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Planning Strategies for the Death of a Partner

-by Neil E. Harl*

Much of the confusion over the effect of the death of a partner on the partnership (and on the deceased partner’s estate) relates to the question of whether the death of a partner results in the closing of the partnership’s tax year with respect to that partner. The confusion is compounded by the fact that the regulations in place do not reflect the 1997 amendment to the statute.\(^ 3\)

The current rule

For years beginning after 1997, the partnership’s year for the decedent generally closes at death.\(^ 4\) The statute was amended to state that –

“The taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates (whether by reason of death, liquidation, or otherwise).”\(^ 5\)

That legislation eliminated the rule that a partnership year does not close upon the death of a partner, effective for tax years beginning after December 31, 1997.\(^ 6\) The regulations then stated (and the regulations have not been amended to reflect the 1997 change) –

“When a partner dies, the partnership taxable year shall not close with respect to such partner prior to the end of the partnership taxable year.”\(^ 7\)

The former rule, stated yet in the current regulations, specifies that “the partnership taxable year shall continue both for the remaining partner and the decedent partner.”\(^ 8\) The Conference Committee report clarifies that the pre-1998 law remained unchanged with respect to transfer of a partnership interest by a debtor to the debtor’s estate under Chapter 7 or 11 of Title 11 relating to bankruptcy.\(^ 9\)

Prior to the effective date of the 1997 amendment, a decedent partner’s share of income generated by the partnership during the year in which death of a partner occurred was reported by the deceased partner’s successor in interest (usually the surviving spouse or the estate of the decedent). In some instances, if the deceased partner’s estate was in a lower income tax bracket than the decedent partner, this treatment caused a reduction in income tax liability and, in some cases, caused a mismatch of income and deductions.

As an example, if a partner had a $100,000 distributive share of partnership income as of the date of death, and as of that date had incurred taxes and mortgage interest of

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$40,000, if the partnership year did not close at the partner’s death, the $100,000 of income would be reported by the partner’s successor in interest but the taxes and mortgage interest would be reported on the decedent’s final individual income tax return. If the successor was the estate, the estate would be required to report the income without the offsetting deductions. The decedent’s final return would report deductions but with no offset against the income.

For partnership tax years after 1997, death of a partner causes a closing of the partnership tax year with respect to the deceased partner with the income and deductions included on the decedent’s final income tax return. That means that the income attributable to the deceased partner’s partnership interest must be allocated between the pre-death and post-death periods. Under the regulations, this allocation is made by an interim closing of the partnership books or, if all partners agree, on a pro rata basis based on the number of days in the period.

Self-employment tax implications

For social security purposes, the distributive share of a partner for the year of death up to the end of the month in which the partner died is reported as self-employment income for the year of death. For the purpose of determining the partner’s distributive share up to the date of death, the ordinary income or loss of the partnership is treated as having been realized or sustained ratably over the partnership’s taxable year. The term “deceased partner’s distributive share” includes the share of the estate or of any other person succeeding, by reason of the partner’s death, to rights with respect to the partnership interest. There is no election involved.

Basis of interest at death

The income tax basis of the partnership interest in the hands of the estate or other successor in interest of the deceased partner is the fair market value of the partnership interest at death reduced by the amount of the deceased partner’s share of unrealized receivables and increased by the partner’s share of partnership liabilities. Unrealized receivables do not receive a new income tax basis at death, retaining their character as income in respect of decedent. In no event can the basis of unrealized receivables be adjusted by an election under either I.R.C. § 743 and I.R.C. § 754 or under I.R.C. § 732(d).

Footnotes

2 Treas. Reg. § 1.706-1(c)(3).
3 I.R.C. § 706(c)(2)(A).
5 Id.
6 See Treas. Reg. § 1.706-1(c)(3).
7 Treas. Reg. § 1.706-1(c)(3)(i).
8 Id.
10 Treas. Reg. § 1.706-1(c)(2)(ii).
11 Id.
12 I.R.C. § 1402(f).
14 I.R.C. § 1402(f)(2).
15 See generally Harl, Farm Income Tax Manual § 914(b) (Matthew Bender 2006).