

Partnerships Held by Trusts and Estates: Discovering the Rules and Optimizing the Opportunities

By David Keene

David Keene examines partnerships and LLCs held by trusts, highlighting the important connection between the rules of RUIPA and the rules governing trust income taxation.

The rise of the family partnership or limited liability company (LLC) as an estate planning vehicle has been fueled by taxpayer successes in the area of valuation discounts. In addition, LLCs are becoming increasingly popular as the entity of choice for newly formed businesses. The combination of limited liability for the members and the income tax benefits of partnerships (as compared to corporations) provide advantages not available with other forms of business. Many of these businesses formed as LLCs will be family owned.

These entities are distinguished from the “tax shelter” partnerships most popular in the 1970s and 1980s in that they will likely comprise a greater portion of a person’s total estate. Also, it is likely that partners will have significant influence over the decisions of the family partnership or family LLC, as well as access to the accounting records and other information of the entity. This influence and access lends itself to a greater opportunity for tax planning.

As result of the convergence of the trend toward the use of family partnerships (and family LLCs) along with the common use of trusts in estate planning, a trust often ends up owning an interest in a partnership or LLC. Dealing with these situations requires knowledge of a number of topics, including the following:

- **Partnership and LLC Income Taxation¹ and Trust Income Taxation.** How are the trust and its beneficiaries taxed as partners in a partnership?
- **Revised Uniform Principal and Income Act (RUIPIA).** How is partnership income determined at the trust level and how is this shared between the principal versus the income beneficiaries?

This article will focus on these topics, highlighting the important connection between the rules of RUIPIA and the rules governing trust income taxation. In the remainder of this article “family partnership” will refer to both family partnerships and family LLCs.

Income Tax Rules Important to the Family Partnership

The general rules of federal partnership income taxation provide for tax-free formation when cash and property is contributed in exchange for a partnership interest and a sharing of partnership income based on each partner’s relative ownership interest. These general rules may initially be reassuring; however, partnership income taxation is replete with exceptions which sometime seem to apply more often than the general rules. In the following, these general rules will be described and some of the exceptions most relevant to family partnerships will also be discussed. As a fair warning to the reader—there are exceptions to the

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general rules of partnership income taxation which are not included in the following discussion.

In the basic scheme of partnership income taxation, taxable income/loss is determined at the partnership level.² Pursuant to Code Sec. 702, each partner's share of income/loss is allocated to the partner and reported on the partner's income tax return. This income/loss is reported on Schedule K-1 of Form 1065. Keep in mind that a partner may receive no distributions yet have taxable income from the partnership.

Generally, neither a partner nor the partnership will recognize a taxable gain or loss when a partner contributes property to a partnership in exchange for an interest in the partnership.³ And the contributed property will have an income tax basis to the partnership equal to the basis it had in the hands of the contributing partner ("carryover basis"⁴).

Generally, each partner's share of the partnership's income is proportional to his interest in the partnership; e.g., a 1/3 partner will be allocated 1/3 of all the partnership's taxable income, deductions, tax credits and other tax items.⁵

Generally, neither the partner nor the partnership will recognize a taxable gain or loss when the partnership makes a current distribution to a partner (*i.e.*, what would be a dividend in a corporate setting) or when the partnership makes a liquidating distribution to a partner (*i.e.*, what would be a redemption in the corporate setting).⁶ A partner's basis in a partnership interest is increased by contributions and income allocated to the partner and decreased by distributions and losses allocated to the partner.⁷ Generally, a partner will recognize a capital gain from the sale of a partnership interest.⁸

An important exception to the general rule that each partner will be allocated partnership taxable income in proportion to that partner's interest in the partnership occurs when property is contributed to the partnership with a fair market value different from its income tax basis.⁹ This difference between fair market value and tax basis is referred to as built-in gain or loss. If the contributed property is sold by the partnership, the built-in gain or loss will be allocated entirely to the contributing partner.¹⁰ Any additional gain or loss (*i.e.*, the result of increases or decreases in value *after* the date of contribution) is allocated to all partners under their usual sharing arrangement.

