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DEATH OF A PARTNER: PRE AND POST-MORTEM PLANNING

by

JEROME HESCH*

INTRODUCTION

The death of a partner has been a troublesome area of partnership taxation for many years because death is not treated as a terminating event for federal income tax purposes.¹ The tax planner frequently is unaware of the detrimental effects of this peculiar facet of the partnership taxation rules. Without proper planning the unsophisticated may commit one of two cardinal sins which can increase the amount of income tax paid. One is that a deceased partner's share of partnership income can be shifted to the higher progressive income tax rates of his estate instead of being reported at the lower progressive rates available on the final individual income tax return. The outcome would be even worse if the final return is a joint return with the surviving spouse, and the benefit of income-splitting was lost. Second, if the partnership is producing a taxable loss, the ability to use the deceased partner's share of the partnership loss may be postponed for several years.

There are several alternative techniques which can be employed to alleviate the income tax problems associated with the death of a partner. The sophisticated tax advisor will understand, however, that some of the suggested techniques may not be practical for all situations. The purpose of this article is to describe these planning techniques and to guide the tax advisor as to which technique is appropriate for his client.

I. OVERVIEW OF BASIC PARTNERSHIP TAXATION PRINCIPLES

At the partnership level a partnership closes its books and determines its taxable income or loss for the twelve-month annual accounting period adopted by the partnership as its taxable year.² Each partner reports his distributive share of partnership income or loss for the partnership’s taxable year as all

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¹Unlike the federal tax treatment, § 31(4) of the Uniform Partnership Act provides that the death of any partner in a general partnership shall dissolve that partnership. UNIFORM PARTNERSHIP ACT § 31(4) (1914) [hereinafter cited as U.P.A.].

²I.R.C. § 703. All subsequent references to sections are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.
being received on the last day of the partnership’s taxable year. The only event in which a partnership closes its books prior to the end of its taxable year and reports income or loss for that short period is if a termination of the partnership occurs. Each partner would then report his share of partnership items for the terminated partnership on the last day of the short partnership taxable year. Since there are only two situations giving rise to a termination of a partnership for federal income tax purposes, other events which terminate a partnership for state law purposes do not terminate the partnership for income tax purposes.

Even though events such as the liquidation of a partner’s interest, the gift of a partner’s interest, and the sale of an entire interest which is less than a 50% partnership interest do not terminate the partnership, these events do close the partnership’s taxable year with respect to the partner who has disposed of his interest. The disposing partner is required to report on the date of disposition his allocable share of partnership items for the period from the start of the partnership’s taxable year to the date of disposition.

The death of a partner does not close the partnership taxable year with respect to the deceased partner. The successor-in-interest to the deceased’s partnership interest continues as a partner and reports the full year’s distributive share allocable to that partnership interest on the last day of the partnership’s taxable year. None of the distributive share for the year in which death occurred, not even that portion allocable to the period the deceased partner was alive, is reported on the deceased partner’s final income tax return.

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1I.R.C. § 706(a). A calendar year partner in a partnership with a fiscal year ended January 31, 1983, will report his entire year’s distributive share of partnership income on his 1983 individual return even though eleven months of the profits are economically allocable to 1982.
2I.R.C. § 706(c)(1).
3I.R.C. § 706(c)(2).
7I.R.C. § 702(a).
8I.R.C. § 706(c)(2); Treas. Reg. § 1.706-1(c)(2) (1960). If a calendar year individual sells his one-third partnership interest in a partnership using a fiscal year ended January 31, 1984, on September 30, 1983, he must report on his 1983 individual return his share of partnership income for the eight months of 1983 as all being received on the date of the sale. Although a gift of a partnership interest does not technically close the taxable year for the donor-partner, the income allocable to the period of time the donor-partner held his partnership interest must be reported by the donor-partner. Treas. Reg. § 1.706-1(c)(5) (1960). This is necessary to prevent an assignment of income while retaining the underlying income-producing property.
11Id. See Applebaum v. Comm’r, T.C.M. (P-H) ¶ 82, 278 (1982).
A. Tax Consequences With Estate As Successor-In-Interest

If the partnership reports a profit during the year a partner died and the estate as successor-in-interest has not distributed the partnership interest by the last day of the partnership's taxable year, the estate will report on its fiduciary income tax return the distributive share of partnership profits for the entire year. This can be advantageous if the marginal income tax bracket for the deceased partner's final income tax return is higher than the estate's marginal income tax bracket. This advantage generally occurs where the deceased partner had substantial income from other sources includible as income on his final income tax return. The later in the taxable year death occurs, the more likely this situation will exist.

