

ACCOUNTING FOR PARTNERSHIP INTERESTS HELD BY ESTATES OR TRUSTS: PLANNING TO AVOID PITFALLS

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DAVID KEENE AND DEAN BUTLER EXPLAIN ACCOUNTING FOR LLC AND PARTNERSHIP INTERESTS HELD BY ESTATES AND TRUSTS AND SHARE PRACTICE TIPS THAT WILL IMPROVE CLIENT RESULTS.

In the February 2002 TAXES article, *A Primer on the Uniform Principal and Income Act: How Accounting Affects Trust and Estate Beneficiaries*,¹ David Keene discussed the framework of the Uniform Principal and Income Act (UPIA) and how it affects the rights of the beneficiaries of trusts and estates. Included in that discussion was how the determination of receipts and disbursements as either income or principal affect the answer to the “who gets what” question for beneficiaries. In this article we also will see how the implementation of this principal/income dichotomy can affect the financial affairs of the trust or estate itself—an issue that has not been given much attention.

As mentioned in the previous article, a new law, the Revised Principal and Income Act of 1997

(RUIA 1997) is being adopted by many states, replacing the original UPIA of 1931 or RUIA of 1962. Changes made by this new law may significantly alter what beneficiaries will be receiving as compared to the results occurring under previous law. Beneficiaries and their advisors may be surprised by some of the changes. Exhibit 1, below, is a useful guide showing what the current version of UPIA is on a state-by-state basis, so you can see what the applicable law is in your state.

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PARTNERSHIP INTERESTS HELD BY ESTATES OR TRUSTS

As in the previous article, when we refer to “UPIA,” it is meant to be a generic term covering UPIA 1931 as well as RUPIA (the 1962 and 1997 versions) and used to introduce universal principles in cases where all three laws share traits in common. The specific laws will be referred to as UPIA 1931, RUPIA 1962 or RUPIA 1997. Other terminology defined in the previous article will be used here; further, many of the concepts developed previously will be important to this discussion. Accordingly, it is recommended that the reader acquaint himself or herself with the previous article before engaging in this one.

A preponderance of UPIA’s text is devoted to rules for determining income versus principal for the receipts or disbursements associated with special kinds of property: IRAs and pensions, rental property, insurance policies, copyrights, annuities and so on. Previously we focused on the broader concepts—the definitions of income and principal and other basic standards—and avoided these property-specific situations for the most part. Given that these broader concepts give structure to the property-specific rules, we now will rely on this structure to look at a particular property—partnership and LLC interests.

For the sake of brevity, the term “partnership” is intended to include both partnerships and LLCs and “partner” will be used to refer to both partners and limited liability company (LLC) members. Also, as a simplifying assumption, all trusts will be presumed to include in their terms a requirement to distribute income at least annually. Additionally, references to trusts will apply as well to estates of decedents, unless otherwise noted. It is also assumed that an LLC interest is to be accounted for and allowed the same income tax treatment as a partnership interest.

EXHIBIT 1

UNIFORM PRINCIPAL AND INCOME ACT—APPLICABLE LAW BY STATE¹

State	UPIA 1931	RUPIA 1962	RUPIA 1997	State	UPIA 1931	RUPIA 1962	RUPIA 1997
Alabama			x	Nebraska			x
Alaska		x		Nevada		x	
Arizona			x	New Jersey			x
Arkansas			x	New Mexico			x
California			x	New York			x
Colorado			x	North Carolina		x	
Connecticut			x	North Dakota			x
District of Columbia			x	Ohio		x	
Florida		x		Oklahoma			x
Georgia		x		Oregon		x	
Hawaii			x	Pennsylvania	x		
Idaho			x	South Carolina			x
Illinois		x		South Dakota		x	
Indiana		x		Tennessee			x
Iowa			x	Texas		x	
Kansas			x	Utah		x	
Kentucky		x		Vermont	x		
Maryland			x	Virginia			x
Michigan		x		Washington		x	
Minnesota			x	West Virginia			x
Mississippi		x		Wisconsin		x	
Missouri			x	Wyoming			x
Montana		x					

¹ The following states have not adopted the Uniform Principal and Income Act: Delaware, Louisiana, Maine, Massachusetts, New Hampshire and Rhode Island.

Why Partnership and LLC Interests?

Family partnerships and LLCs are increasingly popular as estate planning vehicles. At the same time, many small business owners have accepted the LLC form of business as the preferred choice over the partnership, corporate or sole proprietorship forms. The natural consequence of these trends is the assurance that a significant number of estates (as well as the resulting testamentary trusts) will be holding substantial partnership and LLC interests.