Example 1. A and B form a 50/50 partnership with A contributing \$50,000 in cash and B contributing land worth (fair market value) \$50,000 but with a basis of \$30,000. The \$20,000 disparity between the basis and fair market value of the land is referred to as built-in gain. Since the *partnership's* basis in the land will be its carryover basis of \$30,000, if the land were immediately sold by the partnership for \$50,000 a gain of \$20,000 would result. However, under Code Sec. 704(c) this built-in gain would be allocated entirely to partner B as opposed to the standard 50/50 allocation of taxable income to each of A and B. And if the land were sold later for \$60,000 (thus yielding a total gain of \$30,000), the first \$20,000 of gain (the built-in gain) would be allocated to partner B, but the remaining \$10,000 of gain would be allocated \$5,000 to A and \$5,000 to B; the usual sharing arrangement for this 50/50 partnership.

There are also exceptions to the general rule allowing a tax-free pass for partners receiving either current or liquidating distributions. These exceptions to the general rule were designed to curb perceived abuses; however, taxpayers with innocent intentions can find themselves facing an unexpected tax by inadvertently running afoul of these exceptions to tax-free treatment for distributions. Some of these exceptions can occur for family partnerships, as described below.

Under Code Sec. 704(c)(1)(B), for contributed property with a built-in gain or loss the *contributing* partner will recognize the built-in gain or loss when the property is distributed to *another partner* if that occurs within seven years of the contribution. This does *not* apply if the contributed property is distributed to the original contributor.

Under Code Sec. 737(a), gain is recognized (no loss being allowed) when a partner contributes property with a built-in gain and then receives a distribution of other property *and* the distributed property's fair market value exceeds the partner's basis in his partnership interest. Just like Code Sec. 704(c)(1)(B), the potential gain under Code Sec. 737(a) is time limited; it exists for seven years after a partner contributes built-in gain property. The gain under this rule (if any) is the lesser of:

- the excess of the fair market value of the property (other than money) received by the partner over the adjusted basis of the partner's interest

in the partnership immediately before the distribution; or

- the partner's net built-in gain. And net built-in gain is equal to the gain that would be recognized under Code Sec. 704(c)(1)(B) by the partner if the property he contributed were distributed to other partners. However, if the distributee partner receives some of his own originally contributed property, this will not be factored into the partner's net built-in gain.

Finally, pursuant to Code Sec. 731(c), a partner may be forced to recognize gain when marketable securities are distributed to the partner. This section applies a formula for figuring the gain as well as the basis of the property received by the partner receiving the distribution; the overall theory being to treat the distribution of marketable securities as a sale at fair market value and the gain determined under the formula is then taxed to the partner receiving the distribution.

Final Comments and Recommendations

Though the general income tax rules governing partners and partnerships appear relatively simple and taxpayer-friendly on the surface, a number of exceptions to these general rules exist. Because these exceptions cover such a broad range of common partnership activities, many family partnerships will confront them. However, advisors who are aware of the significant exceptions will be able to navigate clients through the formation, operation and exiting stages for partners and partnerships, either avoiding these exceptions or minimizing their effect.

Code Sec. 704(c)(1)(A) requires built-in gains or losses to be allocated back to the contributing partner, contrary to the general rule of allocating income based upon the relative interests of the partners. There is no tax-planning strategy to circumvent this exception, other than avoiding the problem by not contributing property with built-in gain or not later selling property with a built-in gain: probably not very practical solutions for a family partnership funded with securities. Because of this rule, the accountant must track both the fair market value as well as the income tax basis of contributed property. Sympathetic investment advisors aware of this necessity will hopefully provide fair market value information to the accountant who must manage the additional

recordkeeping duties required to track these fair market value/income tax basis differences for contributed property.

The potential gains under either Code Sec. 704(c)(1)(B), Code Sec. 737(a) and Code Sec. 731(c) are often avoidable. Since these sections require the recognition of gain when the partnership distributes *property*—by avoiding property distributions partners will not be harmed by these exceptions to the general rule of tax-free distributions. And in those cases where reasonable alternatives to distributions of property are not available, careful consideration of the property to be distributed and which partner will receive the property may allow the tax burden to be ameliorated.¹¹

And to put a finer point on this issue, Code Sec. 704(c)(1)(B) and Code Sec. 737(a) are time-limited; seven years after a partner contributes property, these sections no longer apply. Accordingly, seven years after a partner contributes property the partnership *could* distribute property without these statutes causing gain to be recognized.¹²

Income Taxation of Trusts, Estates and Beneficiaries

The basic scheme of income taxation for estates and trusts (*aka*, fiduciary income taxation) is as follows:

