PARTNERSHIP INTERESTS
IN ESTATE AND TRUST ADMINISTRATION

by Gary A. Zwick

Working with partnership interests owned by decedents either outright or in their revocable living trusts at the time of death requires a knowledge of both the wealth transfer tax and income tax rules related to estates and trusts along with a knowledge of the partnership tax rules and how the two sets of rules interplay. Needless to say it is a complex area and one that is difficult for any one practitioner to master. This article will attempt to make some sense of the myriad rules.

Ground Rules

Income Taxation of Estates

The first taxable year of an estate begins on the date of death of the decedent. An estate can have any fiscal year it wishes as long as the first taxable year is not longer than twelve months in duration. The final year of an estate may be a short taxable year.

Estates are taxed similarly to individual taxpayers with certain exceptions, including that an estate is entitled to one $600 personal exemption (except in the final year) and no standard deduction. An estate is entitled to a deduction for the income paid or payable to the beneficiary(ies) to the extent of the estate's distributable net income (DNI). There is also no adjusted gross income limitation on donations to charity made by an estate.[1] Deductions taken on the estate's form 706 may not also be deducted on the estate's income tax return and an election must be made to take the deduction on one return or the other and state that the same amount was not taken as a deduction on the other return.[2]

Regardless of the date of distribution of income from the estate, the income is taxable to the beneficiary in the year in which or with which the year of the estate ends.[3] Most distributions from an estate, whether in cash or property, carry out income to the recipient to the extent of DNI.[4] Exceptions include specific bequests, distributions to charitable beneficiaries and distributions specifically designated as corpus.[5]

An estate is exempt from paying estimated taxes until the first taxable year that ends two years or more after the date of decedent's death.[6]

An asset other than income in respect of a decedent received on account of the death of the decedent receives a step up (or down) in basis to date of death value or alternative valuation date value if selected and a long term holding period regardless of the date of sale.

An estate does not annualize its income for short periods. In the final year of the estate, all income and capital gain is taxable to the recipient of the income or the property to which the capital gain attached. Excess deductions in the final year are deductible by the recipient beneficiary(ies). Capital loss carryovers and net operating loss carryovers are transferred to the beneficiary(ies).[7] Unused passive activity losses are added to basis of the property distributed.[8]

Income Taxation Of Revocable Trusts Upon The Death Of The Grantor

Until the date of death of the grantor, the typical revocable living trust is not a separate taxpaying entity. Typically on the date of death, the trust becomes taxable on the income generated from the assets owned by the trust at date of death and on the assets that pour over into the trust after death from the decedent's estate.

A trust (except one that is wholly tax exempt) must select a calendar taxable year. A revocable living trust whose assets are included in the gross estate of the decedent may in the alternative elect under IRC § 645 to be taxed as part of the estate. The election is made on or before the tax return due date for the first taxable year of the estate, on form 8855. The election must be signed by both the trustee and the executor of the estate. This allows the trust to take advantage of the fiscal year of the estate and the exemption from estimated tax. The election is effective for up to two taxable years at which point the trust must begin filing its own tax returns and if the trust owns S corporation stock, must make an election to be either a QSST or an ESBT.

A trust has the same income tax rules as an estate (see above) except that an estate is treated the same as a complex trust and a trust may be a simple trust or a complex trust. The determination of whether a trust is a simple or complex trust is made on a year by year basis. A simple trust is one which requires all income to be paid out at least annually, has not distributed corpus in that year and has not made a charitable donation in that year. All other trusts are complex trusts. In a simple trust, all income is taxed to the beneficiaries in

