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ESTATE PLANNER'S TOOLBOX: THE PASS-THROUGH ENTITY

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I. Introduction

For years, partnerships[1] have been an important tool in the toolboxes of both business and estate planning lawyers. The use of partnerships, however, lead the lawyer down a complicated income tax regime and potentially draconian transfer tax regime that includes estate, gift, and generation-skipping transfer taxes.

With these concerns in mind, this article is intended to introduce the estate planning lawyer to the general income tax issues associated with utilizing partnerships and the business lawyer to the general transfer tax issues associated with utilizing partnerships.

Three attachments are included with this article. Attachment A is a choice of entity grid. Attachment B is The American College of Trust and Estate Counsel (ACTEC) Model LLC Operating Agreement (updated through February 2019). Attachment C is the presentation deck.

II. Income Tax

An entity that is taxed as a partnership for federal income tax purposes is governed by Subchapter K (IRC §§ 701-761) of the Code[2] and its corresponding Treasury regulations.

For income tax purposes, a partnership acts as a conduit through which its items of income and loss are reported to its partners. In other words, a partnership is simply an accounting entity that assists partners and the Internal Revenue Service ("**IRS**") in calculating each partner's share of income and deductions.

Congress intended for Subchapter K to provide flexible, simple rules for those choosing to do business in partnership form, generally allowing for tax-free formation and dissolution and allowing partners to agree among themselves how they share income, gains, losses, deductions, and credits. That simplicity was lost in a complex regulatory scheme adopted to respond to taxpayer's attempts to manipulate the flexible and simple Code structure. Today, Subchapter K has the reputation as one of the most complex areas of tax law.

Part of the complexity of Subchapter K results from its somewhat schizophrenic application of the entity theory of taxation in some cases and aggregate theory of taxation in other cases. Under the entity theory, the partnership is treated as a separate and distinct taxpayer, adopting a method of accounting and tax year and annually reporting its taxable income. Moreover, under the entity theory, partners are deemed to each own an undivided interest in the partnership and are viewed much like shareholders in a corporation. Under the aggregate theory, on the other hand, partners are viewed as co-owners of the underlying partnership assets, with each partner owning an undivided interest in the partnership's assets and each partner separately accounting for its share of partnership transactions. Even lawyers who specialize in partnerships find it confusing. Here is how one preeminent partnership tax lawyer, Terry Cuff, described Subchapter K:

> The tax rules governing partnership allocations are complex, pointillist, and stochastic. The rules are complex in the sense that the text of Treasury Regulations is long, difficult to understand, and bewildering to read. Few partnership tax specialists are masters of the rules of substantial economic effect. The rules are pointillist in the sense that regulations, cases, and administrative authority are

[1] For purposes of this article, any reference to a "**partnership**" means any entity (including a partnership or limited liability company) treated as a partnership for federal income tax purposes. Because this article focuses on family entities, a reference to a partnership will include a family limited partnership ("**LP**") and family limited liability company ("**FLLC**")

[2] For purposes of this article, any reference to the "**Code**," "**IRC**," or a "**section**," unless otherwise indicated, refers to the Internal Revenue Code of 1986, as amended.

> a set of dots; they address a number of limited situations. Many situations are not directly addressed by Treasury Regulations. You must generalize from the pointillist dots to see the full picture. The rules are stochastic in the sense that many of the rules cannot be applied with mathematical precision. Draftsmen can apply tax rules only in terms of probabilities of a particular answer being correct. There is considerable uncertainty built into the partnership tax rules. New partnership tax rules often address problems in terms of probability.[3]

Nevertheless, because of the extensive use of partnerships, it is important that business and estate planning lawyers have a general understanding of partnership allocation provisions and the transfer tax issues that arise when using them. If they do not, they are performing a disservice to their clients and themselves—a disservice which can be both frustrating and costly to the client and embarrassing and costly for the drafting lawyer.

A. General

1. Partnership

The Code defines a partnership as a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust or estate or a corporation.[4] Stated differently, a partnership is any business entity that has at least two members[5] and is not (either by election or default)[6] a corporation.

2. Formation

a. Contributions—IRC § 721

i. Non-Recognition

Generally, no gain or loss will be recognized either to a partnership or to any of its partners upon a contribution of appreciated property to the partnership in exchange for a partnership interest.[7] This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership that is already formed and operating. In addition, the non-recognition rule of Code section 721(a) generally applies to a contribution of a partnership's indebtedness by a creditor to the debtor partnership in exchange for a capital or profits interest in the partnership (commonly referred to as a debt-for-equity exchange).[8]

ii. Exceptions to Non-Recognition Rule

There are several situations where the non-recognition rule of Code section 721(a) does not apply.

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[3] Terence Floyd Cuff, *Several Comments on How to Compromise Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements*, 33rd Annual Advanced Tax Law Course, p. 457, October 29-30, 2015.

[4] IRC § 7701(a)(2).

[5] Reg. § 301.7701-2(b); Reg. § 301.7701-3(a).

[6] Reg. § 301.7701-2(a),(c)(1). Note that Rev. Proc. 2002-69, 2002-2 C.B. 831 permits eligible entities that are wholly owned by a husband and wife in a community property state to treat the entity as either a partnership or an entity that is otherwise disregarded as an entity separate from its owner. Note also that certain partnerships (such as investment partnerships) may elect to be excluded from the application of all or a part of the provisions of Subchapter K. *See* Reg. § 1.761-2.

[7] IRC § 721(a); Reg. § 1.721-1(a).

[8] Reg. § 1.721-1(d)(1).

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