- Taxable income is determined in the same way as for individuals.¹³
- The estate or trust gets a deduction for distributions to beneficiaries (the distribution deduction). This deduction does not necessarily *equal* the amount of actual distributions; it is, however, determined by a formula *based upon* distributions made or required to be made. There are two such formulas for determining the distribution deduction; one for simple trusts¹⁴ and another for complex trusts and estates.¹⁵
- The beneficiaries include the amount of this distribution deduction in their taxable income. This inclusion is governed by either Code Sec. 652—for simple trusts—or Code Sec. 662 for complex trusts and estates. Both Code Sec. 652 and Code Sec. 662 require that the income to the beneficiary retain the same character (capital versus ordinary, *etc.*) as existed at the fiduciary level.
- The income left after the distribution deduction will be the taxable income of the estate or trust.¹⁶
- The estate or trust pays tax on this taxable income.

Notice how different this basic system of taxation is from that of partnerships. A partnership return is prepared so as to determine each partner's share of the partnership's taxable income or loss; however, partnerships never pay an income tax. But for a trust, the taxable income stays in the trust and will be taxed there, unless a distribution is made to a beneficiary and then only to the extent the distribution deduction formula allocates income to a beneficiary.

And from the partner's or beneficiary's point of view—a partner will be subject to tax without regard to distributions, whereas a beneficiary of a trust will be subject to tax only when a distribution deduction exists.

Once the taxable income at the fiduciary level is initially determined (sometimes called the “tentative taxable income”), the next step is to determine if there will be a distribution deduction, and if so, the amount of this deduction.

If a trust has the following characteristics, Code Sec. 651 will control the amount of this deduction:

- the trust instrument provides that all income is required to be distributed currently;
- the trust instrument does not provide for charitable gifts; and
- the trust does not (during the current tax year) make a distribution of principal.

Trusts described under Code Sec. 651 are referred to as simple trusts. If the distribution deduction is based on Code Sec. 651 the deduction will be the lesser of (1) the trust's accounting income; or (2) taxable distributable net income (DNI). Accounting income is the income determined by the trust instrument and, if not addressed in the instrument, by state law. For most states, this law is RUIA. DNI is taxable income with certain modifications. The significant modifications being the distributions deduction and capital gains and losses (in most cases).¹⁷

An estate (always) and any trust not fitting the definition of a simple trust per Code Sec. 651 will look to Code Sec. 661 for determining the distribution deduction. Trusts defined under Code Sec. 661 are referred to as complex trusts. If the distribution deduction is based on Code Sec. 661, it will be the lesser of (1) the amount of accounting income required to be distributed plus “any other amounts properly paid or credited or required to be distributed for such taxable year”; or (2) taxable DNI.

Note the accrual concept for the distribution deduction. Read Code Sec. 651 and Code Sec. 661 carefully; for both, a deduction is allowed for income “required to be distributed currently.” But what if the income is not distributed (even if required), is there still a deduction? Yes, there will be, as clarified in the statutes and regulations:

[T]he amount of income for the taxable year required to be distributed currently by a trust as described in section 651 shall be included in the gross income of the beneficiaries to whom the income is required to be distributed, whether distributed or not.¹⁸

It should be noted that under section 651 a trust qualifies as a simple trust in a taxable year in which it is required to distribute all its income currently ... whether or not distributions of current income are in fact made.¹⁹

Code Secs. 652 and 662 complete the distribution deduction/passthrough loop by requiring the amount of the trust's or estate's distribution deduction to be included in the taxable income of the beneficiary.

The effect of including the trust's income that is distributed to a beneficiary in his/her taxable income is sometimes referred to as “carrying out DNI” to the beneficiary. However, not all distributions carry out DNI. In particular, specific bequests are not included in the distribution deduction, and accordingly, do not carry out DNI. Specific bequests are gifts (from a trust) or bequests (from an estate) of a specific sum of money or specific property. Some examples of what is a specific bequest as defined by Code Sec. 663(a)(1) include the following:

- A bequest of the decedent's interest in a partnership²⁰
- A legacy of \$5,000, which was paid in cash²¹

Some examples of what is not a specific bequest as defined by Code Sec. 663(a)(1) include the following:

- A bequest to the decedent's spouse of money or property, to be selected by the personal representative, equal in value to a fraction of the decedent's “adjusted gross estate” is not a specific bequest because the identity of the property and/or money are dependent both on the exercise of the PR's discretion and on the payment of expenses, neither of which are facts existing on the date of the decedent's death²²
- A residuary bequest (e.g., half of the estate)²³

The Distribution Deduction—Where Tax and Accounting (RUIA) Rules Meet

Because the distribution deduction determines who reports the taxable income—as between the fiduciary and a beneficiary—it will be important to get this deduction right. Computing the distribution deduction is not strictly a tax calculation; accounting enters into the computation.