The adverse income tax consequences of dying as a partner in a profitable partnership can be quite costly. The shifting of the distributive share of partnership income to the estate may place the estate in a higher marginal income tax bracket. Another problem is occasioned when the deceased partner's final income tax return contains deductions in excess of the income reported on his individual return. If the distributive share of partnership income is reported on the estate return, the excess deductions on the individual return will be wasted. In addition to excess itemized deductions on the deceased's final individual return, personal exemptions, net operating loss carry forward available from previous years, and unused investment tax credits may also be lost. It is advantageous to allow an individual to report on his final income tax return the allocable portion of partnership profits for the period he was alive so as to take advantage of deductions and credits that would otherwise be wasted. Moreover, when the estate reports the share of partnership profits, the benefits of income-splitting for joint returns will be lost.

Large tax losses generated by tax shelter partnerships offer a special area of concern. The distributive share of such partnership losses attributable to a deceased partner's interest cannot be claimed on the final individual return if the partnership interest is held by the estate on the last day of the partner-
ship taxable year. A partner dying late in the year with substantial income reportable on his final return will lose the otherwise tax sheltering loss. The loss will be claimed by the estate on its income tax return, but the estate may have little or no income to offset the loss. An estate cannot pass through any unused losses to the beneficiaries as long as it continues in existence. In fact, that loss may remain unused until the estate terminates which may be several years in the future. There is no greater sin that one can commit than to allow a loss from a tax shelter to go unused.

II. PRE-MORTEM PLANNING

There are two techniques available to a partner while alive to insure that the distributive share of his interest will be reported on or in conjunction with his final individual tax return.

A. Sale At Death Under a Buy-Out Agreement

When a partner sells his partnership interest the taxable year of the partnership closes with respect to the selling partner as of the time of the sale. The selling partner reports on his individual return his distributive share of partnership income or loss for the period up to the time of the sale. If a sale occurs automatically at the moment of death, the sale will be effective to close the partnership taxable year as to the deceased partner. Consequently, there will be included on his final income tax return an allocable portion of his distributive share of partnership income or loss for the period before his death. A buy-out provision in the partnership agreement can accomplish the desired result. This technique can avoid the problem of wasted deductions or postponed use of a partnership loss by shifting the reporting to the deceased’s final return. In addition, the final return may be filed jointly with a surviving spouse, thereby assuring the benefits of income-splitting for the deceased partner’s share of the partnership income.

See supra note 14 and accompanying text.

An estate may not carry back a net operating loss from its income tax return to the deceased’s prior individual income tax returns. Since an estate comes into existence in the year of death, it has no prior returns to which it can credit the loss.

I.R.C. § 642(h); Treas. Reg. § 1.642(h)-1 (1960). Unused loss carryovers may be passed through to a beneficiary only upon the termination of the estate. Two recent decisions illustrate the hardship of the rule requiring the estate to report the distributive share of partnership losses on the estate’s fiduciary income tax return. Estate of Hesse v. Comm’r., 74 T.C. 1307 (1980); Applebaum v. Comm’r., T.C.M. (P-H) ¶ 82, 278 (1982). If the loss could have been reported on his final return, it would have generated a net operating loss. Any income tax refund which this net operating loss could have generated when carried back is lost forever. See Estate of Hesse, 74 T.C. at 1316.


I.R.C. § 706(c)(2); Treas. Reg. § 1.706-1(c)(2) (1960).

I.R.C. § 706(c)(3); Treas. Reg. § 1.706-1(c)(3)(iv), (vi) (Example 2) (1960) sanctions this technique. This regulation does not require the buy-out contract be part of the partnership agreement. If a partner desires to sell his partnership interest to an outsider, an independent buy-out contract should also accomplish the desired result.

The preexisting buy-out agreement must be mandatory so that the sale is deemed to occur at the moment of death. The sales price can be paid in future installments because the determination of when the sale occurred is based upon when the buy-out became operative, not when payment is made. Although a liquidation of a partnership interest also closes the taxable year for the partner, the liquidation continues beyond the moment of death. A partner whose interest is liquidated continues as a partner until the last liquidating payment is received. Since the liquidation is complete only when the last liquidating payment is received and not when the liquidation agreement becomes effective, the partnership taxable year does not close at the moment of death under this arrangement. Instead, it closes while the estate is the partner, too late for the distributive share to be reported on the individual’s final return. Therefore, the partners must carefully draft the buy-out agreement to clearly and unambiguously structure the agreement as a sale and not a liquidation.

