Fall 1995

The Death (and Taxes) of a Partner

Stephen Utz
University of Connecticut School of Law

THE PRACTICAL TAX LAWYER
FALL 1995

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Death eliminates a partner's earthly concerns, and exacerbates those of his partnership survivors.

THE TAX CONSEQUENCES OF the death of a partner, for the partnership as well as for the decedent's successor in interest, are for the most part like those of the sale of a partnership interest, for the partnership and the purchaser. The 1939 Code provided few answers to the

Stephen Utz is Professor of Law at the University of Connecticut School of Law. This article is adapted from the author's new book, *Federal Income Taxation of Partners and Partnerships* (ALI-ABA, Philadelphia, 3d ed. 1995). For more information or to purchase this book, call 1-800-CLE-NEWS.

tax problems of partners and partnerships occasioned by the death of a partner, and the answers were sparse and conflicting. The 1954 Code supplied mechanical answers to many of the major problems. Tax legislation of the 1980s has eliminated some of the reasons for preferring liquidation of a partner's interest to a sale of the interest to other partners, by effectively restricting partnerships of individuals to the calendar year as the partnership year for tax purposes.

Nevertheless, the current state of partnership tax law leaves partners and their tax advisors some important choices regarding the sale or liquidation of a partner's interest at death.

EFFECT ON THE PARTNERSHIP • Much of the tax effect of the death of a partner on the partnership turns on whether that death closes the partnership's taxable year.

Year Stays Open

Under pre-1954 law, the Supreme Court had held that the death of a partner did not cause the taxable year of the partnership to close with regard to the surviving partners. *Heiner v. Mellon,* 304 U.S. 271 (1938). In the Court's view, even though death works a dissolution of the partnership, the partnership does not terminate until its affairs are wound up. The danger of bunching more than 12 months' income of the partnership in one taxable year of the surviving partners was thus minimized. The effect of the death of one partner in a two-person partnership, however, remained in doubt.

The 1954 Code provides that "[e]xcept in the case of a termination of a partnership" the taxable year of a partnership shall not close with respect to the survivors upon the death of a partner. Internal Revenue Code ("Code") §706(c)(1). (All section references are to the Code unless otherwise indicated.) Section 708(b)(1)(A) provides that a partnership shall be considered terminated "only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership." Clearly, then, the death of a partner in a three-or-more-person partnership has no effect on the partnership's taxable year if the survivors continue the business.

The Two-Person Partnership

But what of the two-person partnership? Since after the death of a partner the business is not carried on "in a partnership," the partnership might appear to be "terminated" and its taxable year ended with regard to both the decedent and the survivor unless there is an agreement that the partnership be continued by the survivor and the decedent's estate. The regulations state, however, that "[u]pon the death of one partner in a two-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues

to share in the profits or losses of the partnership business." Treas. Reg. §1.708-1(b)(1)(i)(a).

Decedent's Estate as Partner

A decedent's estate or successor in interest may continue to share in profits and losses of the partnership until the partnership affairs are wound up. Such an interest in profits and losses is probably all the regulations require to prevent termination of the two-person partnership by death.

The regulations further provide that if the decedent's estate or successor is to receive payments from the partnership under section 736, the partnership is deemed to continue until all payments have been made. Treas. Reg. §1.736-1(a)(6). Unless these payments are to be made, it would seem advisable to provide by agreement, in the case of a two-person partnership on a taxable year different from that of either of the partners, for the continuation of some part, at least, of the decedent's interest in the profits of the partnership until the end of the partnership taxable year. In this way the survivor can be assured that the death of the other partner will not result in bunching more than 12 months of partnership income in the survivor's single taxable year, as would happen if the partnership year ended at other than its normal year end.

This precaution is unnecessary, of course, if there are only individual partners and the partnership has not validly elected a year other than the calendar year.

Payments in Exchange for a Deceased Partner's Interest

The mostly decisional pre-1954 law of partnership liquidation was obscure with respect to the treatment by the partnership of payments made to a decedent's estate or successor in interest in liquidation of the decedent's interest in the partnership. The central question was whether these payments were nondeductible capital expenditures—with the partnership acquiring the decedent's interest—or were in the nature of income distributions to the decedent's estate, reducing the amount of partnership income to be allocated as distributive shares to continuing partners.

