

Step-Transaction Doctrine: Addressing When Structuring Planning Before 2026 Changes

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Introduction

**Changes are
(likely) coming
before 2026**

Sunset of the 2017 TCJA

- The Tax Cuts and Jobs Act of 2017 (Officially titled the “Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” Public Law (United States) 115–97) is scheduled to sunset as of December 31, 2025, as a matter of current law, potentially resulting in significant changes to the estate and gift tax laws.
- One of the most relevant changes for estate planning practitioners is the reduction of the estate and gift tax exemption, which is slated to be reduced by half from \$10 million inflation-adjusted (\$13,610,000 in 2024, \$13,900,000 in 2025) to \$5 million inflation-adjusted, estimated to be approximately \$7,000,000 in 2026.
- Commentators have long been suggesting that practitioners advise their clients of the need to plan for the upcoming change and use the current estate and gift tax exemption before it is reduced.

Other Potential Changes?

- A reduction in the estate tax exemption and other changes could happen before January 1, 2026, if there is sufficient political will in Washington DC following the 2024 elections. Senator Elizabeth Warren released proposed legislation, the American Housing and Economic Mobility Act of 2024 (the “AHEM Bill of 2024”) which would affect estate tax planning in dramatic ways:
 - Reduce the estate and gift tax exclusion to \$3,500,000;
 - Increase federal estate tax rates to 55%, 60%, and 65%;
 - Enact code section 2901, which treats all assets held in a traditional irrevocable grantor trust as includable in the grantor's gross estate, essentially ending the traditional estate planning use of grantor trusts;
 - Limit valuation discounts where the taxpayer’s family has control of an operating business or where a transfer is made of non-business assets, under proposed code section 2705(a) & (b).
- While the Democratic Presidential nominee Kamala Harris has been vague about her economic agenda, Harris has expressed approval for some of the plans detailed in the AHEM Bill of 2024, particularly as it relates to making housing more affordable by raising the corporate tax rate. The provisions in the AHEM Bill of 2024 are not new; the proposals have been on progressive wish lists for some time

Timing Considerations - 1

- Clients may not have the entire calendar year of 2025 to complete their planning. Depending upon how the November 2024 elections turn out, clients might need to complete their planning this year to hedge against potential tax law change in 2025, if Democrats are able to achieve control of the Presidency, the Senate, and the House of Representatives.
- Consider encouraging clients to finalize their estate plans as soon as possible, if feasible before any new Congress might be able to be seated in early January 2025. Though not a certainty, plans are more likely to be interpreted under the law in place at the time the plan was executed, rather than under a new law that might later be enacted.

Timing Considerations - 2

- When planning in a time-compressed environment, practitioners will need to be cognizant of potential “pitfalls” that could undermine their clients' planning.
- The Step-Transaction Doctrine is often employed by the IRS to challenge clients' planning. In the waning time of 2024, there are steps that practitioners might recommend to their clients to take now in preparation for future planning, which could potentially mitigate the possibility of the IRS successfully raising the step-transaction doctrine on audit.

Step-Transaction Doctrine

What is it?



New Development

- The Tax Court held that the step transaction doctrine did not apply to an irrevocable trust's ownership of life insurance policies on the life of the grantor. The insurance proceeds did not have to be included in the taxpayer's estate under IRC Sec. 2031 and 2033. *Estate of Becker v. Commissioner*.

Substance Over Form

- The concept of “substance over form” permits the IRS to ignore a transaction’s legal form and examine its actual substance. This was established in the U.S. Supreme Court case *Gregory v. Helvering*, 293 U.S. 465 (1935).
- The intent behind the *Gregory* decision was to prevent artificial structures from being designed to avoid paying taxes. The lesson of *Gregory* and its progeny is that practitioners must carefully structure each element of the plan, even if one of the purposes of certain elements is estate tax avoidance or mitigation.
- There is no universally accepted test to determine if the step-transaction doctrine should be applied to a particular transaction. However, Courts have relied on three concepts when evaluating whether the step-transaction doctrine should be applied: the mutual interdependence test, the end result test, and the binding commitment test.

