Insuring that special allocations of partnership income and loss are recognized

The tax advantages available by special allocations of a partnership's tax items to the partners most able to benefit from them will be lost unless the allocations possess substantial economic effect. Here's how to plan such allocations to avoid an IRS challenge.

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A PARTNER'S DISTRIBUTIVE share of partnership tax items (*i.e.,* those described in Section 704(a) and reported on the partners' individual tax returns) is determined by the partnership agreement subject to two exceptions. Thus, partners have flexibility in determining the nature, amount and timing of partnership tax items to be allocated among themselves. There is no requirement, for example, that a partner who basically wants a 50% "interest" in a partnership be allocated 50% of every item of gross income, 50% of all gain, 50% of all losses and 50% of every deduction. The minor exception, contained in Section 704(b)(1), is that if a partnership agreement is silent on the subject of a partner's distributive share, then it will be determined in accordance with the partner's overall "interest" in the partnership based upon all the facts and circumstances. The major exception, contained in Section 704(b)(2), is that allocations in the partnership agreement control unless such allocations lack "substantial economic effect," a key concept which will be explored in greater detail below.

Special allocations

The phrase a "special allocation" of a partnership tax item does not appear in the Code, although it is in the Regulations.[1] To most practitioners, it describes any disproportionate allocation of a partnership tax item to a partner, generally an allocation that does not match a partner's bottom-line (residual) interest in net income or net loss. A perfect definition is not necessary, however, because the substantial economic effect test of Section 704(b)(2) applies not only to special allocations but to all allocations except, perhaps, allocations that are dealt with separately by Sections 704(c)(2), (3).

A simple test can determine whether a partnership agreement contains allocations that may not pass muster under Section 704(b)(2). The test looks to each partner's total economic interest in a partnership, an interest composed of various interests in partnership capital, income, losses and distributions. If a partner's proportionate interest in each of these four items is not identical in each taxable year of the partnership, then, without suitable refinement, the tax allocations contained in the partnership agreement may lack substantial economic effect. This means that the only kinds of partnership agreements that are safe without further analysis are those in which each partner has an unvarying, identical percentage or fixed dollar interest in capital, income, losses and distributions. Not only are such perfectly matching allocations relatively uncommon in all but the simplest general partnership agreements; even if possible, they are unlikely to produce best results.

Certain allocations are easy to identify as allocations that require special attention to Section 704(b)(2): special allocations of particular deductions, net losses, net income and items comprising gross income. Other features in a partnership agreement that may cause problems under Section 704(b)(2) are less readily apparent, *e.g.,* distributions that do not match the allocation of income giving rise to the income distributed or distributions made to a partner that do not correspond to his interest in contributed capital.

Substantial economic effect

The touchstone for determining whether an allocation possesses substantial economic effect under

Section 704(b)(2) is whether the tax allocation may actually affect the partners' shares of total partnership economic income or loss independently of its tax consequences. In other words, tax allocations must affect dollars to be made or lost in the partnership, not vice versa.[2] Prior to its amendment by the Tax Reform Act of 1976 (TRA '76), Section 704(b) provided that allocations would be governed by the partnership agreement unless it were silent or unless the principal purpose of the allocation were tax avoidance or evasion. Regulation 1.704-1(b)(2), which has not been amended to reflect the amendment of Section 704(b)(2), lists factors that are relevant in determining the presence or absence of tax avoidance, and one is whether the allocation possesses substantial economic effect. It is unclear what continuing role, if any, factors other than substantial economic effect will have under new Section 704(b)(2). Notwithstanding a suggestion in the legislative history of TRA '76 that the other factors may still have some vitality,[3] given the specific replacement of the old multifaceted tax avoidance test by the substantial economic effect test, one can argue reasonably that the latter should now be the exclusive test. Not only is this what the statute says; it is difficult to imagine an egregious allocation, one fully worthy of invalidation, that would pass the substantial economic effect test of Section 704 and withstand the attack under various other provisions of the Code. In any case, there is no longer any doubt that Section 704(b)(2) applies in determining the validity of "bottom-line" allocations (allocations of net income and net loss) as well as the validity of allocations of items of gross income and deductions, an issue that was not clear under the provisions of prior law.[4]

