been so highly referred in the sport. Ruth also struck out a lot, which was necessary to have a lot of home runs. Mr. Smaldino also took a big risk, and hit a double instead of a homerun by the authors' estimation. As the Great Bambino once said, "[n]ever let the fear of striking out get in your way."

[3] 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" and did not report any gift to his spouse. *Smaldino v. Commissioner*, No. 5437-18, 2021 Tax Ct. Memo LEXIS 168 (T.C. Nov. 10, 2021).

[4] 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". *Id*. Mrs. Smaldino allocated against this transfer $5,249,118 of her $5,250,000 available Federal estate and gift tax exemption, resulting in zero reported gift tax due. She did not elect to split the gift.

[5] 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 doing so is imposition of or relief from taxation." *FNMA v. Commissioner*, 896 F.2d 580, 586 (D.C. Cir. 1990), cert denied, 499 U.S. 971 (1991) (citing Kanawha Gas & Utilities Co. v. United States, 214 F.2d 685, 691 (5th Cir. 1954).

[6] "The [IRS] contend[ed] that [Mr. Smaldino] made a taxable gift to the Dynasty Trust of a 49% class B member interest in the LLC, including an indirect gift of the 40.95% class B member interest that he purportedly transferred to Mrs. Smaldino and that she purportedly retransferred to the Dynasty Trust a day later". Although the [IRS] determined in the notice of deficiency that the fair market value of the 49% class B member interest (the subject interest) was $8,180,000, in this proceeding [Mr. Smaldino] contends, on the basis of his expert's report and testimony, that the fair market value of the subject interest was actually $8,421,000." *Smaldino*, No. 5437-18, 2021 Tax Ct. Memo at *15.

[7] "[C]ourts have often recognized that the tax consequences of a transaction involving a nominee or straw party 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 fh dismissed from consideration'". *Snyder v. Commissioner*, 66 T.C. 785, 791 (1976) (quoting *Higgins v. Smith*, 308 U.S. 473, 476 (1940)); cf. sec. 1.704-1(e)(2)(i), Income Tax Regs. ("The reality of the transfer and of the donee's ownership of . . . [an interest in a partnership] attributed to him are to be ascertained from the conduct of the parties with respect to the alleged gift and not by any mechanical or formal test.").

[8] The Tax Court noted (indirectly) that the actual signing date of the certificate of assignment and the amendment to restate the membership interests within the operating agreement did not coincide with the dates that Mr. Smaldino claimed the assignment and operating agreement amendment had occurred. *Smaldino*, No. 5437-18, 2021 Tax Ct. Memo.

[9] The IRS and Mr. Smaldino used different experts to value the LLC interests transferred. The Tax Court analyzed the reports of both experts and ultimately concluded that Mr. Smaldino, rather than his wife, made a $7,820,008 gift by transferring 49% of the class B membership interests in the LLC to the trust. This amount was calculated based on the net asset value of the LLC discounted 36% for the minority interest. *Id*.

[10] A husband and wife may consent to "split gifts" for a given calendar year so that all gifts that they both make are considered as having been transferred one-half by each spouse, if each of the following three conditions are met: (1) both spouses must be US Citizens or residents on the date of the gift, (2) both spouses must consent to having all gifts made by each of them treated as having been made one-half each, and (3) the spouses must be married on the date of all gifts made during the year, and cannot remarry during the remainder of the calendar year. I.R.C. § 2513(a). Generally, the IRS will let either spouse signify consent on the later of (1) April 15th of the year following when the gifts are made or (2) when the donor spouse files the gift return. This is so the taxpayers can't make the gift and wait to see if the return is audited before electing gift splitting. See Alan Gassman, *9 Common Mistakes Related to Spousal Gift Splitting*, Gassman, Crotty, & Denicolo, P.A., https://gassmanlaw.com/wp-content/uploads/2013/04/Dynasty_ Presentation.1.pdf.

