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A PARTNERSHIP OF PROFESSIONAL LAW CORPORATIONS

NEWSLETTER

501 WEST BROADWAY, SUITE 700
SAN DIEGO, CALIFORNIA 92101-3563
TELEPHONE: (619) 239-7777
FAX NUMBER (619) 238-8808

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EVENTS:

Presentations and Continuing Education:

How to Handle Short Sales. June 26, 2012, 10:00-11:30 a.m. (Pacific Time). Presented in part by Bradford N. Dewan through the *National Business Institute*. For more information call (800) 931-3140 or visit our website at www.mmpph.com.

In this Issue:

IS THE WRONG PERSON PAYING THE TAXES ON YOUR PARTNERSHIP INCOME?

DeEtte L. Loeffler, JD, LL.M Taxation

Many of our clients have partnerships or other business interests in their trusts. This is a useful method of holding property interests, streamlining management and control, and has the added benefit of simplifying the transfer of that business and/or property to successors over time.

Understanding how partnerships are taxed is a very important aspect of trust administration - and unfortunately one that is often misunderstood by trustees and accountants alike. This is due primarily to the fact that the accounting rules for revocable and irrevocable trusts are different. This difference can cause confusion, and potential tax problems, if not properly understood. In short, not understanding these rules can cause the wrong person to end up paying the taxes on partnership income. In some cases, such significant errors over time can lead to tax penalties and interest that exceed the misreported income.

Pass Through Income Taxation Rules

Partnerships

Partnerships are "pass through" entities for income tax purposes. They in effect act as a conduit for the income and tax deductions of the entity, passing it through to the partners. When a partnership earns income, or has losses, that income (or loss) is allocated among the partners according to the terms of the partnership agreement. The partnership itself is not taxed on the income - instead, the partners report the income (or losses) allocated to them on their personal income tax returns. This is true even when the partnership does not in fact distribute the income to the partners but retains it to pay partnership related expenses such as a mortgage. When partners pay the tax on income retained by a partnership, this income is referred to as "Phantom Income." In recognition that the partnership has retained the income, the partner accounts are adjusted to allocate the retained income to each partner's basis in the partnership, which prevents the partners from being taxed on that income a second time when they dispose of those partnership interests.

Revocable Trusts

In a similar fashion, because revocable trusts can be terminated by the grantor, such trusts act as "pass through" entities. The income of a revocable trust is allocated to the grantors of the trust for tax and accounting purposes, and is reported on their personal income tax returns. A revocable trust does not pay taxes, and generally uses the grantor's social security number rather than a separate taxpayer identification number. Income (including "Phantom Income" from a partnership) passes through the trust to the grantors even if the terms of the trust require the trustee to accumulate the income in the trust rather than distribute it. During the lifetime of the grantor, there is therefore very little difference for the grantor for income tax purposes between owning the partnership interests inside or outside of a trust (although for asset protection, management and estate planning purposes there are significant differences).

Irrevocable Trusts

Irrevocable trusts are treated very differently for tax and accounting purposes. Irrevocable trusts normally come into existence when a grantor makes a gift in trust for a child, or when the grantor dies. Irrevocable trusts are not pass through entities for tax and accounting purposes. Instead, the terms of the trust, and the accounting rules, determine who is ultimately taxable on the income. For example, if a trust requires "all of the net income" to be distributed to a beneficiary, the trustee will issue an IRS Form "K-1" to the beneficiary and will distribute the income to the beneficiary. In contrast, if the trust permits the trustee to "pay or accumulate" the income, only that income which is actually distributed to the beneficiary can be listed on a K-1 and taxed to the beneficiary. Any income not distributed (or which cannot be distributed) must be taxed to the trust. Thus the accounting rule requiring actual distribution to a beneficiary controls who is ultimately responsible for paying the taxes.

