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How the Death of a Partner Could Affect a Partnership's Year-End

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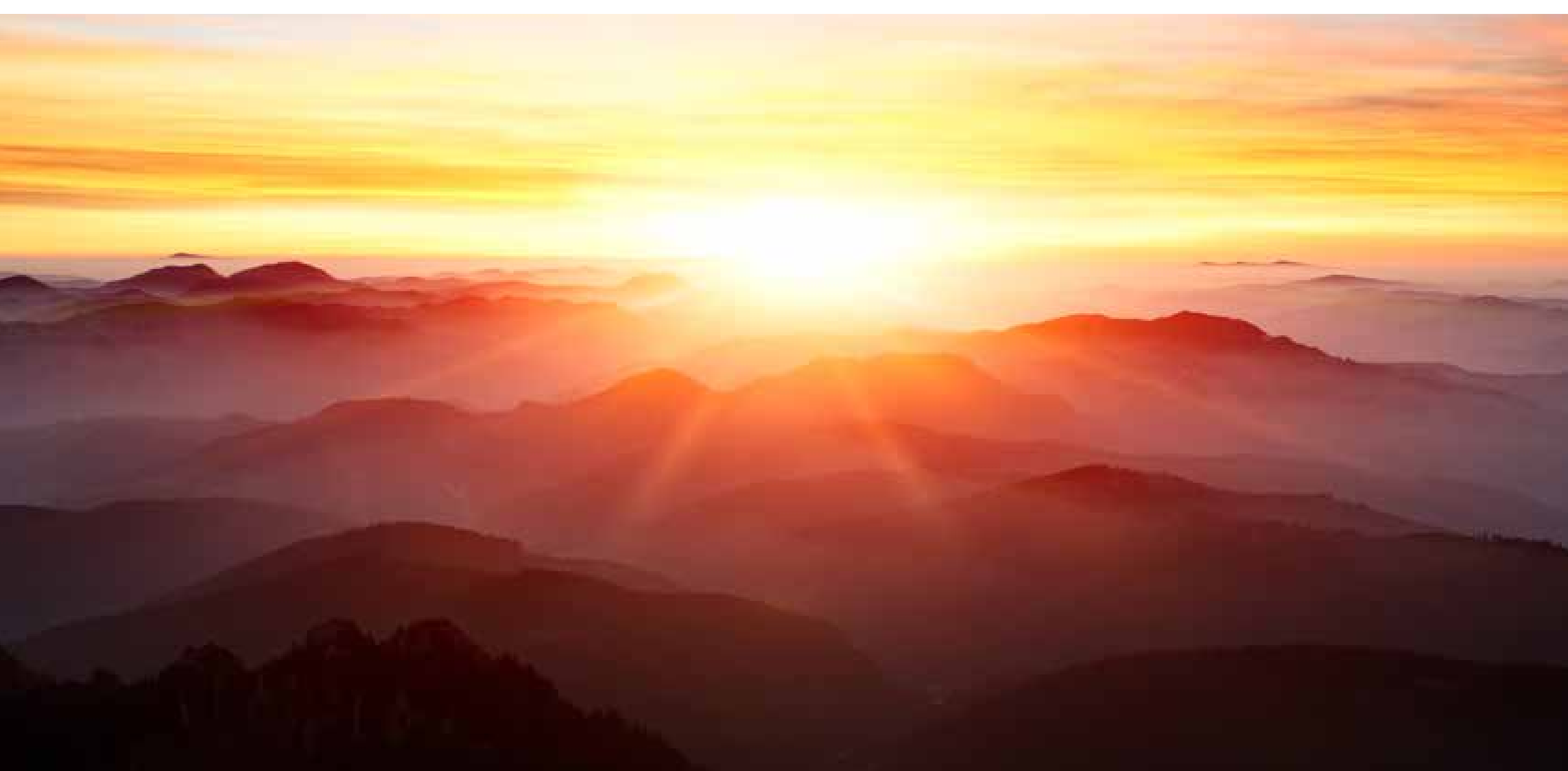

When a partner in a partnership dies, tax practitioners usually have many tax items to think about, including information for the decedent's estate or a new trust for purposes of reporting activity on the partnership's Schedules K-1.

Other examples of items typically considered are income allocations for the year of death such as closing of books or pro rata allocations and whether there is a tax opportunity for a Sec. 754 election or corresponding basis step-up.

However, an important tax implication that practitioners often overlook is the impact on a partnership's year-end when a partner dies and the partner's estate adopts a fiscal year-end. Furthermore, if the decedent's partnership interest was held in a revocable trust before death, and the trustee elects under Sec. 645 for the trust to be included in the estate with a fiscal year-end, the partnership year-end could be similarly affected.