[11] The Tax Court looked past the transfer of LLC interests to Mrs. Smaldino for its lack of economic substance and characterized the two transfers as one, holding that Mr. Smaldino had effectively made a gift (valued at $7,820,008) to the dynasty trust of 49% of the class B membership interests in the LLC. *Smaldino*, No. 5437-18, 2021 Tax Ct. Memo. If the $7,820,008 gift was split with Mrs. Smaldino, Mr. and Mrs. Smaldino would each be considered as having made a $3,910,004 gift, resulting in the imposition of a $1,564,002 gift tax on Mr. Smaldino. *Id*. If the gift was split, Mr. Smaldino would have gotten approximately $10,000,000 worth of real estate (that has probably grown in value tremendously) out of the estate tax system. *Id*.

[12] If the Smaldino's can now elect to split the gift so that he is considered to have gifted $3,910,004 worth of LLC interests their gift tax exposure would be reduced greatly. *Id*. Instead of paying a 40% gift tax on $10,000,000, the undiscounted value of the assets transferred, under the split, the Smaldino's would only pay $1,564,002 in tax, 40% of 3,910,004, Mr. Smaldino's split portion of the gift. *Id*. Note that Mrs. Smaldino's $3,910,004 can pass free of gift tax, as long as she uses her lifetime exemption. *Id*. Ultimately, this would lead to a 60% reduction in what the IRS could have realized (40% of $10 million is $4 million, but under the split Smaldino's only pay $1.6 million in tax, 40% of 4 million and a 60% reduction in what IRS could have realized). *Id*.

[13] IRC § 2035.

[14] *Senda v. Commissioner*, 433 F.3d 1044 (8th Cir. 2006) ("In some situations, formally distinct steps are considered as an integrated whole, rather than in isolation, so federal tax liability is based on a realistic view of the entire transaction . . . . [the] step-transaction doctrine is "impliedly included in the gift tax statute itself.

[15] *Holman v. Commissioner*, 601 F.3d 763 (8th Cir. 2010)

[16] The Grinch: "So whatever the reason, his heart or his shoes, he stood outside his cave, hating the Whos . . . . 'Hate Hate Hate, Hate Hate Hate, Double Hate, LOATHE ENTIRELY.'" Dr. Seuss' How the Grinch Stole Christmas (Universal Pictures & Imagine Entertainment 2000) (emphasis added).

[17] A US District court has explained that:

> The economic substance doctrine allows courts to enforce the legislative purpose of the Internal Revenue Code by preventing taxpayers from reaping tax benefits from transactions lacking in economic reality. *Klamath*, 568 F.3d at 543 (citing *Coltec*, 454 F.3d at 1353-54). Taxpayers undoubtedly have the right to decrease or avoid taxes by legally permissible means. See *Gregory v. Helvering*, 293 U.S. 465, 469, 55 S. Ct. 266, 79 L. Ed. 596 (1935). "The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings. *Yosha v. Comm'r*, 861 F.2d 494, 498-99 (7th Cir. 1988). The application of this well-established doctrine is nevertheless murky: "The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." *Collins v. Comm'r*, 857 F.2d 1383, 1385 (9th Cir. 1988).

Southgate Master Fund v. United States, 651 F. Supp. 2d 596 (N.D. Tex. 2009).

[18] A transaction spanning multiple years can still be characterized as a single transaction under the step transaction doctrine. *McDonald's Rests. of Ill., Inc. v. Commissioner*, 688 F.2d 520, 525 (7th Cir. 1982). The "'binding commitment' test is the most [narrow application] on the step-transaction doctrine because it was formulated to deal with the characterization of a transaction that in fact spanned several tax years and could have remained 'not only indeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen." *Id*. (citing *Commissioner v. Gordon*, 391 U.S. 83, 96 (1968)). In other words, the binding commitment test is targeted towards stepped transactions that happen over a longer period of time, and steps together transactions when there is a binding commitment, usually contractual, to take later steps upon taking a first step. *McDonald's*, 688 F. 2d at 525. In *McDonald's* the transaction spanning 6 months was stepped together because the taxpayer was contractually obligated to take additional steps and actually did take those steps 6 months later. Another case, *Gordon* stepped together a 3 year transaction because the taxpayer had a clause in the contract that gave the taxpayers stock options 3 years after the initial purchase of the stock. 391 U.S. at 97–98. "Accordingly, we hold that the taxpayers, having exercised rights to purchase shares of Northwest from Pacific in 1961, must recognize ordinary income in that year in the amount of the difference between $16 per share and the fair market value of a share of Northwest common at the moment the rights were exercised." *Id*.

