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AMENDMENTS TO VIATICAL SETTLEMENTS MODEL ACT ADOPTED BY NAIC

CCH: Would you provide a brief summary of what the recent amendments to the Viatical Settlements Model Act attempted to remedy? Or conversely, what the recent amendments failed to remedy?

Life settlements are a relatively new concept for insureds over the age of 65 who are in good health and need to sell a life insurance policy to meet their financial needs before death. In the following interview, Larry Simon, CEO, president and director of Life Settlement Solutions, Inc., based in San Diego, CA, provides a brief summary of the recent amendments to the Viatical Settlements Model Act, his assessment of the potential impact on the settlement market, and expected trends among the states to enact and refine regulations. Mr. Simon is the founder of Life Settlement Solutions, Inc., an institutionally funded, direct purchaser of life settlements, and has authored numerous articles pertaining to life settlements.

Mr. Simon: In June, the National Association of Insurance Commissioners (NAIC) announced the adoption of amendments to the Viatical Settlements Model Act (the Model Act). The revisions were recommended by the NAIC's Life Insurance and Annuities Committee in December 2006. The revisions set out to regulate "stranger-originated life insurance" (STOLI) practices, but fell short on many fronts, to the point of the National Conference of Insurance Legislators (NCOIL) formally requesting that the NAIC postpone their proposed amendment for further study.

CCH: What are STOLI practices?

Mr. Simon: STOLI programs are arrangements set up to apply for and obtain newly issued life insurance policies for the benefit of persons not related to or associated with the persons whose lives are insured under the policies. STOLI programs are often done under the guise of a premium financing loan that is actually designed to create assets for the lender or investor rather than to provide financing for an insured that wants to obtain a policy for his or her own family, but may not have cash assets available for payment of what is often a very large premium payment. STOLI programs are viewed as antithetical to traditional life insurance concepts, and, generally, considered to be unethical and often involve violations of the intent of existing insurable interest laws.

CCH: Please describe what the NAIC amendments to the Model Act provide for in relation to STOLI arrangements.

Mr. Simon: The NAIC amendments to the Model Act prohibit the settlement of nearly all premium-financed policies for five years following issuance of the policy, which proponents say is necessary to curb abusive STOLI programs.

Under the new Model Act, a financed policy could be sold in the secondary market beginning two years after policy issuance only if all of the following conditions are met prior to issuance of the policy and for at least two years following issuance:

- Premium is funded by unencumbered assets or "fully recourse" loan;
- Premium-finance loan does not exceed the cash surrender value of the policy;
- No agreement for another person to guarantee or purchase the policy exists; and

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- Neither the insured nor the policy has been evaluated for settlement during the first two years of the policy.

The amendments define a "viatical settlement contract" subject to the five-year prohibition to include a premium finance loan where:

- The policy owner or the insured receives a guarantee of future viatical settlement value of the policy; or
- The policy owner or the insured agrees to sell the policy or any portion of the death benefit at a future date.

The amendments exclude loan proceeds used solely to pay (i) premiums for the policy and (ii) the cost of the loan.

CCH: Were there any other changes to the Model Act?

Mr. Simon: Other changes to the Model Act include the requirement that viatical-settlement providers and viatical-settlement brokers fully disclose to an insurer transactions to originate, renew, continue or finance a policy written by the insurer at any time during the first five years of issuance.

A non-recourse premium-finance loan (i.e., a loan secured only by the value of the policy) would not constitute a "viatical- settlement contract," so long as none of the conditions listed previously are present. Thus, nothing in the amendments appears to prohibit a policy owner from obtaining a non-recourse loan at any time. However, the five-year prohibition on settlements would prevent the policy owner from settling the policy within five years of issuance if there has been non-recourse financing.

Other major changes for viatical-settlement providers and viatical-settlement brokers include:

- $250,000 bonding requirement;
- Additional disclosure requirements;
- Longer rescission periods; and
- Elimination of accredited investor exceptions.

CCH: What is your general assessment of the potential impact that the amendments to the Model Act will have on the settlement market?

