Tax and Accounting Implications Following a Partner's Death: Financial and Operational Considerations

TUESDAY, FEBRUARY 9, 2016, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION

This program is approved for 2 CPE credit hours. To earn credit you must:

• **Participate in the program on your own computer connection (no sharing)** - if you need to register additional people, please call customer service at 1-800-926-7926 x10 (or 404-881-1141 x10). Strafford accepts American Express, Visa, MasterCard, Discover.

• **Listen on-line** via your computer speakers.

• **Respond to five prompts during the program plus a single verification code.** You will have to write down only the final verification code on the attestation form, which will be emailed to registered attendees.

• To earn full credit, you must remain connected for the entire program.

WHO TO CONTACT

For Additional Registrations:
- Call Strafford Customer Service 1-800-926-7926 x10 (or 404-881-1141 x10)

For Assistance During the Program:
- On the web, use the chat box at the bottom left of the screen

If you get disconnected during the program, you can simply log in using your original instructions and PIN.
Tips for Optimal Quality

**Sound Quality**
When listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, please e-mail sound@straffordpub.com immediately so we can address the problem.

**Viewing Quality**
To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.
Tax and Accounting Implications Following a Partner's Death

February 9, 2016

Sarah Allen-Anthony, Tax Senior Manager
Crowe Horwath
sarah.allen-anthony@crowehorwath.com

Madhuri Thaker, Consultant
Plante Moran
madhuri.thaker@plantemoran.com

Walter McGrail, Senior Manager
Cendrowski Selecky
wmm@cendsel.com

John Alfonsi, Managing Director
Cendrowski Corporate Advisors
jta@cendsel.com
ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS’ FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.
Tax and Accounting Implications Following a Partner’s Death
Tuesday, February 9, 2016
Sarah Allen-Anthony, CPA
Disclaimer

The information provided herein is educational in nature and is based on authorities that are subject to change. You should contact your tax adviser regarding application of the information provided to your specific facts and circumstances.
Topics

- Partnership Termination
- Closing of Partnership Tax Year
- Allocation of Income
- Estate Taxable Year
- Required Partnership Tax Year
- Basis of Partnership Interest
- Section 754
- Section 743(b) Adjustment
- Mandatory Basis Adjustment
- Redemption of Estate’s Partnership Interest
Introduction

- When a partner dies, the basis of his/her partnership interest is adjusted to its fair market value on the partner’s date of death or the alternate valuation date, if applicable, less any income in respect of a decedent attributable to the partnership interest.

- In addition, the estate or successor partner receives a long-term holding period in his/her partnership interest.

- The above changes have no effect on the inside basis of the assets of the partnership unless a Sec. 754 election is in effect.

- The partnership year ends for the decedent as of his/her date of death.
Partnership Termination

**General Rule** - A partnership terminates for tax purposes under Sec. 708 if:

1. 50% or more of the capital and profits interests are sold or exchanged within a 12-month period;
2. the partnership ceases doing business; or
3. the partnership ceases to have at least two partners.

A partner's death and the associated partnership interest transfer to his/her estate is **not** treated as a sale or exchange of the interest for these purposes.

- Even in the case of a two-person partnership, a termination does not automatically occur when one of the partners dies (since the decedent's estate or another successor in interest immediately becomes a partner for tax purposes).

Certain transfers *after* a decedent’s death may cause the partnership to terminate for tax purposes.
Closing of Partnership Tax Year

- The death of a partner will result in the closing of the partnership's tax year with respect to that partner under Sec. 706(c)(2)(A).

- Closing Method of Allocating Partnership Items
  - Proration method
  - Interim closing of the books

- Final Schedule K-1 should be issued to deceased partner.

- Must transfer capital and report post-death activity to estate K-1.
Method of Allocating Income in Year of Death

- Assume calendar year partnership with 2 partners (50% each) and taxable income of $60,000 for the year. Partner A died June 30. Income for the first 6 months was $10,000. Income for the last half of the year was $50,000.