Whether a tax allocation may actually affect dollars to be received from a partnership independent of the tax consequences, and whether the allocation possesses substantial economic effect, can be determined by reference to a partner's capital account. A capital account is a bookkeeping account maintained by the partnership for each partner that measures each partner's adjusted investment in the partnership at any given moment, *i.e.*, the amount he should receive from the partnership upon distribution of its assets in liquidation. A properly-computed capital account should be credited with a partner's contributions to partnership capital and partnership income allocated to him and debited with partnership deductions allocated to him and distributions made to him. Thus, the computation of a partner's capital account is similar to the computation of the adjusted basis of his partnership interest under Section 705(a), except that a partner's capital account, unlike the basis of his partnership interest, does not reflect any increase or decrease in his deemed share of partnership liabilities under Section 752.

Court decisions

Two leading cases demonstrate the relationship between substantial economic effect and a partner's capital account. *Orrisch*[5] illustrates an allocation utterly lacking substantial economic effect. In *Orrisch* the partnership agreement was amended to give 100% of all depreciation deductions to the taxpayer. To compensate for this special allocation, the agreement also provided that all of the gain upon disposition of the depreciable property, to the extent of the extra depreciation allocated to the taxpayer, would first be allocated or "charged back" to him. Because these two allocations had no effect whatever on the taxpayer's original, unchanged right to receive a 50% share of the partnership's assets and economic income, the Tax Court refused to recognize the special allocation of depreciation. The factual situation in *Harris,*[6] on the other hand, illustrates a valid special allocation that possessed real economic effect. In *Harris,* the original partnership agreement provided that the taxpayer owned a 40% interest in partnership capital and, based thereon, a 40% interest in partnership income and losses. The partnership agreement was then amended to allocate to him 100% of the tax losses and cash proceeds attributable to the sale of certain property, but the amendment also provided that tax losses specially allocated to him would reduce his capital account and, thus, his interest in future income, losses and distributions. Because the special allocation of losses could produce a corresponding economic loss, the allocation was sustained.

The lesson of *Orrisch* and *Harris* is that an allocation will possess substantial economic effect if the allocation of income (or an income item) or loss (or deduction) is reflected as an increase or decrease in a partner's capital account and final distributions to the partner are made in accordance with his adjusted capital account balance. The Service explicitly endorsed this test in *Ltr. Rul.* 8008054 in which it stated, "substantial economic effect has been found where all allocations of items of income, gain, loss, deduction or credit increase or decrease the respective capital accounts of the partners and distribution

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of assets made upon liquidation is made in accordance with capital accounts. . . ." The reason, of course, that the capital account approach works is that by adjusting capital accounts to reflect tax allocations and by distributing partnership assets in accordance with adjusted capital account balances, the tax allocations actually can affect the partners' share of economic income or loss of the partnership.

An illustration

The foregoing principles can be illustrated by the following example, which involves a special allocation of 100% of the deduction for depreciation in a real estate partnership to the limited partner in a simple, two-man limited partnership.

	General Partner	*Limited Partner*
Capital contribution	$500	$500
Gross income	50%	50%
Deductions, excluding depreciation	50%	50%
Depreciation	0%	100%
Distributions	50%	50%

The partnership uses its $1,000 capital to purchase a depreciable building. In its first year, partnership gross income is $100, nondepreciation deductions are $100, and depreciation is $50. At the end of the first year, the partners' capital accounts are as follows:

	Partnership	*General Partner*	*Limited Partner*
Capital contribution	$1,000	$500	$500
Gross income	100	50	50
Depreciation	(50)	—	(50)
Other deductions	(100)	(50)	(50)
Adjusted capital accounts	$ 950	$500	$450

Because 100% of the depreciation has been allocated to the limited partner, the limited partner must bear the burden of any economic decline in the value of the building up to the first $50, the amount of depreciation specially allocated to him, for this allocation to have substantial economic effect. Thus, if the value of the building declines to $950 and the building is then sold at basis for no gain or loss, the sales proceeds should be distributed to the general partner and the limited partner in accordance with their adjusted capital account balances: $500 to the general partner, $450 to the limited partner. Thus, in this case, the special allocation of a $50 depreciation deduction to the limited partner has actually affected the dollar amount of partnership assets received by him upon liquidation.

