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Choice of Entities for Holding Real Estate: Partnerships

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CHOICES OF ENTITIES FOR HOLDING REAL ESTATE: PARTNERSHIPS

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The widespread utilization in recent years of the partnership form for holding real estate has been attributable to a beneficient combination of local and federal income tax laws. In earlier, simpler days, title to real estate beneficially owned by groups of individuals was more likely to be vested in a corporation or some form of trust. The primary reason for the conveyancer's preference for corporate or trust ownership of record title, as opposed to vesting title in multiple owners as tenants-in-common or as partners, was the increased ease and certainty of dealing with real property title complexities where title to the real property was vested in a separate entity (i.e., a corporation or trustee) insulated from the infirmities which might affect individual owners, such as the death, bankruptcy or incompetency of one or more of them.

While the corporate or trust form retains these advantages, the increasing burden of income taxation upon the ownership of all investment property and, particularly upon corporate investments, has induced the real property lawyers to search for alternatives to corporate and trust ownership which satisfy both the requirements of the practical conveyancer and at the same time ameliorate the tax burdens imposed upon corporations.

Through a series of sometimes unexpected developments, the real property lawyer has been rewarded in this quest beyond what was probably anyone's reasonable expectation. Almost universal adoption of the Uniform Partnership Act[1] and the Uniform Limited Partnership Act[2] throughout the United States has simplified the problem of holding title to real property and insulating such title from infirmities which may affect most, if not all, of the participants. At the same time, the Treasury Department, by the adoption in 1960 of the so-called Kintner Regulations,[3] substantially expanded the scope of enterprises theretofore treated as partnerships for federal income tax purposes, and virtually invited the real estate community not only to avoid corporate taxation but to mass merchandise tax losses.

We are all familiar with the results; a succession of tax reform legislation has been introduced throughout the 1960's and 1970's but the essential break in the dike, i.e., the Kintner Regulations, has not been mended.[4]

1 The Uniform Partnership Act has been enacted in all states and the District of Columbia, other than Georgia and Louisiana.

2 The Uniform Limited Partnership Act has been enacted in all states and the District of Columbia, other than Louisiana.

3 Reg. § 301.7701-2.

4 The Internal Revenue Service issued proposed amendments to the Regulations on January 5, 1977 which were withdrawn by the Secretary of the Treasury the day after their publication in the Federal Register.

Under these circumstances, it is reasonable to assume that absent any substantial changes in applicable law, the partnership form will remain an advantageous form for holding title to real property on behalf of multiple individual investors. The reasons for the popularity of the partnership form may be summarized as follows:

Non-tax Considerations

Under the Uniform Partnership Act, a partnership (general or limited) may hold legal title to real property in the name of the partnership.[5] If it does so, title may be conveyed or encumbered in the partnership name upon the signature of one or more of the general partners so authorized without the requirement for other signatures.[6]

Most importantly, under the Uniform Partnership Act, a partner's interest in the partnership is personal property.[7] A partner has no direct interest in partnership assets,[8] including partnership real property, and while the death, retirement, insanity or bankruptcy or a general partner may dissolve the partnership,[9] title to any real property vested in the partnership name remains unaffected.[10] In addition, if a limited partnership is utilized, infirmities affecting a limited partner need not affect the continuation of the partnership and the limited partnership may even be continued without dissolution upon the retirement, death or insanity of a general partner if the remaining general partners agree to continue the partnership pursuant to a right to do so set forth in the Certificate of Limited Partnership.[11]

While the general partnership exposes its members to personal liability for unpaid partnership debts, a limitation of liabiltiy for such debts is accorded to limited partners in a limited partnership properly organized and operated in accordance with the Uniform Limited Partnership Act.[12] Exposure of the general partners in a limited partnership to personal liability for partnership debts may be limited by the utilization of nonrecourse agreements, insurance and, ultimately, by the use of a corporate general partner.[13]

An important distinction between partners and stockholders is the respective relationships among themselves. While the relationship among limited partners, inter se, is comparable to that among stockholders, general partners are mutual agents in the conduct of the partnership business and within the scope of their apparent authority general partners may