<table>
<thead>
<tr>
<th></th>
<th>Proration Method</th>
<th>Interim Closing of the Books</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A - Individual</td>
<td>$15,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Partner A - Estate</td>
<td>$15,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Partner B</td>
<td>$30,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$60,000</td>
<td>$60,000</td>
</tr>
</tbody>
</table>
Tax Planning relating to choice of allocation method

- Choice of allocation method can potentially save tax

- Depends on many factors & circumstances
  - Need to think through most beneficial allocation in light of circumstances of each case.

- Let’s walk through an example…. 
Example - Choice of Allocation Method

- Same partnership from the previous example:
  - $60,000 income for calendar year
  - Partner A owns 50% and died June 30
  - $10,000 income pre-death
  - $50,000 income post-death

- Assumes no Sec. 754 election

- FMV at date of death of the 50% interest owned by Partner A was $105,000.

- Ignores Partner B (not applicable to example)
## Example: Choice of Allocation Method

<table>
<thead>
<tr>
<th></th>
<th>Proration Method</th>
<th>Interim Closing of the Books</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1040</td>
<td>1041</td>
</tr>
<tr>
<td>Partner A - Individual</td>
<td>$15,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Partner A - Estate</td>
<td>$15,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Beginning Tax Basis</td>
<td>$100,000</td>
<td>$105,000</td>
</tr>
<tr>
<td>Income</td>
<td>$15,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Ending Basis</td>
<td>$115,000</td>
<td>$130,000</td>
</tr>
</tbody>
</table>
Estate Taxable Year

- Estates may choose a tax year ending no longer than 12 months from the date of death.

- Tax year must:
  - End on the last day of a month and
  - Be selected on estate’s first income tax return.

- Certain trusts (Qualified revocable trusts) may elect to be treated as part of the estate under Sec. 645.
Estate Taxable Year

- The selection of the estate’s taxable year may have an impact on the year-end of the partnership…
Required Partnership Tax Year

The year resulting from one of the below rules is the required year. The test date is the first day of the partnership’s tax year.

1. Majority Interest Rule

2. Principal Partners Rule

3. Least Aggregate Deferral of Income Rule
Majority Interest Rule

- The partnership must adopt the tax year of the partners who own, in the aggregate, more than 50% of the capital and profits interest.

- If a partnership changes its tax year to comply with the majority interest rule (as a result of change of majority partners), no further change is required for the next two tax years.

- This consistency rule does not apply to changes under Principal Partners Rule or Least Aggregate Deferral Rule.
Principal Partners Rule

- If no partner, or combination of partners, owning more than 50% of the profits and capital interests has the same tax year, the partnership tax year must be the same as that of the principal partners.

- Principal partners are those owning 5% or more in either profits or capital interests.

- Note: the principal partners rule looks at profits OR capital. The majority interest rule looks at profits AND capital.

- If all the principal partners do not have the same year-end, the partnership cannot determine its required year based on the principal partners rule.
Least Aggregate Deferral of Income Rule

- If neither the majority interest rule nor the principal partners rule applies, the partnership must select a tax year resulting in the least aggregate deferral of income to the partners.

- Determined by multiplying each partner’s percentage of partnership profits for the year by the number of months of deferral that would arise through the selection of the proposed tax year.

- Months of deferral are counted by going forward from the proposed partnership year-end to the partners’ year-ends.

- Tax year that produces least aggregate deferral is required tax year.

- If more than one qualifying year, the partnership can select, unless one is the partnership’s existing year-end (then they must retain that).

- De minimis rule (less than .5).

- This test looks only at profits (not capital).
Example

- Assume a partnership is owned 60% by an individual who dies on July 17, 2015. The estate elects June 30 as its year-end.

- Prior to the individual’s death, the partnership was a December 31 year-end.