	Partnership	*General Partner*	*Limited Partner*
Gain on sale	$ 0	$ 0	$ 0
Distribution of sale proceeds	(950)	(500)	(450)
Adjusted capital accounts	$ 0	$ 0	$ 0

If, however, final cash proceeds were distributed $475 to each partner irrespective of the prior special allocation of depreciation to the limited partner, then the depreciation allocation would lack substantial economic effect because both partners would have shared equally the $50 economic loss even though the limited partner had already been allocated 100% of the corresponding tax deduction. It was this kind of special allocation of depreciation, which can have no effect other than a tax effect, that was held invalid in *Orrisch*. Note the effect of the 50-50 distribution on the partners' capital accounts:

	Partnership	*General Partner*	*Limited Partner*
Capital accounts prior to sale	$950	$500	$450
Gain on sale	0	0	0
Distribution of sale proceeds	(950)	(475)	(475)
Adjusted capital accounts	$ 0	$ 25	($ 25)

Because of the 50-50 final distribution, the general partner is left with a positive $25 capital account balance and the limited partner with a negative $25 capital account balance. From a combined economic and tax standpoint, this means that the general partner has invested $25 more in the partnership than he has received from it, and vice versa for the limited partner.

Any time that the allocations contained in a partnership agreement do not leave all partners with zero capital account balances when the partnership is liquidated, the allocations probably will fail the special economic effect test. Thus, not only is the use of capital accounts a convenient approach for structuring partnership allocations so as to pass the substantial economic effect test; it is also a simple, accurate way in which to check whether existing allocations comply with Section 704(b)(2). All the practitioner need do is assume that immediately after giving effect to each tax allocation individually, all of the partnership's assets are sold at their adjusted bases for cash; the partnership is terminated; and it dis-

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[1] See Regs. 1.46-3(f)(2)(ii), 1.50B-4(a)(3)(ii), 1.702-1(a)(8) and 1.704-1(b)(2).
[2] S. Rep't No. 938, 94th Cong., 2d Sess. 100 (1976); *Harris, Jr.*, 61 TC 770 (1974); *Orrisch*, 55 TC 395 (1970), *aff'd per cur.*, 31 AFTR2d 73-1069 (CA-9, 1973). See also *Kresser*, 54 TC 1621 (1970).
[3] S. Rep't No. 938, *supra* at 100.
[4] S. Rep't No. 938, *supra* note 2 at 99. But see *Boynton*, 72 TC 1147 (1979); *Holladay*, 72 TC 571 (1979); and *Kresser*, *supra* note 2.
[5] *Supra* note 2.
[6] *Supra* note 2.
[7] See, *e.g.*, Reg. 1.721-1(b)(1); *Frazell*, 339 F.2d 885, 65-1 USTC ¶9125, 14 AFTR2d 6119 (CA-5, 1969). Compare Section 704(e)(1).
[8] *Park Cities Corp. v. Byrd*, 534 S.W.2d 668 (Tex. 1976).
[9] Uniform Limited Partnership Act, Sections 16 and 17.
[10] See McKee, *Fed. Tax. of Partnerships and Partners*, ¶10.02(2).
[11] Caruthers, "Real Estate Tax Shelters: Special and Retroactive Allocations under the Tax Reform Act of 1976," 4 *Journal of Real Estate Taxation* 119 (1977).
[12] Regs. 1.46-3(f)(2); 1.50B-4(a)(3)(ii).
[13] *Estate of Franklin*, 544 F.2d 1045, 76-2 USTC ¶9773, 38 AFTR2d 76-6164 (CA-9, 1976); *Beck*, 74 TC No. 109; *Narver*, 75 TC No. 6; *Rev. Rul.* 78-29, 1978-1 CB 62.
[14] S. Rep't No. 938, *supra* note 2 at 100.
[15] *Orrisch*, *supra* note 2; *Kresser*, *supra* note 2; *Holladay*, *supra* note 4.

