

Partnership Interests in Trusts and Estates: A Practitioner's Guide

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Simple Trusts – Common Misconception

- Income is required to be distributed at least annually
- This **does not** mean that all of the trust's taxable income (other than capital gain) is taxed to the income beneficiary and the capital gain is taxed to the trust

What is “Income”?

- “Income Required to be distributed” is Fiduciary Accounting Income
- Not Taxable Income or Distributable Net Income (“DNI”)
- **Tax Implications:** If Fiduciary Accounting Income is less than DNI, not all of the trust’s DNI will be taxed to the beneficiary

Application to Partnerships

- “Income required to be distributed” to beneficiary includes cash distributions (that are not liquidating distributions) from a partnership – not K-1 income
- If a partnership distributes less cash than the income shown on partnership K-1, generally not all of the trust’s DNI will pass out to the beneficiary

Fiduciary Accounting Income under UPIA

- Interest and dividends from bank and brokerage accounts
- Cash distributions from partnerships (not income reported on K-1)
- **Not** Capital Gain
- **Not** property or liquidating distributions from partnerships

Income Tax Liquidity

- If partnership doesn't make distributions, the trust or estate may not have enough \$\$\$ to pay its income tax
 - Option 1: Partnership makes distributions in subsequent year before tax return is due
 - Option 2: Partnership distributes other cash or property to reduce income tax liability

Income Tax Liquidity, cont.

- In the case of a simple trust, how is the income tax paid on partnership income taxable to the trust?
 - Cash distributions are required to be paid to beneficiary
- Other assets?
- In practice, pay income tax first and distribute remaining amount to beneficiary

Passive Activity Rule Applicable to Trusts and Estates

- No Regulation
- Legislative History: depends upon whether executor or trustee, in its fiduciary capacity, materially participated
- *Mattie K. Carter Trust v. U.S.*
 - activities of Fiduciaries, Employees and Agents
- TAM 200733023
 - activities of Trustee
- Grantor Trusts
 - activities of Grantor

IRC §754 Election and QTIP Trust

- Unclear whether the partnership can step-up QTIP's share of inside basis
- Only available for partnership interests sold or exchanged, or transferred because of partner's death
- Back-up: force a sale/exchange

Distribution of Partnership Interest

- Negative Capital Account
- Suspended Passive Activity Losses
- Allocation of Partnership Income/Loss

Negative Capital Account

- Distribution should trigger income to trust or estate unless it is specifically bequeathed
- Theory: Discharge of Indebtedness (IRC §752 and §1001)

Suspended Passive Activity Losses

- Added to Basis
- **Exception:** If an estate satisfies a pecuniary bequest (i.e., fixed dollar amount) with a partnership interest - deemed to be a disposition that frees up losses
 - Estate is not a related party in this context; same rule does not apply to trusts
 - IRC §643(e)(3) election won't free up losses in excess of gain recognized because of related party rules

Allocation of Partnership Income

- **Specific Bequest:** Post-Death income/loss allocated to beneficiary
- **Pecuniary Amount:** Post-Death income/loss allocated to estate/trust until distributed; any post-distribution income/loss allocated to beneficiary

Allocation of Partnership Income, cont.

- Residuary or Discretionary – 2 Options
 - (1) In year of distribution, all income/loss allocated to beneficiary (Treas. Reg. §1.706-1(c)(3)(vi), Ex. 3)
 - (2) In year of distribution, income/loss allocated between trust/estate and beneficiary (*Rev. Rul. 72-352*)



Thank You