Mr. Simon: Although the Model Act is not a law (the NAIC is not a regulatory body, and therefore does not have the authority to promulgate laws), it serves as an advisory resource to legislators in various states in connection with adoption or amendment of state laws regulating the industry. The majority of states that have adopted some form of viatical or life settlement legislation, have based their laws, at least in part, on the NAIC Model Act. The impact to the life settlement market will depend upon the extent to which state legislators and regulators may adopt these amendments in the future. To date, only North Dakota has done so. Other, more densely populated states have not enacted such legislation. There will likely be significant interest in future legislative and rulemaking activities surrounding these issues.

CCH: Are there any other future administrative or regulatory changes relating to life settlements that our readers, primarily estate planners, should be aware of?

Mr. Simon: An increasing number of states are expected to enact and refine regulations regarding life settlements, particularly in the areas of provider and broker/agent licensing and compensation disclosure. NCOIL is also completing research and analysis on their life settlements model act and has recently determined that their recommendation will be to strengthen language on an existing two-year ban on selling life insurance policies, as opposed to the NAIC amendment that calls for a five-year ban. It is also important to note that the Model Act amendments have created some opposition that is important to understand. A number of life-insurance and life-settlement associations have voiced their concern over the revisions and how effective they are. In a statement, the Life Insurance Settlement Association (LISA) renewed its objections to the amendments and reiterated the fact that the revisions fail to provide appropriate solutions to curbing STOLI transactions. The Life Insurance Finance Association (LIFA) also released a statement saying that the model was poorly drafted and did not take into consideration how the life insurance industry and secondary market operate. LISA and LIFA are concerned that the amendments do not do enough to protect consumers and could potentially negatively affect senior clients who purchase their insurance legitimately and subsequently have an urgent need to sell their poli-

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cies before the five-year period, but will now not meet the required waiting time period.

There has been enough opposition that estate planners should keep abreast on where their state stands in regards to the Model Act amendments and pay close attention to any changes that may occur. While the NAIC cannot enact legislation, the amendments are an attempt to regulate the industry. Because of this, it is important that estate planners follow the issue to fully understand all of the implications. Regulation within the industry, in order to create standards for each state, should be considered, but the Model Act as it stands does not do that.

One last item that estate planners are undoubtedly monitoring relates to the federal government's plans for long term estate taxes. During recent budget committee meetings, a significant majority of Senators indicated that they were in favor of a long-term estate tax exemption of $3.5 million as opposed to the long-term repeal of the estate tax. The final outcome is far from certain, but the estate tax exemption decision/vote will have an impact on the amount of life insurance that enters the life settlement market. ✦

LEGISLATIVE UPDATE

House Votes to End Tax Strategy Patents

The House has voted to end the controversial practice of patenting tax-related strategies. A similar provision has yet to be acted upon in the Senate while the Administration has voiced at least tacit approval of legislative action to address this issue.

On September 7, the House voted 220 to 175 in favor of a major overhaul of U.S. patent laws (H.R. 1908). Although the bill includes many provisions that are currently being debated by technology buffs and various industry commentators as to their impact on innovation in general, one particular provision is of interest to tax practitioners. That provision would end the practice of obtaining a patent for a tax strategy.

The controversial issue of tax strategy patents was the subject of a House Ways and Means subcommittee hearing in July 2006, which included the testimony of then IRS Commissioner Mark Everson and other prominent members of the tax community. The 2006 hearing concentrated on several negative aspects of the tax strategy patent issue. For one thing, the IRS has no input on the granting of patents because they come under the jurisdiction of the U. S. Patent and Trademark Office. Another major point of contention is the question of whether the allowance of tax-strategy patents acts to reduce federal tax revenues and to increase the tax compliance costs of taxpayers. A recently issued report from the House Judiciary Committee (H. Rept. No. 110-314) on the patent reform bill reiterated these points and noted that the granting of a patent for a particular tax strategy may confer a presumption of validity, as well as an obvious marketing advantage for the patent holder. The report also points to the potential for even greater dissatisfaction with tax laws than exists at present if tax compliance must be accompanied by patent searches and licensing. The report cites that, as of July 31, 2007, 60 such patents have been issued and a recent search indicates that applications for at least 99 more are pending.