tributes all of its assets in liquidation to the partners in accordance with the provisions of the partnership agreement. If all partners' final capital account balances do not equal zero, then either one or more of the tax allocations is invalid or, if the discrepancy is not the result of any tax allocation, one or more partners have previously obtained a vested interest in capital contributed by another partner, an event which may by itself be taxable.[7]

Gain chargebacks

It should now be clear that one of the unavoidable requirements for insuring that allocations possess substantial economic effect is distribution of liquidation proceeds to each partner in accordance with his adjusted capital account balances rather than according to a predetermined amount or percentage. As *Harris* illustrates, if a disproportionately large share of losses or deductions has been allocated to one partner, distribution of liquidation proceeds in accordance with adjusted capital accounts will, without any further refinement, give the allocation substantial economic effect. But substantial economic effect achieved the *Harris* way can be expensive: if there is an actual economic loss, the result will be to deprive a partner of $1 of distributable cash for every dollar of additional deductions he has been allocated, a result that is not a good economic bargain until the tax rates exceed 100%. Therefore, it is common for partnership agreements containing special allocations of depreciation or net losses to specially allocate a commensurate share of gain or other income first to the partner who received the special allocation, a chargeback that generally occurs upon disposition of partnership property or termination of the partnership. This way the partner may be able to pay for the prior special allocation of deductions or losses with additional future taxable income, and not necessarily dollars, as the following example indicates.

Example. Assume the same facts as in the example above except that at the beginning of year two, the building is sold for $1,000 instead of $950, producing a gain of $50. If the partnership agreement provides merely that liquidation proceeds will be distributed in accordance with the partners' adjusted capital accounts, the following result will occur.

	Partnership	*General Partner*	*Limited Partner*
Capital accounts prior to sale	$ 950	$500	$450
Gain on sale	50	25	25
Distribution of sales proceeds	(1,000)	(525)	(475)
Adjusted capital accounts	$ 0	$ 0	$ 0

In this case, the limited partner in effect has exchanged $25 cash for $25 additional depreciation deductions. It would be better from the limited partner's standpoint if gain upon sale were first allocated to him or her to the extent of previously allocated depreciation deductions, *i.e.,* $50. Then, with final distributions once again made in accordance with the partners' adjusted capital account balances, the result would be as follows:

	Partnership	*General Partner*	*Limited Partner*
Capital accounts prior to sale	$ 950	$500	$450
Gain on sale	50	0	50
Distribution of sales proceeds	(1,000)	(500)	(500)
Adjusted capital accounts	$ 0	$ 0	$ 0

Such "chargebacks" of gain are relatively common in partnership agreements. However, the lesson of *Orrisch* cannot be overemphasized: a mirror chargeback of gain or loss, as the case may be, does nothing by itself to enable a prior allocation to satisfy the substantial economic effect test of Section 704(b)(2). The critical element of the Section 704(b)(2) equation is not the chargeback but the provision in the partnership agreement that mandates final distributions in accordance with adjusted capital account balances, whatever they happen to be. If under the partnership agreement final distributions are instead a fixed dollar amount or fixed percentage of total distributions and the tax allocations are simply adjusted to produce that preordained result, then the allocations will be invalid.

Negative capital accounts

Because a partner's basis in his partnership interest, unlike his capital account, reflects his share of changes in partnership liabilities under Section 752, it is quite possible for a partner to possess simultaneously a negative capital account and a positive basis in his partnership interest. A negative capital account will occur if the sum of distributions to a partner and losses and deductions allocated to him exceeds the sum of his capital contributions and partnership income allocated to him, in other words, if he takes more out of the partnership in the form of distributions and losses than he has invested in it in the way of capital and income.