- What is the impact to the year-end of the partnership?
Example

- Partnership 2015 tax year January 1 – December 31, 2015

- Determination on first day of year
  - Majority partner 1/1/2015 calendar year-end individual
  - Majority partner 1/1/2016 June 30 year-end estate

- Next partnership short period January 1 – June 30, 2016

- Next partnership year July 1, 2016 – June 30, 2017
Basis of Partnership Interest

- The tax basis of a partnership interest acquired from a decedent is the fair market value as reported on the estate tax return.
  - FMV of the interest as of:
    - the date of death, or
    - the alternative valuation date.
Alternative Valuation Date

- The alternate valuation date is the date six months after decedent’s death, or, if within that six months the property has been distributed, then the date of the distribution.

- The election may be made only if valuing the estate on the alternate valuation date decreases both:
  - The value of the gross estate, and
  - The sum of
    - The estate tax imposed on the decedent's estate and
    - The generation-skipping transfer (GST) tax imposed on property included in the decedent's gross estate.
Section 754

- Sec. 754 election is made by the partnership on a timely filed return.

- Election is frequently missed when partnership technically terminates under Sec. 708(b)(1)(B).

- Once made, the election is in effect for all future years (unless IRS Consent to revoke).

- Without this election, the estate would have outside basis different from its share of the inside basis of the partnership assets.

- No basis step up for IRD.
Requirements of Sec. 754 Election for Death of Partner

- Must be made by the partnership;

- In the case of the death of a partner, the estate has one year from the date of death to notify the partnership in writing of the transfer; and

- The partnership is required to reflect the effect of the basis adjustments on the partnership return.

- Typically the “other deductions” or “other information” line of the partner’s Schedule K-1 is used to report Sec. 754 basis adjustment information.
When Not to Make a Sec. 754 Election

- If the discounted value of the partnership interest is less than the partnership’s cost basis in the underlying assets, the partnership should not make the Sec. 754 election.

- If made, the election will reduce the decedent partner’s share of the cost basis of the partnership assets to the discounted amount.

- However, you should note that for deaths occurring after October 22, 2004 the partnership will be forced to make a downward adjustment if the cost basis of all the partnership property exceeds its fair market value by more than $250,000.
Section 743(b) Adjustment

- Transfer of Partner Interest
  - Includes death of a partner

- Affects estate only.

- Allows an adjustment of the “inside” basis of the partnership assets upon the death of a partner.
Sec. 754/743 Example

- If not Sec. 754 election in effect, differing result.

- Sometimes can be remedied by liquidating the interest of the transferee partner.

- Importance of Sec. 754 election example:
  - Calendar year
  - Partner dies January 1
  - FMV at date of death $100,000
  - Assume assets of partnership sold post-death before year-end for $100,000
  - Partnership liquidates
## Sec. 754 Example and Comparison

<table>
<thead>
<tr>
<th></th>
<th>Sec. 754 in effect</th>
<th>No Sec. 754 election</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV partnership interest at date of death</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Adj. basis of share of partnership assets</td>
<td>$40,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Sec. 743 adjustment</td>
<td>$60,000</td>
<td>$-</td>
</tr>
<tr>
<td>Gain on sale of property</td>
<td>$-</td>
<td>$60,000</td>
</tr>
<tr>
<td>Liquidating Distribution</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Adj. basis after sale</td>
<td>$100,000</td>
<td>$160,000</td>
</tr>
<tr>
<td>Gain/(Loss) on liquidation</td>
<td>$-</td>
<td>$(60,000)</td>
</tr>
</tbody>
</table>
Mandatory Basis Adjustment

- Requires a basis adjustment as if a Sec. 754 election were in place for substantial built-in loss.

- Partnership has a “substantial built-in-loss” under Sec. 743 if the partnership’s adjusted basis in its property exceeds the fair market value of the property by more than $250,000.

- A partnership with no Sec. 754 basis adjustment in place will be required to adjust the basis on the death of a partner.