The specific language of H.R. 1908 would prohibit the U.S. Patent and Trademark Office from granting patents for any "tax-planning method." According to the bill, the term "tax-planning method" means a plan, strategy, technique, or scheme that is designed to reduce, minimize, or defer, or has, when implemented, the effect of reducing, minimizing, or deferring, a taxpayer's tax liability. It should be noted, however, that HR 1908 would not prohibit the Patent Office from granting a patent pertaining to tax return-preparation software. The amendment specifies that this prohibition takes effect on the date of enactment, and that it shall apply to any patent or application for a reissue patent that is (1) filed on or after the date of the enactment or (2) filed before that date if a patent or reissue patent has not been issued pursuant to the application as of that date. The amendment also specifies that the prohibition shall not be construed to validate any patent issued before the date of enactment.

For those readers who are interested in investigating the specific tax strategy patents that have granted, the Patent Office classifies tax strategy patents as Subclass 36T in Class 705. Individuals can search for tax strategy patents on the Patent Office website at *www.uspto.gov*. Go to "How to Search" in the toolbar, click "Search Patents Now;" next, click "Advanced Search." In the Query box, type "ccl/705/36T" and press "Search."

The Outlook

The Senate is scheduled to take up its own version of a patent reform measure (S. 1145) later this fall. However, at present, the Senate bill does not include a provision dealing with tax strategy patents. A separate bill, the Stop Tax Haven Abuse Act (S. 681) does include a prohibition on tax shelter patents. In a statement issued prior to the House vote, the Bush administration did not explicitly endorse the House provision on tax strategy patents, but did indicate that it is willing to work with lawmakers to come up with a workable legislative solution. As we go to press, Senate Finance Committee Chairman Max Baucus (D. Montana) and ranking minority member Charles Grassley (R. Iowa) have expressed the desire to work with their Senate colleagues on crafting the necessary legislative language. ✦

PLANNING TECHNIQUES AND TIPS

Trusts and Estates as Partners/Members: Impact on Closing of FLP/LLC Tax Year

Sidney Kess and Martin Shenkman

OBJECTIVE

The rules governing the closing of a partnership's books, or those of a limited liability company taxed as a partnership, are complex. Practitioners need to understand these rules and their specific application to estates and trusts owning partnership interests. These issues arise with greater frequency as family planning, intended to address asset protection, divorce protection, estate and gift tax minimization, and the ubiquitous desire for control, results in tiers of trusts forming and owning partnership entities. For purposes of this discussion, it will be assumed that the limited liability companies (LLCs) referred to will be taxed as partnerships, and partnerships will be referred to as "FLPs" even if they involve non-family members.

The general rule provides that if a partner's entire interest in a partnership terminates, the tax year of the partnership closes with respect to such partner (Code Sec. 706 (c)(2)(A)). The Taxpayer Relief Act of 1997 (P.L. 105-34) changed the rules applicable to the close of an FLP/LLC tax year, thereby affecting the determination of basis on death. (P.L. 105-34, §1246 amending Code Sec. 706). This provision states that the partnership tax year will close on the death of a partner solely as to that partner's interest in the partnership. This contrasts with the result when a partnership terminates and the partnership tax year closes for all partners (Reg. §1.706-1(c)(1)). Thus, all items of income, loss, deduction or credit applicable to the decedent's partnership interest will be reported on his or her final income tax return. A gift by a partner of his entire FLP/LLC interest is not deemed a terminating event (Reg. §1.706-1(c)(5)). "However, a gift of a partnership interest does cause the income of the partnership to be allocated before and after the gift even though the FLP\LLC books do not close," notes Carol Cantrell, a lawyer and accountant with Briggs & Veselka Co., Bellaire, Texas.

TECHNIQUES

When a partnership (or LLC taxed as a partnership) must close its tax year, such as upon the death of a partner during the year, the economic attributes of the partnership for the tax year must be allocated to the deceased partner through the date of death and the closing of the books, and then to the partner's estate (or successor-in-interest) as to the period after the date of death and hence after the closing of the books. There are two methods that can be used to make this allocation: the "interim closing of the books," or the "proration method" (Reg. §1.706-1(c)(2)(ii); *C. Richardson*, CA-5, 83-1 USTC ¶9109, 693 F2d 1189).

Regardless of the method used, if the FLP/LLC is a cash basis taxpayer, it must allocate certain expenses using the accrual method (presumably a daily allocation of these items to the days to which they relate) (Code Sec. 706(d)(2); Prop. Reg. §1.706-3(a)):

- Interest
- Taxes
- Payments for services or the use of property, excluding guaranteed payments subject to Code Sec. 83

Partnership tax law mandates that the interim closing of the books method be used unless the partners elect to the contrary (Code Sec. 706(c)(2)(A); Reg. §1.706-1(c)(2)(ii)).