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[1] IRC § 641(c).
[2] IRC § 642(g).
[3] IRC § 662(c).
[4] IRC § 661.
[5] IRC § 663(a).
[6] IRC § 6654(l)(2)(A).
[7] IRC § 642(h).
[8] IRC § 469(j)(12).
[9] IRC § 642(b).
[10] Treas. Reg. Sec. 1.643(a)-(3).
[11] IRC § 643(g).
[12] IRC § 704(b).
[13] IRC § 731(a).
[14] IRC § 731(c).
[15] IRC § 704(c)(1)(A).
[16] IRC § 751; Treas. Reg. § 1.751-1(g) ex:2.
[17] Treas. Reg. § 1.706-1T(a)(1).
[18] IRC § 706(b)(1)(C).
[19] IRC § 708(b)(1)(B) and Treas. Reg. § 1.708-1(b)(2).
[20] IRC § 706(c)
[21] Treas. Reg. § 1.761-1(e)
[22] IRC § 706(c)(2)(A).
[23] Regs. Sec. 1.661(a)-(2)(f)(1) and 1.706-1(c)(3)(vi) ex: 3.
[24] IRC § 267(b)(13).

the year earned regardless of whether actually paid out during the year. A complex trust taxes the beneficiary on the DNI of the trust in the year paid to the beneficiary or if an election is made under IRC § 643(g) distributions made within the first 65 days of the next year may be treated as having been made in the prior year. Even if the trust is a complex trust, if all income must be paid out at least annually, all of the income will be deemed to have been paid out even if not actually paid out. A simple trust is permitted a $300 exemption. A complex trust that is required to pay out all income is also permitted a $300 exemption. A complex trust that is permitted to withhold income is permitted a $100 exemption.[9]

Capital Gains are not ordinarily included in DNI, particularly if the capital gain is generated by the sale or exchange of an asset inside the partnership unless the capital gain inside the partnership is distributed to the partners. But if the capital gain is generated by a sale or exchange of a partnership interest, or if the partnership generated the capital gain but it was distributed to the trust partner, it may be included in DNI if the trustee has the power to allocate principal to income, the trustee has authority to deem the principal distribution as coming from capital gain and the distribution is a unitrust amount under local law. The amount of capital gain allocable to DNI may not exceed the excess of the total distribution over the amount of income included in DNI.[10]

A trust is required to pay estimated tax quarterly beginning in the first year of existence for tax purposes. If desired, estimated tax payments made by a trust may be attributed to the beneficiary(ies) by filing form 1041-T within 65 days after the year end. This election will attribute the trust's estimated tax payments to the beneficiary(ies) as if all made in the fourth quarter of the year.[11]

The basis and holding period rules and rules related to losses, deductions and annualization of income applicable to estates discussed above apply to trusts as well.

Income Taxation Of Partnerships And Limited Liability Companies Taxed As Partnerships (Only The Pertinent Provisions

Partnerships are not taxpaying entities. Income, losses, deductions and credits of a partnership are allocated among the partners in accordance with the partnership agreement so long as the allocations have substantial economic effect.[12]

Contributions to capital generally are tax free under IRC § 721 unless the partnership is an investment company and the contribution of marketable securities and cash results in diversification of the contributing partner's portfolio (in which case gains but not losses in the contributed property are recognized). Where the contribution does not result in taxable gain, the partnership takes the property with a carryover basis under IRC § 722 and the holding period is tacked under IRC § 1223.

Distributions of property from a partnership to partners generally do not generate income to the partnership or the partner. Exceptions to this rule include the following distributions:

- Distributions of cash or marketable securities in excess of the partner's basis result in gain to the partner.[13] An exception to the exception is where the marketable securities distributed are distributed to the partner who contributed it.[14] An unanswered question is whether a distribution of marketable securities to the donee of a partner who contributed the marketable securities is also tax-free.
- Distributions of any property which was contributed to the partnership by a partner with built-in gain, which is distributed to a different partner within seven years of the contribution, will be treated as a disguised sale under IRC § 704(c)(1)(B) and create taxable income to the contributing partner. Character of the gain to its contributing partner remains the same as it would have been had the contributing partner sold the property on date of contribution.[15] A donee partner steps in the shoes of the donor who contributed the property.
- Where a partner contributes property with a built-in gain to the partnership tax free and within seven years receives other property as a distribution, IRC § 737 causes the partner to include the lesser of the built in gain (but not loss) or the gain as date of distribution in income as if the property was distributed to a different partner. Some would question whether a donee partner is treated as if he is the donor partner for this purpose.
- Where a partnership owns both hot assets such as substantially appreciated inventory, depreciation recapture property or cash basis receivables and non-hot assets, and a partner receives a disproportionate distribution of either type of assets the partner(s) or former partner(s) who end up with a disproportionately large share of non-hot assets is deemed to have sold the share of hot assets he gave up and an otherwise non-taxable distribution may be taxable and a capital gain may be treated as ordinary income.[16]