Mutual Interdependence Test - 1

- Courts will review whether the steps in the plan have to “lean” on each other to stand. If it is determined that subsequent steps must be taken to make the previous steps make sense, those steps might be considered to be interdependent. In other words, would clients have taken step 3 if the client knew that steps 4 and 5 would not also be completed? If not, then the planning may potentially have a step-transaction issue.
- The Court in *Linton v. US*, 638 F. Supp. 2d, 1277 (W.D. Wash. 2009) found that the taxpayers crafted a scheme that consisted of pre-arranged parts of a single tax plan. The Court considered steps to be interdependent and did not believe that the taxpayers would have undertaken the initial steps in the plan without knowing that the later integrated acts would also be taken.

Mutual Interdependence Test - 2

- The ruling in Linton provides several points to consider when preparing a transaction:
 - Identify and evaluate each step of the plan separately.
 - Consider whether each step of the plan is independently meaningful, even if no other steps are taken.
 - For any steps that might appear to be interdependent upon other steps, a practitioner might consider whether the interdependent step might be eliminated or substituted with a different legal arrangement that could stand on its own.
 - Determine whether and how to memorialize each step of a transaction separately.
- Consider ways for each step of an overall transaction to have independent significance. Perhaps, assist the taxpayer with filing a gift and/or income tax return to separately report each step of the transaction, assure separate legal documentation is completed and signed as if each step were the final step, etc.

End Result Test - 1

- Courts also analyze what would happen if the plan stopped at an interim step. This is often referred to as the “end result test.”
- For example, if you have a transaction that involves four separate steps, what would be the result if the plan was stopped mid-stream at step 2, without steps 3 and 4 being completed? Would the result be logical and desirable for the client?
- If the IRS can show the various steps are really pre-arranged parts of a single plan intended from the beginning for a particular end result, courts may not look favorably on the planning.

End Result Test - 2

- When analyzing a transaction under the “end result” test, the practitioner should separately evaluate each step of the transaction and evaluate:
 - What is the purpose of this step?
 - How does taking this step affect the clients?
 - If this step were the last step, would the end-result be reasonable or desirable for the client?
- In order to protect a plan against a challenge under the end-result test, practitioners may wish to document a logical, non-tax reason for each step throughout the planning process.

Binding Commitment Test - 1

- Courts will also review the contractual and other obligations established in the transaction documentation. Would stopping at any particular step cause an issue with the agreements signed at that point? If there is a binding commitment from the inception of the plan to undertake all the following steps until completion, then each step could potentially be considered a fait accompli.
- In *Penrod v. Comr.* 88 T.C. 1415 (1987), the Court analyzed a business transaction where the taxpayer sold interests in an entity that held McDonald's franchise restaurants and that received McDonald's stock as compensation. The taxpayer subsequently sold a portion of the McDonald's stock he received and used a portion of the funds to open a competing restaurant. The IRS argued that the steps of the should be collapsed into a singular transaction.
- The Court analyzed the facts and noted that the sale of entity interests was one almost a year before the sale of McDonald's stock did not take place until January 1976. In addition, the Court determined that the taxpayer intended to retain the McDonald's stock when he acquired it.

Binding Commitment Test - 2

- In *Penrod*, timing mattered. The taxpayer held the McDonald's stock for almost a year before the sales transaction, so the court did not agree with the IRS that the steps should be collapsed.
- The Penrod decision appears to suggest that had there been less time between steps, the IRS challenge might have been more successful. Though there is no specific rule on what amount of time between steps would be sufficient, consider emphasizing to clients that it is likely better for the success of their plan for them to have more time between steps.
- The Penrod rationale is why the risk of a step transaction challenge succeeding continues to grow as we get closer to year end and closer to the end of 2025 (depending on what law changes might occur).

