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Death of a Member of an LLC*

*Susan Kalinka***

The rules of the Louisiana Limited Liability Company ("LLC") Law concerning the death of a member and the rights of a decedent member's legal representative can create problems, both under state law and under federal income tax law. Many of the potential problems can be avoided by careful planning. This article discusses the consequences of the death of a member of a Louisiana LLC and offers some suggestions for avoiding the adverse effects that might otherwise result under the Louisiana LLC Law.

I. CONSEQUENCES ON THE DEATH OF A MEMBER UNDER THE LOUISIANA LLC LAW

Under the Louisiana LLC Law, the death of a member causes the decedent's membership interest in the LLC to cease, and the decedent member's executor, administrator, or other legal representative is treated as an assignee of the decedent's interest in the LLC.¹ It is uncertain whether a decedent member's heir has any rights with respect to the decedent's interest in the LLC unless the heir is also a legal representative of the decedent. The Louisiana LLC Law contains no specific provision permitting the parties to alter the foregoing rules by agreement. No court has decided this issue. It seems, however, that a provision in an LLC's articles of organization or written operating agreement designating a person other than a decedent member's legal representative as the member's successor in interest should be respected. There is no policy reason for prohibiting an heir or any other designee from succeeding to a decedent member's interest in an LLC.² Moreover,

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* Adapted from Susan Kalinka, *Louisiana Limited Liability Companies and Partnerships: A Guide to Business and Tax Planning* § 5.104 in 9 Louisiana Civil Law Treatise (1996) (published with permission of West Publishing Co.).

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1. La. R.S. 12:1333 (1994).

2. Tax considerations may inhibit the parties from designating an heir as the member's successor in interest for fear that an LLC will not be classified as a partnership for federal tax purposes if its interests are heritable. Under the current classification regulations, an LLC will be classified as an association taxable as a corporation, rather than as a partnership, unless the LLC lacks at least two of the following corporate characteristics: (1) continuity of life, (2) centralized management, (3) limited liability, and (4) free transferability of interests. Treas. Reg. § 301.7701-2(a)(2), (3). There may be some concern that if interests in an LLC are heritable, the LLC will have the corporate characteristic of free transferability of interests. However, if a member's successor, like a legal representative, has only the rights of an assignee to share in the LLC's profits, losses, and distributions, but not the right to participate in the management of the LLC, the LLC will not have free transferability of interests. See Treas. Reg. § 301.7701-2(e)(1) (as amended 1993) (free transferability of interests does not exist in a case in which each member can, without the consent of other members, assign only his right to share in profits but cannot assign his rights to participate

the Louisiana LLC Law recites that its policy is to "give maximum effect to the principle of freedom of contract."³

The rule treating a decedent member's legal representative as an assignee of the decedent's interest can be problematic. As an assignee of the decedent member's interest, the decedent's legal representative is entitled only to receive distributions from the LLC as authorized by the LLC's operating agreement or by the members,⁴ to share in the LLC's profits and losses, and to receive allocations of the LLC's items of income, gain, loss, deduction, and credit.⁵ A decedent member's legal representative may not become a member of the LLC or exercise any of the rights or powers of a member unless the LLC's articles of organization or an operating agreement provides otherwise.⁶ Thus, the legal representative of a decedent member may not participate in the management of the LLC, vote on the LLC's affairs, or inspect the LLC's records, unless the LLC's articles of organization or an operating agreement specifically accords such management rights to the decedent's legal representative, or unless the legal

in the management of the organization); La. R.S. 12:1330(A), 12:1332(A), 12:1333 (1994). There is some indication, however, that interests in an LLC may be heritable without causing the LLC to have the corporate characteristic of free transferability of interests. In Priv. Ltr. Rul. 96-04-014 (Oct. 26, 1995), an LLC's operating agreement provided that persons who received an economic interest in the LLC by will upon the death of a member and certain member-related persons who received an economic interest in the LLC from a member by the law of intestate succession could be admitted as a members of the LLC upon agreeing to be bound by the terms of the operating agreement. Otherwise, the transferee of an economic interest could become a member only with the consent of a majority in interest of the nontransferring members. The Service ruled that the LLC in Priv. Ltr. Rul. 96-04-014 lacked free transferability of interests. Care should be taken, however, in relying on the private letter ruling. A private letter ruling is binding on the Service only with respect to the taxpayer to whom it is issued. I.R.C. § 6110(j)(3); Rev. Proc. 96-1 § 11.02, 1996-1 I.R.B. 8. Nevertheless, the issue of whether an LLC has the corporate characteristic of free transferability of interests will no longer be relevant once the "check-the-box" regulations are issued in final form. On May 9, 1996, the check-the-box regulations were proposed to replace the current classification regulations. Prop. Treas. Reg. §§ 301.7701-1 through 301.7701-3, 61 Fed. Reg. 21,989 (May 13, 1996). Under the proposed regulations an LLC in many cases will be able to determine its classification as a partnership or an association taxable as a corporation by making an election. Prop. Treas. Reg. § 301.7701-3(a). The check-the-box approach permits an LLC to be classified as a partnership, regardless of the whether the LLC has free transferability of interests or any of the other corporate characteristics. The check-the-box election will be available when the check-the-box regulations are published in final form in the Federal Register. Prop. Treas. Reg. § 301.7701-1(f), -2(e), -3(e)(1). At that time, an operating agreement may provide that interests in an LLC are freely transferable, both during the life of a member and after the member's death, without the possibility of jeopardizing the LLC's tax status.