The selection of which method to use may have a significant tax and economic impact on the partners/members. One court accepted the partners' agreement to allocate all income solely to the remaining partners under the terms of a redemption agreement (*H. Smith*, CA-7, 64-1 USTC ¶9390, 331 F2d 298). The allocation method to be used may be set forth in the partnership or operating agreement, or the general partner or manager may have the authority to select the method to be used. Therefore, it is incumbent upon practitioners to determine which options are available, and the consequences of each if both are available.

Under the" interim closing of the books" method, the books of the FLP/LLC are closed (as to the partner/member in question) and all items of income, expense, gain or loss occurring before the date of closing are allocated to the partner/member who was the partner/member prior to the closing. All of the aforementioned items occurring after the closing of the books are allocated to the partner/member holding the interest after the closing date (in the case of a deceased partner, typically the deceased partner's estate). The "proration" method presumes that items of income, expense, gain, and loss arose equally each day throughout the tax year. A monthly convention may be used in making the allocations (see H.R. Rep. No. 861, 98th Cong., 2d Sess. 858 (1984)).

An illustrative provision from an LLC operating agreement might be as follows:

"*Adjustments by Accountant or Manager.* In determining the amount of any distribution, the Interest in this Company of any Member, including any beneficiary of a Trust succeeding to the interest of a Trust, or the allocation of income, expenses, losses or gains of the Company, the Manager shall have the power to apply any method which preserves the tax status of the Company, and of each Trust which is a Member herein, and to best carry out the intent of this Agreement, in the sole discretion of the Manager. Such power shall include the right to close the books of the Company as of the date of any such transaction and to allocate any applicable items to the periods before and after such interim closing of the Company books as necessary or appropriate in the Manager's sole discretion. By way of example and not limitation the Manager may elect to use a monthly convention in applying such allocations."

If the executor has discretion as to which asset to fund a bequest under the will, which is common, how might this impact the result? If a pecuniary bypass trust is funded with the interests in an FLP, the tax year would close and the bypass trust would be allocated the pro rata portion of the gain for the portion of the year in which it holds the interests in the FLP. If the executor uses the discretion granted under the will to distribute the deceased partner's interests in the FLP under the residuary clause to a residuary trust, instead of the pecuniary bypass trust (assuming that the will was so constructed), the tax year of the partnership may not close as a result of the estate funding the residuary trust. As a result, all income from the date of death forward would inure to the residuary trust (since there would be no closing as explained below). If this discretion is combined with an interim closing of the books method, in contrast to the proration method, the executor has flexibility to determine which amount of gain to trap in the estate versus what gain (or other tax consequence) will be reported on the tax return of one of the distributee trusts.

These general rules need to be applied to common estate and probate-related situations that practitioners face. The results are not certain as to how every estate/probate event impacts the requirement to close the tax year of an FLP/LLC owned in part by a decedent, estate or trust. For example, Code Sec. 761(e) provides that the distribution of an interest in a partnership will generally be treated as an exchange for purposes of determining whether Code Sec. 743(b) basis adjustment rules will apply. The IRS has held that the distribution of a lower tier partnership by an upper tier partnership constituted such an exchange, thereby permitting a Code Sec. 743(b) adjustment, even though no gain was recognized on the distribution. The regulations indicate that a distribution by an estate is not an exchange (Reg. §1.706-1(c)(3)(vi), *Example (3)*). The IRS has indicated that a distribution by a trust may be an exchange under Code Sec. 706, thus permitting a basis adjustment under Code Sec. 743(b) (Rev. Rul. 72-352, 1972-2 CB 395). Congressional committee reports appear to indicate intent to exclude distributions by an estate or trust triggered by the death of a member from the exchange provisions of Code Sec. 761(e) (S. Rep. No. 99-313, at 924 (1986)). These rules are discussed below in the context of specific estate events.