Deductions attributable to property contributed by a partner are allocated to the contributing partner. For contributions of built in gain property after October 22, 2004 and for partnerships whose operating agreements are substantially modified after that date, the gain on the contributed property must be allocated to the contributing partner to the extent of the built in gain on date of contribution. It is important to note that the same is not necessarily true for losses – transactions between related parties are subject to the loss limitations of IRC § 707(b).

Partnerships are required to use a calendar taxable year with the following exceptions:

- If an election is made under IRC § 444, a year ending September, October or November may be used as long as the deposit requirements of IRC § 7519 are met, meaning that a deposit must be made by the partnership in May of the next year for the incremental income for the deferral period multiplied by the highest marginal individual tax rate plus 1%. The deposit is held by IRS until the deferral is torn down or the entity terminates and is repaid by IRS without interest at that time.
- If any partner owns more than 50% of the partnership and has a fiscal year other than a calendar year, the entity must conform its taxable year to the taxable year of the majority owner.
- If no partner owns more than 50% of

the entity, then the partnership must conform its tax year to the tax year of a majority of the partners by percentage ownership and if they are all over the place, then the partnership must use the tax year that results in the least aggregate deferral of income to its partners.[17]

- If a valid business purpose such as a natural business year can be established, that year end may be used with no deposit requirement.[18]

A transfer of 50% or more of the interests in a partnership within a twelve-month period will cause a partnership termination.[19] The consequences of a partnership termination of this type are as follows:

- The tax year of the partnership cuts off on the date of termination and partner share of income and losses are determined as of that date[20]

- The property of the partnership is deemed contributed to a new partnership

- The interests in the new partnership are deemed distributed pro rata to the owners (including a purchaser) of the terminating partnership. There is no liquidating distribution of partnership property and there is no sale or exchange[21]

- Tax elections including the IRC § 754 election of the terminating partnership do not carryover to the new partnership.

Types of transfers that may cause a partnership termination include:

- A sale of the partnership interest in a taxable transaction

- Distribution of a partnership interest from a trust or estate if an election under IRC § 643(e) has been made to treat the asset as having been sold by the trust

- The events which are treated as a sale or exchange or funding of certain bequests discussed below.

Transfers not causing partnership terminations include:

- Gifts or devises of partnership interests

- Tax-free contributions of partnership interests to capital of other entities

On the death of an owner of a partnership interest or the death of an individual whose partnership interest is owned in his/her revocable living trust, the interest in the partnership interest takes a basis equal to the fair market value of the interest on the date of death or alternative valuation date. Absent a Section 754 election, the basis of the assets inside the partnership are not changed.

A Section 754 election, if desired, is made with the timely filed tax return of the partnership in the year of the transaction or event that causes a basis step up of the partnership interest. Such events include the death of a partner or a sale of a partnership interest. If the election is late, Treas. Reg. Sec. 301.9100-2 provides an automatic extension to file for twelve months from the due date of the partnership tax return including extensions. The filing must include a notation at the top saying “Filed pursuant to § 301.9100-2.”

If the partnership already had a Section 754 election in place before death, the election remains in effect and applies to the basis on death. No additional election need be made but if the election is not desired, a revocation of the election is only available with the permission of the Secretary, which permission is not easily obtained.

The election if made and if the basis of the assets inside the partnership are stepped up, creates a separate basis for the asset inside the partnership, the basis of which and deductions generated from which, are allocated to the partner whose basis changed as a result of the event allowing the election. The basis alteration is allocated amongst the capital assets or § 1231(b) property inside the partnership per § 1.755-1(c)(1)(iii) in proportion to the gains in basis of each of these assets.