[5] U.P.A. § 8(3).
[6] U.P.A. § 10(1).
[7] U.P.A. § 26; *cf.* U.L.P.A. § 18.
[8] *Cf.* U.L.P.A. § 18.
[9] *Cf.* U.L.P.A. §§ 29, 31.
[10] *Cf.* U.L.P.A.; 30.
[11] U.L.P.A. § 20.
[12] U.L.P.A. § 7.
[13] *See, e.g.,* Rev. Proc. 72-13, 1972-1 C.B. 735.

bind each other to third parties.[14] In limited cases, this may extend to liability for torts committed by a partner while acting in the course of the business of the partnership.[15] The obvious conclusion is that one should be even more careful in joining as a general partner with others than in sharing a common interest in a corporate enterprise. By limiting the number of participants who need to be in the general partner relationship, a limited partnership, with most of the participants holding only interests as limited partners, substantially minimizes this problem (and most others associated with the vulnerability of general partners). However, it should be remembered that protection from partnership liabilities may be lost by a limited partner if he "takes part in the control of the business."[16] Also, where limited partners are involved, general partners owe them a fiduciary duty as well as to each other,[17] and general partners in a limited partnership are subject to more restrictive statutory rules than those imposed upon partnerships without limited partners.[18]

As indicated above, while the partnership does not enjoy the automatic continuity of existence implicit in most corporate and trust arrangements, a high degree of practical continuity can be achieved in partnerships organized under the Uniform Acts, particularly in the case of limited partnerships, where properly drafted agreements permit remaining general partners to continue the partnership business even after an event which would otherwise result in dissolution of the partnership. However, participants in partnerships must realize that any general partner has the power to dissolve the partnership at any time, even in breach of the partnership agreement.[19] This power to force a dissolution may be of particular significance if conflicts of interest arise between general partners, for example, where one partner may have a substantially different tax basis for his interest in the partnership as a consequence of having acquired such interest by purchase or inheritance.[20]

While transferability of partnership interests is somewhat inhibited by the inability of a transferee to ascertain good title to the transferred interests with the same degree of certainty as is available in connection with the acquisition of a share of corporate stock, inherently closely-held enterprises, not requiring access to large public capital markets, can achieve sufficient marketability for their interests in partnership form to satisfy their requirements. Transfers of partnership interests may be accomplished, in accordance with the relevant partnership agreement,

[14] U.P.A. §§ 9(1), 15.
[15] *Cf.* U.P.A. § 14.
[16] U.L.P.A. § 7.
[17] U.P.A. § 21.
[18] *Compare, e.g.,* U.L.P.A. § 9 *with* U.P.A. § 18.
[19] U.P.A. § 31.
[20] *See* note 32, *infra.*

either with or without substitution of the assignee as a partner in place and stead of the assignor.[21] Assignees of partnership interests who are not substituted as partners in place of the assignor become essentially assignees of proceeds and are entitled to all of the economic benefits attributable to the transferred partnership interest although they are deprived the right to act as partners, including the right to examine the partnership's books. These inhibitions do not appear, however, to have materially affected utilization of the partnership form for holding real estate.

The corporate form permits a changing centralization of management dependent upon the votes of stockholders. Centralization of management in a partnership is generally achieved through the partnership agreement by designating managing partners in the case of a general partnership and by depriving limited partners of management rights in the case of a limited partnership.[22] The practical difficulties in granting limited partners, for example, the right to replace management, have apparently not prevented utilization of the partnership form for holding real property even in the case of large public syndications.