Partnership tax years must follow a hierarchy of rules when determining the required tax year. Sec. 706(b) dictates the year-end of the partnership, using the first day of the year as an annual measurement date. Partnerships must re-evaluate their current fiscal year when a partner dies, since the estate may have a different year-end than the individual partner. These rules could cause a change in the required partnership year-end upon the death of a partner. Furthermore, a partnership tax return may inadvertently be filed late if the change to the year-end is not discovered until after the short-year partnership return is due.

The Partnership Tax Return Is Late: So What?

Assume a partnership has 40 partners. Due to the death of one partner, the partnership year-end changes, and the tax practitioner does not realize this until after the short-period due date. As a result, the partnership tax return is filed six months late, without an extension.

Penalties: If a partnership return is not timely filed, the IRS assesses a $195 per month penalty on the partnership multiplied by the number of partners during the partnership's tax year. In this example, the partnership would owe $46,800 in penalties.

Elections: If the partnership desires to make an election under Sec. 754 to step up the basis of the partnership's assets to fair market value at the date of death under Sec. 743(b), an election must be made with a timely filed partnership return. If the partnership does not timely file its return, the opportunity for a basis step-up could be missed, which could prove costly to the partnership and its partners. (The possibility of Sec. 9100 relief in certain circumstances for late Sec. 754 elections is outside of the scope of this discussion, but tax professionals who have missed a deadline for making a Sec. 754 election should investigate it further.)

Other affected filings: Other filings could be negatively affected by a late-filed partnership return, which could be costly to the partnership. One example is Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations." If a partnership is required to file this form, it is due with a timely filed partnership return. A late-filed Form 5471 results in substantial penalties, starting with $10,000 for each foreign corporation failing to file timely.

Partnership Required Year-End: The Three-Tier Test

Under Sec. 706(b)(1)(B), the partnership year-end is determined as follows (unless a business purpose is established under Sec. 706(b)(1)(C) allowing a different year-end):

- **Majority interest:** The partnership must adopt the tax year of the partner or partners who own more than 50 percent of the partnership's capital *and* profits.
- **Principal partners:** If no single partner, or combination of partners with the same year-end, owns more than 50 percent of the capital and profits, the partnership must adopt the tax year of the principal partners (those owning 5 percent or more in either profits *or* capital).
- **Least aggregate deferral:** If there is no tax year determined under either of the first two tests, then the partnership must adopt the tax year that results in the least aggregate deferral of income, which is the tax year of one or more of the partners in the partnership that will result in the least aggregate deferral to the partners. The aggregate deferral for a particular year is equal to the sum of the products determined by multiplying the month(s) of deferral for each partner that would be generated by that year and each partner's interest in the partnership's profits.

Other Rules

In determining a majority interest, both capital and profits must be considered. However, for determination of the principal partner(s), the test looks at either capital or profits.

The consistency rule of Sec. 706(b)(4) is used for purposes of determining whether the ownership structure meets the majority-interest rule. This rule states that the test date is the first day of the partnership's tax year.

A special *de minimis* rule provides that if the tax year with the least aggregate deferral produces an aggregate deferral that is less than 0.5 months of the aggregate deferral of the partnership's existing tax year, the existing tax year will be treated as the tax year with the least aggregate deferral. Thus, no change in tax year is necessary or permitted.

If a partnership changes its tax year to comply with the majority-interest rule (because of any changes in the tax years of majority partners), no further change is required for the next two tax years, under Sec. 706(b)(4)(B). However, the partnership has the option to change again if there is another change in the majority interest (such as a distribution of the partnership interest from an estate to individual beneficiaries) before the next two years have passed.

Example 1: An individual partner dies in 2016, and the estate adopts a June 30 estate year-end. The estate is the majority interest partner, so the partnership's required year-end changes to June 30, 2017.

The partnership is not required to change its year-end again for the next two years, even if there is another change to the majority interest year-end. If the estate distributes the partnership interest in December 2017 to the individual beneficiary, the partnership has the option to change to a calendar year-end for July 1 through Dec. 31, 2018, but it is not mandatory because of this consistency rule. The partnership has the option to retain the June 30 year-end for two tax years following the year of change (which would be the years ending June 30, 2018, and June 30, 2019). The partnership would then have to change to a calendar year-end for July 1, 2019, through Dec. 31, 2019.

Does the Death of a Partner Cause a Technical Termination?

Although a partner's death terminates the partnership year for that partner, the partner's death does not automatically cause the closing of the partnership's tax year for the other partners.

Under Sec. 708(b), a partnership shall be considered as terminated if 50 percent or more of the capital and profits interests are sold or exchanged within a 12-month period; the partnership ceases doing business; or the partnership ceases to have at least two partners. A partner's death and associated transfer to his or her estate is not treated as a sale or exchange for these purposes. Similarly, the transfer of the partnership interest from a living revocable trust to a post-death trust is not a sale or exchange for Sec. 708(b)(1)(B) purposes. Furthermore, even for a partnership with only two partners, one partner's death

does not terminate the partnership because his or her estate or other successor in interest immediately becomes a partner for tax purposes.