Taxation Of The Decedent In The Year Of Death

Death closes the tax year of the partnership with respect to the decedent and income of the partnership through date of death is reported on the final income tax return of the decedent (or on the joint tax return with spouse) through the date of death.

The income in the year of death may be allocated to the decedent either based on a per-share, per-day proration or the books can be actually closed and the actual income through date of death can be allocated to the decedent.[22]

Taxable Events On Distribution Of Partnership Interests From The Estate Or To Fund The Marital And Family Trusts

Certain distributions of assets from an estate to fund a bequest are treated as a sale or exchange which close the books with respect to the estate and may cause a partnership termination if the estate owns more than 50% of the partnership. Not included in this category are the funding of specific bequests or residuary bequests.[23] Using a partnership interest to satisfy a specific dollar amount bequeathed (pecuniary bequest) is treated as a sale or exchange causing the recognition of gain or loss.[24]

Distributions of partnership interests held by the living trust at death to fund a pecuniary bequest including funding a marital trust or family trust with a pecuniary amount formula also causes gain recognition if applicable but not loss recognition.

Applying The Groundrules To Specific Situations

Ben and Mary Smith are married and have substantial wealth. In 2003, Ben and Mary set up the BMS Family LLC to which they contributed a rental property worth $1,000,000 with a basis of $400,000, marketable securities worth $800,000 with a basis of $600,000 and undeveloped land which they plan to subdivide and sell off, with a fair market value of $500,000 and a basis of $500,000. No further contributions were made to the partnership. Ben and Mary each initially owned 50% of the LLC and appointed their three children, Joe, Jim and Nancy as co-managers of the entity. Over the next several years, they each transferred 15% of the entity by gift equally to the three children and their remaining 35% interests to each of their revocable living trusts. At Ben’s death on May 23, 2005, the rental property had not appreciated in value but the basis had been reduced by depreciation to $250,000. The marketable securities portfolio had

increased in value to $900,000 and the basis of the securities was $650,000. The undeveloped land had been subdivided into residential lots. 20% of the lots had been sold off and the basis of the remaining 80% including land improvements less the basis of the lots sold off was $550,000. The fair market value of the remaining lots was $1,300,000. The net asset value of the underlying assets of the LLC in the aggregate at date of death was $3,200,000. Before discounts, the 35% interest in the LLC owned by Ben at his death based on the net asset value of the underlying assets was $1,120,000. The appraiser applied a 38% combined discount and thus valued the LLC interests owned by Ben at his death at $694,400. The combined bases of the underlying assets at that time was $1,450,000 and Ben's 35% at his death was allocated $507,500 of basis. January 1, 2005 through May 23, 2005, the partnership earned $10,000 of taxable income and from May 24 through December 31, 2005, the partnership earned $50,000. In January of 2005, the partnership had a loss of $5,000 and from January 1, 2006 through April 30, 2006 the partnership earned $70,000.

Ben & Mary's 1040 for 2005 will include Ben's portion of the partnership income through May 23, 2005 of $3,500 plus Mary's equal $3,500 plus Mary's 35% of the post May 23r income ($17,500) for a total of $24,500 of income from the partnership.

Ben's passive activity losses accumulated from his ownership of the partnership will be deductible on his final Form 1040 in whole or in part.

Ben's death does not cause a partnership termination. The partnership tax year does not change because the estate only owns 35% of the partnership and the other 65% is owned by calendar year taxpayers.

After careful consideration, the estate's fiscal year end selection is January 31 with the first taxable year ending January 31, 2006.

The trustee of his living trust (Mary) and the executor (Mary) elect under IRC § 645 to treat the trust as being part of the estate and the trust does not file a tax return for the years ending January 31, 2006 and January 31, 2007. No estimated tax payments are made. The income from Ben's interest from May 24, 2005 through January 31, 2006 of $15,750 falls in the January 31, 2006 fiscal year end, the tax on which is payable on May 15, 2006. Careful consideration was given to selecting an April 30 fiscal year but it was considered better to select January primarily for the positive effect in the second year versus the potential deferral for another three months.