Step-Transaction Doctrine

***Smaldino* Exemplifies
Risks of Step-Transaction
Doctrine**

Smaldino Case Facts

- In *Smaldino v. Comr.*, T.C. Memo. 2021-127 (November 10, 2021), the husband gave the wife interests in a family limited liability company (LLC), which she purportedly transferred to a trust for the benefit of the husband's children from a prior marriage the next day.
- The wife never signed any documentation as a member of an LLC, such as an operating agreement reflecting her ownership. The family did not address transfer restrictions that were incorporated into the LLC's operating agreement in order to permit the transfer to the wife. She received no economic benefit from being a member, such as a distribution from the LLC. The LLC failed to issue a Schedule K-1 to the wife for the partial period of the year when she was a member of the LLC.
- The Court found that there was no economic significance of the initial transfer of the LLC interests by the husband to the wife. Because the husband's gift to the wife appeared to have been dependent upon the wife's agreement to transfer the asset to a trust for his children, the Court concluded that the wife was merely an intermediary who facilitated the ultimate transfer. For this reason, the Court collapsed the transactions and treated the transfer as having been made by the husband to the trust for his children. This created a tax cost for the Smaldino family, as the husband had already exhausted his gift tax exemption.

How Long of a Holding Period Is Sufficient? - 1

- While the *Smaldino* court found holding the LLC stock for one day was an insufficient period of time, in *Thomas Holman*, 130 TC No. 12, 5/27/08, the court found that holding Dell stock for a mere six days, in one step along the planning path, was enough time for the tax plan to work.
- The *Holman* court determined that during the six-day time period between transfer of the Dell stock to an FLP, and later transfer of those FLP interests to a trust, the volatility of Dell being a publicly traded stock created an economic risk, i.e., the value of the stock interests could change significantly during that six-day period.

How Long of a Holding Period Is Sufficient? - 2

- While few commentators might suggest that a six-day holding period is ideal when planning a transaction, the lessons of the Holman case are valuable. The facts and circumstances of a particular transaction will affect the inherent step-transaction risk.
- For example, is six days (or a “reasonably longer period”, whatever that might be) for a transfer of rental property sufficient? What if it is a commercial rental property and the primary or sole tenant is a public traded company that could have financial issues putting the lease and property in jeopardy?

No Bright Line Rules

- While the Court in *Smaldino* stated that the steps taken by the *Smaldino* family were insufficient to prevent the collapse of the planning steps, the Court did not state which actions would have been sufficient to cause the transaction to be respected.
- Meanwhile, the *Holman* case found that a six-day waiting period was sufficient.
- Unfortunately, there is no definitive “bright line” rule regarding what would prevent the application of the step-transaction doctrine.
- Consider cautioning clients that there is no way to ensure insulation from the step-transaction doctrine and provide them with examples of good practices and actions they could take to reduce the risk of the IRS successfully arguing for the collapse of the steps in transaction.

Step-Transaction Doctrine

**Hypothetical to
Compare to
Smaldino**



Facts of Hypothetical - 1

- Wife is a neurosurgeon, and she wants to protect her assets from malpractice claims and move value out of her estate before the estate tax exemption is reduced by half. Her husband is a schoolteacher and has few assets in his name and a low risk profile for asset protection considerations. Wife gifts \$7 million in cash to her husband at the end of November 2024. The following day, the husband deposits the gift into an account that he has in his sole name, which previously held the husband's personal investment assets.
- Husband then hires a new investment advisor who creates a new financial plan and investment policy statement and reallocates the asset allocation of the marketable securities from his wife. He directs the purchase of investments with any cash he received or had on hand prior to the gift.

Facts of Hypothetical - 2

- The husband withdraws funds periodically from this new account and treats the funds as his own, using those funds for living expenses, vacations, purchasing tangible goods, etc.
- More than six months later, in the new 2025 tax year, the husband hires an estate planning attorney who creates a trust for which the husband will be the settlor, and to benefit the wife and descendants pursuant to a plan the attorney developed with the husband.
- The husband funds the initial \$100,000 gift to the trust from funds he inherited many years ago. Then the husband has his financial planner create new financial forecasts and determines through that analysis the amount of money that husband might reasonably gift to the new trust. The financial advisor's analysis suggests \$5 million could be gifted, and the following month the husband makes that gift.

What if Transaction in Hypo is Collapsed?