An inhibition on utilization of the partnership form for holding real estate which appears to be generally ignored is the limitation upon the status of a creditor-participant in a partnership, as opposed to a creditor-stockholder of a corporation. Subject to the judicial doctrine of thin capitalization, and bankruptcy inhibitions upon preferential or fraudulent transfers, an individual stockholder may be a secured creditor of a corporation in which he holds stock, without losing the benefit of whatever priority over other creditors his security permits. On the other hand, a general partner advancing funds to a partnership finds his right to repayment of his loan generally subordinated to third party partnership creditors,[23] and a limited partner may not create a security interest in partnership assets which will be valid as against third party creditors.[24]

In some situations statutory rules may prevent utilization of the partnership form. For example, prior to amendment, subsidized housing projects built under the New York State Mitchell Lama Housing Law were required to be owned by corporations. In earlier eras this was also true of certain projects subsidized through mortgages insured by the Federal Housing Administration. Of more current significance are laws in some states excluding corporations from pleading the defense of usury and thereby forcing some transactions involving loans which would otherwise be usurious to be cast in corporate form. The problems

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[21] U.P.A. § 127; U.L.P.A. § 19.

[22] But note requirements of Midwest Securities Commissioners Association, Statement of Policy Regarding Real Estate Programs, dated Feb. 28, 1973, amended Feb. 26, 1974, July 22, 1975, § VII.B.

[23] U.P.A. § 40.

[24] U.L.P.A. § 13.

of utilizing so-called nominee corporations for this purpose [25] are beyond the scope of this article.

Tax considerations [26]

The primary tax attribute unique to partnerships is the virtually full pass through nature of partnerships for federal income tax purposes. The partnership, while an income computing entity, does not itself pay tax; each member of a partnership is taxed separately on his or its distributive share of the partnership's items of taxable income, deduction and credit. Generally, these items maintain the same character when passed through to the individual members of the partnership as they originally possessed when incurred. This may not always be a benefit as, for example, in the case where tax preference items pass through and may result in the imposition of minimum tax, or some maximum tax offset, to an individual partner.

On the other hand, it is obvious that the ability possessed by a partnership to pass through to its partners the benefit of the new investment tax credit for qualifying rehabilitations of older commercial buildings [27] will stimulate additional use of the partnership form of organization. It should be noted that while the partnership form of organization possesses this substantial tax attribute of virtually full pass through of all tax items, qualification as a partnership is not nearly so restrictive as the special statutory rules relating to qualification as a small business corporation or real estate investment trust.[28]

In recent years, the ability of a partnership to pass through tax losses has been of increasing significance and undoubtedly has resulted in a very substantial increase in utilization of the partnership form for real estate transactions of all kinds, but particularly those, such as subsidized housing projects, which are anticipated to produce substantial tax losses.

A partnership has a great advantage over other quasi-pass-through entities, such as real estate investment trusts and small business corporations, with respect to losses, since the basis for a partner's partnership interest includes his share of partnership liabilities. This inclusion in

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[25] *See, e.g., Stang* v. *Comm'r,* 66 T.C. 12 (1976), *aff'd per curiam,* 30 A.F.T.R.2d 77-934, 77-1 U.S.T.C. ¶ 9240 (2d Cir. 1977).

[26] *See, generally,* Aronsohn, Partnership Income Taxes (Practising Law Institute, 1978 Edition); Aronsohn, Tax Planning for Acquisition and Operation of Investment Real Estate by Groups of Investors, 18th Tulane Tax Institute 573 (1969); Aronsohn, Kurtz and Kronovet, Advantages and Disadvantages of Various Ways of Holding Real Estate, 28th NYU Annual Institute on Federal Taxation 145 (1970)).

[27] I.R.C. § 48(a)(1)(E) added by § 315(a) of the Revenue Act of 1978. Note, however, restrictions on the availability of the investment credit to noncorporate lessors. I.R.C. § 46(e)(3).

[28] *See, e.g.,* I.R.C. §§ 1371 and 856.

basis, which in the case of nonrecourse indebtedness, is predicated upon the same theory as the inclusion of nonrecourse debt in an individual's basis for property subject to such indebtedness under the Supreme Court's decision in the *Crane* case,[29] may be compared with the computation of a stockholder's basis for his interest in a small business corporation, which does not include any share of corporate liabilities. The partner's larger basis for his partnership interest permits a more substantial distribution of losses to the partner.