For purposes of this article, it is assumed the partnership interests being discussed are ones the trust has substantial ownership in (enough to have significant influence over the partnership's business.) RUIA 1997 has changed the income/principal classification rules for trusts owning partnership interests, and this change can significantly alter what beneficiaries will be receiving as compared to RUIA 1962. Accordingly, if RUIA 1997 has been adopted recently by your state (or is likely to be), it is advisable to look at existing trusts to decide if remedial action needs to be taken. Additionally, it may be worth rethinking how future trust documents should be drafted, or what trust funding choices should be pursued or avoided based upon these new rules.

The Issues

Though much attention has been given to gift and estate tax valuation issues regarding partnership interests, especially the positioning for discounts, there has been insufficient focus on what happens after formation. For our purposes, we will be

concerned with the post-formation issues after a partnership or LLC interest becomes the property of a trust or estate. Specifically, this article addresses the following issues:

- How is an estate or trust's income from a partnership defined and determined?
- How do these definitions of income differ for RUIA 1962 and RUIA 1997?
- How can the method used to determine the trust's income influence the financial and income tax situations of the income versus the principal beneficiary?
- What effect will the trust's definition of partnership income have on the financial and income tax matters of the trust?
- What trust provisions could or should an attorney draft into the trust instrument to alter the definition and determination of income to the trust and its beneficiaries?

RUIA 1962—Yes, Partnerships Are Different from Corporations

Most are familiar with UPIA's rules regarding the receipt of corporate dividends by a trust: Dividends are generally classified as income,² thus increasing the income beneficiary's stake in benefits from the trust. However, partnership distributions (sometimes erroneously referred to as dividends) are treated differently from corporate dividends under RUIA 1962. This difference is based on the recognition of the essential differences between partnerships and corporations.

RUIA 1962 follows the accounting model for determining

a trust's income from a partnership interest; income is the trust-partner's share of partnership income.³ This accounting model correlates with the legal rights and obligations of partners, which are different from those of shareholders. Though this generally accepted accounting principles (GAAP)-based model is not familiar to all, it is emulated in income tax law. This provides the opportunity to discuss these GAAP concepts by referring to tax accounting, which is likely more familiar to the nonaccountants. Let us look at the tax law system which parallels RUIA 1962's GAAP-based approach in defining income.

The IRS Schedule K-1 received by partners reflects the partner's *pro rata* share of taxable income. For example, if a partnership's only activity results in ordinary income of \$100,000 then a 10-percent partner would see \$10,000 income reported on his Schedule K-1. This \$10,000 amount of income would be included in the taxable income of the partner *regardless of distributions the partnership made to the partner*. Distributions from a partnership to a partner are generally a nonevent in terms of taxation, except that a distribution reduces the partner's *adjusted basis* in his partnership interest. As straightforward as this explanation may be, those unfamiliar with the rules of partnership taxation seem to have trouble with this concept. For instance, if significant distributions are made in a year when the partnership suffers a taxable loss, some partners wonder why they do not "have income" from the partnership.⁴ It may help to explain that the tax rule for determining a partner's income from a partnership works independently from the rule for distributions.

Once you understand the above tax accounting regime for partners, you are 90 percent of the way to understanding RUIA 1962's rules for determining the income from partnership interests. To begin with, RUIA 1962 follows the same share-of-income concept, which provides that income for the trust-partner is the partner's share of partnership income on a GAAP basis (as opposed to on an income tax basis). And there are two things worth keeping in mind regarding this potential difference between partnership income de-

In short, RUIA 1962's rules for determining income from a partnership parallel the income tax rules, with the trust-partner's income being its share of the partnership's GAAP income (rather than tax basis income), and the distributions from the partnership being applied as a reduction in the trust's *investment in partnership* account (rather than the *adjusted basis*).

To complete the loop on RUIA 1962's accounting for partnership interests, we will need to address the principal side of the income/principal dichotomy; however, it

will take a few intermediate steps before we get there. As mentioned, distributions from the partnership will reduce the balance of the *investment in partnership* account. There are two other trans-

actions that will affect this investment in partnership account:

- The account is increased initially by the amount of the purchase price when the partnership interest is acquired.
- This account also is increased by the annual share-of-income amount (or decreased should the partnership suffer a loss for the year).

Taken together, we can now arrive at the formula for the investment in partnership account balance: add original cost plus the annual income minus annual losses (if any) then subtract the distributions. (It is worth noting that the same formula is used for computing *adjusted basis* for income tax purposes, except that income and losses are computed on an income tax as opposed to a GAAP basis of

accounting.) When the partnership interest is sold or otherwise disposed of, the result of all these additions and reductions to the investment in partnership account will then affect the trust's principal: At this time, the resulting gain or loss, which will be the difference between the proceeds from sale and the investment in partnership account balance, will be an addition to or reduction of the principal. It is also worth noting that the investment in partnership account is not static in amount; it constantly changes with the annual income, losses and distributions.