- There is no assurance that the IRS or a creditor will not successfully challenge the foregoing hypothetical planning under the step-transaction doctrine, creating a situation where the wife really funded the trust to benefit herself, causing the trust to be considered the equivalent of a self-settled trust.
- If the trust is established in a state that does not permit self-settled trusts, that reclassification could cause the assets to be considered inside the wife's estate (cf. Rev. Rul. 76-103). Not only would this result undermine the couple's estate planning goals, it would also potentially make the assets reachable by her creditors, thereby defeating her asset protection goals.
- If both SLATs had situs in a self-settled trust jurisdiction, that un-crossing may result in two self-settled trusts, each of which might, if qualification as a self-settled trust were feasible, retain estate tax exclusion and creditor protection.
- However, even if the trusts were established in one of the approximately 20 trust-friendly jurisdictions that permit self-settled trusts, unless the planning followed that states' statutory requirements to establish a self-settled trust, the clients' planning goals may be undermined.

Smaldino vs Hypothetical - 1

- Due to the additional steps taken by the husband and wife in the hypothetical, the practitioner has several better arguments to advance when arguing that the husband's funding of the trust was not part of the same integrated plan of the wife's gift to him. Some of the factors that might help support the hypothetical plan include:
 - The husband treated the gifted funds as his own in several ways. He reallocated investments, withdrew and used funds from the gifted money, and commingled the money with an old account of his own. In contrast to the Linton case discussed above, if the husband chose to keep the assets in his own name at this point, it would have still achieved several objectives of the wife and husband.
 - For example, the wife was concerned with asset protection, so having assets out of her name and in her husband's name provided a measure of insulation. In addition, the husband did not have significant funds in his name before this gift. It could be argued that providing the husband with greater assets in his own name provided him with peace of mind and could help marital unity.

Smaldino vs Hypothetical - 2

- The husband hired his own investment advisor to advise him on the funds and the nature of the funds changed dramatically from a cash gift to an investment portfolio.
- The amount the wife gave the husband did not correlate directly to the amount husband gave the trust.
- The husband did not merely re-gift the funds his wife gave, but he had an independent analysis completed to arrive at the amount that he might gift to a trust for his wife. The amount of the gift husband made to the trust was less than the amount he received from his wife.
- Several months passed from wife's gift to husband's funding of the trust. Consider Holman's waiting period in comparison. The longer the assets are held in each "step," the stronger an argument there may be to deflect the step-transaction doctrine.
- The husband's gift was in a separate tax year from wife's gift.

Step-Transaction Doctrine

**Considerations on
Structuring
Transactions**



Additional Analysis Needed

- A notable case is De Goldschmidt Rothschild 168 F 2d 975 (2d Cir, 1948).
- While the hypothetical included several “good fact” points regarding the step-transaction doctrine, there was only one planning technique involved in the transaction, a SLAT.
- It is likely planning before the exemption is reduced will use a plethora of different planning techniques, each with their own unique concerns for the Step-Transaction Doctrine.
- Following is a more in-depth discussion of the nuances and concepts to consider when crafting planning for clients.

Planning Considerations – Timing and Economic Differences - 1

- The greater the time span between each step or phase of a plan, the more likely that each planning step may stand independently on its own. However, as exemplified by Holman, what is considered sufficient time is based on the facts and circumstances of each particular transaction. Considering this, time alone should not be the sole factor practitioners address when crafting a plan.
- Ideally, there should be several, and if possible, significant, economic implications for each step of the plan. If one spouse transfers assets to the other spouse, while the second spouse holds the asset, there should be a meaningful risk of economic consequences during that period of ownership.

Planning Considerations – Timing and Economic Differences - 1

- As in Holman, if the assets are interests in publicly traded companies, the simple action of holding the asset for a period of time creates volatility. If an action such as reporting an earnings date happens during the period the second spouse has ownership, it can inject additional volatility.
- However, for privately held entity interests, it is not as simple as holding the asset for a period of time. For example, if interests in an LLC are transferred, a distribution might be made from the entity while that recipient holds the interests (although in some cases there could be income tax consequences of doing so).
- If the asset is a vacation home and there are expected capital improvements or repairs that are intended to be made soon, having those actions taken while the second spouse is the owner may potentially show significant economic implications.