"Phantom Income," as noted above, can occur when a partnership retains some of its income for any reason. While Phantom Income is passed through to the partners of the partnership for tax purposes, if the partner is an irrevocable trust, the income must be taxed to the trust and not to the trust beneficiary because no asset has actually been distributed out of the trust. Instead, the income is treated as "trapped" at the trust level and is taxed to the trust. This can be expensive because most trusts are taxed at the maximum income tax rate (35%) if they earn $11,650 or more of income annually. By contrast, an individual is not taxed at the maximum (35%) rate until s/he earns $388,350. The highly compressed trust tax rates result in more overall tax being paid on the income.

Irrevocable trusts may also have trouble paying their taxes unless they have other income, or assets, from which to pay the tax on Phantom Income. If the taxes are paid from assets (i.e. principal), no additional tax will be owed (unless an asset having gain has to be sold), but the overall trust assets are depleted by the payment of these taxes. If the trust has no other income or assets, some trustees and accountants mistakenly believe they can pass this tax burden on to the trust beneficiaries and take a deduction at the trust level. However, in such case by law the trustee must borrow money from another trust, or the trust beneficiaries, in order to meet its obligations, or may be forced to demand an actual cash distribution from the partnership so that it can timely pay its taxes.

Even where the irrevocable trust has other income from which to pay the tax, tax issues can arise. Since an irrevocable trust can only pass through to the beneficiaries (and deduct) income that is actually distributed to the beneficiaries, to the extent other income is used to pay the tax on Phantom Income, this income is "retained" by the trust and is therefore also taxed. In effect, taxes must be paid on the funds used to pay the taxes, which results in an iterative (circular) tax calculation.

Partnerships owned by trusts often make distributions calculated to cover the cost of the taxes that will need to be paid on Phantom (and other) Income allocated to the partners. However, issues can become more complicated where the tax rates of the trust beneficiaries are different, or taxes must be paid at the trust level, since a distribution sufficient to cover the additional taxes payable by one partner (or trust beneficiary) may be insufficient to pay the entire tax due by another.

If you have questions about how to account for trust income, or are concerned that your trust might not have been accounting correctly for the income, please let us know. Please note that not all accountants are familiar with trust accounting, so a specialist is recommended. We would be happy to assist your accountant, and/or trustee, in understanding how income taxes should be determined for your trust.

Example of Partnership Taxation:

An example may make this easier to understand.

a. Assume Bob and Mary are married, have three children, and own a real property partnership. Each year the partnership earns $100,000, from which it retains $50,000 to pay down debt on the properties, and distributes the remaining $50,000. In 1990 they form a revocable family trust and put the partnership interests into that trust. In 2000, they establish gift trusts for their children and gift and/or sell 30% of the partnership interests to these trusts. In 2010, Bob dies and half of the family trust's partnership interests (i.e., 35% of the partnership) are used to fund an irrevocable "bypass (or credit shelter)" trust, while the remainder are distributed to a revocable "survivor's trust" for Mary.

b. Between 1990 and 2000, the income of the partnership (including any Phantom Income) was allocated to the family trust as the sole partner of the partnership. Because the family trust was fully revocable by Bob and Mary, its income was taxable to them. Assuming they are in a 25% income tax bracket, they receive a distribution of $50,000 (and are allocated $50,000 of Phantom Income), and they pay $25,000 in taxes.

c. The 2000 gift to Gift Trusts for the children changes the taxpayers and tax rates to be paid on the income. Between 2000 and 2010, seventy percent (70%) of the net income continued to be taxable to Bob and Mary as discussed above (i.e., they are allocated $70,000 of the partnership income, receive a distribution of $35,000 cash, and pay $17,500 in taxes). However, the thirty percent (30%) in the Gift Trusts is treated much differently. Because the Gift Trusts are irrevocable, only the income actually distributed to the trust beneficiaries is taxable to them while the rest is taxable to the Gift Trust itself. Of the $30,000 (30%) of the partnership income allocated to the Gift Trust, one-half ($15,000) is Phantom Income because it is retained by the partnership. The trust would therefore have to pay tax on this $15,000 of Phantom Income (for a tax of $5,250 at a 35% tax rate). However, unless the trust had other assets from which to pay the tax, it would have to pay that tax from the $15,000 cash it also received from the partnership, further reducing the amount available to distribute to the beneficiaries. This results in an iterative (circular) calculation, in which the amount of money used to pay the taxes increases the amount taxable to the trust since it was not distributed to the beneficiaries. If taxes are paid from the cash distributed to the Gift Trust, the total tax paid by the Gift Trust will be $8,074.91 (not $5,250). The trust beneficiaries thus receive only $6,925.09 of the $30,000 cash and Phantom Income allocated from the partnership. The overall taxes paid on the partnership income therefore rises from $25,000 a year to $26,156.36.