As previously mentioned, the distribution deduction under Code Sec. 651 is the lesser of (1) taxable distributable net income (DNI); or (2) accounting income. As result, if the accounting income is less than DNI then this lesser amount will be deducted from the taxable income of the trust and included in the beneficiary's taxable income. The likely result of this outcome would be that some taxable income would be left behind in the trust after the distribution deduction, and taxed at the trust level.

On the other hand, if accounting income is greater than DNI, then the distribution deduction will be limited to the DNI. Since the income required to be distributed (*i.e.*, the accounting income) is greater than DNI, the beneficiary will receive more than he will be taxed on.

As the amount of accounting income is critical to this tax computation of the distribution deduction, what authority should be relied upon for determining the accounting income? Code Sec. 643(b) states that the accounting instructions contained in the trust agreement itself or applicable local law are to be relied upon in determining the accounting income. For most states, this “applicable local law” is the Revised Uniform Principal and Income Act (RUIA). A noteworthy feature of this law is that its rules will be overridden to the extent the trust agreement or will provide instructions contrary to the law.²⁴

The unique feature of RUIA, as an accounting construct, is its classification of income and expense items into two equity accounts; income or principal. The net of all the income and expense items included in the equity account “income” will result in the trust's accounting income for the year. And this net amount in any year could be a loss; *i.e.*, the accounting income may be a net loss. Other items of income and expense are instead included in the equity account “principal” (principal/income and

principal/expense). And though these items of income and expense would be includible in the income statement for a commercial enterprise (*e.g.*, capital gains), for a trust or estate they are reflected in a separate statement reflecting the increases and decreases to the equity account “principal.”

Based on RUIA Section 401, the income or principal from a partnership interest is based upon the distributions from a partnership, not the K-1 income of the partnership.²⁵ Specifically, the distributions from a partnership will be classified as income for a trust/partner, unless these distributions exceed certain thresholds; *e.g.*, greater than 20 percent of the partnership assets as reflected in the partnership's financial statements, or are distributions of property—in which case the distributions will be classified as principal.

As previously discussed, the income tax rules for partnerships and partners require a trust/partner to be taxed on its share of partnership taxable income or loss (the “K-1 income” from the partnership). However, this is likely to be different from the distributions the trust will receive from the partnership (*i.e.*, the income per RUIA). This disparity between what the trust will be obliged to pay tax on and what it may receive in distributions from the partnership may cause financial predicaments for a trust.

How the likely difference between the trust/partner's K-1 income from the partnership and partnership distributions will affect the trust can best be understood by looking at various examples. Examples of this interaction between trust accounting income and partnership K-1 income are described below. These examples have the following facts in common:

- The example trusts are required to distribute accounting income—and no other distributions are made; these are simple trusts.
- The example trusts have no earned tax-exempt income.
- All income for the example trusts is ordinary income.
- The example trusts rely on the RUIA statutes for determining income, and none contain contrary instructions as to the determination of income in the trust agreement.
- We will presume the partnership's distributions are properly classified as income, not principal.

Example 1—No Partnership Distributions but K-1 Income

There is no trust accounting income as no distributions were made by the partnership. The taxable DNI of \$50,000 is based upon the partnership's K-1 income. The trust's income tax liability on this \$50,000 taxable income is \$16,474. If this trust had no other assets besides the partnership interest, it would indeed be unable to pay this tax liability.

Example 2—Partnership Distributions Less Than K-1 Income

The trust's taxable DNI of \$50,000 (based on the partnership's K-1) exceeds the accounting income of \$5,000 (the partnership distributions received by the trust). In this example, the distribution deduction partially offsets the taxable income for the trust; \$5,000 of the total taxable DNI of \$50,000 is taxed to the beneficiary and the remaining \$45,000 (the amount left behind after the distribution deduction) is taxed to the trust. For the trust, the resulting tax liability is \$14,724.²⁶

Example 3—Partnership Distributions Equal K-1 Income

As the trust's taxable DNI (based on the partnership's K-1 income) equals the accounting income, all the DNI will be swept out of the trust and be taxed to the income beneficiary; who will bear the entire tax liability from the partnership income.