- Mandatory adjustment under Sec. 743 can be less than $250,000 if partnership has substantial built-in loss.
Mandatory Step-Down Example

- Partnership has no liabilities and no Sec. 754 election in effect.

- Partnership assets have a FMV of $1 million and adjusted basis of $1.4 million.

- Partnership has substantial built-in loss because the adjusted basis of its property exceeds its FMV by more than $250,000.

- Even if partner dies who owned 50% of partnership, a downward basis adjustment is required of $200,000.

- Same would be true if partner who died owned 1%, and downward basis adjustment of $4,000.
Redemption of Estate’s Partnership Interest

- Treated as a liquidating distribution under Sec. 736(b).

- Gain will be recognized to the extent that cash distributed exceeds the estate’s basis in its partnership interest.

- If property is distributed, it will generally receive the same basis as it had in the hands of the partnership limited to the estate’s basis in its partnership interest.
For more information, contact:

Sarah Allen-Anthony, CPA
Direct +1 574 235 6818
sarah.allen-anthony@crowehorwath.com

In accordance with applicable professional standards, some firm services may not be available to attest clients.

This material is for informational purposes only and should not be construed as financial or legal advice. Please seek guidance specific to your organization from qualified advisers in your jurisdiction.

© 2016 Crowe Horwath LLP, an independent member of Crowe Horwath International crowehorwath.com/disclosure
Effects on Deceased Partner’s Final 1040

By Madhuri Thaker
Options to successor in interest
Tax Year
Reporting Distributive Share
  • Income Tax
  • SE Tax
  • NIIT
  • Basis adjustments
PALS & Carryovers
IRD
DRD
Suspended Losses on Termination
Effects on Deceased Partner’s Final 1040

When an individual dies, the estate or successor in interest generally has following options:

1. Successor in interest becomes a partner
2. Successor sells partnership interest to outsider
3. Successor sells partnership interest to remaining partners
4. Partnerships buys successor – liquidation
5. Partnership liquidates eg. 2 partner partnership.
**Effects on Deceased Partner’s Final 1040**

**Tax Year:** IRC 706 (c)(2)(A) The tax year for a partner who dies terminates. The tax year also closes when the interest is sold, exchanged or liquidated.

Under some state LLC statutes, the death of a member results in the dissolution of the LLC.

The LLC can continue if members unanimously (or majority) consent to continuation within 90 days.

- A termination under state law does not necessarily result in a termination for federal income tax. An LLC terminates for tax purposes only if no part of the LLC's business is carried on or if 50% or more of the LLC's capital and profits is sold or exchanged during a 12-month period [IRC Sec. 708(b)(1)(B)].
• Generally, the death of a member in a two-member LLC terminates the LLC for federal income tax purposes. The LLC income for the short year (prior to death) is included on partner’s final individual income tax return. Income earned between date of death and LLC year-end is taxed to deceased member’s estate or beneficiary. Income is allocated either by 1) closing the LLC books or 2) prorating allocation based on number of days.
• **SE tax**: is calculated on pre-death income allocation based on decedent’s status as a partner (G.P. or L.P.) and the character of income.

• The basis of the LLC interest to the estate or the beneficiary is the FMV of the LLC interest as of date of death or alternate valuation date. In other words, there is a basis adjustment to the outside basis, not necessarily inside basis of the LLC interest. The LLC can elect to adjust basis of its assets under IRC 754 for benefit of transferee member.
Reporting the Distributive Share – Year of Death:

• **NIIT** – IRC 1410 can potentially apply to allocations of passive income from LLCs or gains on sales of LLC interests in which the member was passive unless the member was a material participant. See Prop Reg 1.1411-4(g)(11).

• An estate tax valuation of the partnership interest is calculated by a qualified appraiser. Various methods exist for valuing the partnership interest eg. NBV, FMV of partnership assets, capitalized cash flow, etc.
Reporting the Distributive Share – Year of Death:

• The basis of the LLC interest to the estate or the beneficiary is the FMV of the LLC interest as of date of death or alternate valuation date.

