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THE CORPORATE GENERAL PARTNER IN A LIMITED PARTNERSHIP

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Background

In the late 1960s the use of a corporate general partner ("CGP") in a limited partnership became a lively and troublesome issue, particularly for sponsors of tax sheltered investments. A trend had developed toward the use of CGPs primarily in order to have the best tax and non tax results: limited liability combined with a single tax at the partner level and a pass through of losses. As requests for rulings on partnership status increased, to provide the investors with a measure of tax certainty and the sponsor a selling point, the Internal Revenue Service (IRS) embarked on a policy designed to make ruling more difficult to obtain and indirectly to discourage the widespread use of CGPs. This culminated in the ruling guidelines of Revenue Procedures 72-13 and 74-17—both of which went beyond the IRS §7701 Treasury Regulations dealing with "association" versus partnership status. Because the guidelines make it difficult if not impossible to obtain rulings in many cases, there has been increased reliance on tax counsels' opinions and on the individual general partner.

The Regulations Under IRC §7701

The background to the CGP situation would not be complete without reference to the present Treasury Regulations under IRC Section 7701.¹ Following in the wake of cases that had permitted medical clinics and similar professional service organizations to be treated as associations taxable as corporations—and thus use corporate pension, profit sharing and other employee benefit plans—the Regulations are geared to make association status difficult for most general and limited partnerships. An organization has to have *more than two* of the four relevant corporate characteristics (continuity of life, centralization of management, limited liability, and free transferability of interests) to be an association. This basic concept is backed by a view of the states' laws regarding these characteristics such that limited partnerships formed under statutes "corresponding to" the Uniform Limited Partnership Act do not have the characteristics of continuity of life, centralization of management, or limited liability, in the absence of special facts.

The Regulation describing the characteristic of limited liability is the only one that expressly refers to the CGP. It provides that:

"if a corporation is a general partner, personal liability exists with respect to such partner when the corporation

¹ Treasury Regulations §301.7701-1 to -3.

has substantial assets (other than its interest in the partnership) . . . if the organization is engaged in financial transactions which involve large sums of money, and if the general partners have substantial assets. . . , there exists personal liability although the assets of such general partners would be insufficient to satisfy any substantial portion of the obligations of the organization."²

That Regulation then concludes with the ambiguous and enigmatic statement that:

"In addition, although the general partner has no substantial assets (other than his interest in the partnership), personal liability exists with respect to such general partner when he is not merely a 'dummy' acting as an agent of the limited partners."

Does this last sentence apply to a CGP? If so, then even if the CGP has no substantial assets, the characteristic of limited liability would be missing (an advantage if you want to be a partnership) so long as the corporation is not a 'dummy' of the limited partners. This question has never been definitively answered, nor has the meaning of 'dummy' been clarified, although the recent *Larson* case³ and several articles indicate that that is what it should mean.⁴

Revenue Procedure 72-13

After two to three years of unpublished ruling guidelines that filtered their way to the tax journals, the IRS finally emerged with Revenue Procedure 72-13 and its net worth and stock ownership tests for limited partnerships with a *sole* CGP.⁵ This is not the time to go into an extended analysis or critique of that

² Regulation §301.7701-2(d)(2).

³ Phillip G. Larson 66T.C.159 (April 27, 1976) (a reviewed decision with six dissents, following withdrawal of a November, 1975 opinion in favor of the Government.)

⁴ See: BNA Tax Management Memo. 76-7 (3/29/76) pp. 5-6; Mendenhall & Ferguson, "What Risks Now For Partnership Treatment of Shelters? Lessons of Larson, Zuckman," 45J. Tax 66 (Aug. 1976)

⁵ Rev. Proc. 72-13, 1972 1 CB 735 succinctly spelled out the main ruling conditions as follows:

.01 The limited partners will not own, directly or indirectly, individually or in the aggregate, more than 20 percent of the stock of the corporate general partner or any affiliates as defined in section 1504(a) of the Internal Revenue Code of 1954. For the purpose of determining stock ownership in the corporate general partner or its affiliates the attribution rules set forth in section 318 of the Code are applicable.