3. La. R.S. 12:1367(B) (1994).

4. La. R.S. 12:1324(A), 12:1330(A) (1994).

5. La. R.S. 12:1330(A) (1994).

6. La. R.S. 12:1330(A), 12:1332(A)(1) (1994). Unless an LLC's articles of organization or a written operating agreement provides otherwise, a decedent member's legal representative, as an assignee of the decedent member's interest, may be admitted as a member of the LLC only if the other members unanimously consent in writing. La. R.S. 12:1332(A)(1) (1994).

representative is admitted as a member of the LLC.⁷ Without the rights to vote and inspect records, a decedent member's legal representative will have little ability to protect the interests of the decedent's estate or heirs with respect to the decedent's interest in the LLC.

The Louisiana LLC Law does not require an LLC or the remaining members to purchase a decedent member's interest. A Louisiana LLC is not required to make interim distributions to the estate or other successor of the decedent after the member has died. While the default rules of the Louisiana LLC Law require a distribution to a member who withdraws or resigns from an LLC,⁸ it does not seem that the termination of a member's interest upon the member's death constitutes a withdrawal or resignation from an LLC for this purpose.⁹ Thus, unless an operating agreement requires that interim distributions be made or that the LLC must purchase a member's interest when the member dies, a member's legal representative will receive interim distributions from the LLC on behalf of the member's estate or other successor only if such distributions are authorized by the remaining members.¹⁰ If the remaining members are able to withdraw profits from the LLC as salary or other payments, they may have little incentive to authorize distributions in which a decedent member's successor may share.

If the interest of a decedent member is not purchased by the remaining members or by the LLC when the member dies, the estate or heirs of the decedent will only be entitled to a distribution from the LLC if and when the LLC dissolves.¹¹ Because the estate and heirs have a financial stake in the LLC, they will be concerned with the LLC's profitability. However, as stated above, there will be no one to protect their interests because of their lack of management powers.

The rules restricting the management powers of a decedent member's legal representative apply regardless of the size of the decedent's interest or the decedent's voting power with respect to the LLC's affairs.¹² Thus, upon the

7. See La. R.S. 12:1332(A)(1) (1994) (default rule providing that an assignee of a member's interest may not participate in the management of an LLC unless the other members unanimously consent in writing), La. R.S. 12:1318 (1994) (default rule providing for voting rights of members), La. R.S. 12:1319(B)(1) (1994) (default rule providing that a member of an LLC may inspect its records).

8. La. R.S. 12:1325(C) (Supp. 1996).

9. See La. R.S. 12:1334(3) (1994) (listing "death" and "withdrawal" of a member as separate events that may trigger dissolution of an LLC).

10. See La. R.S. 12:1324 (1994).

11. See La. R.S. 12:1337(A) (1994) (default rule requiring distributions to members and former members on dissolution of the LLC).

12. Under the default rules of the Louisiana LLC Law, members of an LLC vote on a *per capita* basis, *i.e.*, one-member, one-vote, majority rule. La. R.S. 12:1318(A) (1994). The default rules may be altered by a provision in the LLC's articles of organization or a written operating agreement. *Id.* In many cases, a written operating agreement will provide that the members of the LLC will vote in proportion to their relative contributions to the capital of the LLC. See, *e.g.*, Form of an Operating Agreement, Option 2—Complex Manager Managed § 3.1, reprinted in Susan Kalinka, Louisiana Limited Liability Companies and Partnerships: A Guide to Business and Tax Planning, Appendix B in 9 Louisiana Civil Law Treatise (1996).

death of any member of an LLC, there will be no one to ensure that the LLC makes distributions to the decedent's successor or conducts its business in a manner that is beneficial to the interests of the decedent's estate or other successor.

The rules concerning the rights of a decedent member's legal representative also may raise questions with respect to the person who should report the LLC's items of income, gain, loss, deduction, or credit allocated to the decedent member's interest after the member has died. Treasury regulations recite: "A partner retires when he ceases to be a partner under local law. However, for purposes of subchapter K, . . . a deceased partner's successor will be treated as a partner until his interest in the partnership has been completely liquidated."¹³ This rule should apply with respect to an LLC that is classified as a partnership for purposes of federal income taxation. The quoted language seems to indicate that a decedent member's interest continues for tax purposes even after the member's interest has terminated under state law and that the member's successor may be taxed on a distributive share of the LLC's income, even if the successor is not admitted as a member of the LLC. The quoted language, however, applies only to payments made to a deceased partner's successor in interest in liquidation of the partner's entire interest in the partnership.¹⁴ It does not apply if a deceased partner's estate or other successor continues as a partner in its own right under local law.¹⁵