EXAMPLES

1. GreenLand, FLP owns raw land purchased for $100,000 years earlier. GreenLand has three equal partners, Georges, Landon, and Pietro. GreenLand sells its land on August 1 for $1 million. Pietro dies on August 30. Assume that Pietro's interest in GreenLand is transferred to a pecuniary bypass trust under his will on October 1. Pietro's death, as well as the funding of a pecuniary bequest, each result in the closing of the partnership's tax year as to Pietro and then the trust (see below). The "closing" is effective on August 30 as to Pietro. Since the raw land was sold prior to the closing, the entire gain of $300,000 [($1 million - $100,000)/3] is allocable to Pietro, and none to his estate. The entire gain would be reported on a Schedule K-1 issued to Pietro and reflected on his final Form 1040. If the tax on this amount was $45,000, Pietro's estate would be entitled to deduct this $45,000 as a debt on the estate tax return (Reg. §20.2053-6(f)).
2. Assume the same facts as above, except Pietro died on July 31, just prior to the sale. In this case, the entire gain would be allocable to his estate, and none to Pietro. No gain would be reflected on Pietro's final Form 1040.
3. Assume that on June 30, GreenLand signed an option agreement with the buyer for the property. The bypass trust was funded on October 1 with Pietro's interests in GreenLand. On October 22, the land was sold, after GreenLand's interests were transferred to the bypass trust. The closing of the partnership tax year as of Pietro's death would not reflect any gain

from the sale. The subsequent closing on the funding of the bypass trust on October 1 would not result in any of the gain being allocated to Pietro's estate. When the option was exercised on October 22, and a closing of the sale occurs on that date or later, the entire gain would be allocable to the bypass trust.

4. RentLand, FLP, a cash basis partnership, rents real estate. RentLand has three members, Mainard, Lupe and Phillipe. Phillipe is terminally ill. A few weeks prior to Phillipe's death, RentLand pays a substantial management fee and bonus to Lupe. Phillipe dies August 30, and his will provides for a pecuniary bypass trust for his surviving spouse (see below), which will be funded with Phillipe's interests in RentLand. This funding triggers a closing of RentLand's tax year as to Phillipe's estate. If RentLand used an interim closing of the books method of determining gain allocable to Phllipe's estate versus his bypass trust, the large cash fee paid prior to Phillipe's demise would, absent a special limitation, reduce estate income and increase the bypass trust income. To prevent taxpayers from manipulating the reporting of income under these rules, the accrual method of accounting is required for certain cash basis expenses regardless of which of the two alternate methods is used.
5. MBD, FLP owns raw land purchased for $100,000 years earlier. MBD has three equal partners, Mortimer, Bernard, and Dante. MBD sells its land on August 30 for $1 million. Dante dies on August 30. The "closing" of MBD's books is effective on August 30 and the proration method is used. Since the raw land was sold after eight full months of the tax year, 8/12ths of the gain or $200,000 [($1 million - $100,000)/3 x 8/12] is allocable to Dante, and $100,000 to Dante's estate. $200,000 of gain would be reported on a Schedule K-1 issued to Dante and reflected on his final Form 1040. If the tax on this amount was $30,000, Dante's estate would be entitled to deduct this $30,000 as a debt (Reg. §20.2053-6(f)). $100,000 of the gain would be reported on a Schedule K-1 issued to the bypass trust and reflected on its Form 1041. Andy Wolfe, an attorney and accountant in the Estate and Trust Practice of J.H. Cohn in Roseland, New Jersey, notes that, "When appropriate, practitioners should consider making a Code Sec. 754 election, (in which case the deceased partner's proportionate interest in the underlying partnership property would be entitled to a step-up in basis), thereby avoiding gain recognition upon a post-death sale of the raw land."
6. Assume that Dante's interest in MBD is transferred to a pecuniary bypass trust under Dante's will on November 1. The funding of a pecuniary bequest results in another closing of the partnership's tax year as to his estate (see below). The bypass trust would be allocated 2/12ths of the gain.

PITFALLS & TRAPS

The presumption that FLP/LLC allocations must be made by an interim closing of the books, unless the partners agree to the contrary, is the opposite of the law with respect to S corporations, so practitioners should exercise caution not to confuse the two. S corporation law requires that the S corporation pro rate earnings unless there is an express agreement to the contrary to close the S corporation books (Code Sec. 1366(a)(1); Code Sec. 1377(a); Reg. §1.1377-1(a)(1)).

