Estate of Skaggs v. Commissioner, 72 T. C. 449 (1979)

Partnership assets do not qualify for a basis adjustment under Section 1014 upon the death of a partner if the partnership continues to operate post-death.

Summary

Estate of Skaggs involved a dispute over whether partnership assets could receive a step-up in basis under Section 1014 upon the death of Ernest Skaggs. The partnership, owned by Ernest and his wife Carolyn as community property, continued to operate after his death, managing and selling crops. The court held that the partnership did not terminate upon Ernest's death, thus the partnership assets did not qualify for a Section 1014 basis adjustment. Furthermore, a late election under Section 754 to adjust the basis of partnership assets was invalid because it was not timely filed with the partnership's return. This case clarifies the conditions under which partnership assets may or may not receive a basis adjustment upon a partner's death.

Facts

Ernest D. Skaggs and his wife Carolyn operated a farming business as partners in Santa Rita Ranch Co. , holding their partnership interests as community property. Ernest died on December 31, 1973. At his death, the partnership had harvested but unsold crops, a sugar beet crop in the ground, and accounts receivable. The partnership was heavily indebted. Carolyn, as executrix of Ernest's estate, continued to manage the farming business, selling crops and paying off debts into 1974. No notice of partnership dissolution was published. The estate and Carolyn claimed a step-up in basis for the partnership's crops and depreciable assets under Section 1014.

Procedural History

The IRS issued deficiency notices to Carolyn and the estate for the 1974 tax year, disallowing the claimed basis adjustments. Carolyn and the estate then filed a petition in the Tax Court, seeking a basis adjustment under Section 1014 and, alternatively, an election under Section 754. The Tax Court upheld the IRS's determination, ruling that the partnership did not terminate upon Ernest's death and that the attempted Section 754 election was invalid.

Issue(s)

1. Whether the partnership terminated upon Ernest Skaggs' death, thereby allowing the partnership assets to qualify for a basis adjustment under Section 1014(a) and (b)(6).
2. Whether Carolyn C. Fike's attempt to elect under Section 754 to adjust the bases of partnership assets was valid.

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Holding

1. No, because the partnership did not terminate upon Ernest's death; it continued to operate, and thus the partnership assets did not qualify for a Section 1014 basis adjustment.
2. No, because the attempted Section 754 election was not filed timely with the partnership's return as required by the regulations.

Court's Reasoning

The court determined that under both California law and the Internal Revenue Code, the partnership did not terminate upon Ernest's death. California law specifies that a partner's death causes a dissolution but not an immediate distribution of partnership assets. The Internal Revenue Code defines partnership termination under Section 708 as occurring only if no part of the business continues to be carried on by any partners. Here, the estate continued to share in the partnership's profits, indicating continuity. The court cited Section 1. 708-1(b)(1)(i)(a) of the Income Tax Regulations, which states that a two-member partnership does not terminate upon one partner's death if the estate continues to share in the partnership's profits or losses. The court also found that the partnership agreement's use of "terminate" meant dissolution followed by winding up, not immediate termination. Regarding the Section 754 election, the court ruled it invalid because it was not filed with the partnership's return for the year of the transfer (1973), as required by Section 1. 754-1(b)(1) of the Income Tax Regulations. The court rejected arguments based on installment method election cases, finding them distinguishable.

Practical Implications

This decision impacts how partnerships should handle the death of a partner. It clarifies that if a partnership continues to operate after a partner's death, the partnership's assets do not automatically receive a basis adjustment under Section 1014. Instead, a timely election under Section 754 is required to adjust the basis of partnership assets. Practitioners must ensure that such elections are made with the partnership's return in the year of the transfer to be valid. This case underscores the importance of understanding the distinction between dissolution and termination under both state and federal law and the necessity of timely action in electing basis adjustments. Subsequent cases have referenced Estate of Skaggs when addressing similar issues of partnership continuity and basis adjustments upon a partner's death.

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