• There is a **basis adjustment** to the outside basis, not necessarily inside basis of the LLC interest.

• The LLC can elect to adjust basis of its assets under IRC 754 for benefit of transferee member.
Reporting the Distributive Share – Year of Death:

• **Reporting FMV**: FMV of the LLC interest must be reported to IRS as well as the beneficiary.
PALS & Carryovers:

• Special rules apply to passive loss and qualified business credit carryovers allocable to the decedent

• Under IRC Sec. 469(g)(2), unused passive losses deducted on the decedent's final tax return but only to the extent greater than the excess (if any) of basis attributable to the passive activity property in the hands of the transferee over adjusted basis of such property immediately before death.
**Example:** A, a single taxpayer, died on Aug 1, 2015. His suspended loss from ABC partnership was $10,000. His basis in the partnership interest was $17,500 and the FMV was $20,000. Thus, he received a step-up of $2,500. His suspended loss will be reduced by $2,500 for the final 1040. Any remaining loss would be lost.
• Under IRC Sec. 196(b), a qualified business credit [e.g., investment credit, alcohol fuels credit, and other credits as defined in IRC Sec. 196(c)] carryforward does not carry over to the estate but is allowed only as a deduction on the decedent's final tax return. They are lost at death [IRC Sec. 469(g)(2)(A)].
INCOME IN RESPECT OF DECEDENT:

- **IRD** IRC 691 – income earned by decedent prior to death but was not subject to tax. Example: Installment sale, unrealized receivables. Thus, it does not get picked up on final 1040. IRC 736(a) payments are IRD.

- IRD is picked up on the estate tax return as an asset of the decedent.

- IRD income is taxable to the estate or the beneficiary.

- IRD not eligible for step-up in basis. IRC 1014 (c).
INCOME IN RESPECT OF DECEDEENT:

• Liquidating payments – IRC 736. If payments represent income or guaranteed payments, then IRD.
• If payments represent exchange of partnership interest – generally no IRD (except to the extent of unrealized receivables).
• **DRD**: To mitigate double tax, the estate or the beneficiary can take a Deduction In Respect of Decedent (DRD).
• DRD is complex calculation.
• DRD benefit only applies if there was estate tax paid.
SUSPENDED LOSSES OF AN ESTATE:

• **NOLS and CAPITAL LOSSES**: Deductions unused by the estate upon termination cannot be carried over or used by beneficiaries. Instead, IRC 642(h) allows a carryover of net operating loss or capital loss to flow to beneficiaries in the year of termination. They retain their character.

• IRC 642(h)(2) allows **excess deductions** (not personal exemption or charitable deductions) on termination of estate to flow to beneficiaries.
Tax and Accounting Implications Following a Partner's Death: Financial and Operational Considerations

Tuesday, February 9, 2015
Speaker Biography

Walt McGrail JD, CPA, Principal Cendrowski Corporate Advisors
wmm@cendsel.com

Walt has provided consulting services to a variety of businesses and their owners for over 30 years. His experience includes the real estate industry and he has assisted with a variety of succession plans.
Distribution of Partnership Interests to Beneficiaries
Transfer of Partnership Interests to Beneficiaries

• The resulting treatment of the transfer of an interest in a partnership by a descendant’s estate to the decedent’s heirs depends on whether the transfer is in satisfaction of a pecuniary bequest or a specific or residual bequest.