Section 736 resolves this dilemma decisively, at least in most settings:

- Payments made by the partnership for the value of the decedent's interest in partnership property are neither excludable from the computation of the survivors' distributive shares of income nor deductible by the partnership.

- Payments for the value of the decedent's interest in partnership goodwill are excludable or deductible by the survivors unless the decedent was a general partner, the partnership is a service enterprise and the partnership agreement specifically provides for payment for goodwill to a decedent.

• Payments for the decedent's interest in unrealized receivables are excludable or deductible by the survivors unless the partnership agreement validly provides for payment for goodwill.

• Payments for the decedent's interest in unrealized receivables are excludable or deductible, as are payments in the nature of mutual insurance.

• Payments that are not excludable or deductible are treated as distributions by the partnership in liquidation of the decedent's partnership interest and are governed by the distribution rules.

The effect of the provisions for distributions to a deceased partner's successor in interest are virtually identical with the effect of such provisions for distributions in liquidation of the interest of a retiring partner.

BASIS OF PARTNERSHIP ASSETS • As a general rule, the death of a partner has no effect on the basis of partnership assets. §743(a). However, if an election under section 754 is in effect, the bases of the partnership assets are adjusted for the benefit or to the detriment of the decedent's successor in interest only. The election is identical to that provided for a transfer of an interest by sale or exchange, and the adjustment, also made under section 743(b), generally will operate in the same fashion on the death of a partner as on a sale or exchange of a partnership interest.

Amount of Adjustment

The amount of the adjustment is the difference between the basis for the decedent's partnership interest in the hands of his successor (usually the value at date of death or at the optional valuation date plus the estate's share of partnership liabilities) and the decedent's proportionate share of the partnership's basis for its assets.

No Income in Respect of a Decedent

The basis of the decedent's partnership interest does not include any value resulting from the right to receive income in respect of a decedent. §1014(c). If there are distributions under section 736(a), that portion of the value is not included for purposes of the adjustment under section 743(b) because payments under section 736(a) are income in respect of a decedent. §§691, 753; Treas. Reg. §1.742-1.

Sale or Death = Same Treatment, Mostly

Generally, the section 743 adjustment to the basis of partnership assets is the same upon the transfer of the partnership interest at death as it is upon a transfer by sale. However, there is some question whether the adjustment to the basis of unrealized receivables is different in the two circumstances, particularly if the interest of the decedent is liquidated. If the interest is not liquidated, the treatment should be the same in both circumstances.

In a transfer of a partnership interest by sale, an adjustment under section 743(b) (if the election under section 754 has been made by the partnership) gives a basis to unrealized receivables for the benefit of the transferee.

In a transfer of a partnership interest by death, especially if the decedent's successor continues as a partner, the partnership provisions of the Code appear to provide the same rule. Section 743(b) provides for an adjustment to the basis of partnership assets for a transfer of an interest in the partnership upon the death of a partner just as it does upon a transfer by sale or exchange. The adjustment is the same, an increase or decrease equal to the difference between the basis for the partnership interest and the transferee partner's proportionate share of the basis of partnership property. §743(b). The basis of the partnership interest is the fair market value of that interest in the decedent's estate. §1014(a). If the value is greater than the partner's proportionate share of the basis of partnership property, including unrealized receivables, that partnership property, including the receivables, should get an increased inside basis for the benefit of the transferee partner.

The effect is the same as in the case of a transfer by sale or exchange. When the receivables are collected, they would have a basis equal to the amount of the adjustment, all for the benefit of the transferee partner and the partnership, and thus the transferee partner would have less income by the amount of that adjustment.

No Inside Basis Adjustment

However, with respect to transfers of partnership interests by death, the Service takes the position that there is no inside basis adjustment for the unrealized receivables, whether the decedent's successor remains a partner or the interest is liquidated. For liquidation, the reasoning seems to be that section 736(b) provides that payments in liquidation of unrealized receivables are not in exchange for partnership property and are instead a distributive share of partnership income under section 736(a). Section 753 provides that amounts includable in the gross income of a successor in interest under section 736(a) are income in respect of a decedent under section 691. Section 1014(a), which gives property received from a decedent a new basis, does not apply to property that constitutes a right to receive an item of income in respect of a decedent under section 691. §1014(c); Treas. Reg. §1.742-1.