Planning Considerations – Exercising Control

- The recipient of a transfer should exercise control, to the extent feasible, over the asset received. For marketable securities, this may be choosing to change the asset allocation or rebalance the portfolio.
- For an entity, such as an LLC, it may be taking significant administrative actions for that entity, such as signing an agreement with a third-party (e.g., a new lease with a tenant in the case of rental property), agreeing to sell assets held in the entity, signing a lease with a tenant, etc.
- To the extent feasible, each step in the plan should be able to stand on its own as the final step of the plan. There should ideally be no requirement or even need to proceed to later steps.

Planning Considerations – Adhering to Entity Formalities - 1

- Carefully adhere to all the legal formalities the plan would seem to suggest are necessary. For example, interests in an entity, such as an LLC, are transferred from one person to another and then to a trust.
- The LLC should have a new operating agreement that could be amended and restated, and signed at each transfer, confirming the new owner after that particular step. This is not always feasible if there are multiple independent parties, e.g., a mere joinder agreement might be used. But in such a situation the existence of such independent third parties may lend more credibility to the planning steps.

Planning Considerations – Adhering to Entity Formalities - 2

- If there are any restrictions or covenants in the operating agreement prohibiting transfers, a document should be signed confirming those restrictions were either waived by the members for each of these transactions, or otherwise adhered to.
- For entities where there are any mortgages or third-party agreements involved, confirm if the transfers are permitted under those documents, and if there are any steps that need to be taken to approve the transactions with those third parties, ensure they are followed.

Planning Considerations – Respecting Transaction in All Documents

- Carefully adhere to all the tax formalities the plan would seem to suggest are necessary. Consider a transaction where interests in an entity, such as an LLC, are transferred from one person to another, then to another entity, and finally to a trust.
- The LLC, assuming that it is taxed as a partnership for income tax purposes, should issue a K-1 to each owner properly reflecting the number of days each owned an interest in that LLC during the year. (Even if the entity is a complete passthrough so no tax returns for it need be filed, it may be best to file whatever is feasible and permissible to enhance the appearance of respecting the entity.) This point was exemplified in *Sorensen v. Commissioner*, Tax Ct. Dkt. Nos. 24797-18, 24798-18, 20284-19, 20285-19 (decision entered Aug. 22, 2022), where the taxpayer's defined value mechanism was not respected due to the legal documents failing to adhere to the terms outlined in the gift the taxpayer made.
- If the clients do not adhere to the formalities of the transaction they implemented, the IRS or a creditor will likely not need to do so either.

Conclusion and Additional Information

Conclusion

- Similar to the crush of planning that was completed at the end of 2012, 2020, and 2021, the results of the upcoming election in November 2024 and the reduction of the estate and gift tax exemption at the sunset of the TCJA provisions on December 31, 2025, have the potential to create a tsunami of work for practitioners.
- Clients, when wanting to complete planning on an urgent basis, may not understand the nuance of the step-transaction doctrine. They will not appreciate the potential pitfalls that are created when implementing planning on a tight deadline. Often, clients will simply say they want to “get it done.” However, if issues arise due to completing planning in a compressed manner, clients will likely respond negatively to the practitioner.
- Communication in the upcoming environment may assist in preventing clients from having “buyer’s remorse” when establishing trusts.

Additional information

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Extra Slides

- See following.

Can You Wait To Get This Started?

Step Transaction Doctrine

- *Senda, Holman*, and other court decisions.
- A transfer of assets to an LLC that is immediately followed by a transfer of non-voting member interests by gift will be considered to be a gift of the underlying assets, with no discount permitted.
- It is safest to wait 30 - 45 days between contribution and member interest transfer.
- The more volatile the asset contributed, the less waiting time required.



Summary of cases where courts have addressed the step transaction doctrine by analyzing the close proximity between date of funding of entity and date of transfer of entity interests.

