Lessons from the Tax Court: Smaldino v. Commissioner

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A recent Tax Court case, *Smaldino v. Commissioner*, T.C. Memo. 2021-127, provides important lessons on gifting. The Tax Court found that Louis Smaldino understated the size of his gift to a trust set up for his children because he never effectively transferred a portion of the assets to his wife before they were gifted.

Mr. Smaldino owned 100% of an LLC. Mr. Smaldino was married and had children by a prior marriage. Mr. Smaldino wanted to make gifts of the LLC's membership interests to a trust that he had created for his children, but wanted to utilize Mrs. Smaldino's unified credit in making the gift. Mr. Smaldino gifted LLC membership interests to Mrs. Smaldino. On the very next day, Mrs. Smaldino gifted those same membership interests to the trust.

Spouses are permitted to make unlimited gifts to one another, free of tax. However, the IRS and the Tax Court concluded that, based on the circumstances, Mr. Smaldino never effectively transferred the LLC membership interests to Mrs. Smaldino. As a result, the two transfers were collapsed and the "substance over form" or "step transaction doctrine" was applied, meaning Mr. Smaldino and not Mrs. Smaldino was deemed to make the gift of the membership interests to the trust. Due to this recharacterization, Mr. Smaldino was required to pay over $1 million of gift tax.

What Might Mr. Smaldino Have Done Differently?

- Mr. Smaldino should have allowed more time between the date of the gift to Mrs. Smaldino and the date Mrs. Smaldino gifted the property to the trust.
- During the period Mrs. Smaldino held the membership interests, there should have been something to confirm her ownership, e.g., a distribution or a vote on some governance matter.
- Mr. Smaldino should have obtained a written consent for the transfer of the membership interests to Mrs. Smaldino. The LLC's operating agreement required written consent of the LLC Board for the transfer of the membership interests to Mrs. Smaldino and no such consent was signed.
- The LLC's ownership schedule was never amended to reflect Mrs. Smaldino was a member. Upon the gift from Mr. Smaldino to Mrs. Smaldino, the LLC's ownership schedule should have been updated to reflect that Mrs. Smaldino was a member.
- Mrs. Smaldino should have signed a document indicating she agreed to be bound by the terms of the LLC's operating agreement. Mrs. Smaldino never agreed to be bound by the terms of the LLC's operating agreement – a requirement under the operating agreement for all new members.
- Mrs. Smaldino should have been reflected as a member of the LLC on the LLC's tax return for the period she was a member. The LLC's tax return for the year when the transfers occurred did not show that Mrs. Smaldino was an owner during the year.

All transactions between family members should be properly documented. While such documentation may seem to be unnecessary, excessive, and expensive, it is essential when your transaction is questioned on audit.