[19] *Whiteley v. Commissioner*, 42 B.T.A. 402 (1940), aff'd, 120 F.2d 782 (3d Cir. 1941), cert. denied, 314 U.S. 657 (1941). In *Whiteley*, there were approximately 7 days between the creation of a trust and a $200,000 gift which became a main issue in the case. The *Whiteley* court, however, did not touch on the short passage of time in its analysis and instead focused on the rights retained by the taxpayer after the transfer.

[20] Under Section 2036(a) assets that are the result of a gift will be considered as owned by the grantor if the grantor retains certain rights over the assets, unless the transfer made by the decedent was considered to be a "bona fide sale for adequate and full consideration." Alan Gassman et al., *The Thursday Report Issue 306*, Gassman, Crotty, & Denicolo, P.A. (June 17, 2021), https://gassmanlaw.com/thursday-reports/9247/. Generally, Section 2036(a) is implicated when (1) the grantor retains income from or possession of the property for life or (2) the grantor reserves the right to change beneficial enjoyment over the property.

[21] *Commissioner v. Gordon* , 391 U.S. 83, 88 S. Ct. 1517 (1968).

[22] Ray A. Knight and Lee G. Knight, *A Walk Through the Step-Transaction Doctrine*, The Tax Adviser (May 1, 2021), https://www.thetaxadviser.com/issues/2021/may/step-transaction-doctrine.html.

[23]

[24] *Commissioner v. Gordon*, 391 U.S. 83, 96 (1968)

[25] On another matter, effective dating versus back dating documents, Martin M. Shenkman et al. had some great guidance, excerpted below:

> 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.

Article 4

What Your Giving Strategies Could Be Missing

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LIBERALITY
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SECURITY
ABUNDANCE
PROSPERITY
OBLIGATION
respect
FIDELITY
honor
GRATITUDE
ACCOUNTABILITY
RESPONSIBILITY
WEALTH
create
function
WELLBEING

Written By: Jonathan Gassman, CPA/PFS, CFP®, CAP®

Jonathan Gassman is the CEO and founder of The Gassman Financial Group, a New York City-based public accounting firm, and is co-founder of G&G Planning Concepts Inc., a financial planning firm, which, through the years, has evolved to be one of the leading wealth management firms in New York City. G&G Planning Concepts, Inc. is an outgrowth of the original firm founded in 1926.

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*1 Here are **10 Year-End Giving Statistics Every Fundraiser Should Know**.*

*2 Learn more about **The 2021 Bank of America Study of Philanthropy: Charitable Giving by Affluent Households**.*

Sincerely,

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For Finkel's Followers

6 Emotional Intelligent Skills Your Executive Team Should Possess

By: David Finkel; Author, CEO, and Business Coach

A few weeks back we talked about some key things you should think about before promoting someone to your executive team. Today, I wanted to expand on that concept and add one more: emotional intelligence. Emotional intelligence is a leader's ability to identify and manage one's own emotions, as well as the emotions of others. Which, as you would expect, goes a long way to determining how good of a leader you will become.

Here are the six emotional skills that I feel are most important for a leader and member of your executive team to possess. If they don't yet have these mastered, further coaching may be needed before inviting them to your team huddle.

1. Team Building: A leader's ability to build and maintain a team is crucial to scaling and growing your business. They should be able to help create a shared vision, meaning, and culture to shape belonging and behaviors within the various members of your team.

2. Motivation and Inspiration: Business growth is often anything but linear, so it is important that your leaders are able to inspire and motivate your staff when things get tough. They should be skilled in gaining buy-in, selling your vision of the company, and helping people want to do great work.

3. Self-Awareness and Self-Management: This is one of the areas that I think a lot of business owners struggle with and therefore have a difficult time training and seeing this skill set in other leaders in their company. If you tend to be a micromanager, for instance, it is important to know that about yourself so that you can self-regulate your behavior for the sake of your team and your business. Understanding your default drives and behaviors and how they impact others while becoming a role model for the behaviors you want to see in others.