It is not entirely clear whether, as a matter of partnership law, a general partner with a deficit capital account balance upon liquidation of the partnership is required to restore the deficit to the partnership. Such a requirement may be implicit in Section 18(a) of the Uniform Partnership Act, which requires each partner to make good partnership losses

according to his share of the profits, a principle which presumably extends to the restoration of losses or deductions specially allocated to him. However, whatever their obligations under general partnership law, partners can provide for a different result in the agreement and eliminate any partner's obligation to restore a deficit capital account balance. Just how stiff such an obligation can be is illustrated in a recent case in which the Texas Supreme Court held that the estate of a deceased general partner was obligated to restore to the partnership in cash a deficit capital account balance of approximately $2 million even though that deficit was attributable entirely to a special allocation of 100% of depreciation to the general partner in the partnership agreement.[8]

The rules governing the obligation of limited partners to restore deficit capital account balances are slightly different. Under certain circumstances, limited partners will be liable to restore deficits to the extent attributable to distributions of cash or property, but they are not obligated to restore deficits attributable to allocations of deductions or allocations of losses.[9]

We have seen now that allocations will lack substantial economic effect unless, at the very least, liquidation proceeds are distributed in accordance with final adjusted positive account balances. A far more difficult question is whether substantial economic effect also requires that a partnership agreement compel partners who are left with a deficit capital account upon termination and liquidation of the partnership to restore the deficit in cash to the partnership. One commentator takes the position that in the absence of nonrecourse liabilities, any allocation that creates or increases a deficit capital account will lack substantial economic effect unless upon termination and liquidation of a partnership, a partner with such an account is required to restore the deficit to the partnership.[10] The argument is straightforward and appealing. In the absence of such an obligation, a partner whose final capital account balance is negative because of excess losses or deductions allocated to him will have taken a tax loss but will not have borne the associated economic loss. Similarly, a partner whose final capital account balance is negative because he has received excess income distributions will have received more in the way of economic income than he properly was entitled to receive, given the taxable income allocated to him.

All of this is true, but the assumption underlying the argument seems to be that if under any circumstances a partner can be left with a negative capital account, "substantial economic effect" requires restoration of the deficit balance. Because such a requirement will inevitably cause all prior tax allocations to affect a partner's share of the partnership's economic income or loss in all circumstances, it appears that mandatory restoration of deficit capital account balances assumes that "substantial" economic effect really means "total" or "complete" economic effect.

Another commentator suggests that the standard may be less rigorous and that a combination of less onerous provisions in a partnership agreement may suffice.[11] One of these provisions is a chargeback of gain, like that in *Orrisch,* which is intended to restore a partner's capital account balance roughly to where it would have been but for the prior tax allocations. By itself, as we have seen, such a chargeback will do nothing to achieve substantial economic effect. But a chargeback followed by final distributions in accordance with adjusted positive capital accounts may be sufficient to achieve substantial economic effect without requiring, in addition, the restoration of deficit capital accounts. Whether this is true depends upon the interpretation of "substantial." Whatever it means, it must mean something less than "complete" or "perfect." In defining "substantial economic effect," both the Senate Finance Committee Report accompanying the 1976 Act and pre-1976 Reg. 1.704-1(b)(2) state that the test is whether the tax allocation in question "*may* actually affect" the partners' shares of income or loss irrespective of the tax consequences. Until there is more explicit authority, it seems reasonable to read amended Section 704(b)(2) as sanctioning tax allocations that are likely to affect a partner's economic income or loss from the partnership. By this standard, an income chargeback to a partner who has been allocated excess deductions or losses, followed by proper liquidating distributions, should suffice as producing "substantial," albeit not necessarily perfect, economic effect even without a restoration provision as long as it is reasonably likely that there will be sufficient income to allocate to deficit account partners to restore their accounts at least to zero. This usually will be the case if a deficit capital account is the result of deductions like depreciation, particularly leveraged deductions, that tend to produce corresponding future gain. It may not be the case, however, if a deficit capital account is attributable to distributions that are disproportionately large in view of the income allocated to the distributee. In these circumstances, it is by no means certain that there ever will be sufficient income to allocate to eliminate the deficit, and one should never bootstrap his income chargeback provisions into success by assuming that there will always be sufficient income to allocate to restore all deficit capital accounts at least to zero. Rather, he should always

assume that each partnership asset is disposed of at its adjusted basis and that the remaining assets of the partnership are distributed in accordance with the partnership agreement.