Similarly, as a result of a partner's larger basis for his partnership interest, a partner may not only receive distributions of property from the partnership in kind without in most cases the realization of any immediate gain, but may actually receive distributions of cash without the realization of gain except to the extent any such cash distribution exceeds the basis for the distributee's partnership interest or may be treated as in exchange for the distributee's interest in partnership "unrealized receivables" or "substantially appreciated inventory".

This result is particularly useful if the partnership refinances a mortgage on its real estate resulting in excess mortgage proceeds which may then be distributed to the partners without, in most cases, the realization of any gain.

Treatment of a partnership as free from federal income tax results in the avoidance of not only the corporate regular income tax, but also the corporate minimum tax, any penalty tax on unreasonable accumulations of earnings, any personal holding company tax or any consequences which might otherwise flow from the so-called collapsible corporation provisions.

While the Code includes so-called collapsible partnership provisions dealing with partnership "unrealized receivables" and "substantially appreciated inventory"[30] these provisions are generally narrower in scope than the comparable corporation provisions.

For example, the construction of an apartment house by a corporation may result in treatment of the corporation as a collapsible corporation if any gain with respect to the stock of such corporation is realized within 3 years following the completion of such construction.

In the case of partnership, unless the partnership or partner involved held the apartment house for sale to customers in the ordinary course of business, sale of a partnership interest can be accomplished at any time without concern that the so-called collapsible partnership provisions will convert into ordinary income a gain otherwise treated as capital gain.

Another substantial advantage unique to the partnership form is the flexibility accorded to partnerships in allocating various economic benefits among partners in differing ratios and, subject to certain limita-

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[29] 331 U.S. 1 (1947).

[30] I.R.C. § 751.

tions, being able to allocate the tax consequences which flow from such agreements.[31]

While variations in the treatment of investors may be achieved within the corporate form by issuing various classes of debentures and stock, a much broader degree of flexibility is possible in the case of partnerships, where the only limitation is the desire and ingenuity of the members. Where the partnership agreement provides for allocations of tax consequences among partners, the agreement will be effective for income tax purposes so long as the tax allocations accord substantially with the economic consequences of the underlying allocations provided in the agreement. Except in cases involving nonrecourse debt, the economic effect of allocations provided in a partnership agreement is usually determinable without too much difficulty. On the other hand, where a partnership agreement provides for shifting allocations of income and loss among the partners in different years and dependent upon future economic contingencies which may be impossible to presently determine, current allocations of tax losses may be virtually impossible to correlate, with absolute certainty, to economic effects.

Where a party purchases stock in a corporation from an existing stockholder or an interest in a real estate investment trust from a current holder of such an interest, there is no adjustment to the basis of the corporation's or REIT's interest in their assets as the result of any increase in price which the purchaser may have paid for his interest. A partnership on the other hand provides the purchaser with a possible adjustment to the basis of the partnership's interest in partnership property to reflect any increased price which the purchaser may pay to a selling partner for his interest in the partnership[32] Where, for example, the partnership owns depreciable assets which have a value in excess of their adjusted basis to the partnership, this potential adjustment to basis may be of substantial value to the purchasing partner.

Where the partnership is selling property, an installment sale may be made by the partnership without incurring a second level of tax which confronts a corporation attempting to sell all of its assets with a distribution of the sales proceeds to the shareholders. Corporate sale planning in such a situation often involves the necessity for arranging a sale of each of the individual stockholder's stock in order to qualify the sales transaction as an installment sale with a single level of tax. As a practical matter purchasers interested in acquiring real estate may not wish to do so through the mechanics of a purchase of corporate stock where there are concerns over any contingent liabilities which the corporation may possess.

When a partner's interest in a partnership is retired, payments to

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31 I.R.C. § 704(a).

32 I.R.C. § 743(b).

the partner for any values in excess of the retiring partner's "interest in partnership property" may be made to the partner in a form which is deductible to the partnership consisting of the remaining partners even though such payments are, in effect, for partnership good will.[33] This result may be more difficult to achieve with other forms of organization.