If the trust-partner's share of income is greater than the partnership's distributions, a potential dilemma exists. Suppose the income as defined by RUIA 1962 is \$10,000, but the partnership's distributions are \$8,000; assuming all income is to be distributed to the trust's income beneficiary (the traditional distribution scheme), it will be necessary for the trust to come up with an additional \$2,000 from somewhere. If the trust has other assets besides the partnership interest, this \$2,000 shortfall may not be a concern. However, if the partnership interest is the only asset in trust, this shortfall creates a real problem. This and other financial dilemmas resulting from the RUIA rules will be brought out in more detail as we compare RUIA 1962 with RUIA 1997.

RUIA 1997— Partnerships and Corporations Treated the Same

The general rule for RUIA 1997 is explained easily: the distributions from a partnership are considered to be the income. Quite

ALTHOUGH ONE CAN ARGUE FOR OR AGAINST THE TRUST-PARTNER'S CHOICE BETWEEN THE RUIA 1962 AND RUIA 1997 MODEL, THE ULTIMATE TEST IS WHAT AN INFORMED TRUSTOR DESIRES.

terminated on an income tax basis of accounting versus partnership income determined on a GAAP basis: (1) this difference may be nonexistent or immaterial (depending upon the situation),⁵ and (2) an accountant (with the proper information from the partnership) will be able to convert tax basis financial information to GAAP basis, if need be.

Just like the tax accounting, the partnership's distributions to the trust-partner do not affect the trust-partner's income under RUIA 1962. Such distributions instead will reduce the carrying value of the partnership interest on the books of the trust. This carrying value will be reflected on the trust's books in the balance sheet account *investment in partnership*.

simply, partnership distributions are treated the same as corporate dividends; in fact, the rules for both are contained in the same section of RUIA 1997.⁶ Why this change in approach occurred from RUIA 1962 only the drafters of RUIA 1997 know.⁷

What starts out initially simple gets embellished a bit. Though Act Sec. 401 of RUIA 1997 begins by classifying partnership and corporate distributions received by a trust as income receipts, there is an exception for (partnership or corporate) distributions that are “greater than 20 percent of the entity’s gross assets.” Such distributions are to be classified as receipts of principal. Similarly, liquidating distributions are classified as principal.

Just like RUIA 1962, the RUIA 1997 rule defining the income from a partnership interest poses a dilemma for the trust itself. Suppose the trust’s income from a partnership interest is \$10,000 (*i.e.*, this was the partnership’s distribution to the trust), but the trust’s partnership taxable income is \$15,000. Assuming all income is to be distributed to the income beneficiary (in this case \$10,000), it will be necessary for the trust to pay tax on the trust’s \$5,000 (\$15,000 – \$10,000) final taxable income.⁸ However, if the partnership interest is the only asset in trust—funds for payment to the IRS will not exist.

For the Accountants

For those doing the accounting, further discussion should prove useful—especially in regard to RUIA 1962’s instruction to apply GAAP in determining a trust’s income from a partnership interest. This discussion as well as references to additional resources follow.

GAAP for partners is addressed in Accounting Interpretations of Accounting Principles Board (APB) Opinion No. 18⁹ (in Interpretation No. 2—*Investments in Partnerships and Ventures*). The interpretation provides that APB Opinion No. 18 is to be extended to investments in partnerships (the original applied specifically to investments in corporations). As a general rule, this results in such interests being accounted for by partners by following the *equity method* in recording the investment and the income from the investment. The following accounting conventions are used when employing the equity method of accounting for a partnership investment:

- The investment is recorded in the balance sheet at cost *and* adjusted each year for distributions and the partner’s share of income or loss from the partnership. (Typically, the balance sheet account for such activity would be designated as *investment in partnership*.)
- The income statement of the partner would reflect the partner’s share of partnership income or loss.

The accounting entries for the equity method for a given fact situation are shown in Illustration 1 below. The accounting treatment follows the methodology discussed above (*see* “RUIA 1962—Yes, Partnerships Are Different from Corporations”), including use of the formula described for determining the account balance of the *investment in partnership* account. Specifi-

cally, the ever-changing status of the *investment in partnership* account and the trust-partner reflecting its share of partnership

IN THE PROCESS OF PERUSING THE PARTNERSHIP’S ACCOUNTING, THE TRUST-PARTNER’S ACCOUNTANT WILL ALSO BE CONSIDERING THE PRINCIPAL/INCOME DISTINCTIONS IMPORTANT TO THE TRUST.

income or loss distinguish this from the RUIA 1997 approach, where the *investment in partnership* account is static and income equals partnership distributions.

AICPA Statement of Position (SOP) 78-9¹⁰ discusses some of the finer points of applying APB No. 18 for a partner’s accounting. Some of the conclusions of SOP 78-9 bear repeating.¹¹ Overall, the SOP reiterates the recommendation of Interpretation No. 2 (discussed above) in that partners generally would apply APB No. 18’s *equity method* in their accounting for the activity of a partnership interest.