Thus, the value of the successor's partnership interest attributable to unrealized receivables does not add to basis and there is no excess partnership basis to allocate to unrealized receivables. Treas. Reg. §1.755-1(b)(2).

The collection of the receivables by the partnership results in ordinary income in the full amount, and there is no offsetting basis. Rev. Rul. 66-325, 1966-2 C.B. 249; *Woodhall v. Commissioner*, 28 T.C.M. (CCH) 1438 (1969), *aff'd*, 454 F.2d 226 (9th Cir. 1972).

If a decedent's successor in interest continues as a partner, subchapter K argues implicitly for an increased basis.

A Strained Position

This argument, even as applied to an interest that is liquidated, appears to suffer from some basic fallacies.

First, it is open to question whether section 1014(c) applies at all. The partnership interest, which is the property received from the decedent, gets a new basis, and that property is not income in respect of a decedent or a right to receive income in respect of a decedent. That the partnership owns unrealized receivables does not mean that the decedent's successor in interest acquires a right to them. Receivables, together with other property of the partnership, are subsumed in the partnership interest. Thus, if section 1014(c) does not apply, part of a basis increase is attributable to the unrealized receivables and should be allocated to them under sections 743(b) and 755.

Second, before section 1014(c) can apply to deny a stepped-up basis to the unrealized receivables, it must be determined that a payment is income in respect of a decedent under section 753 because it comes under section 736(a). But such a payment comes under section 736(a) only to the extent it is not in payment for an interest in property, and the regulations provide a payment is not for property only to the extent it is in excess of the partnership basis, including any special basis adjustment, for the unrealized receivables. Treas. Reg. §1.736-1(b)(2). Thus, the question is begged: there is no special basis adjustment because the payments are under section 736(a), but the payments are under section 736(a) because there is no special basis adjustment.

Treating the Continuing Partner and Liquidation Alike

If a decedent's successor in interest continues as a partner, subchapter K argues implicitly for an increased basis. There would be no payments in liquidation under section 736; section 753 could not then apply; there would be no income in respect of a decedent under section 691; section 1014(c) would not apply; and the partnership's unrealized receivables should have an increased basis.

If this is so when the successor continues as a partner, there is reason to deny the special basis adjustment to

The 1954 Code effectively eliminates the possibility of bunching in the decedent's last return when the partnership consists of three or more members.

unrealized receivables when the successor's interest is liquidated. Although there appears to be an ambiguity in the Code in the case of a liquidation of the successor's interest, the Code can be read to allow the special basis adjustment even in that case. If the adjustment is allowed when there is no liquidation, any ambiguity that exists when there is a liquidation should be resolved to permit the adjustment so as to treat the two situations identically.

Despite the force of the foregoing analysis, the Tax Court has refused to permit the special basis adjustment for unrealized receivables even when the decedent's successor continues as a partner. *George Edward Quick Trust v. Commissioner,* 54 T.C. 1336 (1970), *aff'd per curiam,* 444 F.2d 90 (8th Cir. 1971). The court brushed aside the partnership provisions and concluded that section 691 applied. In doing so, the court held that amounts other than those paid under section 736(a) can be income in respect of a decedent. It also held that a partnership interest is not a "unitary res" but that it can be fragmented into its underlying assets, thus permitting the receivables themselves to be treated separately in the hands of the successor as a right to receive income in respect of a decedent within the meaning of section 1014(c). If these partnership assets can be removed from the unitary character of the partnership interest, it is possible that others can also. In such circumstances the need for section 754 and section 743(b) to permit a basis adjustment to reflect death values would seem to be greatly diminished.