d. After Bob's death, another 35% of the partnership interests become held by an irrevocable trust, this time the bypass trust. The thirty percent (30%) held by the Gift Trust remains taxable to the Gift Trusts as discussed in paragraph "c" above. Thirty-five percent (35%) is taxable to Mary through the survivor's trust (which is revocable) as described in paragraph "a" above. The remaining 35% is taxable to the bypass trust (which is irrevocable) and/or its beneficiaries. As with the Gift Trust, the Phantom Income allocated to the bypass trust, and any income used to pay that tax, is taxable to the bypass trust at the highest applicable tax rate. Total tax payable on the partnership income climbs to $27,704.47, paid $8,672.75 by the bypass trust, $8,074.91 by the Gift Trust and $10,965.81 by Mary (who pays income tax on the bypass income passed through to her as a beneficiary, as well as on the income of the survivor's trust.)

As shown above, the higher income tax results from the partnership's inability to distributed out all of its taxable income to its partners. In such case, tax planning might be available at the partnership level for the debt payments to be paid from partner capital contributions, rather than create Phantom Income.

LEGISLATIVE UPDATE: Congress and Sacramento Make No Progress on Amending the Tax Code

Infighting continues in Washington as members of both parties position themselves for the coming elections. Pressure is building because of what Federal Reserve Board Chairman Ben Bernanke call the "Fiscal Cliff", which is expected to occur on January 1, 2013 when the Bush Era tax cuts expire at the same time as large automatic spending cuts go into effect. This Cliff, he warns, will take $500 billion out of the economy in 2013 and could stall the economic recovery. Republicans claim that this event will result in the largest tax hike in history, $310 billion. Increasing the pressure is the fact that the current debt ceiling needs to be reviewed, and possibly raised, in early 2013 if nothing changes.

Although Members of both parties agree that "something" must be done, they do not agree on what that "something" should be. Moreover, while some are pushing for immediate tax reform, most concede no agreement will be reachable before the November 2012 elections. House Republicans have introduced legislation to immediately extend the Bush Era Tax cuts, as well as other renewable tax expenditures (including the AMT). Democrats have countered with an offer to extend only "middle class" tax cuts. Each approach is tailored to appeal to the party voting base and as such has little or no bipartisan support. With Republicans controlling the House, and Democrats the Senate, bills passed by either along strictly ideological lines remain doomed to failure.

Of interest is a recent proposal by Representative Dave Camp, Chairman of the House Ways and Means Committee, to set deadlines for tax reform legislation in 2013. His proposal includes the use of "fast track" bills to reform the tax code (such bills force deadlines and cannot be amended, but require an up or down vote). Mr. Camp believes that pressure from the expiration of the Bush Tax cuts will finally force tax reform to occur.

Congress remains focused on payroll, income and corporate taxes, with little attention being paid to estate, gift or generation skipping taxes which are estimated to generate less than 1% of overall tax revenue, compared to 42% for income taxes, 40% for payroll taxes and 9% for corporate taxes.

At the State level, Governor Jerry Brown has revised his tax proposal in conjunction with the California Teacher's Union to increase the proposed tax rate "on the rich" (defined as $250,000 (single)/ $500,000 (couples)) from the current 10.3 % to up to 13.3% (graduated from 1% to 3% on income from $250,000 to $500,000), while the proposed sales tax rate has been adjusted downward to .025% from .05%.

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RALPH GANO MILLER, RETIRED
THOMAS M. MONSON
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SUSAN L. HORNER
BRADFORD N. DEWAN
PHILIP R. FREDRICKSEN†
DeETTE L. LOEFFLER
JUDY S. BAE
†OF COUNSEL

Internet: http://www.mmpph.com