Practice Pointers

1. Since most FLPs/LLCs maintain monthly financial reports, using an interim closing method may prove easier. If a partner died in April, the monthly statement through March plus an allocation for April, would provide a means of determining the allocation pre- and post-death.
2. There are planning opportunities that practitioners can avail their clients of to the extent that the closing of the tax year of the FLP/LLC can be coordinated with the various estate and trust events.
   a. *Specific Bequest*: If a decedent makes a specific bequest of an interest in a particular FLP or LLC to a designated heir so as to retain control of a family business in the hands of the heir working in that business, or, alternatively, to equalize other distributions, the partnership tax year will not close as to the deceased partner's estate's interest in the partnership. The rationale for this result is that the transfer of the partnership interest to the specific legatee under the decedent's will is tantamount to the direct transfer of the partnership interest by the decedent to the legatee. The result for income tax reporting purposes follows this concept. The legatee partner should report his or her share of the partnership or LLC income, expense, gain and loss from the date of death onward. No Schedule K-1 would be issued to the partner's estate. This can be illustrated with a bequest as follows: "I give, devise and bequeath any interest of mine in the Smith Family Widget FLP to my son, Tom." If a specific bequest is made of an interest in an FLP or LLC (taxed as a partnership), the distribution should not be treated as a sale, exchange or distribution that would trigger the closing of the partnership's tax year. Code Sec. 663(a)(1) excludes any amount which, under the terms of the will or other governing instrument, is properly paid or credited as a bequest of specific property, and which is paid or credited all at once, or in not more than three installments.

b. *Pecuniary Bequest*: If a will provides that the bypass trust is funded in terms of a specific dollar amount (a pecuniary bequest), then the funding of that bequest with a partnership interest, or a membership interest in an LLC, will trigger the closing of that FLP's or LLC's tax year. This is because the funding of a pecuniary bequest is equivalent to a sale or exchange of the FLP or LLC interests (Reg. §1.661(a)-2(f)). This type of clause can be illustrated as follows: "If my spouse survives me, I give, devise and bequeath the pecuniary sum which is the largest dollar amount that will not result in a federal or state estate tax on my death, to the Trustee, in trust, to be administered in accordance with the provisions below. The trust, if any, formed under this provision shall be known as the "Applicable Exclusion Trust." "The rationale of this treatment is that the estate must fund this bequest with a specified (pecuniary) dollar amount and if the estate does so with an in-kind distribution, it is equivalent to the estate's sale or exchange of that asset and use of the proceeds to satisfy the specific dollar bequest," observes Mr. Wolfe. "This characterization as a sale or exchange will cause the closing of the partnership's books with respect to the estate as a partner. Thus, funding a bypass trust with an interest in the FLP or LLC could cause the FLP or LLC tax year to close with respect to the estate as a partner." Thus, a Schedule K-1 would be issued to the estate covering the period from date of death to the date of distribution, and then to the bypass trust covering the period following the distribution to the trust.

c. *Distribution When Trusts Makes 643(e) Election*: An estate or trust may make a distribution of membership interests in an LLC or partnership interests in an FLP to satisfy a required distribution triggered by the beneficiary reaching a designated age. This type of provision can be illustrated as follows: "When the Child attains the age of Twenty-Five (25) years, the Trustee shall transfer, convey, and pay over to such child One-Third (1/3) of the principal of the trust, as it shall then be constituted. When the Child attains the age of Thirty (30) years, my Trustee shall transfer, convey, and pay over to such child One-Half (1/2) of the principal balance of the trust, as it shall than be constituted. When the Child attains the age of Thirty-Five (35), my Trustee shall transfer, convey, and pay over to the Child the entire remaining balance of the trust, as it shall then be constituted." In the provision above, at age 25, 30, and 35, the Trustee must distribute trust corpus to the beneficiary, which may include an interest in an FLP/LLC.

The trust or estate may make an election under Code Sec. 643(e)(3) to recognize gain or loss on the distribution to the beneficiary. If the trust makes this election, the tax year of the partnership will close as to that trust or estate. The applicable code provision provides that in the case of any distribution of property (other than cash) to which a Code Sec. 643(e) election applies, gain or loss shall be recognized by the estate or trust in the same manner as if such property had been sold at its fair market value. This is why the tax year must close as to the distributee. If a Code Sec. 643(e) election is made, it will apply to all distributions made by the estate or trust during the tax year, and once made, the election may be revoked only with IRS consent.