The Louisiana LLC Law provides some protection to a decedent member's estate or heirs. Under the default rules of the Louisiana LLC Law, an LLC dissolves upon the death of a member unless, within ninety days of the member's death, the remaining members unanimously consent to continue the LLC.¹⁶ Upon dissolution of an LLC, the LLC's affairs are wound up,¹⁷ and its assets are distributed, first to the LLC's creditors, and then to the LLC's members and former members.¹⁸ If an LLC dissolves on the death of a member, the decedent member's legal representative, as an assignee of the member's interest, will be entitled to receive any distribution to which the decedent would have been entitled.¹⁹

The protection accorded under the default rules of the Louisiana LLC Law triggering dissolution of an LLC on the death of a member may be illusory. It is likely that the remaining members of an LLC will consent to continue the LLC after

13. Treas. Reg. § 1.736-1(a)(1)(ii) (as amended in 1965).

14. Treas. Reg. § 1.736-1(a)(1)(i) (as amended in 1965).

15. *Id.* The issue of whether and under what circumstances an assignee of a member's interest (such as the legal representative of a member who has died) may receive an allocation of the LLC's tax items is discussed in Louisiana Limited Liability Companies and Partnerships. See Kalinka, *supra* note 12, at § 1.40. See also Susan Kalinka, *Assignment of an Interest in a Limited Liability Company and the Assignment of Income*, 64 U. Cincinnati L. Rev. 443, 529-48 (1996).

16. La. R.S. 12:1334(3) (1994).

17. La. R.S. 12:1336(A) (1994).

18. La. R.S. 12:1337(A) (1994).

19. La. R.S. 12:1330(A) (1994).

a member has died, thereby avoiding the dissolution of the LLC. Moreover, the default rules may be altered by a provision in the LLC's articles of organization or a written operating agreement that permits the LLC to continue after the death of a member without the consent of the remaining members.²⁰

The parties can avoid the adverse consequences to the estate or heirs of a decedent member by planning ahead. An LLC's articles of organization or a written operating agreement may provide that, upon the death of a member, (1) the decedent member's successor will be admitted as a member of the LLC, (2) the remaining members of the LLC will buy the decedent's interest (for a fixed amount or an amount determined according to a formula), or (3) the LLC will liquidate the decedent's interest (for a fixed amount or an amount determined according to a formula).²¹

The following parts of this article discuss the income tax consequences to the estate or other successor of a decedent member (hereinafter sometimes referred to as a member's successor) on the admission of a decedent member's successor or the sale or liquidation of the decedent's interest in an LLC. The primary issues concern (1) the adjusted basis of the membership interest in the hands of the decedent member's successor and whether items of the LLC's income should be considered income in respect of a decedent, and (2) the allocation of the LLC's income to the member's estate or the member's successor for the year in which the member dies.

II. ADJUSTED BASIS OF A DECEDENT'S INTEREST IN AN LLC AND ITEMS CONSTITUTING INCOME IN RESPECT OF A DECEDENT

Determining the adjusted basis of a decedent member's interest in an LLC is important, regardless of whether the decedent's successor is admitted as a member of the LLC or the interest is sold or liquidated. The adjusted basis of an interest in an LLC is a measuring rod that determines the amount of an LLC's net losses that a member may deduct and the amount of cash distributions that a member may receive from an LLC without incurring a tax liability. A member may deduct the member's distributive share of the LLC's net losses only to the extent of the adjusted basis of the member's interest in the LLC at the end of the LLC's taxable year in which the loss occurred.²² A member must recognize gain on the

20. La. R.S. 12:1334(3) (1994).

21. If an LLC is closely held, the remaining members may not want to admit the decedent's successor as a member of the LLC. It may be preferable for an LLC's articles of organization or a written operating agreement to provide for a buy-out or liquidation of a decedent member's interest, perhaps giving the parties an option to admit the decedent's successor as a member by mutual agreement. Regardless of whether an LLC is closely held, the parties may not desire to permit a member's successor to be admitted as a member without the consent of other members to avoid adverse tax consequences. As explained in *supra* note 2, a provision in an operating agreement that interests in an LLC are heritable may jeopardize the classification of the LLC.

22. I.R.C. § 704(d) (West 1996).

distribution of cash from an LLC to the extent that the money distributed exceeds the adjusted basis of the member's interest in the LLC.²³ The adjusted basis of a member's interest also determines the amount of gain or loss that is recognized on the sale or exchange of the member's interest,²⁴ the amount of gain or loss that is recognized on the liquidation of a member's interest,²⁵ and the adjusted basis of property other than money received in a distribution from the LLC.²⁶

In general, the adjusted basis of a decedent member's interest in an LLC is the fair market value of the interest on the date of the decedent's death or the alternate valuation date provided in section 2032 of the Internal Revenue Code.²⁷ This amount is increased to reflect the estate's or other successor's share of the LLC's liabilities and is reduced to the extent that the value of the interest is attributable to items constituting income in respect of a decedent.²⁸