EFFECT ON DECEDENT'S SUCCESSOR IN INTEREST • Under pre-1954 law, the possibility of bunching the decedent's distributive share of more than 12 months' partnership income in the decedent's last return when decedent and partnership were on different taxable years was substantial. In most circuits this danger could be averted by agreement for the continuation, irrespective of a partner's death, of the partnership to the end of its taxable year. However, in the Second Circuit such an agreement was held ineffective, and the Commissioner had indicated he considered the view of the Second Circuit to be correct. *Commissioner v. Waldman's Estate,* 196 F.2d 83 (2d Cir. 1952). *Contra Estate of Tyree v. Commissioner,* 20 T.C. 675 (1953), *aff'd,* 215 F.2d 78 (10th Cir. 1954), *nonacq.* 1954-1 C.B. 9.

The Code Eliminates Bunching . . .

The 1954 Code effectively eliminates the possibility of bunching in the decedent's last return when the partnership consists of three or more members. It states that the taxable year of a partnership with respect to a partner who dies shall not close before the end of the partnership's taxable year, or until the partner's interest is liquidated or sold or exchanged. Treas. Reg. §1.706-1(c)(3)(i).

. . . But Causes a New Problem for Sbared Taxable Years

In eliminating the bunching problem for fiscal year partnerships, the Code creates a problem for the normal situation where the partnership and the decedent were on the same taxable year. If at the death of a partner the partnership taxable year does not close until its normal time, none of the partnership income for the taxable year in which the decedent's death occurs would be included in the decedent's last return and the decedent's entire distributive share for that year would be taxable to his estate or to his designated successor in interest. §1.706-1(c)(3)(iii). Thus, unless this problem is cured, the decedent's deductions as well as his right to split income with his spouse would be wasted for there would be no distributive share of partnership income to be offset or split. This result could be costly.

Example: Higher Tax When Income Not Included

In the *ABC* partnership, both the partnership and Able report on a calendar year. Able is married and has three children. During 1970 Able had \$6,500 of deductions in interest, taxes, etc. Able died on December 27, 1970. His share of partnership income for 1970 was \$40,000. Because the partnership year did not end with his death, none of the partnership income will be taxed in Able's final return for the period ended December 27, 1970, or December 31, 1970, if a joint return with Mrs. Able were filed for the entire year. §6013(a)(3). The entire \$40,000 will be included in the first fiduciary income tax return of Able's estate. A comparison of tax results of being able to include the \$40,000 in Able's final return as against having it taxed in the fiduciary return of the estate is as follows:

	Fiduciary Return	*Able's Final Joint Return*
Income from partnership	\$40,000	\$40,000
Deductions		6,500
Net taxable income	\$40,000	\$33,500
Personal exemptions	600	3,125
Taxable income	\$39,400	\$30,375
Tax	\$16,222	\$ 8,026

There would be a tax saving of \$8,196, over 50 percent, had the partnership income been included in Able's return so that the benefit of the deductions, exemptions, and income splitting could be realized.

The Code does not eliminate the possibility of bunching in the decedent's last return when a two-person fiscal-year partnership is involved.

How To Get the Partnership Income in the Final Return

The regulations provide two ways of assuring inclusion of Able's share of partnership income in his final return. One method is for the partnership agreement to permit a partner to designate his successor in interest, and for Able, in accordance with the agreement, to designate his widow as that successor. In that event she will get Able's share of the partnership income for the partnership year within which Able dies and will be able to include it in a joint return with Able for that year. Treas. Reg. §1.706-1(c)(3)(iii). If Able and the partnership are on different taxable years, even this may not succeed. If Able is on a calendar year and dies in December and the partnership is on a January 31 year, Able's share of the partnership income for the *partnership* year within which he dies will not be included in Able's return for the *tax* year (the calendar year) in which he dies. Presumably, however, Able's deductions and exemptions for that tax year can be offset against the partnership income for the partnership year ended the previous January 31, and the partnership income for the year ended January 31 following Able's death can still be included in a joint return with his widow under the surviving spouse provision.

Sale of Partnership Interest on Date of Death

The other method provided in the regulations is a sale of the decedent's partnership interest on the date of his death. The regulations provide:

"If, under the terms of an agreement existing at the date of death of a partner, a sale or exchange of the decedent partner's interest in the partnership occurs upon that date, then the taxable year of the partnership with respect to such decedent partner shall close upon the date of death." Treas. Reg. §1.706-1(c)(3)(iv).

