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Michael T. Madison

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INITIAL PITFALLS ASSOCIATED WITH USE OF THE LIMITED PARTNERSHIP

MICHAEL T. MADISON

I. Introduction. Except for Subchapter S corporations, corporate losses may not be deducted by shareholders. By contrast, the ability of partners to deduct their distributive share of partnership losses has been a keystone of partnership taxation. In addition, a partner’s adjusted basis in his partnership interest is ordinarily equal to the sum of cash and his adjusted basis in property contributed to the partnership.1 However, under certain conditions (severely circumscribed by the Tax Reform Act of 1976) a partner’s adjusted basis in his partnership interest may also include a share of the liabilities of the partnership.2 This has been important especially for the leveraged partnership engaged in a tax shelter enterprise including those having a proprietary interest in farm operations, oil and gas drilling funds, equipment leasing operations, production of movie films, professional sport franchises, and last but not least, real estate. But why has this add-on to basis rule been so important for these leveraged tax-shelter syndicates? Essentially, there are two reasons. First, since partners are not allowed under Sec. 704(d) to deduct any portion of their share of losses in excess of their adjusted basis, this rule has enabled partners in a leveraged partnership to deduct losses way in excess of their actual cash or property investment in the partnership. Second, because under Sec. 731(a)(1) gain is recognized to a distributee partner only to the extent that cash distributions exceed the adjusted basis in his partnership interest, this add-on to basis rule has permitted partners in a leveraged partnership to receive, without current taxation, cash distributions from the partnership (generated, for example, from operations or loan proceeds) in excess of their actual cash or property investment in the partnership. By contrast, the liabilities of a Subchapter S corporation are not taken into account in determining the adjusted basis of a shareholder in his stock.3 Accordingly, the “achilles heel” of a limited partner in a leveraged partnership is that he may not add a share of the partnership liabilities to his tax basis unless certain circumstances or requirements are met.

A second initial tax pitfall for the limited partner is that the loss pass-through advantage may be lost and the specter of double taxation raised if a limited partnership should possess too many corporate attributes under Reg. Sec. 301.7701-2 Through 301.7701-4 so as to render corporate tax treatment for the entity notwithstanding its local law denomination as a partnership.

II. Basis Problem for the Limited Partner in a Leveraged Partnership.


Since the basis problem most often arises in the context of a leveraged tax-shelter enterprise, the following is a prefatory description of how the tax shelter principle works along with an example involving a real estate limited partnership. To obtain financial leverage a syndicate will customarily fund its acquisition of improvement of income-producing real estate by means of high-ratio and constant payment long term mortgage financing. Because such mortgages provide for low amortization of principal in the earlier years, use of accelerated depreciation (which

4 If an investor can borrow a portion of his equity requirement at an interest rate lower than his rate of return from the investment, the effective rate of return is increased and the investment is said to be leveraged. For example, if A has $50,000 to invest in land generating $5,000 of net annual income representing a 10% return on his equity he would increase his return by 150% if he borrows $50,000 at 5% per annum and doubles his land investment to $100,000: His equity return would jump from 10% ($5,000/$50,000) to 15% ($10,000 less $2,500 interest=$7,500/$50,000). Moreover, if the land appreciates each year by 5% his appreciation return would double to 10% since by leveraging he doubles the amount of his investment from $50,000 to $100,000, the base to which the 5% applies. Accordingly, a small increase in property value can produce a much larger increase in the value of the equity.

5 An institutional lender when allowed by local law will generally loan between 75% to 80% of the appraised value of the income producing property comprising the security for the loan except that the loan ratio may be higher when FHA insurance is available to protect the lender.

But this value is not determined by analyzing costs; rather it is determined by discounting future net rental income at a fixed capitalization rate. Since a lender will advance a certain percentage of the discounted future income stream regardless of the syndicate's construction cost, the equity requirement and capacity for leverage will vary substantially depending upon the cost efficiency of the developer. Finally, a syndicate can usually increase its leverage by means of secondary financing, or refinancing if the outstanding principal indebtedness declines at a faster rate than does the income stream which primes the mortgage.

6 The Tax Reform Act of 1969 restricted the use of the 200% declining balance and sum-of-the-years digits methods of accelerated depreciation to new residential rental housing, defined as buildings in which 80 percent of the income is from residential units. Sec. 167(j)(2). The fastest write-off allowable for other new real property is the 150% declining balance method. Int. Rev. Code of 1954, § 167(j)(1)(B). Only straight line depreciation can be utilized on used realty, except for used residential rental housing where the 125% declining balance method may be used if the remaining useful life at acquisition is 20 years or more. Int. Rev. Code of 1954, § 167(j)(5).