Income in respect of a decedent generally includes amounts to which a decedent was entitled as gross income but which were not includible in computing the decedent's taxable income for the taxable year ending on the date of the decedent's death or for a previous year under the decedent's method of accounting.²⁹ For example, accounts receivable for services performed by a cash method taxpayer that are not collected before the taxpayer dies³⁰ and gain deferred on an uncollected installment obligation³¹ constitute income in respect of a decedent in the hands of the decedent's successor. On the other hand, the gain inherent in appreciated property that has not been sold by the decedent is not income in respect of a decedent. For example, the appreciation in value of a shareholder's stock that is subject to a buy-sell agreement requiring the corporation to purchase the shareholder's stock on his or her death does not constitute income in respect of a decedent because the sale is made after the shareholder's death.³²

23. I.R.C. § 731(a) (West 1996). *See also* I.R.C. § 731(c) (West 1996) (treating a distribution of marketable securities as a distribution of money under certain circumstances), § 737 (West 1996) (requiring a member who has contributed appreciated property to an LLC to recognize gain on a distribution of property from the LLC in an amount equal to the lesser of: (1) the fair market value of the distributed property less the adjusted basis of the member's interest in the LLC immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution or (2) the member's net pre-contribution gain).

24. I.R.C. § 1001(a) (West 1996).

25. I.R.C. §§ 731(a), 737 (West 1996).

26. I.R.C. § 732(a)(2), (b) (West 1996).

27. I.R.C. § 1014(a) (West 1996). If the decedent's interest in the LLC is community property, the decedent's surviving spouse will compute his or her basis in the spouse's one-half share of the interest with reference to the fair market value of one-half of the interest at the date of the decedent's death or the alternate valuation date. I.R.C. § 1014(b)(6) (West 1996). The decedent's one-half community share of the interest will be computed with reference to its fair market value at that time. I.R.C. § 1014(a) (West 1996).

28. I.R.C. § 752(a), 1014(c) (West 1996). Treas. Reg. § 1.742-1 (1960).

29. Treas. Reg. § 1.691(a)-1(b) (as amended in 1965).

30. *See, e.g.*, Treas. Reg. § 1.691(a)-2(b) Example (1) (1960).

31. *See, e.g.*, Treas. Reg. § 1.691(a)-2(b) Example (5)(1) (1960).

32. *See, e.g.*, Treas. Reg. § 1.691(a)-2(b) Example (4) (1960).

Thus, while the fair market value of a decedent's interest in an LLC (which may include the decedent member's distributive share of items that were not reported on the decedent's tax return) is included in the decedent's gross estate for estate tax purposes,³³ the adjusted basis of the decedent member's interest in the LLC does not include the decedent member's distributive share of the LLC's items that constitute income in respect of a decedent. The basis rule may have different tax consequences, depending on whether (1) the decedent member's successor is admitted as a member of the LLC, (2) the interest is purchased by the remaining members, or (3) the interest is liquidated.

A. Admission of a Decedent Member's Successor as a Member

If a decedent member's successor is admitted as a member of the LLC, the successor will include in income a distributive share of the LLC's income, gain, loss, deduction, or credit earned or incurred by the LLC after the decedent's death.³⁴ If the LLC has a section 754 election in effect at the time of the decedent's death, the adjusted basis of the LLC's property will be increased or decreased to reflect the difference between the adjusted basis of the successor's interest in the LLC ("outside basis") and the successor's proportionate share of the total adjusted basis of the LLC's property ("inside basis").³⁵ To the extent that the successor's outside basis exceeds his or her proportionate share of the LLC's inside basis, a section 754 election will require an upward adjustment to inside basis, *i.e.*, the basis of the LLC's property.³⁶ To the extent that the successor's proportionate share of the LLC's inside basis exceeds his or her outside basis, a section 754 election will require a downward adjustment to the basis of the LLC's property.³⁷ The step-up or step-down in inside basis applies only with respect to the decedent member's successor and not to the continuing members.³⁸ Courts have held that if a step-up in basis is required because a partnership has a section 754 election in effect at the time of a partner's death, none of the upward adjustment applies to the accounts receivable of a cash method partnership, which are items of income in respect of a decedent.³⁹ The Internal Revenue Service takes the same position on this issue.⁴⁰ The same analysis should apply to an LLC that is classified as a

33. I.R.C. §§ 2031, 2033 (West 1996).

34. I.R.C. § 702(a) (West 1996). The allocation of an LLC's tax items between the decedent and the decedent's successor for the LLC's taxable year in which the decedent dies is discussed *infra* Section III.

35. I.R.C. §§ 743(b), 754 (West 1996). See Kalinka, *supra* note 12, § 5.93.

36. I.R.C. § 743(b)(1) (West 1996).

37. I.R.C. § 743(b)(2) (West 1996).

38. I.R.C. § 743(b) (flush language) (West 1996). For the rules for determining a member's proportionate share of the LLC's inside basis, see Treas. Reg. § 1.743-1(b)(2) (1960).

39. See, e.g., *George Edward Quick Trust*, 54 T.C. 1336 (1970), *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971); *Chrissie H. Woodhall*, 28 T.C.M. (CCH) 1438 (1969), *aff'd*, 454 F.2d 226 (9th Cir. 1972).