This SOP also did address the issue of consolidating an investor and investee-partnership’s financial statements. The Enron debacle encourages a bit more interest in this subject. Before discussing the specific consolidation issue addressed in SOP 78-9, a general discussion on consolidated financial statements should help the reader who normally does not deal with such things.

Consolidated financial statements show the same net income and same net assets as would result from strictly applying the equity method of accounting for a partnership interest, but would also include the

details of revenues and expenses and assets and liabilities of both entities (the investor and investee-partnership).¹² In short, if the equity method is applied properly (as we recommend), then the issue of offering consolidated statements (or not) is a disclosure issue, not an income measurement issue. Stated another way, if the income beneficiary's only issue is getting his due, then he would be indifferent as to whether the trust followed the equity method of accounting for a partnership interest or offered consolidated financial statements of the trust and partnership, as both would reflect the same income.

In real life, beneficiaries are not such one-dimensional characters, and a financial statement disclosure shortcoming for a trust is something to be avoided. Which leads us back to SOP 78-9's consolidation issue. In paragraph 11, the SOP recommended against the so-called *pro rata* consolidation method, followed in certain industries (which is a departure from the standard consolidating methodology). Some might interpret

this as a directive to not consolidate a partnership interest in the investor's financial statements (by any method); however, the SOP was silent as to specifics of the application of the consolidation rules in general (not recommending for or against). Accordingly, it seems the more reasonable interpretation is that the SOP's directive was only to disallow this specific nonstandard consolidation method but not preclude following the standard method, when otherwise appropriate.

Though our opinion is that the consolidation and other accounting rules dealing with investments in corporations also apply to investments in partnerships (except to the extent authoritative literature makes exceptions for partnership investments), others may conclude that the paucity of guidance on partnership-specific situations allows the accountant considerable leeway in determining GAAP in such circumstances.

Should you follow our opinion stated above, then you will want to refer to Financial Accounting

Standards Board (FASB) Statement No. 94¹³ and the authority referenced therein to determine when consolidation is necessary. It would be wise to temper this recommendation with a practical consideration; preparing consolidated financial statements is usually a time-consuming (expensive) process and trustees may understandably not deem this expense to be justified. (This might be true, for instance, if the partnership interest is a family partnership with little or no debt and owning conservative investments.) In such a situation, technical suitability as well as full disclosure concerns could be accommodated by *not* offering consolidated financial statements (though complying with the equity method in accounting for the partnership interest), and then mentioning this departure from GAAP in the accountant's report accompanying the trust's financial statements *and* presenting a copy of the partnership's financial statements to all the readers of the trust's statements.

EXHIBIT 2
RUPIA (1962)–THE GAAP METHOD

<p>1. Basic premise and significant rules:</p> <ul style="list-style-type: none"> a. Based on generally accepted accounting principles. b. Trust income equals trust-partner's share of partnership income. c. Trust principal is increased by initial investment (the trust's contribution to the partnership) plus its share of income, and is reduced by distributions received from the partnership and losses of partnership.
<p>2. Positive features:</p> <ul style="list-style-type: none"> a. It is theoretically sound, and recognizes the aggregate concept of accounting for partnerships, which is based on the economic and legal aspects of partnerships.¹ b. Follows the same general concept as the Internal Revenue Code does in accounting for partnerships (both being based on the aggregate concept). Should GAAP income and income as determined on the income tax basis of accounting be the same or not materially different, adopting this method would alleviate the necessity of maintaining two separate accounting records, one for GAAP, the other to track the adjusted basis of the partnership interest.
<p>3. Negative features:</p> <ul style="list-style-type: none"> a. If the trust accountant does not have full access to the accounting information of the partnership, it may be difficult or impossible to implement.² b. If the partnership has numerous transactions that are classified as principal transactions, the accounting process can be time-consuming.

¹ Accountants familiar with GAAP will easily be able to apply this method.

² This is not likely to be a problem where the trustor or his family formed the partnership, but it may be difficult when the trust owns an interest in a publicly traded partnership.

As also mentioned in SOP 78-9, it may be necessary for the partner to convert a partnership's non-GAAP accounting to GAAP in applying the equity method. As a practical matter, if the accountant for the trust-partner has access to the partnership accounting records (and the partnership uses a non-GAAP basis for its accounting), this adjusting to GAAP should not be difficult. For those situations where the trust is a partner in a family partnership or a partnership business the decedent participated in, the access issue should not be a problem. In any case, this process starts with the accountant looking at the partnership's accounting to determine if it does or does not comply with GAAP.