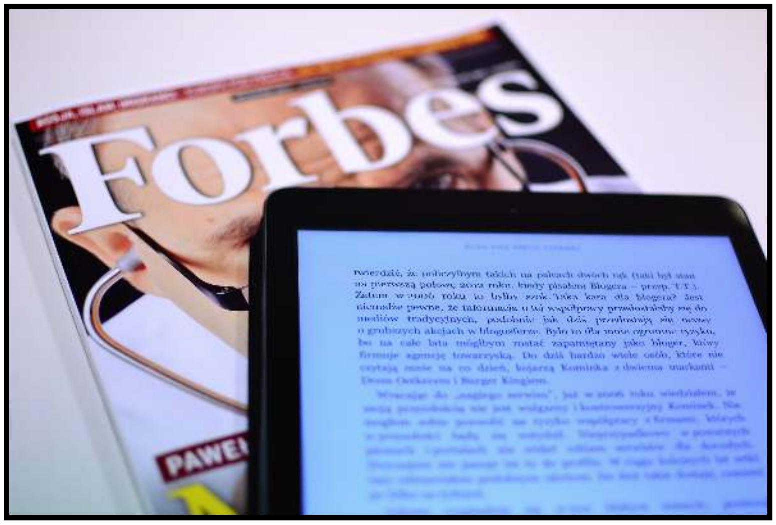
4. Social Intelligence: Another really important aspect of emotional intelligence has to do with the ability to understand why those under you behave the way they do. Understanding the drives, attitudes, and behaviors of others is an important skill for any leader. In addition, it allows us to effectively work with other people and move towards a shared goal.

5. Communication: It is extremely difficult to build and manage a team if you struggle with communication issues. Your executive team should know how to effectively listen, give people a voice, share their message, and make sure your team is on the same page. This often occurs with time and practice and is something that should be worked on at all levels of your business.

6. Navigating Differences: The last skill that I think your executive team should possess is the ability to deal with differences and have “adult conversations.” I have worked with many business owners and leaders who are scared to have tough conversations and struggle for months or even years to grow their business because they have a difficult employee or vendor that is causing them to be stagnant. Your executive team should all know how to deal with people different from themselves, gain common ground, and have tough conversations if the need arises.

Promoting someone to your executive huddle shouldn’t be taken lightly. It involves a lot of retrospection and coaching to help your team members get to where they need to be an effective leader. If done properly, however, the growth and strategic depth that follows is well worth the planning and waiting.

Forbes' Corner



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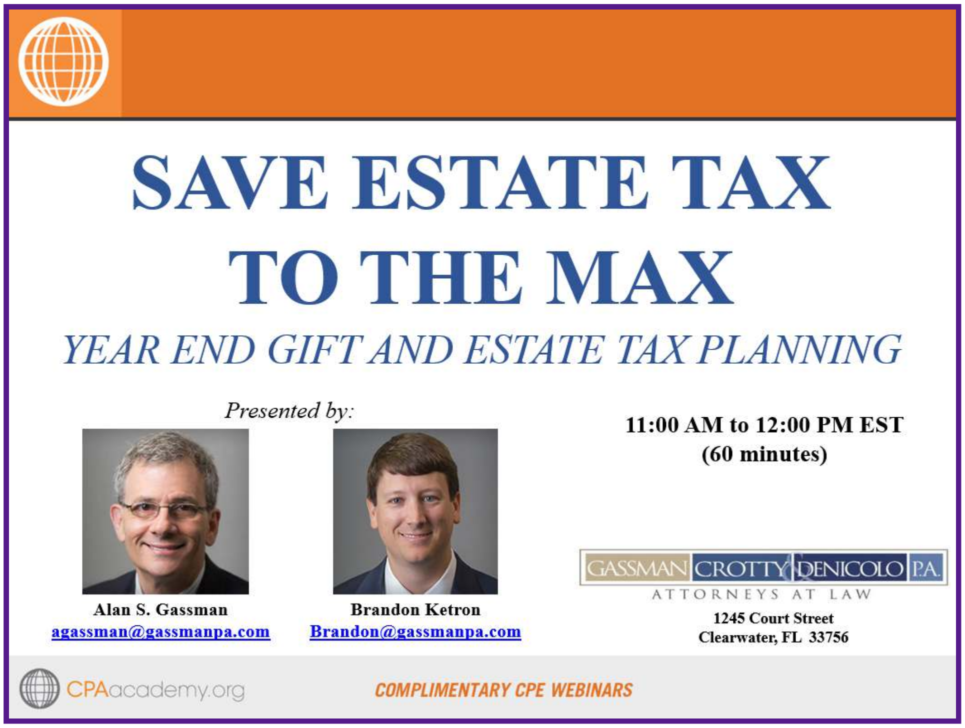