.02 If the corporate general partner has an interest in only one limited

Revenue Procedure; that has been done elsewhere.⁶ Perhaps the most important point to note is that the guidelines are superimposed on the requirements of the Treasury Regulations' "corporate resemblance" characteristics and tests, and appear to exalt the absence of limited liability as a *sine qua non* of partnership status. Another way to look at it is that even after the Revenue Procedure 72-13 tests are fulfilled, the classification tests of the Regulations must still be met.

Although the IRS never stated so formally, it has become clear that Revenue Procedure 72-13 and subsequent Revenue Procedure 74-17⁷ are IRS applications of the "substance-over-form" doctrine. Whatever the technical or doctrinal rationale for the guidelines, the practical intent and effect was to stem (or at least reduce) the flood of ruling requests from partnerships that the IRS believed were structured as tax avoidance devices and that should not be sanctioned through the rulings process.

Ruling Guidelines/Audit Policies

The furor caused by Revenue Procedure 72-13 might have been significantly less if the IRS had stated clearly that the tests would not be used on audits or for litigation purposes. But it was not until Revenue Procedure 74-17 that that view

partnership and the total contributions to that partnership are less than \$2,500,000, the net worth of the corporate general partner at all times will be at least 15 percent of such total contributions or \$250,000, whichever is the lesser; if the total contributions to that partnership are \$2,500,000 or more, the net worth of the corporate general partner at all times will be at least 10 percent of such total contributions. In computing the net worth of the corporate general partner, for this purpose, its interest in the limited partnership and accounts and notes receivable from and payable to the limited partnership will be excluded.

⁶ See for example, Weiler, *Limited Partnerships With Corporate General Partners: Beyond Rev. Proc. 72-13*, 36 J. Tax. 306 (1972); Fraser, *Taxing the Limited Partnership as a Corporation*, 50 Taxes 333 (1972); Welter, *Limited Partnership With a Corporate General Partner*, Rev. Proc. 72-13, 3 Tax Adviser 329 (1972).

⁷ Rev. Proc. 74-17, 1974-1 CB 438 sets forth certain "operating rules" which if not met, will "ordinarily" result in no ruling being issued on partnership status:

.01 The interests of all of the general partners, taken together, in each material item of partnership income, gain, loss, deduction or credit is equal to at least one percent of each such item at all times during the existence of the partnership. In determining the general partners' interests in such items, limited partnership interests owned by the general partners shall not be taken into account.

.02 The aggregate deductions to be claimed by the partners as their distributive shares of partnership losses for the first two years of operation of the limited partnership will not exceed the amount of equity capital invested in the limited partnership.

.03 A creditor who makes a nonrecourse loan to the limited partnership must not have or acquire, at any time as a result of making the loan, any direct or indirect interest in the profits, capital, or property of the limited partnership other than as a secured creditor.

was stated expressly. In spite of this official Service view, many practitioners continued to believe that agents would apply them in one form or another on audits. This suspicion seems to be confirmed, because this past week I heard from a reliable source that certain IRS districts have been suspending cases since 1972 which involve a sole corporate general partner, whether or not the Revenue Procedure 72-13 tests are met. Now this is startling news since no audit suspension notice has been published in the IRS Manual. Apparently the justification for the suspense was originally the *Zuckman* case,⁸ and is now *Larson*, which is on appeal.

This situation creates a practical dilemma for the sponsor and his counsel. What is one to say in the tax opinion letter and/or the prospectus when something like this floats out? Probably the best one can do is to make reasonable good faith inquiries and disclosure, (e.g. "We have been advised informally that certain districts have been suspending audits, etc."). This situation is another example of the continuing tension between the present Section 7701 Regulations, which are oriented toward a partnership result, and the IRS view that many partnerships more closely "resemble" corporations despite literally meeting the Regulations' test.

Net Worth of the General Partner

The source of the net worth test in Revenue Procedure 72-13 is the "substantial assets" factor in the Treasury Regulations' discussion of the characteristic of personal liability. The guidelines requirement that the net worth test must be met "at all times" is interpreted literally by the Service. Last week I discussed this with someone in the Rulings Division and was told that there is still no *de minimus* rule that would permit the test to be applied on a quarterly or other periodic basis. Because the relative net worth of the CGP is measured by the current fair market value of its assets in relation to the amount of contributions made by the partners, any changes in either of these elements will affect the ability to meet the test. This creates potential policing and valuation problems, not only for those obtaining rulings conditioned on maintaining the net worth at all times, but also for those relying on tax opinions that are based on substantial compliance with the guidelines. The degree of scrutiny on audits is uncertain and will vary from district to district as well as from agent to agent.