  – Pecuniary Bequest - a bequest of a specific monetary amount.
    • Example, a beneficiary of an estate is entitled to $10,000.
  – Specific or Residual Bequest – a bequest of specified property (including remainder property) left to a particular heir.
    • Example, a beneficiary of an estate is entitled to the decedent’s interest in a partnership.
Transfer of Partnership Interests to Beneficiaries

• Effect of a Pecuniary Bequest –

  – Sale or Exchange Treatment.
    • Treasury Regulations 1.661(a)2(f) and 1.1014-4(a)(3)).
  – The Estate has a recognition event.
    • The Estate recognizes taxable income or loss as appropriate
  – As with most “sales or exchanges” of interests in partnership, a pecuniary bequest to heirs is a sale or exchange for purposes of IRC Section 708(b)(1)(B).
    • Therefore, the distribution of 50% or more of the interests in a partnership (including the pecuniary bequest) with a 12 month period terminates a partnership for federal income tax purposes.
Transfer of Partnership Interests to Beneficiaries

• Effect of a Specific or Remainder Bequest –

  – **NO** Sale or Exchange Treatment.

  – Generally, the Estate does **NOT** have a recognition event.
    • No gain or loss from the distribution taxable to the Estate

  – The distribution of a partnership interest in satisfaction of specific or remainder bequests do **NOT** result in the technical termination of a partnership under IRC Section 708(b)(1)(B).
Transfer of Partnership Interests to Beneficiaries

• Effect on Allocable Shares of Partnership Income
  – When an estate distributes a partnership interest to a beneficiary as a specific bequest
    • The beneficiary generally reports all income or loss for the entire partnership tax year of distribution.
  – However, if the distribution of the partnership interest satisfies a pecuniary bequest
    • The partnership's tax year closes on the date of distribution with respect to the estate
      – The tax year closes with respect to all partners if the distribution triggers a technical termination
    • The partnership must allocate the year's income or loss between the estate and the beneficiary
Section 736(b)
Sec. 736 - Payments to Deceased Partner’s Successor

- Section 736 applies to
  - Payments by a partnership;
  - In liquidation of a partner’s entire interest;
  - Made to a deceased (or retired) partner; and
  - The successor partner remains a partner until all withdrawal payments are made.
Sec. 736 - Payments to Deceased Partner’s Successor

• Section 736 is classification provision rather than a taxation provision.

  – Section 736 does NOT generally determine whether items are taxable or nontaxable

  – Payments subject to Section 736 are deemed to be either:

    • An allocation of items of partnership income or gain, etc. or
    • Deemed to be amounts received in exchange for interests in a partnership.
Sec. 736 - Payments to Deceased Partner’s Successor

- Effect of Section 736 Application
  - Section 736(a)

  - The decedent’s Successor Partner recognizes either:
    - An allocable share of partnership items if the amounts to be paid are determined with respect to earnings of the partnership; or
    - Guaranteed Payments to the extent that the amounts to be paid to the successor are NOT determined with respect to earnings of the partnership

  - In either case, such payments reduce the taxable income of the other members of the partnership other than the decedent’s successor in interest.

  - No adjustments to basis
Sec. 736 - Payments to Deceased Partner’s Successor

• Effect of Section 736 Application
  – Section 736(b)

  • The decedent’s Successor Partner recognizes:
    – Gain or loss from the disposition of an interest in a partnership
      » Including Section 751 Hot Asset determinations

• Such payments do NOT reduce the taxable income of the other members of the partnership.
Sec. 736 - Payments to Deceased Partner’s Successor

• Determinations of whether Section 736 (a) or (b) Apply
  – Section 736(a) payments include:

  • Payments to the successor which are NOT made in exchange for the withdrawing "partner's interest in partnership property".