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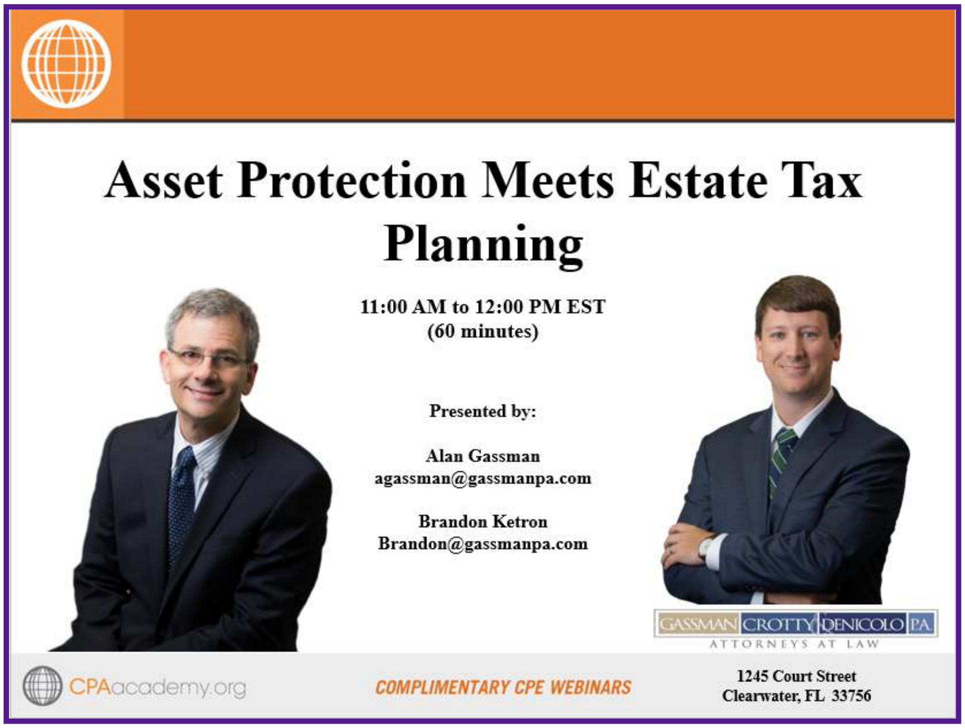

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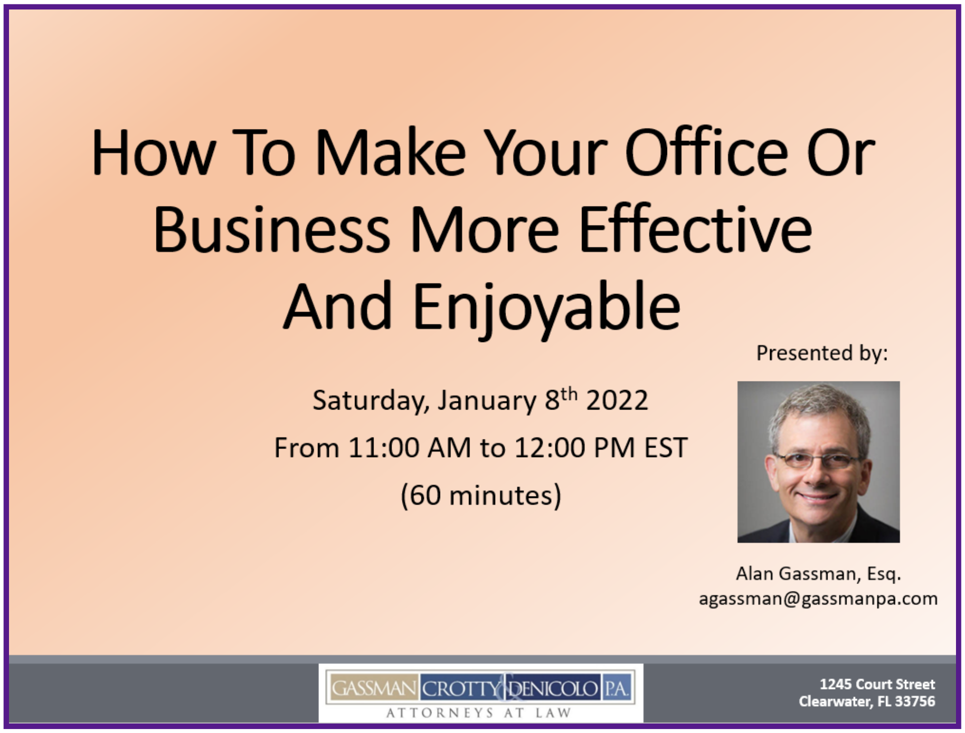