Because the basis of the partnership interest is $507,500 but the fair market value is $694,400, a Section 754 election is made with the consent of all of the partners and attached to the timely filed tax return for the LLC for the 2005 fiscal year end. The additional basis of $186,900 is allocated to the assets of the partnership based on relative fair market value. If any of the underlying assets constituted IRD such as a sale of property before death with proceeds receivable after death likely no step-up in the basis of that asset.

Ben's living trust contains a formula marital clause which allocates the applicable exclusion amount to the family trust and the rest to a marital trust. The marital trust is a general power of appointment trust. Mary makes no further transfers of interests in the entity except that she takes the interest that Ben owned which was allocated to his marital trust out of the trust and transfers it to her revocable living trust along with the 35% she owned herself. She dies on July 17, 2007. Her 70% interest is owned in her living trust which becomes irrevocable on her death. Her estate and trustee elect to treat the trust as part of the estate and again select a January 31 fiscal year for the trust.

On Mary's death, the 70% interest is owned by a fiscal year entity, the estate. The partnership tax year must change to January 31 for the year ending in 2008. Mary's death does not cause the partnership to terminate. The tax year terminates as to Mary and her revocable trust on July 17, 2007 and income from January 1, 2007 through July 17, 2007 is allocated to Mary's final tax return.

The partnership calculates its taxable income through December 31, 2007. The income from July 18, 2007 through December 31, 2007 is allocated to the estate and other partners. Then the partnership has a one month year from January 1, 2008 through January 31, 2008 and issues a Schedule K-1 to the partners on that basis.

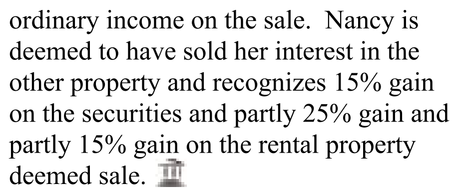
IRS audits the estate and in July 2008, the audit is closed. A discount of some amount is sustained. The partnership continues to own the rental property, the marketable securities and the undeveloped land which although some more lots have been sold off, the remaining property held has appreciated in value. Joe, Jim and Nancy immediately get together and begin dividing up the partnership. Against advice of counsel, they terminate the partnership and distribute property in the partnership to themselves on or before December 31, 2008. Joe asks for and receives the rental property as his one-third. Jim wants and receives the marketable security portfolio as his one-third and Nancy takes the undeveloped land since she has been managing this project. Each is satisfied that they have received equal value.

With respect to the 70% owned by Mary, by virtue of basis step-up and IRC § 754 elections, there is no pre-contribution gain issue and no IRC § 737 disguise sale issue.

With respect to the gifted units held by the children, under IRC § 737, a disguised sale has occurred. Since Ben and Mary contributed the property a question arises as to whether the children are deemed to have stepped into Ben and Mary's shoes avoiding a taxable event. This is an unanswered question. It is best to keep the partnership alive through 2010.

Jim's basis in his partnership interest is less than the fair market value of the securities portfolio. Ordinarily this gives rise to capital gain. An exception would be where the contributing partner receives back the same securities. The regulations are silent as to whether a portion of what Jim receives with respect the gifted interest falls into this section. It is likely most or all of this will be capital gain to him. However, this must be calculated in conjunction with item d below such that the ordinary gain that Jim recognizes in item d will reduce the capital gain that he is to recognize.

Since Nancy's property is all hot assets, a deemed sale under § 751(b) has occurred. Jim and Joe are deemed to have sold their pro-rata portion of the undeveloped land to Nancy and recognize

ordinary income on the sale. Nancy is deemed to have sold her interest in the other property and recognizes 15% gain on the securities and partly 25% gain and partly 15% gain on the rental property deemed sale. 

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