A sale upon death, however, will cause the immediate recognition of ordinary income if the partnership has outstanding accounts receivable. If no sale occurs, the ordinary income attributable to receivables will not be reported until it is collected by the partnership. However, the mandatory sale may inadvertently cause the partnership itself to terminate thereby triggering other adverse tax consequences. The mandatory sale, when combined with previous sales within the past twelve months, can result in a cumulative 50% of partnership interests sold.

Another impediment to a buy-out is funding. Typically, the remaining partners will purchase the deceased’s interest which may present liquidity problems.

24In Applebaum v. Comm’r, T.C.M. (P-H) ¶ 82, 278 (1982), it was argued that under the partnership agreement the deceased’s general partnership interest was converted at the moment of death into a limited partnership interest. The conversion thereby closed the partnership taxable year as to the deceased partner making a pro rata portion of the distributive share of partnership losses reportable on the deceased’s final joint return. The court rejected this contention because the record was insufficient for the court to hold as a matter of state law that the agreement in and of itself converted the partnership interest from a general to a limited interest upon his death. Therefore, the court did not address the issue of whether a conversion of a partnership interest at death has the same effect as a sale. Should a subsequent court find that the conversion takes place at the moment of death, the Commissioner will argue that the conversion does not close the taxable year at death because such a conversion is not a sale or exchange. In both Ltr. Rul. 8150134, Sept. 21, 1981, and Ltr. Rul. 7948063, Aug. 29, 1979, the Commissioner takes the position that the conversion of a general partnership interest into a limited partnership interest was not a sale or exchange. See Ltr. Rul. 8211121, Dec. 22, 1981 (conversion of limited into general partnership interests held not a sale or exchange).

25Treas. Reg. §§ 1.708-1(b)(i)(ii) (1960), 1.736-1(a)(6) (1960). If a partner dies on June 30 and his estate receives a lump sum liquidation payment on July 15, the partnership taxable year closes as to the estate on July 15, even though the partner left the partnership at the earlier date.

26In Foxman v. Comm’r, 41 T.C. 535 (1964), aff’d, 352 F.2d 466 (3rd Cir. 1965), the language of the buy-out was so vague that the court had to decide whether it was a sale or liquidation.

27Woodhall v. Comm’r, 454 F.2d 226 (9th Cir. 1972); I.R.C. §§ 741; 751(a), (c). The section 743(b) special basis adjustment is not allowed for the accounts receivable because such receivables are in the nature of income in respect of a decedent. See I.R.C. § 1014(c).

28Upon a termination the partnership is deemed to distribute all of its assets to the partners. Treas. Reg. § 1.708-1(b)(i)(iv) (1960). Investment credit recapture may occur if the distribution is an early disposition. Also, a partner with a negative capital account because of special allocations of partnership losses may have to recognize gain because of the treatment of partnership liabilities.
B. Designation of an Individual As Successor-In-Interest

Although the death of a partner does not automatically close the partnership taxable year, if the deceased partner designates his spouse as the beneficiary of his partnership interest in his will, the surviving spouse will hold the partnership interest on the last day of the partnership taxable year instead of the estate. The entire year’s distributive share of partnership income or loss would be reported by the surviving spouse. This technique allows the entire year’s distributive share of partnership income or loss to be reported on the final joint return. If a sale had occurred at death, only the allocable portion of the partner’s distributive share for the period before his death would be reported on the final joint return. This technique of designating an individual as beneficiary of the partnership interest has the advantage of allowing more of the distributive share to be shifted to the final return.

In order for the designation to be valid, not only must the partner designate his beneficiary in his will but also the designation must be done in accordance with the terms of the partnership agreement. If the partnership agreement does not provide for this power, it may be added by amendment.

In a partnership in which the partners manage an active business the remaining partners may not welcome a deceased partner’s spouse as a new member, and may prefer a cross-purchase buy-out. Alternatively, they may wish to choose the successor. Further, if the partnership is a professional organization, such as a medical practice, state law may prohibit the designation of a non-professional as a successor.