In the process of perusing the partnership's accounting, the trust-partner's accountant will also be considering the principal/income distinctions important to the trust. For instance, if the partnership were to sell property, the resulting gain or loss would be classified as a principal item for the trust/partner. This is where the GAAP equity method and the existence of two equity accounts for trusts converge to require two accounts rather than one to represent the trust's share of partnership income. (And as described in the February 2002 TAXES

article, these would be within the *principal-income* accounts and *income-income* accounts.)

For RUPIA 1997, the accounting is simpler, following the same rules as used for recording (on the cost basis) the activity of owning stock of a corporation. In short, this accounting relies on the entity theory, whereas RUPIA 1962 follows the aggregate theory of accounting for an investment. The accounting entries to be used in following RUPIA 1997 are reflected in Illustration 2.

Comparison of RUPIA 1962 to 1997—The Beneficiary Issues

From a trust beneficiary's point of view the preferred approach as between RUPIA 1962 and 1997 would be based upon the answer to the question, would the RUPIA 1962 or the RUPIA 1997 model allow more for the beneficiary?¹⁴ The answer to this question is fact-specific and will vary from case to case. However the beneficiaries may view this choice, it is unfortunately not theirs to make—the trustor will be making this decision. And the trustor should have the benefit of knowing the alternatives, as opposed to defaulting to state law automatically (realizing the trustor

can choose to override state law by providing otherwise in the trust agreement). Exhibits 2 and 3 give an outline summary of the RUPIA 1962 and 1997 laws, as well as pros and cons for each. This information may help trustors in deciding what method they would choose.

It would seem wise for the trustor to document (in the controlling instrument) his or her choice between these two methods, even if this choice corresponds with current state law. One good reason for doing so is to avoid later conflicts between beneficiaries, which could result if one beneficiary later believed the trustor was unaware he or she had a choice. Further, especially if the current state law is RUPIA 1962, making an affirmative selection between the methods would avoid the potential of confusing or upsetting beneficiaries should a change in state law cause a major change in the outcome to beneficiaries.

Comparison of RUPIA 1962 to 1997—The Fiduciary's Issues

Using the same fact situation as in Illustration 1, Illustration 2 shows the difference in the out-

EXHIBIT 3

RUPIA (1997)—THE INCOME EQUALS DISTRIBUTIONS METHOD

1. Basic premise and significant rules:

- Treats the trust accounting for partnership interests the same as for corporate stock. In certain circumstances, however, RUPIA 1997 treats a distribution as principal.
- Trust accounting income equals the distributions received from the partnership.
- Principal reflects initial investment.

2. Positive features:

- It is state law in a majority of states. Adoption by trust would not *require* language in trust instrument for these states.
- Ease of implementation (unless distributions have to be analyzed for the principal versus income classification issues).
- Simple to understand and explain to clients.

3. Negative features:

- Theoretically at odds with GAAP and partnership income tax law. This digression from the aggregate concept may result in unusual income tax burdens being placed on the usually high-bracket trust taxpayer.
- Penalizes the income beneficiary in cases where the partnership is a growing business; characterized by a partner's share of income being significantly greater than the corresponding distributions.
- Would require additional accounting records to track the adjusted basis in the partnership interest.

come to the beneficiaries of RUIA 1962 versus RUIA 1997. (Illustration 2 does, however, omit from its analysis the purchase and sale of the partnership interest that was included in Illustration 1.) Over the five-year period shown, the income beneficiary will receive \$200,000

trust's tentative taxable income (\$75,000 of partnership income) is exactly offset by the \$75,000 distribution deduction, the trust has no taxable income, nor income tax liability.

RUIA 1997. The trust receives the \$20,000 distribution from the partnership; since this is defined

to be the trust income, the same amount is in turn distributed to the income beneficiary. Because the tentative taxable income of \$75,000 (income from the partnership) is reduced by the distribution deduction of \$20,000 (the distribution to

the income beneficiary), a taxable income of \$55,000 exists. Since all the cash received was given to the income beneficiary, the trust tax liability of \$17,050 becomes a cash shortfall of the same amount.

With either method, financial impossibilities can occur easily. For RUIA 1962, any year the trust's share of partnership income exceeds distributions from the partnership, the trust will not be able to pay the beneficiary the full amount due. For RUIA 1997, any year the trust's share of partnership income exceeds distributions from the partnership, the trust will have an income tax liability it will not be able to pay.

Presuming a trust that will be required to make annual income distributions (e.g., a marital trust where such distributions are required) the solution to this problem is to avoid it occurring in the first place. This can be done

by funding the trust with other property (liquid assets) in addition to the partnership interest, thus providing another source of funds to cover the above-mentioned cash shortfalls. With some calculation effort, the proper mix of partnership interest versus other assets can be arrived at to assure the funding alternative that will avoid such future cash shortfalls.