Case Name/ Court	Decision Date	Date Entity Formed	Date Assets Transferred	Date Interest Gifted	# of days in between	Court Found For	Type of Assets Invested	Court Held	Court's Dicta	Special notes
Holman v. Comr. (U.S. Tax Ct.)	5/27/08	11/3/99	11/2/99	11/8/99	6	Taxpayer	Shares of Dell stock	The limited partnership was formed and the shares of Dell stock were transferred to it almost 1 week in advance of the gift, so that on the facts before us, the transfer cannot be viewed as an indirect gift of the shares to the donees. Furthermore, the gift may not be viewed as an indirect gift of the shares to the donees under the step transaction doctrine.	This case is distinguishable from <i>Senda</i> because petitioners did not contribute the Dell shares to the partnership on the same day they made the 1999 gift; indeed, almost 1 week passed between petitioners' formation and funding of the partnership and the 1999 gift. Petitioners bore the risk that the value of an LP unit could change between the time they formed and funded the partnership and the times they chose to transfer the LP units. Therefore, the Court decided not to disregard the passage of time and treat the formation and funding of the partnership and the subsequent gifts as occurring simultaneously under the step transaction doctrine. Also, in this case, the IRS conceded that a 2-month separation is sufficient to give independent significance to the funding of a partnership and a subsequent gift of LP units.	There were other gifts and transfers, but the Court was only concerned with the November set of transactions.



Summary of cases where courts have addressed the step transaction doctrine by analyzing the close proximity between date of funding of entity and date of transfer of entity interests.

Case Name/ Court	Decision Date	Date Entity Formed	Date Assets Transferred	Date Interest Gifted	# of days in between	Court Found For	Type of Assets Invested	Court Held	Court's Dicta	Special notes
Senda v. Comr. (U.S. Tax Ct.)	7/12/04	6/3/98 (SFLP I)	12/28/98	12/28/98	0	IRS	Shares of stock	The taxpayers' transfers of stock to partnerships, coupled with transfer of limited partnership interests to their children, were indirect gifts of stock to children, and thus, stock and not partnership interests, would be valued for gift tax purposes.	Petitioners presented no reliable evidence that they contributed the stock to the partnerships before they transferred the partnership interests to the children. It is unclear whether petitioners' contributions of stock were ever reflected in their capital accounts. At best, the transactions were integrated and, in effect, simultaneous. Therefore, the Court concluded that the value of the children's partnership interests was enhanced upon petitioners' contributions of stock to the partnerships and were indirect gifts.	On January 31, 2000, petitioner gave to each child an additional 4.5-percent limited partnership interest in SFLP II.
		12/2/99 (SFLP II)	12/20/99	12/20/99	0		Shares of stock			



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Case Name/ Court	Decision Date	Date Entity Formed	Date Assets Transferred	Date Interest Gifted	# of days in between	Court Found For	Type of Assets Invested	Court Held	Court's Dicta	Special notes
Estate of Jones v. Comr. (U.S. Tax Ct.)	3/6/01	1/1/95 (JBLP)	1/1/95	1/1/95	0	Tax-payer	Assets including real property	Transfers of property to partnerships were not taxable gifts.	All of the contributions of property were properly reflected in the capital accounts of the taxpayer, and the value of the other partners' interests was not enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts.	
		1/1/95 (AVLP)	1/1/95	1/1/95	0					



Summary of cases where courts have addressed the step transaction doctrine by analyzing the close proximity between date of funding of entity and date of transfer of entity interests.

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Shepherd v. Comr. (U.S. Tax Ct.)	10/26/00	8/2/91	Leased Land (8/1/91) ; Bank Stock (9/9/91)	8/2/91	Varies	IRS	Fee interest in timberland subject to a long-term timber lease and stocks in three banks	Transfers represent separate indirect gifts to his sons of 25% undivided interests in the leased timberland and stocks.	Not every capital contribution to a partnership results in a gift to the other partners, particularly where the contributing partner's capital account is increased by the amount of his contribution, thus entitling him to recoup the same amount upon liquidation of the partnership. Here, however, petitioner's contributions of the leased land and bank stock were allocated to his and his sons' capital accounts according to their respective partnership shares. Upon dissolution of the partnership, each son was entitled to receive payment of the balance in his capital account.	