If there are several CGPs, the net worth test is determined on an aggregate basis; each of the CGPs need not by itself meet the 10%-or-15%-of-total-contribution net worth requirement. On the

⁸*Zuckman*, 524 F.2d 729 (Ct. Cl. 1975) Both *Larson* and *Zuckman* involved sole CGPs who had little or no assets apart from the limited partnership interest. In both cases the courts applied the Regulations and found partnership status.

other hand, if the CGP is a general partner in more than one limited partnership, it must have sufficient net worth to meet the test under both of the partnerships. This can make it difficult for a sponsoring group to have at the same time several limited partnerships for which it acts as general partner.

Revenue Procedure 75-16, which contains a checklist of information and documents to be submitted with a ruling request on partnership status, makes it clear that the IRS wants specific information and evidence as to substantial net worth of the general partner (whether corporation or individual). A mere representation that the general partner has substantial assets or meets the net worth test will not be sufficient.

The "total contributions" of the partners will include commitments to make additional contributions that are definite and not contingent. If, however, there are real and substantial contingencies, the contingent amount would not be considered a contribution, and the net worth of the general partner would not have to be increased.

Individual General Partners

The Service has not applied the Revenue Procedure 72-13 guidelines where an individual is the general partner or one of several general partners. Also, the "substantial assets" factor in the Regulations relating to limited liability has been applied liberally. For example, if a limited partnership has \$5 million of partners' contributions, an individual general partner with a net worth of \$250,000 or somewhat less would be sufficient. This attitude has led to a significant increase in the use of individuals as general partners in limited partnerships involving tax shelter investments.

Tax Planning

Certain tax planning considerations should be kept in mind by sponsors and investors where the general partner is a corporation. The investor should obtain complete information from the sponsor on the potential income tax problems and consequences, including an advance ruling on partnership status and other matters or an opinion letter from reputable tax counsel. He should try to obtain appropriate representations from the corporation (and, if possible, its principal shareholders) that the Revenue Procedure 72-13 tests are met and will be maintained. The sponsors/general partners should on the other hand consider obtaining representations from the limited partners that they will not acquire in the aggregate more than a 20% stock interest in the CGP. Consideration should also be given to having an individual general partner with "substantial assets" in conjunction with the CGP.

To help maintain the net worth tests a sponsor should consider loans from third parties or the leasing of business property, instead

of additional capital contributions. The CGP should consider whether it can and should elect treatment as a Subchapter S Corporation. Finally, the state tax consequences of partnership activities on both the partnership and the CGP should be considered, and, if possible, steps taken to minimize exposure to income tax and the need for an authorization to do business.

The Tax Reform Act of 1976 does not have any provisions that bear directly on the question of association versus partnership status. But in the so-called "at risk" provisions added by the Act (IRS §§465 and 704(d)) to reduce the use of leveraging to generate losses in excess of actual investment, partners that are regular corporations (not Subchapter S or personal holding companies) essentially are excluded from the adverse effects.⁹ This may result in the increased use of corporations as general partners in limited partnerships and in the expanded use of joint ventures by corporations.

S.E.C./Disclosure Aspects

The tax problems of the limited partnership with a CGP is reflected in SEC Guide 60 relating to real estate partnerships:

"It should be disclosed [in the prospectus or offering memorandum] how the general partner proposes in the future to maintain the net worth and other requirements which must be maintained in order for an entity to preserve its partnership tax status. If no ruling has been requested, the opinion of counsel as to partnership status should be summarized and the risk of reclassification on audit by the IRS should be disclosed."

Tax opinions and offering memoranda relating to other forms of investment also generally cover such matters, if not to satisfy the disclosure requirements of the securities laws, then to comply with the anti-fraud provisions.