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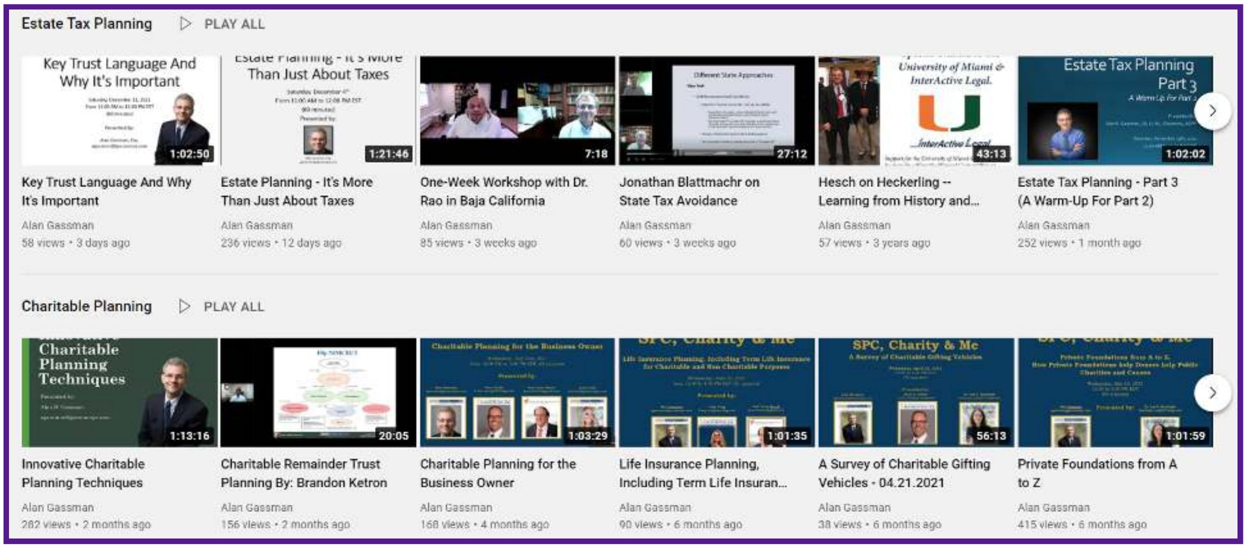