Certain transfers of the partnership interest after death may cause the partnership to terminate, however.

For example, if a partner's interest in a partnership is transferred to the decedent's heirs to satisfy a pecuniary bequest, this may cause the partnership to technically terminate because, under Sec. 761(e), the distribution of a partnership interest is treated as a sale or exchange of the interest under Sec. 708.

Estate Year-End

All trusts (other than charitable trusts) must use a calendar year. The executor of an estate is free to select any fiscal year; however, the year must end on the last day of a month and cannot have more than 12 months. By carefully selecting a fiscal year, it is possible to equalize the income tax rates during the various fiscal years or to defer income so it is taxed in a beneficiary's subsequent year.

Under Sec. 645, the executor (if any) of an estate and the trustee of a qualified revocable trust may elect for the trust to be treated and taxed as part of the estate and not as a separate trust. This allows the income and expenses from the trust to be reported by the estate on a combined Form 1041, "U.S. Income Tax Return for Estates and Trusts." A qualified revocable trust (QRT) means any trust (or portion thereof) that was treated under Sec. 676 as owned by the decedent, including a revocable trust. Once the Sec. 645 election is made, it is irrevocable under Regs. Sec. 1.645-1(e)(1). As a result of the Sec. 645 election, the trust has the same year-end as the estate.

Examples: Majority-Interest Rule

The following examples illustrate the determination of a partnership's tax year in the year after the death of an individual majority interest holder in three scenarios.

Example 2: Partnership interest owned individually: FLP Investments LLC (FLP) is a family limited partnership owned by individuals and thus has a calendar year-end. Grandpa (G) owns 60 percent of FLP; his children and grandchildren own the remaining units. Because on Jan. 1, 2016, G is the majority interest partner, FLP's 2016 year-end is Dec. 31, 2016. Upon G's death in July 2016, the executor of his estate selected a June 30 year-end.

On Jan. 1, 2017, G's estate, the majority partner in FLP, has a year-end of June 30, and thus the required year-end of FLP changes to June 30. FLP would file a short-year return from Jan. 1 through June 30, 2017. The next year is July 1, 2017, through June 30, 2018.

Example 3: Partnership interest owned via revocable trust that does not make a Sec. 645 election with estate: Assume the same facts as in Example 2, except G owns 60 percent of FLP via his revocable trust instead of individually. The trustee of G's revocable trust (G Rev Trust) elects *not* to make a Sec. 645 election with G's estate; therefore, the trust files its own return on a calendar year, and the estate would file its own return using the estate's elected June 30 year-end.

On Jan 1. 2017, because G Rev Trust, the majority partner in FLP, continues to have a year-end of Dec. 31, FLP will continue to file on a calendar year.

Example 4: Partnership interest owned via revocable trust that makes a Sec. 645 election with estate: Assume the same facts as in Example 2, except G owns 60 percent of FLP via his revocable trust, but upon G's death in July 2016, the executor of his estate and the trustee of his trust made a Sec. 645 election. Therefore, the combined entity files using the estate's June 30 year-end.

The result in Example 4 will be the same as Example 2 in which G owned the partnership interest individually. On Jan. 1, 2017, G Rev Trust, the majority partner in FLP, has a year-end of June 30, and thus the required year-end of FLP changes to June 30. FLP files a short-year return from Jan. 1, 2017, through June 30, 2017. The next year is July 1, 2017, through June 30, 2018.

Neither G's death nor G's estate and trust making a Sec. 645 election is considered a termination of the partnership since the decedent's estate or revocable trust immediately becomes the partner for tax purposes (Regs. Sec. 1.708-1(b)(1)(i)).

If the partnership year changes, the short-period partnership tax return will only report income during the applicable time period (Jan. 1-June 30) and must not annualize (Regs. Sec. 1.706-1(b)(8)(i)(B)). Thus, the individual partners will be deferring six months' worth of partnership income beginning with their 2017 individual returns but eventually will report a year and a half of income when the partnership reverts to a Dec. 31 year-end (following the closing of the estate). The revocable trust will report a year and a half of partnership income on its June 30, 2017, Form 1041 (including 2016 income).

Final Considerations

When a partner dies, tax advisers must remember to consider the partner's ownership as it could cause a mandatory year-end change for the partnership. Important issues that must be settled include:

- Confirming whether the partnership interest is held by an individual or grantor trust prior to death (since in both cases the partnership's Schedule K-1 may report the individual as the owner);
- If the interest is held by an individual, asking the executor of the estate what the estate is electing as its fiscal year; or
- If the interest is held by a revocable trust, asking the trustee if he or she will be filing a Sec. 645 election to combine the estate and trust. If yes, determine what fiscal year the trustee will elect.

This is an example of a situation where proactive and solid communication between accountants, estate attorneys, and the executor of the estate is extremely important to avoid costly tax compliance errors.

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