III. POST-MORTEM PLANNING

Even if no planning strategy was in place before death to shift the partnership income or loss from the estate’s return to the final individual return,
there are a variety of alternatives available after death which can accomplish the same result or at least minimize the adverse tax consequences of the estate reporting the partnership distributive share. 36

A. Distribution of the Partnership Interest

Whoever has succeeded to the partnership interest on the last day of the partnership’s taxable year must report the entire year’s distributive share of income or loss. If the administration of the estate can be completed to the extent necessary to allow for distribution to beneficiaries, a distribution of the partnership interest to the surviving spouse before the end of the partnership’s taxable year in which death occurs will shift the reporting of the entire distributive share to the surviving spouse. 37 This assumes that the surviving spouse is the principal beneficiary of the estate so that the bequest is large enough for her to receive a distribution of the partnership interest. A distribution not in satisfaction of a pecuniary bequest, 38 however, will probably not be treated as a sale by the estate. 39 If time is an important factor, consideration should be given to a preliminary distribution of the partnership interest to insure that an individual has succeeded to the interest before the last day of the partnership’s taxable year.

A distribution of a partnership interest may be impractical, especially if the partner dies late in the year. Time can be a limiting factor since several administrative steps must be completed before such a distribution can be made. Qualifying the executor, collecting and accounting for the estate’s assets, and probating the will, all require time. Also, a probate court order may be necessary for the preliminary distribution. The distribution may also place an executor who is uncertain about the solvency of the estate in a difficult situation with respect to the executor’s personal liability to estate creditors. The estate should have sufficient other assets so that it need not use the partnership interest to meet administrative expenses. Finally, the executor may balk at authorizing the distribution without probate court approval.

If administration of the estate prevents a distribution of a partnership interest, the shifting of income from the estate to an individual beneficiary might

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36 If the estate reports the distributive share of partnership income, the executor can elect to deduct the estate administrative expenses on the estate’s income tax return instead of the estate tax return.

37 Treas. Reg. § 1.706-1(c)(3)(vi) (Example 3) (1960). The surviving spouse will be recognized as the successor to the partnership interest on the last day of the partnership’s taxable year.

38 A distribution of property in satisfaction of a pecuniary bequest is a sale by the estate. This sale would close the partnership taxable year for the estate, and the distributive share up to the time of sale would be reported by the estate.

39 There is a possibility that the Commissioner will take the position that any distribution of a partnership interest is a sale by the estate. See Rev. Rul. 72-352, 1972-2 C.B. 395. Even if the Commission is correct, a closing of the partnership’s taxable year for the estate should not preclude a distribution of property for purposes of distributable net income. A terminating distribution will first be treated out of distributable net income and should still allow the estate to take a deduction under § 661. Thus, the incidence of taxation should shift from the estate to the person receiving the distribution.
be accomplished by a distribution of the right to receive the distributive share of partnership income. The distributive share of partnership income up to the time of a partner's death is treated as income in respect of a decedent. Thus, the rules governing such income, which tax a residuary legatee on income in respect of a decedent after that legatee has received such income by transfer from the estate, should support the shifting of the income.

B. Distribution of Property Other Than the Partnership Interest

A reliable method used to shift partnership income from the estate to a spouse is by a distribution to the spouse of cash or other property equal in value to the distributive share of partnership income. If this distribution is made prior to the end of the partnership's taxable year and the estate selects as its taxable year a year that ends with or within the partnership's taxable year, then the distribution carries the distributable net income out of the estate and it is reported by the spouse. The estate reports the distributive share in income and receives a corresponding deduction for the distribution.

This method also has the advantage of shifting the entire year's distributive share, instead of only the allocable portion, up to the time of death. However, collateral considerations may dictate otherwise than to shift the entire share of partnership income. A distribution of property with a value less than the entire distributive share will leave some of the partnership income taxable to the estate. This will have the effect of equalizing the marginal income tax brackets for the individual and his estate. The ability to divide income between two taxpayers should always be considered. Again, the later in the year death occurs, the more difficult it will be for the estate to make the necessary distribution.

C. Selection of the Estate's Taxable Year

In the event the estate must report the distributive share of partnership income and none of the shifting techniques are applied, the estate can defer its tax on this income by judicious selection of its taxable year. Since there are no restrictions on an estate's selection of its taxable year, the estate should select a taxable year ending the month before the last day of the partnership's taxable year. For example, assume a partner in a calendar year partnership dies on November 1, 1983. If the estate elects a fiscal year ending November 30, it will not report the distributive share of partnership income on its short return ending November 30, 1983. Instead, the share of partnership income will be reported as received on December 31, 1983. This income will be reported

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4Treas. Reg. § 1.753-1(b) (1960).
7If the estate distributes property with a basis less than its value and the value of the property equals the amount of distributable net income, the individual's basis in the property will be equal to its value and the estate will recognize no gain on the realized appreciation in the property. Treas. Reg. § 1.661(a)-2(f) (1960).
in the estate's return with a fiscal year ending November 30, 1984, thereby achieving eleven months of deferral. The deferral will also allow the estate to accumulate deductions, such as administration expenses, so as to offset the income reported.