40. Rev. Rul. 66-325, 1966-2 C.B. 249.

partnership for federal income tax purposes. Under this authority, a decedent member's successor who is admitted as a member of the LLC must include in income a distributive share of the LLC's items that constitute income in respect of a decedent when they are earned, regardless of whether the LLC has a section 754 election in effect at the time of the decedent member's death.⁴¹

Commentators have suggested that the foregoing analysis is not necessarily correct under a literal reading of the Internal Revenue Code.⁴² Section 691(e) provides, "[f]or application of this section [691] to income in respect of a deceased partner, see section 753."⁴³ Section 753 provides, that "[t]he amount includible in the gross income of a successor in interest of a deceased partner under section 736(a)⁴⁴ shall be considered income in respect of a decedent under section 691."⁴⁵ Commentators argue that since "for application" of section 691 with respect to a deceased partner references section 753 exclusively, and since section

41. See Treas. Reg. §§ 1.706-1(c)(3)(v) (as amended in 1987), 1.753-1(b) (as amended in 1965).

42. See, e.g., 2 William S. McKee et al., *Federal Taxation of Partnerships and Partners* ¶ 23.03[2][c] (2d ed. 1990).

43. I.R.C. § 691(e) (West 1996).

44. I.R.C. § 736 (West 1996) divides payments made in liquidation of a partner's interest into two types of payments: (1) section 736(a) payments and (2) section 736(b) payments. Section 736(b) payments generally are payments made to a retiring partner or a partner's successor in interest in exchange for the partner's interest in partnership property. I.R.C. § 736(b)(1) (West 1996). Section 736(a) payments are all payments other than section 736(b) payments. Often, section 736(a) payments will represent a premium payment in excess of the retiring or deceased partner's share of the fair market value of partnership property. However, in the case of a partnership for which capital is not a material income-producing factor, payments made in liquidation of a general partner's interest in the partnership include amounts paid for the partner's share of the partnership's unrealized receivables (usually zero-basis accounts receivable) and goodwill, to the extent that the partnership agreement does not provide that payments are to be made for goodwill. I.R.C. § 736(b)(2), (3) (West 1996). Section 736(b) payments are not deductible by the partnership and generally result in capital gain to the recipient, except to the extent that I.R.C. § 751(b) applies to the transaction. Section 736(a) payments are treated either as a distributive share of partnership income or as guaranteed payments. I.R.C. § 736(a) (West 1996). If the amount of the section 736(a) payments to be made is determined with respect to partnership income (e.g., as a percentage of partnership profits), the section 736(a) payments are treated as a distributive share to the recipient, the character of which is determined according to the character of income earned by the partnership (e.g., ordinary income, capital gain or loss, or section 1231 gain or loss). I.R.C. § 736(a)(1) (West 1996). Section 736(a) payments that are treated as a distributive share shift partnership income to the recipient and away from the remaining partners, resulting in a *de facto* deduction to the remaining partners. If the amount of a section 736(a) payment is determined without regard to partnership income (usually as a fixed amount), the section 736(a) payment is treated as a guaranteed payment, resulting in ordinary income to the recipient and an ordinary deduction to the partnership that flows through to the remaining partners. I.R.C. §§ 162(a)(1), 707(c), 736(a)(2) (West 1996); Treas. Reg. § 1.707-1(c) (as amended 1983). The application of I.R.C. § 736 to the liquidation of a member's interest in an LLC for which capital is not a material income-producing factor is problematic because it is uncertain whether or under what circumstances a member of an LLC is to be considered a general partner for purposes of § 736. For a discussion of the application of § 736 to an LLC, see Kalinka, *supra* note 12, §§ 5.83-5.85. See also Steven G. Frost, "Square Peg, Meet Round Hole:" *Classifying LLC Members as "General Partners" or "Limited Partners" for Federal Tax Purposes*, 73 *Taxes* 676, 695-96 (Dec. 1995).

45. I.R.C. § 753 (West 1996) (citation added).

753 applies only to section 736(a) payments, no other partnership item should qualify as income in respect of a decedent.⁴⁶ A similar argument could be made with respect to an LLC. Currently, however, no court has adopted this analysis. Moreover, while section 753 provides that section 736(a) payments constitute income in respect of a decedent, section 753 is not necessarily the only authority that applies in determining whether partnership items or LLC items are income in respect of a decedent.

If the rights of a successor of a decedent member of an LLC to items of the LLC's income attributable to periods during the decedent's life ("income rights") are not treated as income in respect of a decedent, a section 754 election would give the successor a basis in those items equal to their fair market value at the time of the decedent's death or the alternate valuation date. In that case, the successor would not be subject to income tax when the items are realized and recognized by the LLC. It may be better, however, for the successor to treat the income rights as income in respect of a decedent. A successor of a decedent member is entitled to claim a deduction for the portion of the estate tax that was paid with respect to the items constituting income in respect of a decedent in the year in which the items are included in the successor's income.⁴⁷ The deduction may offset any adverse effects of the successor's including the items in income, regardless of whether the LLC has a section 754 election in effect. If an LLC's items of income and deduction are not treated as income in respect of a decedent, no deduction is allowable for the estate tax attributable to the fair market value of the decedent member's interest in the items.