Conclusion and Planning Ideas

The income from a partnership interest owned by a trust is defined to be either the trust-partner's share of the partnership income (RUIA 1962) or the distributions from the partnership (RUIA 1997). Since the amounts distributed by a partnership to its partners will often vary significantly from the partnership's income, the choice of one of these definitions of income over the other can result in very different outcomes for a trust's income beneficiary. And since any benefit to an income beneficiary will result in that much less being available to the principal beneficiary, there exists a natural conflict between these beneficiaries.

Although one can argue for or against the trust-partner's choice between the RUIA 1962 and RUIA 1997 model, the ultimate test is what an informed trustor desires. Since the trustor has the authority to choose what he believes to be most suitable, the adviser's role is to present and explain the alternatives. Like most choices, there is no "best way"—different situations and desires of the trustor call for different answers.

Due to the potential for conflict between beneficiaries and the ability of the trustor to choose the method for determining income, regardless of state law, one can con-

MOST ESTATE PLANNING AND ADMINISTRATION PRACTITIONERS WILL BE DEALING WITH SITUATIONS WHERE PARTNERSHIP INTERESTS ARE SIGNIFICANT ASSETS FOR THEIR CLIENTS ... [AND] FUNDING A TRADITIONAL TRUST EXCLUSIVELY WITH A PARTNERSHIP INTEREST WOULD BE A BAD IDEA.

under RUIA 1962 and \$125,000 under RUIA 1997. This \$75,000 difference in benefits would be meaningful to most beneficiaries.

Illustration 2 also demonstrates an important financial constraint for the example trust. What is shown for both RUIA 1962 and RUIA 1997 is the net effect on cash of the trust's activity, assuming the trust's only income-earning asset is the partnership interest. As simplifying assumptions, it is presumed the GAAP income of the partnership equals its taxable income, and the income tax rate of the trust is a flat 31 percent. Let us discuss year 4 of these analyses to see what is occurring.

RUIA 1962. The trust receives a \$20,000 distribution from the partnership. However, since the trust's partnership income is \$75,000, this amount must be distributed to the income beneficiary. This creates a \$55,000 shortfall in cash for the trust. Also, since the

clude that it is ultimately wise for the trustor to state his or her choice in the controlling instrument. It is unlikely (and also would be legally challenging) for a beneficiary to dispute such a choice, once made. Overall, documenting such a considered decision by the trustor will provide reasonable insurance against future beneficiary conflicts.

As discussed, funding a trust exclusively with a partnership interest may cause the unintended consequence of financially ham-

stringing the trust whenever partnership income exceeds partnership distributions. If RUIA 1962 governs the trust, it will be unable to meet its obligation to pay the income beneficiary his due; if RUIA 1997 governs the trust, it will be unable to pay the trust's income tax liability. The obvious way to avoid this problem is to include other nonpartnership interest property in trust funding. However, this may not be so easy, as for instance

in the case where an estate contains a significant partnership interest, as compared to its other property. Given the traditional marital/credit shelter trust estate planning model (for a married couple) and an estate with a significant partnership interest, there are other options available to overcome these problems.

For example, let us assume it is desirable to fund the credit shelter trust with the partnership interest because the interest is ex-

ILLUSTRATION 1
RUIA PARTNERSHIP EXAMPLE
FACTS AND SUMMARY OF ANNUAL ACCOUNTING ENTRIES

FACTS							
Description						Total	
Purchase of partnership interest (for cash)						\$400,000	
Partnership Activity:	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5		
Distributions	\$5,000	\$0	\$20,000	\$20,000	\$80,000	\$125,000	
Income/(Loss)	(\$5,000)	\$15,000	\$50,000	\$75,000	\$60,000	\$195,000	
Difference (Distributions v. Income/(Loss))	\$10,000	(\$15,000)	(\$30,000)	(\$55,000)	\$20,000	(\$70,000)	
Sale of partnership interest (for cash)						\$500,000	
RUIA 1962							
Yr	Description	Cash	Investment in Partnership	Equity		Annual Income/Expense	
				Income	Principal	Income (var)	Principal (var)
0	Acquisition of partnership interest	(400,000)	400,000				
1-5	Trust's share of partnership income/loss		195,000			(195,000)	
1-5	Receipt of distribution from partnership	125,000	(125,000)				
1-5	Distribution to trust beneficiary	(200,000)		200,000			
1	Transfer income deficit to principal				5,000	(5,000)	
5	Balances (before closing)	(475,000)	470,000	200,000	5,000	(200,000)	0
1-5	Effect of annual closing entries			(200,000)		200,000	
5	Post-closing balances	(475,000)	470,000	0	5,000	0	0
6	Sale of p'ship interest; cash received	500,000					(500,000)
6	Sale of p'ship interest; relieve cost		(470,000)				470,000
6	Balances (before closing)	25,000	0	0	5,000	0	(30,000)
RUIA 1997							
Yr	Description	Cash	Investment in Partnership	Equity		Annual Income/Expense	
				Income	Principal	Income (var)	Principal (var)
0	Acquisition of partnership interest	(400,000)	400,000				
1-5	Receipt of distribution from p'ship/income	125,000				(125,000)	
1-5	Distribution to trust beneficiary	(125,000)		125,000			
5	Balances (before closing)	(400,000)	400,000	125,000	0	(125,000)	0
1-5	Effect of annual closing entries			(125,000)		125,000	
5	Post-closing balances	(400,000)	400,000	0	0	0	0
6	Sale of p'ship interest; cash received	500,000					(500,000)
6	Sale of p'ship interest; relieve cost		(400,000)				400,000
6	Balances (before closing)	100,000	0	0	0	0	(100,000)
Comparison of RUIA 1962 to RUIA 1997 - Difference in Year-End Account Balances							
Yr	Description	Cash	Investment in Partnership	Equity		Annual Income/Expense	
				Income	Principal	Income (var)	Principal (var)
5	Balances (before closing)	75,000	(70,000)	(75,000)	(5,000)	75,000	0
1-5	Effect of annual closing entries	0	0	75,000	0	(75,000)	0
5	Post-closing balances	75,000	(70,000)	0	(5,000)	0	0
6	Sale of p'ship interest; cash received	0	0	0	0	0	0
6	Sale of p'ship interest; relieve cost	0	70,000	0	0	0	(70,000)
6	Balances (before closing)	75,000	0	0	(5,000)	0	(70,000)