d. *Residuary Bequest:* A residuary bequest is a distribution of the remainder of the estate after distribution of prior bequests and devises. This can be illustrated as follows: "On my death, my residuary estate shall be divided into a sufficient number of shares so that there shall be set aside one such share for each child of mine, per stirpes, to be disposed of as follows: [insert dispositive provisions]." If an interest in an FLP or LLC is distributed as part of a residuary bequest under a will, it is not clear (absent the estate making an election under Code Sec. 643(e)(3), discussed above) whether the tax year of the partnership must close. However, it would appear that a residuary distribution will not be treated as a sale or exchange (Reg. §1.706-1(c)(3)(iv)).

e. *Distribution by Terminating Testamentary Trust*: A terminating testamentary trust can be illustrated by trust described above making its final distribution to a child beneficiary when that child attains the age of 35. The regulations indicate that a distribution by an estate is not an exchange (Reg. §1.706-1(c)(3)(vi), Example (3)). The IRS has indicated that a distribution by a trust may be an exchange under Code Sec. 706, thus permitting a basis adjustment under Code Sec. 743(b) (Rev. Rul. 72-352, 1972-2 CB 395). As mentioned earlier, Congressional committee reports indicate the intent to exclude distributions by an estate or trust triggered by the death of a member from the exchange provisions of Code Sec. 761(e) (S. Rep. No. 99-313, at 924 (1986)). If a terminating testamentary trust distributes an FLP or LLC interest, the partnership tax year will close with respect to the trust (Prop. Reg. §1.706-1(c)(2)(i)). If the tax year of the partnership closes, then a Schedule K-1 would be issued to the trust for the period prior to the distribution, and to the beneficiary thereafter. However, any distributable net income earned by the trust prior to the distribution would be passed out to the beneficiary as part of the final terminating distribution.

3. The practical difficulty of implementing these rules is tremendous. The cost of compliance for a small estate can be out of proportion to the tax consequences. For smaller general practitioners who make up a large segment of the profession, understanding and interpreting these rules is nearly impossible. Carol Cantrell explains that "It's hard to ignore the fact of having an estate administration, so many practitioners use a hybrid method. They simply allocate recurring income on a prorata basis, and if there is something substantial (like a large capital gain) they will allocate that on a "closing of the books basis."

Tools and Practice Aids

▼ CCH Explanation	FINANCIAL AND ESTATE PLANNING, Vol. 1 ¶3030.
▼ Forms	FINANCIAL AND ESTATE PLANNING, Vol. 1¶8058.01.

SUMMARY

Objective

- The closing of a partnership's books upon termination of a partnership interest are complex and practitioners need to understand these rules and their specific application to estates and trusts owning partnership interests.

Technique

- Under the interim closing of the books method, the partnership books are closed as to the partner in question and all items of income, expense, gain or loss occurring before the date of closing are allocated to the partner while all items occurring after the closing of the books are allocated to the partner holding the interest after the closing date.
- Under the proration method, items of income, expense, gain and loss are presumed to have arisen equally each day throughout the tax year.
- Pecuniary trust funded with a partnership interest would result in the closing of the tax year and a pro-rata allocation of the gain for the portion of the year in which it held the partnership interest.
- Discretionary funding of a residuary trust with a partnership interest would not result in the closing of the partnership tax year and all the income would inure to the trust. If combined with an interim closing of the books, the executor has flexibility to determine amount of gain to trap in estate versus one of the distributee trusts.

Examples

- Death of partner and bequest of interest to pecuniary trust both result in closing of partnership tax year, gain on assets sold prior to closing would be fully includible in deceased partner's final income tax return. Gain on assets sold after closing would be includible on the estate tax return.
- Option exercised by purchaser after asset funded pecuniary trust, gain is to be fully allocated to trust.
- Accrual method of accounting required for certain cash basis expenses regardless of closing method used.
- Allocation of gain prorated between deceased partner's final income tax return and estate.

Pitfalls & Traps

- Partnership allocations must be made by an interim closing of the books, unless the partners agree to the contrary, whereas S corporations must pro rate earnings unless there is an express agreement to the contrary.

Planning Pointers

- Interim closing of the books may be easier for FLP/LLC's maintaining monthly financial reports.
- Planning opportunities are available to coordinate closing of the tax year with various estate and trust events—specific bequests, pecuniary bequests, distributions upon Code Sec. 643(b) election, residuary bequests, and distributions upon termination of testamentary trust.

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