  – The total amount paid for partnership property (Section 736(b) payments) is determined by agreement among the partners based on the retiring partner’s share of the fair market value of partnership property.
  – The total amount of Section 736(a) payments is the total amount of all payments less the Section 736(b) payments.
Sec. 736 - Payments to Deceased Partner’s Successor

• Determinations of whether Section 736 (a) or (b) Apply (continued)

  – Section 736(a) payments include:

    • Distributions from a partnership where capital is not a material income producing factor (including service partnerships); and
      – The decedent was a general partner’
      – The partnership assets included either:
        » Unrealized receivables; or
        » Unspecified appreciated goodwill.
Pre and Post Mortem Planning for Death of a Partner
John Alfonsi CPA/ABV, CFF, CFE, CVA, Managing Director
Cendrowski Corporate Advisors
jeta@cendsel.com

John has provided business valuation, forensic accounting, and tax consulting services to clients for more than 30 years. He is a recognized business valuation and economic damages expert who has presented expert witness testimony in various courts and has provided consulting to businesses and their owners.
Pre-Mortem Planning Considerations
Selecting a Successor in Interest

- The deceased partner’s interest passes to his estate unless he/she has previously designated another successor under the partnership agreement.
- Be aware that naming a charity (tax-exempt entity) may present issues for the organization (e.g. unrelated business taxable income).
- More than one successor in interest may be designated provided each receives an undivided share of all the decedent’s rights (e.g. cannot segregate capital and profits interests).
- **Planning note** - Consider the type of income or loss the partnership will generate when selecting a successor.
Termination of the Partnership

• Death of a partner may directly and indirectly cause a termination of the partnership for tax purposes
• Sale or exchange of 50 percent or more of capital and profits interest in a twelve month period results in a termination
• Redemptions of 50 percent or more of a capital and profits interest does not result in a termination.
• Planning note – *If the continuing partners want to ensure that the death of a partner will not terminate the partnership for tax purposes, the partnership agreement should provide for the liquidation/redemption of the interest rather than for its sale*
Two Person Partnership

• A partnership interest continues beyond the death of a member of a two person partnership where (i) the successor in interest shares in profit and losses of the partnership, and (ii) where the deceased partner’s interest is liquidated but only until the liquidation is completed.

• If the successor is obligated to sell the interest to the other partner, the partnership terminates on the date of sale.

• **Planning note** – Consider the admission of a third partner for a small interest if a termination would otherwise occur because of a required sale.

• **Planning note** – Consider using a series of liquidating payments by the partnership to defer the termination date.
Buy-Sell and Redemption Agreements

• Buy-sell and redemption agreements are common amongst business owners and are often funded with insurance.

• Cross-purchase option – each partner purchases an insurance policy on the life of each other partner with each purchasing partner naming himself as beneficiary; proceeds are then used to purchase a portion of the decedent’s interest.

• Partnership owned policy – partnership owns insurance on the lives of each partner; proceeds are used to redeem/liquidate the decedent’s interest.

• **Planning note** – Consider using a formula for the purchase/liquidation price or getting an annual valuation and adjusting insurance levels accordingly.
Post-Mortem Planning and Considerations
Valuation

• Partnership interests are generally valued in the same manner as interests in other business enterprises

• IRC § 2032A provides special-use valuation rules for certain real property used as a family farm or in a family business
  – If applicable, qualifying real property is valued with respect to its current use rather than its highest and best use

• IRC § 6166 provides rules for a qualified “interest in a closely held business”
  – If applicable, the estate tax attributable to the interest can be deferred for up to five years and thereafter payable in up to ten consecutive equal annual installments

• **Planning note** – Consider the application of IRC §§ 2032A and 6166 where the partnership owns real property and/or conducts a trade or business (does not apply to “passive assets”).

Source: www.divorcestatistics.org
§ 754 Election

• IRC § 754 provides an election to adjust the inside bases of partnership assets pursuant to IRC § 743(b) on the transfer of an interest caused by a partner’s death.
  – Eliminates the discrepancy between the outside basis after adjustment to FMV and the successor in interest’s share of the partnership’s inside basis of its assets.

• The election must be in effect or made for the year that includes the deceased partner’s date of death.

• Generally, a step-down is required (even without a § 754 election) if the partnership has a “substantial built-in loss”

• Planning note – Consider making a § 754 election in the year of death if one is not already in effect.

• Planning note – A § 754 election also needs to be in effect at lower tier partnerships