Nonrecourse borrowing

Partnerships that employ nonrecourse borrowing present a special case because no partner can suffer any economic (as opposed to tax) detriment if the nonrecourse loan is not repaid. The lender's sole remedy on default is against the property securing the nonrecourse loan, and if the economic value of the security has declined, it is the lender and not the borrower who will suffer the economic detriment. Consequently, one might argue that under Section 704(b)(2), any tax allocation that is affected by nonrecourse borrowing, which by its very nature produces only tax consequences, will lack substantial economic effect. There are two problems, however, with this line of reasoning. First, it ignores the full scope of Section 704(b), which specifically covers the allocation of tax credits, items which have no effect other than a tax effect, and the Regulations specifying how certain credits are allocated among partners.[12] Second, deductions based on nonrecourse borrowing will produce an economic effect assuming the loan is repaid, because the source of repayment will be either future economic income or capital, which otherwise would be available for distribution to the partners. What is more, this important assumption must be made. If it cannot be, the loan will be deemed a contingent obligation; it will not be includable in the basis of property acquired with the proceeds of the loan;[13] and the allocation problem at hand will disappear. There will be, of course, situations in which the nonrecourse loan is not repaid, and in such cases the only detriment that the borrowing partnership may incur is the recognition of gain upon disposition of the encumbered property. In this case, economic effect is impossible, but fairness to the other partners dictates that the partners who were allocated deductions attributable to the nonrecourse borrowing be allocated a commensurate amount of the resulting taxable gain. If such a gain chargeback is accompanied by a provision mandating final distributions in accordance with adjusted capital accounts, then the partnership has done the most it possibly could to satisfy the substantial economic effect test, and the allocation based upon the nonrecourse financing should be respected. The following example illustrates how a special allocation of depreciation would operate in the case of a partnership that purchases depreciable real property with the proceeds of nonrecourse borrowing.

Example. Assume same facts as in the examples above, but the partnership uses $1,000 capital plus the proceeds of a $19,000 interest-only nonrecourse loan to purchase a $20,000 depreciable building. First year depreciation of $1,000 is allocated entirely to the limited partner. At the beginning of year two, the building is sold for $22,000, producing a gain of $3,000 and net distributable cash of $3,000 after repayment of the $19,000 loan. For the purposes of simplicity, operating income and nondepreciation deductions, which are assumed to offset each other, are excluded. Just prior to sale, the partners' capital accounts will be as follows:

	Partnership	*General Partner*	*Limited Partner*
Capital accounts	$1,000	$500	$ 500
Depreciation	(1,000)	(0)	(1,000)
Adjusted capital accounts	$ 0	$500	($ 500)

The basis of the limited partner's interest is $9,000 even though there is $500 negative capital account, because the basis includes the partner's one-half share of the $19,000 nonrecourse liability. Thus, under the provisions of Section 704(d), the limited partner has been able to deduct partnership losses that have exceeded the actual cash investment that he originally made in the partnership.

In this situation, gain upon disposition of the building first should be allocated to the limited partner to eradicate the $500 deficit balance in the capital account. The remainder of the gain may be allocated between the partners in whatever proportions they agree to as long as final distributions are made in accordance with their adjusted positive capital account balances computed after the gain allocations. If the partners wish to justify what they hope will be a 50-50 distribution of final cash proceeds, then an additional $500 gain must be allocated to the limited partner to equalize the partners' capital accounts before residual gain of $2,000 is allocated 50-50. The result will be as follows:

	Partnership	*General Partner*	*Limited Partner*
Capital accounts prior to sale	$ 0	$ 500	($ 500)
Gain upon sale	3,000		
a. Restoration of limited partner's negative capital account		0	500
b. Equalization of partners' capital accounts		0	500
c. Residual gain		1,000	1,000
Distribution of net sales proceeds	(3,000)	(1,500)	(1,500)
Adjusted capital accounts	$ 0	$ 0	$ 0

If, however, all gain were allocated 50-50 and final cash distributed 50-50, the special allocation of depreciation to the limited partner would lack sub-

stantial economic effect, as the partners' final capital accounts would indicate:

	Partnership	General Partner	Limited Partner
Capital accounts prior to sale	$ 0	$ 500	($ 500)
Gain upon sale	3,000	1,500	1,500
Distributions of net sales proceeds	(3,000)	(1,500)	(1,500)
Adjusted capital accounts	$ 0	$ 500	($ 500)

Invalid allocations

If a partnership agreement fails to specify a partner's distributive share of partnership tax items, or if an allocation lacks substantial economic effect, then under Section 704(b) it will be disregarded, and a partner's distributive share of partnership tax items will be "determined in accordance with . . . [the partner's] interest in the partnership (determined by taking into account all facts and circumstances)." The Senate Report accompanying the 1976 Tax Reform Act provides that relevant factors to be taken into account include the partner's interests in profits and losses if different from that of taxable income or loss, cash flow and his rights to distributions upon liquidation.[14] Thus, what appears to determine the proper allocation is the partner's overall economic interest in the partnership: the money invested, the partner's share of the money earned or lost, and the money the partner is entitled to receive. The approach taken by those cases which invalidate allocations has been to ignore the invalid allocation entirely and to treat the partner as having been allocated what would otherwise have been the partner's distributive share of the tax item in question.[15] Ironically, that which invalidates an allocation is the mechanism for redefining an invalid allocation. The valid one determines, and is not determined by, a partner's share of the partnership's economic income or loss. However, it is the partner's share of the partnership's economic income or loss and capital that redefines the invalid allocation.

Some of the more interesting techniques of using special allocations and their attendant risks will be discussed in the second half of this article, which will appear in the next issue. ★

No estate taxes on insurance payable to decedent's trust

INSURANCE PROCEEDS escaped inclusion in an estate where a revocable trust created by the decedent was the policy beneficiary. So held the Eighth Circuit recently, affirming a Tax Court decision issued over seven dissents, in *Estate of Margrave,* 618 F.2d 34, 80-1 USTC ¶13,346, 45 AFTR2d 80-1787 (CA-8, 1980), *aff'g* 71 TC 13 (1978). Despite the affirmance by the Eighth Circuit, the case remains an illustration of faulty estate planning. (See *Naming insured's trust as beneficiary is questionable,* 7 TL 308 (March/April).)

In 1970, the decedent's wife acquired insurance on his life. She possessed all ownership rights in the policy and paid the premiums out of her own funds. However, she designated as beneficiary of the policy, the trustee of a revocable trust which the decedent created earlier.

The Service argued that the decedent's right to revoke or modify the trust constituted either an "incident of ownership" in the policy or a general power of appointment. Under Sections 2042(2) and 2041, respectively, either would cause the proceeds to be included in the estate.

The Eighth Circuit agreed with the Tax Court majority that, at the time of the decedent's death, the trustee possessed a "mere expectancy" as to the insurance proceeds. The decedent's wife could have changed the beneficiary designation at any time. The court refused to find a power over a mere expectancy to constitute an "incident of ownership." The case was distinguished from Fifth Circuit cases such as *Terriberry,* 517 F.2d 286, 75-2 USTC ¶13,088, 36 AFTR2d 75-1635 (CA-5, 1975), in which the policy itself was part of the trust corpus and the decedent was the trustee.

Similarly, both courts conceded that the decedent possessed a general power of appointment over the trust corpus, but held that it did not attach to a property interest. Again, only an "expectancy" was involved. Accordingly, the proceeds were not includable in the decedent's estate.

Clearly, the arrangement is flawed from several standpoints. First, although in this instance the Tax Court dismissed in a footnote the possibility that the decedent and his wife "prearranged" the disposition of the proceeds, such an assertion could be raised by the Service in the future. If upheld, the wife's powers would be attributed to the decedent.

Second, there may be adverse gift tax consequences to the decedent's wife. Under *Goodman,* 156 F.2d 218, 46-1 USTC ¶10,275, 34 AFTR 1534 (CA-2, 1946), an owner of an insurance policy (other than the insured) is deemed to make a gift at the insured's death of the proceeds payable to a third party.

The proper approach would be to name the wife (or the trustee of her own revocable trust) as the beneficiary of the policy when it is purchased. Gift taxes and IRS attacks would then be precluded. ★