B. Purchase of a Decedent Member's Interest

If the remaining members purchase a decedent member's interest, gain is recognized by the member's successor to the extent that the amount realized on the sale exceeds the adjusted basis of the interest on the date of the sale.⁴⁸ Loss is recognized on the sale of an interest in an LLC if and to the extent that the adjusted basis of the interest exceeds the amount realized.⁴⁹ As explained above, the adjusted basis of a decedent member's interest in an LLC is the fair market value of the interest on the date of the decedent member's death or the alternate valuation date, increased by the successor's share of the LLC's liabilities, if any, on that date, and reduced to the extent that the fair market value of the interest is attributable to items constituting income in respect of a decedent.⁵⁰ Thus, to the extent that the fair market value of a decedent member's interest in an LLC is attributable to items of income in respect of a decedent, the decedent member's successor may have to recognize gain.

46. McKee et al., *supra* note 42.

47. I.R.C. § 691(c) (West 1996).

48. I.R.C. § 1001(a) (West 1996).

49. *Id.*

50. Treas. Reg. § 1.742-1 (1960).

The character of the gain or loss recognized on the sale of an interest in an LLC is capital, except to the extent that the amount realized is attributable to the LLC's unrealized receivables or substantially appreciated inventory items.⁵¹ Any gain recognized that is attributable to the LLC's unrealized receivables or substantially appreciated inventory items is therefore ordinary.

For this purpose, unrealized receivables generally include any rights to payment for goods and services that have not previously been included in income, except that in the case of goods, the right to payment for goods is an unrealized receivable only if the sale proceeds therefrom would be treated as received in exchange for non-capital assets.⁵² The term "unrealized receivables" also includes certain recapture income and short-term obligations.⁵³

The term "inventory items" includes not only inventory but also property which, if sold by the LLC or the selling member, would be considered property other than a capital asset or section 1231 property.⁵⁴ Inventory items are substantially appreciated if the aggregate fair market value of all of the LLC's inventory items exceeds 120 percent of the aggregate adjusted basis of the inventory items in the hands of the LLC.⁵⁵ Because the definition of inventory items is broad enough to include the LLC's zero-basis unrealized receivables, the aggregation of the LLC's inventory items for purposes of the substantial appreciation computation in many cases will cause the LLC's inventory items to be substantially appreciated.⁵⁶

The character of income in respect of a decedent is the same in the hands of the decedent's successor as it would have been in the hands of the decedent if the decedent had lived and received the amount.⁵⁷ Thus, to the extent that the gain recognized by the successor of a decedent member on the sale of the decedent's interest in an LLC is attributable to items of income in respect of a decedent that represent unrealized receivables, the successor must report ordinary income. The existence of unrealized receivables also may cause the decedent's share of the LLC's inventory items to be substantially appreciated, thereby increasing the amount of ordinary income recognized on the sale of the interest.

C. Liquidation of a Decedent Member's Interest

Under section 753 of the Internal Revenue Code, the amount includible in the income of a successor in interest of a decedent member under section 736(a) is considered income in respect of a decedent. If a retired member dies before

51. I.R.C. §§ 741, 751 (West 1996). For a discussion of the tax consequences on the sale or exchange of a member's interest in an LLC, see Kalinka, *supra* note 12, §§ 5.91-5.94.

52. I.R.C. § 751(c) (West 1996).

53. *Id.* (flush language).

54. I.R.C. § 751(d)(2) (West 1996).

55. I.R.C. § 751(d)(1)(A) (West 1996).

56. See Kalinka, *supra* note 12, § 5.92, Example #2.

57. I.R.C. § 691(a)(3) (West 1996).

his or her interest in the LLC is completely liquidated, any remaining section 736(a) payments made to the member's successor constitute income in respect of a decedent.⁵⁸ Thus, the member's successor will receive no step-up in basis with respect to the section 736(a) payments and will be required to include all of the section 736(a) payments in income when they are made. The member's successor also will be entitled to claim a deduction for the portion of the estate tax paid with respect to the section 736(a) payments.

If an LLC is an LLC for which capital is not a material income-producing factor and the decedent member was considered to be a general partner, section 736(a) payments include amounts paid for the decedent's interest in the LLC's unrealized receivables and for unstated goodwill.⁵⁹ Thus, on the liquidation of a decedent member's interest in an LLC, the decedent member's successor may have income in respect of a decedent with respect to an LLC's goodwill, an item that generally does not constitute income in respect of a decedent.

