Orrisch v. Commissioner, 55 T. C. 395 (1970)

A partnership's special allocation of depreciation deductions to one partner will be disregarded if its principal purpose is tax avoidance.

Summary

In Orrisch v. Commissioner, the Tax Court ruled that a special allocation of all partnership depreciation deductions to the Orrisches, while equalizing other income and expenses, was primarily for tax avoidance under IRC section 704(b). The partners, Orrisch and Crisafi, had initially shared profits and losses equally in their real estate venture. However, an amendment allocated all depreciation to Orrisch, who had taxable income to offset, while Crisafi had no taxable income. The court found no substantial economic effect from this allocation, as it would not alter the partners' economic shares upon dissolution, only their tax liabilities. Thus, the court upheld the Commissioner's determination to allocate depreciation equally between the partners.

Facts

In May 1963, Stanley and Gerta Orrisch formed a partnership with Domonick and Elaine Crisafi to purchase and operate two apartment buildings. Initially, profits and losses were to be shared equally. In early 1966, the partners amended their agreement to allocate all depreciation deductions to the Orrisches, with other income and expenses still shared equally. The Orrisches had taxable income from other sources that could be offset by these deductions, while the Crisafis had no taxable income due to other real estate losses. The agreement also stipulated that upon sale, any gain attributable to the specially allocated depreciation would be charged back to the Orrisches' capital account, and they would pay the tax on that gain.

Procedural History

The Commissioner determined deficiencies in the Orrisches' income tax for 1966 and 1967 due to the special allocation of depreciation. The Orrisches petitioned the U. S. Tax Court, arguing that the allocation was valid under IRC section 704(a) and had economic effect. The Tax Court heard the case and ruled in favor of the Commissioner, finding that the principal purpose of the allocation was tax avoidance under IRC section 704(b).

Issue(s)

1. Whether the special allocation of all partnership depreciation deductions to the Orrisches, while maintaining an equal split of other income and expenses, was made for the principal purpose of tax avoidance under IRC section 704(b).

Holding

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1. Yes, because the allocation was primarily designed to minimize the partners' overall tax liabilities without any substantial economic effect on their shares of partnership income or loss apart from tax consequences.

Court's Reasoning

The court applied IRC section 704(b), which disregards special allocations if their principal purpose is tax avoidance. The court considered factors such as the business purpose of the allocation, its economic effect, and the overall tax consequences. The court found that the allocation was adopted after the partners could reasonably estimate the tax effect, and it only affected the Orrisches' tax liabilities due to their other income, while the Crisafis benefited by avoiding capital gains tax. The court rejected the Orrisches' argument that the allocation equalized capital accounts, noting that it would create a greater imbalance. The court also found no evidence that the allocation would affect the partners' economic shares upon dissolution, concluding that it lacked substantial economic effect apart from tax consequences.

Practical Implications

This decision emphasizes that partnership agreements must have a business purpose beyond tax avoidance to be upheld. Practitioners should ensure that special allocations reflect the economic realities of the partnership and not merely shift tax liabilities. The case highlights the importance of documenting the business rationale for any special allocations. Subsequent cases like Jean V. Kresser have applied this principle, reinforcing the need for economic substance in partnership agreements. For businesses, this ruling suggests that tax planning through partnership agreements should be carefully structured to withstand scrutiny under section 704(b).

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