The regulations go on to state that any transfer of a partnership interest at death as a result of inheritance or any testamentary disposition is not a sale or exchange within this rule.

The contract must apparently embody a binding commitment effective on the date of death without further action. An option would appear to be insufficient. It would also seem that the agreement could be with some or all of the remaining partners or with an outsider. There may be some risk, however, if the purchaser is the partnership itself. If payments are made by the partnership in liquidation of the partner's interest, the successor remains a partner until the interest is completely liquidated. §1.736-1(a)(6). Thus if the payments from the partnership are not all made on the date of death, the partnership year may not have closed on the date of death.

Two-Person Fiscal-Year Partnerships

The Code does not eliminate the possibility of bunching in the decedent's last return when a two-person fiscal-year partnership is involved. Since the two-person partnership would terminate on death of a member, because no part of the partnership business would be continued in partnership form, section 706(c)(1) would not prevent the taxable year from closing. The regulations, however, indicate that bunching can be avoided, in the case of two-person fiscal-year partnerships, by an agreement to continue the decedent's successor's interest in profits or losses of the partnership during the winding up period. Treas. Reg. §1.708-1(b)(1)-(i)(a). Furthermore, if payments are to be made under section 736, the partnership is not considered to be terminated until all payments are made. §1.736-1(a)(6).

The termination of a two-person partnership on the same taxable year as the deceased partner will enable the use of the decedent's deductions, etc., to offset the decedent's distributive share of partnership income to the date of his dcath. But if one of the partners is on a taxable year different from that of the partnership, the termination may cause bunching hardship to either the decedent or the survivor. Thus, it may not always be easy for the members of a two-person partnership to rcach an accord as to whether the statute should be permitted to run its course and terminate the partnership on the death of either one, or whether their agreement should continue the decedent's interest in profits or losses beyond the date of dcath. For federal tax purposes, the partnership continues during the winding up period, even in the absence of an agreement, until the decedent's successor's interest in profits or losses has been liquidated.

Payments to the successor in interest of a deceased partner in liquidation of his interest are treated like distributions in liquidation of the interest of a retiring partner.

TREATMENT OF LIQUIDATING DISTRIBUTIONS • Payments to the successor in interest of a deceased partner in liquidation of his interest are treated like distributions in liquidation of the interest of a retiring partner. The rule is that payments that are for the interest of the decedent in partnership property, including goodwill if the agreement calls for a payment for goodwill, are to be treated under the distribution rules. All other payments are income to the decedent's successor in interest.

If payments of the latter type are not fixed but are to be determined by reference to the partnership income, they are to be treated as a distributive share of annual income. If such payments are fixed, they are to be treated as guaranteed payments under section 707(c).

Noncharacterized Payments

If payments are made without characterization and include both payments for property and other payments, are fixed in amount, and are to be paid over a fixed number of years, the recipient must segregate each payment into its components. That portion of each such payment for the year that bears the same ratio to the total fixed agreed payments for such year as the total fixed agreed payments to be treated as a distribution under section 736(b) bears to the total fixed agreed payments under both sections 736(a) and (b) is to be treated as a distribution for the taxable year. If the payments are not fixed in amount, the entire payment shall be considered a distribution until the total payments received equal the decedent's interest in partnership property, and thereafter the entire amount of each entire payment shall be considered a distributive share, or ordinary income.

The partners may agree to any allocation different from those prescribed, provided that the total amount to be treated as a distribution shall not exceed the value of the recipient's interest in partnership property. Thus, the partners may agree that the entire amount of each fixed payment is to be treated as a distribution until the total payments equal the decedent's interest in partnership property. Conversely, they may agree that a proportion of each variable payment shall be treated as a distributive share, even though the recipient may not yet have received payments totaling his interest in partnership property. Treas. Reg. §1.736-1(b)(5)(i), (ii) and (iii).

Distrihntion in Liquidation

If there is no section 751 property involved, the portion of the liquidation payments that is for the decedent's interest in partnership property is to be taxed just as any other distribution in liquidation. §731. The portion of each payment that is not for an interest in partnership property is taxed as ordinary income. §736(a). If there is gain or loss on the distribution portion, and the payments are fixed in amount, the entire payment is treated as a return of basis until basis is recovered unless the recipient elects (in a statement attached to the return for the first year payments received) to alloeate a portion of basis to each year's payments. Treas. Reg. §1.736-1(b)(6).