Example 4—Partnerships Distributions Greater Than K-1 Income

The trust's taxable DNI of \$5,000 (reflected on the partnership's K-1) is less than the accounting income of \$50,000 (the partnership distributions received by the trust). In this example, the distribution deduction fully offsets the taxable income for the trust; accordingly, the taxable DNI of \$5,000 is taxed entirely to the beneficiary. However, although the beneficiary bears the entire tax burden for the \$5,000 of taxable DNI, he will receive \$45,000 free of any tax burden (\$50,000 total less \$5,000 subject to tax).

Example 5—Partnership Distributions but K-1 Loss

Because of the partnership loss, there is no taxable DNI, and correspondingly, no tax due by either the

trust or its income beneficiary. Nonetheless, the accounting income of \$5,000—as determined by RUIA—results in that same amount being passed on from the trust to its beneficiary.

A few generalizations can be made regarding these examples. For a trust required to distribute income; if the distributions from a partnership to a trust are income under RUIA—the same amount will be distributed from the trust to its income beneficiary. This results in a straight “passthrough” from the partnership, to the trust, and on to the income beneficiary.

When a partnership's distributions exceed its K-1 taxable income the trust's income beneficiary will receive more in distributions from the trust than he will be taxed on. This outcome is based on the distribution deduction formula for simple trusts, this being the *lesser* of taxable DNI or trust accounting income.

In contrast—when partnership distributions to a trust are less than K-1 income—the beneficiary will receive the lesser accounting income amount (as compared to K-1 income) and the trust will be obliged to pay income tax on the difference between the K-1 income and partnership distributions (providing trust expenses do not eliminate this income).

Final Comments and Recommendations

When a partnership makes no distributions or minimal distributions as compared to partnership K-1 income—as in Examples 1 and 2—the trust will have an income tax liability it will be unable to pay unless the trust has other assets besides the partnership interest to pay this income tax bill. This dilemma is avoided by (1) the trust owning sufficient other assets—in addition to the partnership interest—so it will have the funds for paying its taxes; and/or (2) the partnership following a distribution policy of distributing at least enough to the trust so as to cover the trust's income tax liability.

The discordance between the definitions of trust income from a partnership per RUIA (in general, the partnership's distributions) versus the partnership income per the income tax rules can be taken advantage of to favor either the trust's principal or income beneficiary.

Most obviously, an income beneficiary can be slighted if the partnership simply withholds or minimizes distributions to the trust. Of course this also allows for the building of a cache within the

partnership for the principal beneficiary to eventually receive.

By a less direct route, this system can be played in favor of an income beneficiary so that the principal beneficiary pays most all the tax resulting from partnership income and the income beneficiary gets his share more or less tax free. This works as follows: The partnership makes minimal or no distributions during years when substantial K-1 income exists but large partnership distributions occur when the K-1 reflects a loss or small amount of income.

The result of this strategy is that in the years of substantial partnership K-1 income (and minimal or no distributions) the trust pays most or all of the resulting significant tax bill in these years; and when the partnership has a poor year with little or no K-1 income, and then significant distributions are made, the income beneficiary is able to receive these significant distributions ("passed through" from partnership to trust to beneficiary) with little or no tax liability to pay.

In either of the above situations where one beneficiary may be slighted, the trustee, *per se*, does not have the direct control to avoid such inequities; it is the management of the partnership that will cause these situations to occur by its control over partnership distributions. The trustee's available options are to use his influence to encourage the partnership to alter its distribution policy or, if that fails, to rid the trust of the partnership interest.

However, a trustor who is also a founding member of a family partnership would have the opportunity to set policies at the partnership level so as to ensure the timing and amount of partnership distributions to the trust do not favor one beneficiary over another. Specifically, a written distribution policy at the partnership level could avert potential problems for the trustee and trust beneficiaries.

The trusts and partnerships we all work with have not necessarily been formed with forethought of the issues discussed above. And even when the trustee and the partnership's management work together to implement an acceptable distribution policy, sometimes events undermine the objective of a fair sharing of the tax burden for the trust's beneficiaries. When this happens RUIA provides the trustee with a tool to achieve an equitable solution. This tool and the standard tax allocation rules of RUIA are discussed in the next section.

RUIA'S Tax Allocation Rules

Section 505 of RUIA provides the standard income tax allocation rules for trusts. This statute is reproduced below.

Section 505. Income Taxes.

(a) A tax required to be paid by a trustee based on receipts allocated to income must be paid from income.

(b) A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.