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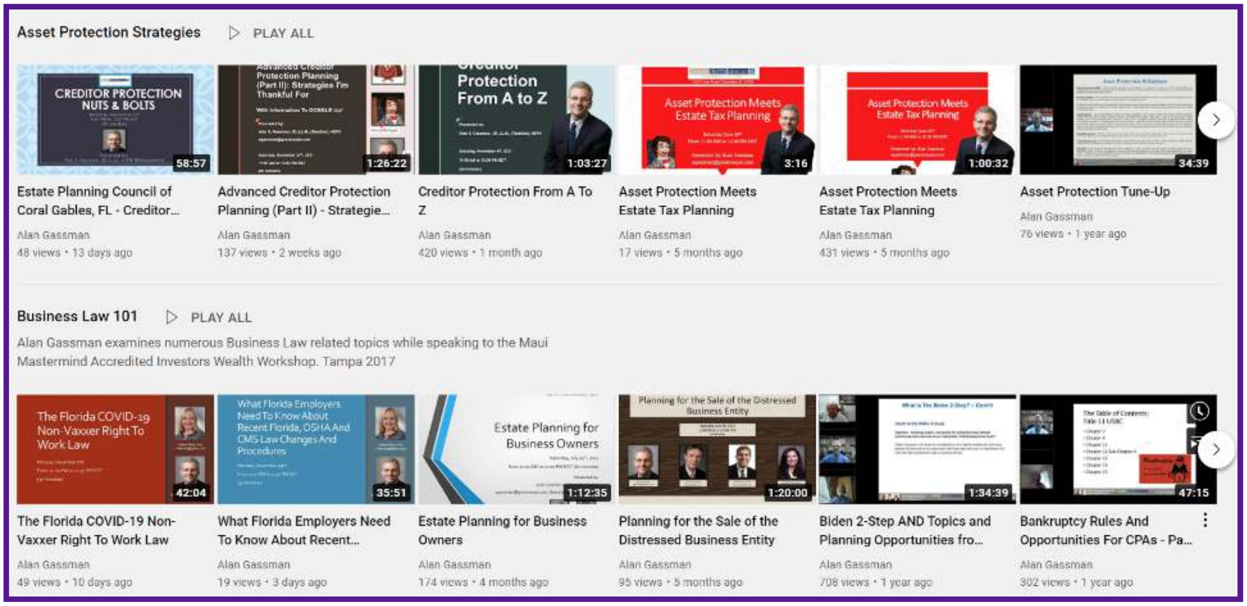

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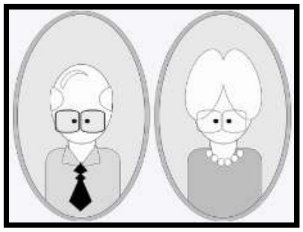
Poem Written By: Ron Ross



MyDNA, Helix, 23 and me,
A gift for you under the Christmas tree.
So now you can trace back your physical roots,
Find out why you must wear those orthopedic boots.

Your father gave you one ear bigger than the other,
Your tendency towards drama, you got from your mother.
Grandpa is why you won't give up the remote control,
And Grandma passed along that ugly-looking mole.

Grandma Maw Maw gave you that twitch in the neck,
Paw Paw is why you won't pick up the check.
And now you see there's no hidden half brother,
Go farther in the past, see what you discover.

From an ancestor named Moshe you got an embarrassing itch,
A Griselda passed on your snore with that high pitch.
Your investment blunders come from someone named Winifred,
But you resist the urge to plunder you got from "Eric the Red".

It's the greatest gift for Christmas, they gave you more than your name,
Your ancestry will always give you someone else to blame.

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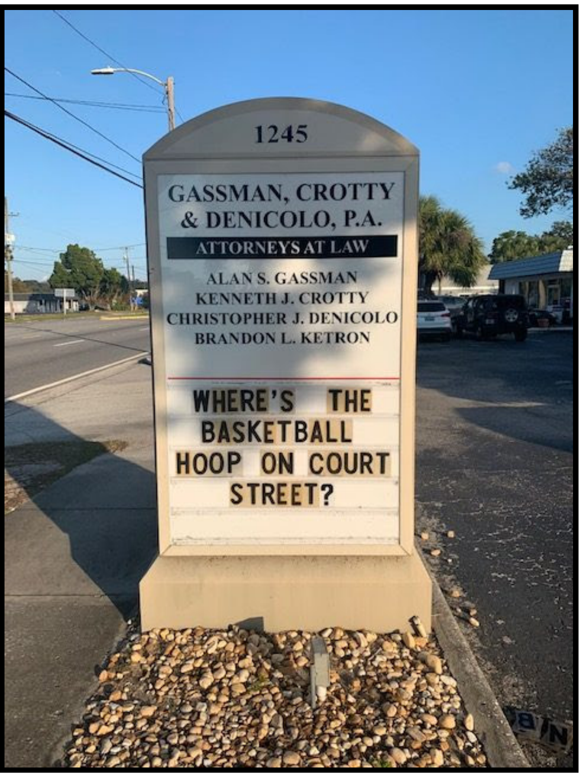
FROG PARKING
ONLY
OTHERS WILL BE
TOAD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WHERE'S THE
BASKETBALL
HOOP ON COURT
STREET?

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GHOST LIKE TO
RIDE ELEVATORS
BECAUSE IT LIFTS
THEIR SPIRITS

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LET OUT A
SIGN OF
RELIEF

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ATTORNEYS AT LAW

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