If the deceased partner's will establishes a testamentary trust, the deferral can be extended even further. This can be achieved by combining the choice of taxable years for the estate and the trust with the proper timing of distributions from the estate and the trust. An example can best illustrate this technique. Assume D, a partner in a calendar year partnership, dies on December 1, 1982. The distributive share of income for the entire year reportable by D's estate is $12,000. The estate reports this share of income as received on December 31, 1982. The estate elects a taxable year ending November 30. On November 1, 1983, the executor distributes $12,000 in cash to the trust. For the estate's taxable year ending November 30, 1983, the estate offsets its $12,000 of income with a $12,000 distributions deduction. The trustee elects a taxable year for the trust ending October 31. The trustee distributes the $12,000 in cash it received from the probate estate to the individual beneficiary between January 1, 1984 and October 31, 1984. For the trust's taxable year ending October 31, 1984, the trust offsets its $12,000 of income by a $12,000 distributions deduction. The individual beneficiary reports the $12,000 in income on his 1984 return. Thus, the $12,000 of partnership income earned in 1982 does not generate an income tax liability until 1984.

If the objective is to have the distributive share of partnership profits for the year of death reported in the deceased partner's final joint return, the estate must elect the same taxable year as used by the partnership. Otherwise, the distributable net income will be reported by the surviving spouse on a later individual return. For example, suppose a partner in a calendar year partnership dies on June 30, 1983. If his estate elects a fiscal year ending November 30, the estate will report its distributive share of partnership profits for the 1983 taxable year on December 31, 1983, and it will appear on the estate's return for fiscal year ending November 30, 1984. Consequently, a distribution will carry out the distributable net income attributable to the 1983 share of partnership profits to the spouse's 1984 return instead of the final joint return for 1983.

D. Closing the Estate

Obviously, some of the techniques discussed in this article can be used only to shift partnership income. If the partnership has a taxable loss, however, and the estate must report the loss because there was no sale at death or no timely distribution of the partnership interest, there is yet another way to pass this loss through to an individual beneficiary. As long as the estate remains

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*Treas. Reg. § 1.706-1(c)(3)(vi) (Example 1) (1960) illustrates this deferral technique. Other partners are generally restricted in their ability to select a taxable year different from that of the partnership. I.R.C. § 706(b)(2).
in existence it cannot pass unused losses through to a beneficiary. However, any loss carryovers may be passed through upon the termination of the estate. Therefore, the executor should attempt to close the estate as soon as possible so that the loss does not remain in suspense. If the executor has done all that is necessary to close the estate except procuring the final court order, he can argue that the estate is closed for federal income tax purposes. To support this position he can rely by analogy on those cases which deal with attempts to unnecessarily prolong the life of the estate.

E. Cash Distributions As a Loss Pass-Through

Section 167(h) of the Internal Revenue Code provides that the depreciation deduction for property held by an estate shall be apportioned between the estate and a beneficiary on the basis of the income from the property allocable to each. This section may have special application where the deceased partner was a member of a tax-shelter partnership producing tax losses traceable to depreciation deductions. If that partnership has a positive cash flow, an argument can be made that the beneficiary receiving a cash distribution traceable to the partnership's distribution of cash to the estate should report the distributive share of the partnership loss instead of the estate. This position is based on fiduciary accounting principles under state law which treat cash as estate income.

The Service has issued rulings holding that depreciation deductions may be allocable by an estate to a beneficiary on the basis of "trust income" allocable to the beneficiary and that such deductions may exceed such income. Therefore, it can be argued that the cash distribution by the estate carries with it the distributive share of partnership losses attributable to the depreciation deductions. As a precaution there should be a direction in the deceased partner's will that the estate distribute immediately any cash distribution which it receives from the partnership. This assures that the cash distribution is certain and not discretionary. Although the validity of this technique has not been approved or addressed in the cases or rulings, it seems to be a proper application of the aggregate theory of partnership taxation. The crucial factor is that the term "income" as used in section 167(h) of the Internal Revenue Code is not limited to taxable income but also includes fiduciary accounting income.

CONCLUSION

Although the death of a partner can create problems with adverse income tax consequences for the estate and the deceased partner's final income tax
return, the sophisticated tax planner can minimize or eliminate the adverse effects by judicious use of the various techniques suggested in this article.