If the payments are not fixed, the distribution portion is always treated as a return of basis until basis has been recovered and thereafter each payment is treated as gain. Loss is never recognized until payments cease.

The realization of gain or loss with respect to section 736(b) distributions is not likely to occur in the case of fixed payments to a deceased partner's successor. The successor's basis for his partnership interest will equal the value of the decedent's interest in partnership property. The payments for this interest, which are section 736(b) payments, should generally equal the value of the decedent's interest in partnership property, resulting in no gain or loss. However, variable payments might ultimately be insufficient to permit recovery of basis. Here loss will be recognized when payments stop.

Goodwill Payments

One possible difference between payments to a decedent's successor in interest and to a retiring partner is in the area of payments for goodwill. The Code provides that payments for goodwill are not payments for an interest in partnership property unless capital is not a material income-producing factor and the agreement specifically provides for such payments to a general partner. §736(b)(2)(B). However, the regulations state that payments treated as distributions only exclude any amount paid for a partner's share of partnership goodwill *in excess of its partnership basis,* including special basis adjustments to which the partner is entitled, unless the agreement provides for goodwill payments. Treas. Reg. §1.736-1(b)(3). At the very least this regulation implies that payments equal to the partnership basis for goodwill will be treated as in exchange for an interest in partnership property despite the apparently contrary provision of the Code.

Example: Retiring Partner vs. Decedent's Successor in Interest

If the regulation is correct, a major difference can exist between a retiring partner and a decedent's successor in interest as follows: Assume ABC Co. has the following assets and no liabilities—

	Basis	*Value*
Cash	$ 90	$ 90
Accounts receivable	30	30
Inventory	30	30
Building	30	60
Goodwill	0	30
	$180	$240

Charlie retires and is paid $100 for his interest. The partnership agreement says nothing about payments for goodwill. The value of Charlie's interest in partnership property other than goodwill is $70, so that amount will be treated as in exchange for Charlie's interest in property. The remaining $30 will be treated as ordinary income. If Charlie died, however, and his interest was valued at $80, and the partnership election under section 754 was in effect, the partnership would acquire a basis of $10 for goodwill for the benefit of Charlie's successor in interest. Under the regulations then, $80 of the $100 would be in exchange for Charlie's interest in partnership property and only $20 would be taxed as ordinary income. (The result should be similar if Charlie had purchased his interest paying $10 for his share of goodwill and then retired.)

A similar situation exists with respect to unrealized receivables. Again the Code provides that payments for unrealized receivables are not payments in exchange for property. §736(b)(2)(A). (This result cannot be changed by partnership agreement as in the case of goodwill.) And again the regulation treats this provision as applying only to payments in excess of the partnership's basis in the receivable, including special basis adjustment. Treas. Reg.§1.736-1(b)(2).

The extent to which payments in liquidation of the decedent's interest that are attributable to uurealized receivables and goodwill are in exchange for property rather than distributive shares of income thus depends upon the basis of those items to the partnership and whether that basis may be increased by the special basis adjustment under section 743(b).

More Income in Respect of a Decedent

Other items of income in respect of a decedent arising from the death of a partner should be noted. If a retiring partner receiving payments under section 736(a) dies before the completion of the payments, receipt of such payments by the decedent's estate constitutes income in respect of a decedent. Treas. Reg. §1.753-1(a). If the estate or other successor should sell its right to such payments, the amount realized would also constitute income in respect of a decedent. S. Rep. No. 1622, 83d Cong., 2d Sess. 406 (1954).

If a partner's death does not close the partnership taxable year as to him or her at the date of death so that the decendent's distributive share of partnership income up to the date of death is includable in the income of the estate or other successor for its taxable year with or within which the partnership taxable year closes, then the entire distributive share attributable to the period before death is income in respect of a decedent. This is so even for amounts withdrawn by the decedent before death and, therefore, not counted in determining the value of the decedent's partnership interest for estate tax purposes. Treas. Reg. §1.753-1(b).