Recent cases make it clear that attorneys and accountants of sponsors have a duty to verify critical facts in connection with the distribution of partnership interests and may be subject to civil

⁹ This exclusion is stated expressly in new Section 465 which limits deductions to the amount "at risk" in the case of certain specified activities (motion pictures or tapes, farming, leasing of personal property, and exploring for or exploiting oil and gas). The general partnership "at risk" provision of Section 704 (d), on the other hand, has an ambiguous exclusion for "any activity to the extent that section 465 . . . applies." Although the Committee reports are not helpful, the intent of the drafters was (as reflected in a Joint Committee on Taxation explanation) apparently to exclude corporate partners from 704 (d) also if the activity was described in Section 465 even though there was in fact no denial of a deduction under Section 465 because of the specific exclusion for corporations. The Treasury Department has issued a Temporary Regulation taking this position. Temp. Reg. §7.704-1 (T.D. 7445, 12/76).

liability under the securities laws or the general rules of negligence for failure to do so. Although the accountant's duty to check the facts may be somewhat greater than the lawyer in certain cases, attorneys should not rely on a possible lesser duty of due diligence in preparing and following through on their checklists.

IRS and the Courts

The attempt to import into audit and litigation policy such concepts as the Revenue Procedure 72-13 ruling guidelines has met—and probably will continue to meet—with stiff resistance from the courts at least until the Regulations are amended. In the recent *Larson* and *Zuckman* cases various Government arguments were rejected—albeit reluctantly—in the face of the explicit corporate characteristic tests in the Regulations. A 1976 Tax Management Memorandum (TMM 76-7) summarized the situation well:

“(W)ithout substantial amendment of the regulations under 7701, the guidelines are far too imprecise to be of substantive use. In addition, for the most part there seems to be little or no case law support for them although there has been speculation that a failure to meet one of the operating guidelines could constitute an additional corporate characteristic to be taken into account. Under the Treasury Regulations, none of the recent cases has seen fit to take that approach.”

The “other factors” to which the Regulations refer have never been delineated by the IRS. It will be interesting to see whether the Government and the courts focus on this phrase as a lever for considering such matters as the method by which limited partnership interests are sold and the number of limited partners.

Amendment of the §7701 Regulations

The Treasury will probably propose changes in the Section 7701 Regulations within the next several years. Indeed, they practically were invited to do so by several Tax Court judges in the *Larson* case. For ten years or more this has been a major project at Treasury, but no proposed amendments have yet seen the light of day.¹⁰ When I spoke to the Legislation and Regu-

¹⁰ In January, 1977, the following unusual series of events occurred:

- (a) On January 5th proposed regulations to §7701 were published in the Federal Register. They would have changed substantially the existing regulations (see BNA Daily Tax Report, January 5, 1977, J-1 et. seq.)
- (b) Later in the day on January 5th, the Secretary of the Treasury announced that the proposed regulations were withdrawn. Apparently

lations Division of the IRS on their current status recently, incredibly they would not admit that there even was such a project!

Because so much of the controversy relating to association versus partnership status has been connected with tax shelter investments, it will be interesting to see if amendments to the Regulations attempt to draw a line between a tax shelter partnership and other partnerships. One suggested approach is to consider the method used to sell partnership interests and the number of investors by analogy to the securities laws. It would not be surprising however, if some of the IRS ruling guideline tests (in perhaps modified form) are incorporated into new regulations in this area.

The amendments hopefully will continue to make a CGP feasible, because, in addition to providing a measure of limited liability to sponsors, a CGP can provide continuity of management and permit more flexible financial and control arrangements among the members of the sponsoring group.

Clarification of the "association" and partnership tests should minimize the need for advance rulings, give attorneys and their clients some degree of certainty as to the tax status of the entity, and even cut down significantly on tax opinions replete with qualifications and conditions. If it is too much to expect that such a day will dawn—given the myriad of transactions the regulations deal with and the never ending ingenuity of tax practitioners—as lawyers and accountants we can at least hope for and help work toward that goal.

strong protests from the Department of Housing and Urban Development and real estate interests were the main reasons for the action. (See Daily Tax Report, January 6, 1977, G-6) The Secretary said a decision on whether to reissue, revise, or drop the proposed rules would be made before January 20—when President Ford's term of office is ended.

- (c) On January 17th, the Secretary released a statement that the proposed regulations will not be repropounded. (See Daily Tax Report, January 17, 1977, G-2)