(c) A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid proportionately:

(1) from income to the extent that receipts from the entity are allocated to income; and

(2) from principal to the extent that:

(A) receipts from the entity are allocated to principal; and

(B) the trust's share of the entity's taxable income exceeds the total receipts described in paragraphs (1) and (2)(A).

(d) For purposes of this section, receipts allocated to principal or income must be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.

Sections 505(a) and 505(b) address income or principal receipts which are subject to income tax (e.g., interest or capital gains). However, for the purposes of RUIA, income or principal receipts from a partnership are equal to partnership distributions, which are not subject to income tax; thus, these sections do not apply. It is the rules of Sections 505(c) and 505(d) that apply to allocate the taxes due from partnership income (as well as the income of S corporations).

When distributions from the partnership are less than K-1 income, James Gamble—a co-reporter of the Uniform Principal and Income Act—interprets the above to require the trustee to calculate the tax liability on the partnership’s taxable income and subtract all or a portion of it from the income receipts before making the trust’s distribution to the income beneficiary, reducing the final income distribution accordingly.²⁷ This view is contrary to the approach used in the Examples in this article. These Examples instead follow the interpretation of Carol Cantrell and other commentators²⁸ on the subject. Let us first look at Mr. Gamble’s interpretation, which, as noted above, will differ from that of Ms. Cantrell, *et al*, only when the trust’s share of partnership taxable income is greater than partnership distributions.

In Illustration No. 2 from Mr. Gamble’s outline, the partnership K-1 taxable income is \$100,000 and the partnership distributes \$60,000 to the trust. The trust is a simple trust and its income tax rate is 35 percent. Gamble’s solution for this case is found by applying the following algebraic formula shown in Chart 1.²⁹ The result of applying this formula to Illustration 2 is shown in Table 1.

Chart 1.

$D = (C - R \times K) / (1 - R)$	
D	is the distribution to the income beneficiary from the trust.
C	is the distribution from the partnership to the trust.
R	is the income tax rate of the trust.
K	is the K-1 income of the partnership.

Table 1.

Trust Tax Return	
Description	Amount
Tentative Taxable Income (=K-1 Income of P’ship)	100,000.00
Distribution Deduction (D, per formula)	(38,461.54)
Final Taxable Income	61,538.46
Tax Due	21,538.46
Trust Cash Flow	
Description	Amount
Partnership Distribution Received	60,000.00
Distribution to Income Beneficiary (D, per formula)	(38,461.54)
Income Tax Payment	(21,538.46)
Remaining Funds, after distributions and taxes	0.00

If you were to apply this formula to variations of the above fact situation where the partnership distributions received were less than the \$100,000 K-1 income, you will observe a pattern; the sum of the distribution to the income beneficiary and the trust’s income tax payment would equal the partnership distributions received. This would hold up until the partnership distribution received were \$35,000 or less (the income tax due from the \$100,000 K-1 income) at which point the entire distribution received from the partnership would be applied toward paying the trust’s income tax—leaving nothing to be distributed to the income beneficiary.

Based upon Ms. Cantrell’s interpretation of RUIA Section 505, the distribution to the income beneficiary will equal the partnership’s income per RUIA, unreduced by the tax liability (if any) resulting from partnership K-1 income. As shown below, solving Mr. Gamble’s illustrations, but using Ms. Cantrell’s interpretation of the RUIA Section 505, achieves very different results.

The result of applying Cantrell’s interpretation of the tax allocation rules of RUIA to Illustration 2 from Mr. Gamble’s outline are shown in Table 2. The \$60,000 partnership distribution will be passed through to the income beneficiary—no part of this \$60,000 therefore being available to the trust.

Table 2.

Trust Tax Return	
Description	Amount
Tentative Taxable Income (=K-1 Income of P’ship)	100,000.00
Distribution Deduction (=Distribution from P’ship)	(60,000.00)
Final Taxable Income	40,000.00
Tax Due	14,000.00
Trust Cash Flow	
Description	Amount
Partnership Distribution Received	60,000.00
Distribution to Income Beneficiary (=Distribution from P’ship)	(60,000.00)
Net Available After Distribution	0.00
Income Tax Payment	(14,000.00)
Additional Funds Required (after distributions and taxes)	14,000.00

A potential shortcoming of the above methodology would arise should the trust lack sufficient funds to pay the \$14,000 tax bill. Regardless of whether the trustee applies the Gamble or the

Cantrell interpretation of the tax allocation rules of RUIA Section 505—inequities in the sharing of the income tax burden can occur when partnership distributions are out of synch with partnership K-1 income.