If an LLC is an LLC for which capital is a material income-producing factor or if the decedent member is not considered to have been a general partner, section 736(a) payments do not include payments made for the decedent member's interest in unrealized receivables,⁶⁰ items that normally would constitute income in respect of a decedent. Instead, payments for a decedent member's interest in unrealized receivables under these circumstances are treated as section 736(b) payments.⁶¹ A literal reading of the Internal Revenue Code would treat section 736(b) payments for the decedent member's interest in the LLC's unrealized receivables as not constituting income in respect of a decedent. In other contexts, however, courts have held that amounts received by the successor of a decedent partner for the partner's interest in the partnership's unrealized receivables constitute income in respect of a decedent, regardless of whether the amounts constitute section 736(a) payments.⁶² These opinions have been discussed above. This authority may apply to the liquidation of a decedent member's interest in an LLC.

III. ALLOCATION OF PRE-DEATH INCOME

A member of an LLC includes in income the member's distributive share of the LLC's items of income, gain, loss, deduction, and credit for the LLC's taxable year ending with or within the taxable year of the member.⁶³ For example, if a member of an LLC is a calendar-year taxpayer and the LLC reports its income on

58. Treas. Reg. § 1.753-1(a) (1960).

59. I.R.C. § 736(b)(2), (3) (West 1996).

60. *Id.*

61. I.R.C. § 736(b)(1) (West 1996). See Kalinka, *supra* note 12, § 5.84.

62. See, e.g., *George Edward Quick Trust*, 54 T.C. 1336, *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971); *Chrissie H. Woodhall*, 28 T.C.M. (CCH) 1438 (1969), *aff'd*, 454 F.2d 226 (9th Cir. 1972). See also Rev. Rul. 66-325, 1966-2 C.B. 249.

63. I.R.C. § 706(a) (West 1996).

the basis of a taxable year ended January 31, the member will include in income and may deduct (if a deduction is allowed) on the member's 1996 income tax return the member's distributive share of the LLC's items of income and deduction that were earned or incurred during the period February 1, 1995 through January 31, 1996. If the member and the LLC both report their income on the basis of a calendar year, the member will include in income and deductions for 1996 the member's distributive share of the LLC's income and deductions earned or incurred during the period January 1, 1996 through December 31, 1996.

When a member dies before the end of the LLC's taxable year, there may be an issue as to whether the member's distributive share of the LLC's items of income and deduction for the LLC's taxable year in which the member dies should be reported on the decedent member's final income tax return or should be treated as income in respect of a decedent to be reported by the member's estate or other successor. The death of a member generally does not cause an LLC's taxable year to close unless the member's interest is sold or exchanged.⁶⁴ When an LLC's taxable year continues after the death of a member, the distributive share of the LLC's taxable income for the LLC's taxable year ending after the decedent's last taxable year is included in the return of the decedent member's estate or other successor in interest.⁶⁵

EXAMPLE #1: A owns a one-third interest in the ABC LLC. A is a calendar-year taxpayer. The LLC also reports its income on the basis of a calendar year. A dies on June 30, 1996. The LLC's operating agreement provides that on the death of a member, the LLC will distribute to the member's estate or other successor an amount equal to the fair market value of the member's interest on the date of the member's death. The distribution, which will liquidate the decedent member's interest, will occur within 120 days of the member's death. Because A's interest is not sold or exchanged on the date of A's death, the LLC's taxable year does not close as a result of A's death. A's taxable year, however, ends on June 30, the date of A's death. A's distributive share of the LLC's taxable income earned from January 1 through June 30 is not reported on A's final income tax return. Thus, A's unreported distributive share of the LLC's taxable income constitutes income in respect of a decedent and is reported by A's estate or other successor in interest.

The drafters of subchapter K intended to shift a member's share of an LLC's year-of-death income to the member's successor to prevent a "bunching" of income on the member's final return.⁶⁶

64. I.R.C. § 706(c) (West 1996).

65. Treas. Reg. § 1.706-1(c)(3)(ii) (1987).

66. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 67, A225-A226 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 91 (1954).

EXAMPLE #2: D is a calendar year taxpayer and a member of the DEF LLC whose taxable year ends on January 31 of each year. D dies on December 31, 1996. If an LLC's taxable year closed with respect to a member on the member's death, D would report 23 months of the LLC's income on D's final return—income for the 12-month period ending January 31, 1996, as well as income for the 11-month period ending with D's death on December 31, 1996.⁶⁷

The bunching of income problem is not as significant today as it was when subchapter K originally was enacted. Under the current rules of subchapter K, an LLC often is required to have the same taxable year as its members.⁶⁸ The shifting of income to a decedent member's successor, however, can be problematic. For example, if most of a member's income is attributable to the member's share of LLC income, the member may not have sufficient income on his or her final return to take advantage of deductions and exemptions allowable for the year.⁶⁹ The shift of income to a decedent's successor also will prevent a decedent's spouse from including the member's distributive share on a joint return if the successor is anyone other than the decedent's spouse.⁷⁰ In a community property state like Louisiana, the decedent's spouse should report on the spouse's income tax return the spouse's one-half of the distributive share of the LLC's year-of-death income.⁷¹ It may be advantageous for a decedent member's spouse also to include the decedent's half of the distributive share of the LLC's year-of-death income on a joint return in order to take advantage of deductions and exemptions allowable on the joint return as well as the more favorable income tax rates that apply to joint filers.⁷²