PARTNERSHIP INTERESTS HELD BY ESTATES OR TRUSTS

pected to appreciate well over time (e.g., where the partnership is a successful, growing business). Doing so would shelter future growth from estate tax on the surviving spouse's death. In this situation the estate planning documents could exclude the common provision that the credit shelter trust was obliged to distribute its income to the surviving spouse (or children) annually, and instead provide for a *discretionary* distribution of income (none, all or a portion) from the trust. This would allow the ability to benefit the surviving spouse (or children)—if this was felt necessary—but also would avoid the financial impossibilities described above.

Let us assume the partnership interest is such a large portion of an estate (e.g., a family partner-

ship consisting of securities that comprise most of the married couple's property) that the interest must be used to fund the marital trust. Further, assume only minimal other assets exist that would be available to fund the marital trust and this trust *must* distribute its income annually to the surviving spouse (as would be so for a qualified terminable interest property (QTIP) trust). In this case, the QTIP trust could be drafted as a unitrust with, say, a four-percent-asset value annual income/distribution.¹⁵ This would lock in the annual income at a certain amount to be distributed, making this, in effect, an end-run around the financial impossibilities that occur if either RUIA 1962 or 1997 is followed. (The assumption is that this four-percent

amount would be less than or equal to the expected distributions from the partnership for any year, *and* partnership distributions also would cover any income tax liability after taking into account the trust's distributions of income.)

For any situation where the applicable law is RUIA 1997, after the initial principal/income distinctions are made, the trustee has the discretion to adjust between income and principal. This power to adjust could be used to work around the financial problems discussed above in those years where a trust's taxable income from a partnership exceeds distributions. However, it would seem desirable to employ other possible solutions first, and to use this discretionary power as a last resort.

Most estate planning and administration practitioners will be

ILLUSTRATION 2 RUIA PARTNERSHIP EXAMPLE FACTS AND SUMMARY OF TRUST AFTER TAX CASH FLOW

FACTS						
Description	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Total
Partnership Activity:						
Distributions	\$5,000	\$0	\$20,000	\$20,000	\$80,000	\$125,000
Income/(Loss)	(\$5,000)	\$15,000	\$50,000	\$75,000	\$60,000	\$195,000
Difference (Distributions v. Income/(Loss))	\$10,000	(\$15,000)	(\$30,000)	(\$55,000)	\$20,000	(\$70,000)

RUIA 1962						
Yr Description	Cash	Distributions from Partnership	to Income Beneficiary	Tentative* Taxable Income	Final Taxable Income	Income Tax @ 31%
1 Activity	\$5,000	\$5,000	\$0	(\$5,000)	(\$5,000)	\$0
2 Activity	(\$15,000)	\$0	(\$15,000)	\$15,000	\$0	\$0
3 Activity	(\$30,000)	\$20,000	(\$50,000)	\$50,000	\$0	\$0
4 Activity	(\$55,000)	\$20,000	(\$75,000)	\$75,000	\$0	\$0
5 Activity	\$20,000	\$80,000	(\$60,000)	\$60,000	\$0	\$0
1-5 Total	(\$75,000)	\$125,000	(\$200,000)	\$195,000	(\$5,000)	\$0

* Taxable income *before* distribution deduction.