RUIA Section 506, *Adjustments Between Principal and Income Because of Taxes*, gives trustees an opportunity to cure perceived inequities in the sharing of the tax burden. Under this section, a trustee “may make adjustments between principal and income” including those resulting from “[t]he ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includible in the taxable income of the estate, trust, or a beneficiary.”

However, RUIA Section 506 provides no specific formula—it only allows the trustee the discretion to make an adjustment. And as is discussed in the following section, such a special allocation would necessarily be fashioned to take into account the specific situation at hand—including recognizing the intent of the trustor and also factoring in the operations of the partnership as well as the (sometimes fluid) circumstances of the beneficiaries. So trustees will be left to their own solution when figuring the amount of such adjustments.

Final Comments and Recommendations

The Gamble versus the Cantrell interpretations of the standard RUIA tax allocation rules will give a different result only in those cases where the partnership distributions are less than partnership K-1 income.³⁰

For these cases, the key difference between the Gamble interpretation and that of Cantrell is that the Gamble method reduces the income beneficiary's distribution by all or a portion of the income tax resulting from partnership income whereas the Cantrell interpretation does not call for such a reduction of the beneficiary's distribution: Following the Cantrell interpretation, the full amount of the partnership distribution would “pass through” to the income beneficiary, unreduced by taxes.

Accordingly, for trusts required to distribute all income, the Gamble interpretation would result in lower distributions to the income beneficiary as compared to the Cantrell interpretation in cases where distributions from the partnership were less than K-1 income.³¹

The remaining comments assume the more straightforward Cantrell interpretation of the standard RUIA tax allocation rules will be applied.

In those cases where no partnership distributions are made but K-1 income exists, the tax allocation rules require the entire tax burden be borne by the trust itself. This outcome is equitable in that the principal beneficiary will be the eventual benefactor of the partnership interest which has been augmented by retaining the income. But how about those cases where minimal distributions occur along with a much more significant amount of K-1 income?

The income beneficiary will receive the partnership distribution as a pass-through and pay tax on it. The trust will pay the tax on the K-1 income reduced by the distribution deduction (equal to the beneficiary's pass-through of the partnership distribution). So, for both the income as well as the principal beneficiary, there appears to be equity for this tax allocation in that each bears responsibility for taxes in proportion to what each has received in benefits.

However, if in a later year the partnership has minimal income but (based on its previous earnings) is able to make a substantial distribution—the income beneficiary will receive a significant amount with little or no associated tax liability—as the tax would have been previously paid by the trust, *i.e.*, the principal beneficiary. It is these situations where a special allocation under RUIA Section 506 would be justified.

Three recommendations that would minimize the possibility of either financial problems for the trust or a clearly inequitable sharing of the tax burden between the income and principal beneficiary follow:

1. Fund the trust with sufficient assets in addition to the partnership interest. Doing so will avert the potential for the trust to have a tax bill in excess of its ability to pay—as could happen when the partnership earns significant K-1 income but has insufficient cash flows to be able make distributions adequate to cover the resulting tax bill.
2. Be sure the partnership has a distribution policy that allows the income beneficiary his fair share of partnership earnings. At a minimum, provide that the distributions to be made will at least cover the tax liability resulting from the partnership K-1 income.
3. Include guidelines (possibly a specific formula) in the trust agreement for the trustee to follow for making a special allocation under RUIA

Section 506, should that be necessary. In even the best planned circumstances, events may occur at the partnership level where significant taxable income is generated but the cash flow is much less. It is these situations where an adjustment to the standard tax allocation may be justified.

Partnership's Capital Gain is DNI for Trust/Partner

Generally, DNI excludes capital gains. Code Sec. 643(a) defines DNI to be taxable income with various modifications; one such modification being the exclusion of "Gains from the sale or exchange of capital assets ... to the extent that such gains are allocated to corpus"

When a partnership's K-1 reflects a trust/partner's share of capital gains, such taxable income is *not* subject to allocation to corpus (or income) by the trust; remember, per RUIA it is the partnership's

distributions that are to be classified as either income or principal. Accordingly, partnership capital gains passed-through to a trust *are* included in DNI. Though it may at first seem an anomaly for capital gains to be included in DNI, this straightforward reading of Code Sec. 643(a) has held up in court.³²

Conclusion

For those families that will find the family partnership to be a suitable vehicle for achieving their financial and tax objectives, the family partnership can offer significant opportunities. Optimizing these opportunities and avoiding mistakes does require significant coordination between the family partnership and the trusts that end up as partners, as well as coordination between the various advisors. And understanding the various rules governing the tax and accounting consequences of these relationships is an important factor in being able to achieve the available opportunities.