It is possible to ensure that a decedent's distributive share of an LLC's year-of-death income is includible on a joint return by careful planning. A member of an LLC may be able to achieve this result by naming his or her spouse as the member's successor in interest. Treasury regulations provide that a person who is designated as a partner's successor in interest under the terms of a partnership agreement will be treated as the partner's successor for income tax purposes.⁷³ The application of this rule to a member of a Louisiana LLC, however, is

67. See *Estate of Hesse v. Commissioner*, 74 T.C. 1307, 1311 n.3 (1980).

68. I.R.C. § 706(b) (West 1996). See Kalinka, *supra* note 12, § 5.4.

69. Cf. *Estate of Hesse*, 74 T.C. 1307 (decedent's distributive share of a partnership's losses were reportable by the estate, rather than by the decedent, thereby precluding the decedent from carrying back a net operating loss to prior returns).

70. *Id.*

71. *Poe v. Seaborn*, 282 U.S. 101 (1930). Cf. *Adams v. Commissioner*, 82 T.C. 563 (1984) (divorced spouse of a partner in a community property state required to report as income one-half of the partner's distributive share of partnership income attributable to the portion of the year during which the couple was married).

72. Compare I.R.C. § 1(a) (West 1996) (tax rates for a surviving spouse) with I.R.C. § 1(e) (West 1996) (tax rates for an estate).

73. Treas. Reg. § 1.706-1(c)(3)(iii) (1987).

uncertain unless the member's spouse is the member's executor, administrator, or other legal representative. As explained above, the Louisiana LLC Law provides that a deceased member's executor, administrator, or other legal representative is treated as an assignee of the member's interest.⁷⁴ The Louisiana LLC Law is silent with respect to the ability of an heir who is not a decedent member's legal representative to be treated as a successor in interest with respect to the decedent's interest in the LLC. Nevertheless, a provision in an LLC's articles of organization or an operating agreement designating a person other than a member's legal representative as the member's successor in interest should be respected under the policy of the Louisiana LLC Law to give maximum effect to the principle of freedom of contract.⁷⁵

Another way to prevent the shifting of a decedent member's distributive share of an LLC's year-of-death income to the member's successor is to include in an LLC's written operating agreement a provision that the member's interest will be purchased on the date of the member's death. The taxable year of an LLC closes with respect to a member whose entire interest is sold.⁷⁶ Treasury regulations provide that if, under the terms of an agreement existing at the date of the death of a partner, the partner's interest is sold on that date, the partnership's taxable year closes with respect to the partner, and the decedent's distributive share of partnership income or loss through the date of the partner's death is included on the partner's final tax return.⁷⁷ Presumably, this rule applies to a member of an LLC whose interest is sold on the date of the member's death if the LLC is classified as a partnership.

Care should be taken to provide that the remaining members, rather than the LLC will purchase the decedent member's interest if the objective is to prevent shifting of year-of-death income to the member's successor. If the LLC purchases the member's interest, the transaction is not a sale or exchange of the interest, but instead, constitutes a liquidation of the interest.⁷⁸ The liquidation of a decedent member's interest in an LLC does not cause the LLC's taxable year to close with respect to the decedent.⁷⁹ Thus, if a decedent member's interest in an LLC is liquidated, the decedent's distributive share of the LLC's year-of-death income must be reported by the decedent's successor in interest.

Commentators also have suggested that the income-shifting problem can be alleviated with respect to year-of-death partnership income where the decedent partner's successor is the partner's estate and the estate distributes either the partnership interest or the estate's distributive share of partnership income to the

74. La. R.S. 12:1333 (1994).

75. La. R.S. 12:1367(B) (1994).

76. I.R.C. § 706 (West 1996).

77. Treas. Reg. § 1.706-1(c)(3)(iv), (vi) Example (2) (1987).

78. *Cf. Foxman v. Commissioner*, 352 F.2d 466 (3rd Cir. 1965) (distinguishing a sale of a partnership interest from a liquidation of a partnership interest).

79. I.R.C. § 706(c)(2)(A)(ii) (West 1996).

decedent's surviving spouse.⁸⁰ This technique should be available where a member's estate is the member's successor with respect to an interest in an LLC that is classified as a partnership for federal income tax purposes. The use of this technique may not be feasible, however, because income-shifting from the member's estate will not be possible unless the estate distributes the property during a taxable year of the estate that ends both (1) concurring with, or subsequent to, the end of the LLC's taxable year in which the member's death occurs and (2) prior to, or concurrently with, the end of the spouse's taxable year in which the member's death occurs.⁸¹ It also is not certain whether this technique will apply with respect to an interest in Louisiana LLC. As explained above, it is not certain whether anyone other than a decedent member's legal representative may be considered a successor in interest of a decedent member's interest in a Louisiana LLC. Accordingly, it is not certain under the Louisiana LLC Law whether an estate may be a decedent member's successor with respect to the decedent's interest in an LLC.

80. McKee et al., *supra* note 42, at ¶ 23.01[2][a].

81. The same timing is necessary with respect to distributions from a partner's estate to the partner's surviving spouse. *Id.*