RUIA 1997						
Yr Description	Cash	Distributions from Partnership	to Income Beneficiary	Tentative* Taxable Income	Final Taxable Income	Income Tax @ 31%
1 Activity	\$0	\$5,000	(\$5,000)	(\$5,000)	(\$5,000)	\$0
2 Activity	(\$4,650)	\$0	\$0	\$15,000	\$15,000	\$4,650
3 Activity	(\$9,300)	\$20,000	(\$20,000)	\$50,000	\$30,000	\$9,300
4 Activity	(\$17,050)	\$20,000	(\$20,000)	\$75,000	\$55,000	\$17,050
5 Activity	\$0	\$80,000	(\$80,000)	\$60,000	\$0	\$0
1-5 Total	(\$31,000)	\$125,000	(\$125,000)	\$195,000	\$95,000	\$31,000

* Taxable income *before* distribution deduction.

dealing with situations where partnership interests are significant assets for their clients. Having gotten this far, you have gathered that funding a traditional trust exclusively with a partnership interest would be a bad idea. And you can go beyond simply avoiding problems to improving your client's results by incorporating the following into your practice:

- Thoughtful and more imaginative drafting of testamentary

trust provisions so as to avoid problems while optimizing the inherent estate tax advantages of partnership interests. Keeping in mind that UPIA allows drafters to make their own rules, practitioners should consider the options, not always restricting themselves to the given state law.

- The innovative practitioner will benefit clients by anticipating the trust and beneficiaries' future before implementing a

particular mix of partnership and nonpartnership assets for trust funding.

The use of the partnership and LLC form of business will be valuable to estate planning as long as the benefits of valuation discounts exist. Once these interests are in trust, it will be an advantage to any practitioner and his or her clients to be able to avoid problems as well as find ways to optimize the financial and tax benefits.

ENDNOTES

¹ TAXES, Feb. 2002, at 29.

² There are some exceptions; such as liquidating distributions and the like (as explained in the previous article).

³ Specifically, Act Sec. 8 of RUIA 1962 provides, "the net profits of the business, computed in accordance with generally accepted accounting principles for a comparable business, are income." By comparison, RUIA does not address the accounting for a corporate interest, since a trust-shareholder is not affected by the accounting practices of the corporation. (Only the receipt of corporate distributions will affect the trust's income.)

⁴ And more typically—for my clients anyhow—they seem perplexed when no distributions occur, even though the partnership realizes income for the year and this causes an increase in their tax liability.

⁵ For example, if the income determined under GAAP was the same as the partnership's taxable income, then a trust-partner in this situation would have \$10,000 of income per RUIA 1962.

⁶ RUIA 1997, §401. And it should also be mentioned that neither RUIA 1997 nor RUIA 1962 make any special mention of S corporations. RUIA 1997 treats all corporate as well as partnership interests the same. And RUIA 1962's rules for receipts from corpora-

tions would include (and treat the same) both S and C corporations.

⁷ Realizing that the drafters were not accountants, it is possible they were not aware of what RUIA 1962 meant by directing the income from a partnership interest be determined in accordance with GAAP. For instance, one of the drafters wrote a commentary on RUIA 1962 positing various mechanisms that might be used to allocate partnership distributions as between income and principal, apparently unaware that in accordance with GAAP, income is defined to be the trust-partner's share of partnership income, not distributions.

⁸ In this case, the trust's tentative taxable income is \$15,000 (the amount that will be shown on the Schedule K-1 from the partnership). The trust is then allowed a deduction for the income distributed to the income beneficiary (\$10,000) to arrive at the trust's taxable income. This deduction is referred to as the *distribution deduction*.

⁹ *The Equity Method of Accounting for Investments in Common Stock*, APB Opinion No. 18, Mar. 1971.

¹⁰ *Accounting for Investments in Real Estate Ventures*, SOP 78-9, 1978.

¹¹ Though SOP 78-9 is directed at partnership interests where the partnership owns real estate, many of the SOP's

conclusions would reasonably be extended to situations where the underlying partnership was engaged in other activities besides the ownership and development of real estate.

¹² This lack of detail provided by strict application of the equity method results in the method sometimes being referred to as the *one-line consolidation method*.

¹³ CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, Statement of Financial Accounting Standards No. 94 (Financial Accounting Standards Bd. 1987).

¹⁴ Obviously, the principal beneficiary would choose the alternative contrary to the income beneficiary's choice and vice-versa.

¹⁵ Proposed Reg. §1.643(b)-1 addressed the unitrust concept and its affect on the income taxation of trusts. See REG-106513-00, 66 FR 10396 (Feb. 15, 2001). Specifically, the proposed regulation suggests that a unitrust provision would not be recognized (as defining trust income for tax purposes) unless it was based upon state statute. Accordingly, this approach would be risky at best in those states where a unitrust statute did not exist. It should be noted that only some of the states having adopted RUIA 1997 have such unitrust statutes.