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¹ Limited liability companies with two or more members will be treated as partnerships for federal income tax purposes, unless an election is made to the IRS to be treated as a corporation. Accordingly, by default, LLCs will generally be taxed the same as partnerships for federal income tax purposes. Reg. §301.7701-3(b)(1).

² Code Sec. 701.

³ Code Sec. 721. However, Code Sec. 721(b) requires gain to be recognized when a partnership would fall under the definition of an investment company pursuant to Code Sec. 351. To trigger such gain, the pooling of stocks and securities must result in "diversification" as described in Reg. §1.351-1(c), which is *not* attained unless two or more persons contribute nonidentical assets. Accordingly, if only one person was the sole contributor of securities at formation, this rule would not apply to cause gain, nor would it apply if two (or more) persons contributed already diversified portfolios.

⁴ Code Sec. 723.

⁵ Code Sec. 704.

⁶ Code Sec. 731.

⁷ Code Sec. 705.

⁸ Code Sec. 741. However, to the extent the partnership owns property that would result in ordinary gain or loss if sold (as opposed to capital gain or loss), then Code Sec. 741 and Code Sec. 751 operate to

characterize a portion of the total gain or loss from the sale of the partnership interest as ordinary.

⁹ Code Sec. 704(c)(1)(A).

¹⁰ And for partnership interests that are gifted by the contributing partner, this Code section requires the built-in gain potential (but generally not built-in loss potential) to carryover to the donee; thus the donee may end up being allocated all or a portion of the built-in gain inherent in the gifted interest.

¹¹ For example, Code Sec. 704(c)(1)(B) and 737(a) do not operate to require gain recognition when the original contributor of the property receives it in a later distribution.

¹² Code Sec. 731(c) has no such time limit.

¹³ Code Sec. 641(b).

¹⁴ Code Sec. 651.

¹⁵ Code Sec. 661.

¹⁶ There may be some modifications to this taxable income after the distribution deduction such as the exemption amount and occasionally a deduction for estate tax paid on income in respect of a decedent.

¹⁷ Code Sec. 643(a).

¹⁸ Code Sec. 652.

¹⁹ Reg. §1.651(a)-1(b).

²⁰ Reg. §1.663(a)-1(b)(1).

²¹ Reg. §1.663(a)-1(b)(3).

²² Reg. §1.663(a)-1(b)(1).

²³ Reg. §1.663(a)-1(b)(2)(iii).

²⁴ See RUIA Section 103(a)(1): "[A] fiduciary

shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this Act."

²⁵ Interesting note: Partnership distributions are governed by the same income/principal classification rules as distributions (*i.e.*, dividends) from corporations.

²⁶ An alternative interpretation is that the tax due based on partnership income is to be charged against the income beneficiary's accounting income (in this case fully offsetting the \$5,000 of trust accounting income). This alternative view is based on RUIA's tax allocation rules—and will be discussed in the following section of the article.

²⁷ E. James Gamble, *Trust Accounting and Income Taxes*, AICPA Advanced Estate Planning Conference (July 2005).

²⁸ Carol Cantrell, *Handling Partnership Interests in Estate and Trust Administration*, Seattle 51st Annual Estate Planning Seminar (Nov. 2006).

²⁹ This formula is found in Carol Cantrell's explanation of Gamble's method of iteration (see note 28).

³⁰ In the alternative cases—where partnership distributions equal or exceed K-1 income—both interpretations result in the income determined under RUIA (presuming partnership distributions are classified as income and not principal) being

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distributed to the income beneficiary and the full amount of partnership K-1 income thus being swept out to the beneficiary *via* the distribution deduction and being taxed exclusively to the beneficiary.

³¹ On the other hand, where the trust is *not* required to distribute all income (*e.g.*, a

trust where the trustee could choose to distribute a portion of or none of the income), RUIA Sections 505(c) and 505(d) *would* require the trust income to be reduced by its portion of the income tax based on partnership K-1 income. But this would not have any affect on an income beneficiary

unless the trust accumulated its income, retaining its character as income (*i.e.*, not characterizing undistributed income to principal at year-end) and made it available for later distribution.

³² *D.W. Crisp*, FedCI, 95-2 USTC ¶150,493, 34 FedCI 112.

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