Despite all of these tax advantages, it must be recognized that the partnership form brings with it some tax disadvantages.

An increasing number of provisions in recent Tax Reform Acts have been directed towards noncorporate taxpayers. As a result, for example, the investment interest limitations,[34] the requirement for amortization of construction period interest and taxes,[35] and the "at risk" rules[36] are applicable to individual partners but not to regular corporations.

Similarly, the availability of the investment credit is subject to limitations where the property involved is owned by a noncorporate lessor.[37]

The many fringe benefits available to a corporate stockholder who is also a corporate employee are either unavailable or substantially curtailed in the case of a partner.[38]

Corporations also enjoy the potential for entering into tax free corporate reorganizations with public entities far more easily than partnerships. On the other hand, despite objections by the Service,[39] at least two courts[40] have held that, in certain situations, an exchange of partnership interests may constitute a like-kind exchange under Code § 1031, a provision not applicable to exchanges of securities.

Any review of the differences between the tax treatment of partnerships and corporate enterprises should note the different treatment of non-business deductions, transactions with related entities, and restrictions on the use of a fiscal year. A partnership is not entitled to non-business deductions which are passed through to individual partners, with possible consequences in connection with the tax preference item relating to certain itemized deductions in excess of 60% of adjusted gross income and in the calculation of any net operating loss.

Transactions between partnerships and with related entities are subject to statutory provisions analogous to those in the corporate area, but not identical.[41] In this connection, attempts to segregate invest-

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[33] I.R.C. § 736.
[34] I.R.C. § 163(d).
[35] I.R.C. § 189.
[36] I.R.C. § 465.
[37] I.R.C. § 46(e)(3).
[38] *See, e.g.,* I.R.C. § 401.
[39] Rev. Rul. 78-135, 1978-15 I.R.B. 12.
[40] Estate of Rollin E. Meyer, Sr., 58 T.C. 311 (1972), *nonacq., aff'd on other grounds,* 503 F.2d 556 (9th Cir. 1974); *Miller* v. *United States,* 12 A.F.T.R. 2d 5244 (S.D. Ind. 1963).
[41] *Compare, e.g.,* I.R.C. § 707(b)(2) *with* § 1239.

ment and dealer property may be more successfully achieved where the segregation is between individual and corporate accounts as opposed to individual and partnership accounts.

On the other hand, sharing income with family members through a properly constituted family partnership may be more easily achieved than similar attempts utilizing corporations. A family partnership is not subject to the limitations as to income, source and number and nature of participants which are applicable to small business corporations, for example.

On the other hand, in an enterprise in which capital losses may be anticipated, to the extent Section 1244 stock may be available to a corporation, the partnership is at a disadvantage. Any partnership capital losses will pass through as capital losses to partners. Any losses realized by a partner upon the liquidation of his partnership interest will normally constitute capital losses. There may be an exception to this rule in the case of abandonment or forefeiture of a partnership interest where the partnership has no liabilities.

A minor detriment to the partnership form is the double application of the limits on used investment credit property and on any first year depreciation allowance, since the statute requires that such limits be applied both at the partnership level and at the partner level.

Of course federal income tax laws are not the only taxing statutes which may be relevant to an investment decision. Local tax laws must also be considered, and the applicability of franchise taxes, business taxes, real property transfer taxes and other miscellaneous taxes must be considered in connection with any particular transaction. Where transfers of substantial real estate are anticipated in jurisdictions involving large real property transfer taxes, the ability to transfer ownership through the sale of stock, which is generally more feasible than through the sale of a partnership interest, may be a consideration.

Finally, our tax laws are peculiarly subject to change. It would appear that few legislative sessions pass without proposals for tax "reform". These "reforms" may have substantial effects on the advisability of any particular form of ownership. For example, in connection with the recently passed Revenue Act of 1978, the House version of the Bill contained a provision for indexing capital gains with respect to certain assets. Under the House Bill, stock in a corporation would have been subject to the indexing proposal, but a partnership interest would not have qualified for this benefit.