Example: The ABC Corporation constructs an apartment building having a useful life of 50 years, with no salvage value. Under straight line depreciation, a deduction of 2% (100% - 50) per annum may be taken, and under the 150% declining balance depreciation a deduction of 3% [(100% - 50) x 200%]
may be claimed on the full leveraged cost of the acquired property and not merely the equity investment) frequently results in an excess of deductible depreciation over nondeductible mortgage amortization and capital expenditures during the early years of operation. Since depreciation deductions do not reflect actual expenditures of cash whereas nondeductible amortization payments and capital expenditures do, any excess of depreciation permits a cash return to investors in excess of their taxable income; or in tax law parlance, a “tax-free return of capital.” Indeed, it is not uncommon for an economically profitable real estate operation not only to shelter its cash-flow from taxation but also to produce tax losses which distributee-investors may use to offset their ordinary income from other sources (such as salaries and dividends). Later, the property can be sold and the excess of sale price over the remaining depreciated basis would be treated as long term capital gain except to the extent that excess depreciation is recaptured as ordinary income.\(^7\)

on the decreasing basis; and the use of the sum of the years-digits method produces a depreciation deduction in the first year of 3.92%. Thus, the accelerated methods of depreciation, particularly the double-declining balance and sum-of-the-years-digits methods, produce much greater depreciation over the first few years of the property’s useful life.

This fundamental tax advantage, which may be derived from high basis, low amortization, investment real property through the utilization of accelerated depreciation deductions has been acknowledged by the inclusion in the Housing and Urban Development Act of 1968 of a provision for the establishment of so-called National Housing Partnerships. The Partnerships are intended to induce investment in urban renewal and low-cost housing under government programs which offer scant prospect of any economic return on the investment involved beyond the presumed tax advantages flowing from the interplay between the accelerated depreciation deductions being taken during the early years of project ownership and the low amortization requirements of long-term government insured mortgages.

\(^7\)The depreciation deduction reduces ordinary income and also reduces the tax basis of the property. If the property is held and sold for long-term gain, the taxpayer is in effect taxed on the depreciation previously taken since it has reduced his basis; however, absent corrective legislation, this gain would be long term capital gain under Sec. 1231 if the property is used in a trade or business. In 1964 the law was amended to convert this long term capital gain to ordinary income to the extent of the depreciation taken in excess of straight line depreciation; however, the law provided that this “depreciation recapture” would decline by 1% per month after the property had been “held” 20 months with the result that there would be no recapture and the gain would be long term capital gain in its entirety after the property had been “held” for ten years. This rule was continued by the Tax Reform Act of 1969 only with respect to new residential rental property financed pursuant to Sections 221(d)(3) or 236 of the National Housing Act or similar state and local programs. For other residential rental property the amount of recapture would decline 1% per month after the property had been held 100 full months; so that there would be no recapture if the property were sold after being held 16 years and 8 months. All other real estate would be subject to full recapture of “excess” depreciation regardless of holding period. Int. Rev. Code of 1954, § 1250(a)(1)(c).
For example, assume that a limited partnership is formed by G, the general partner, and L, the limited partner, to construct an apartment building on some ground-leased land at a cost of one million dollars. Each partner contributes $100,000 equity capital in exchange for a 50 percent interest in partnership profits or losses, and capital. The balance of the construction cost is funded by an unsubordinated first leasehold mortgage of $800,000 which is self-liquidating and has a ten percent annual constant, with constant annual payments of $82,213 to be applied first to interest at nine and one-quarter percent on the unpaid balance and then to amortization or repayment of principal. Assume that the venture yields a free and clear return of ten percent (or $100,000 net rent after paying all expenses other than income taxes and mortgage payments). Lastly, assume that the building has a useful life of 40 years with zero salvage value, and since it qualifies as "residential rental property the partnership is entitled to use for tax purposes the 200% declining balance method of accelerated depreciation.

For the first year of operations the cash-flow and tax results are as follows:

<table>
<thead>
<tr>
<th>Cash-Flow</th>
<th>Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net operating income .................. $100,000</td>
<td>Net operating income .................. $100,000</td>
</tr>
<tr>
<td>Mortgage interest .................. 73,643</td>
<td>Mortgage interest .................. 73,643</td>
</tr>
<tr>
<td>Mortgage amortization ........ 8,570</td>
<td>Accelerated depreciation .................. 50,000</td>
</tr>
</tbody>
</table>

82,213 123,643

Accordingly, while the syndicate may disburse $17,787 as a tax-free return of capital, these same partners can avail themselves of a $23,643 tax loss to offset their ordinary income from outside sources such as salaries and dividends. This paradox is explained by the fact that deductible depreciation exceeds non-deductible mortgage amortization by nearly $42,000. Assuming that both G and L are in a 50 percent tax bracket and have sufficient outside income to absorb their losses, the partners' collective cash return in the dramatic first year would be $17,787 and their tax savings $11,822 so that their total after-tax cash return accordingly would be $29,607 or about 15% of their net $200,000 investment. Moreover, the true economic return is even

Effective for taxable years ending after December 31, 1975. Section 202 of the Tax Reform Act of 1976 now provides for full recapture of post-1975 accelerated depreciation in excess of straight-line depreciation on residential rental property, except for certain subsidized and other type low-income housing. With respect to such low-income housing there will be full recapture if the owner sells the property during the first 8 1/3 years. Thereafter, the recapture amount will be reduced by 1% each month so that there will be no recapture at all after 200 months, or 16 2/3 years.
higher when the equity build-up attributable to mortgage amortization is taken into account. Obviously, had the syndicate purchased and not leased the fee it would also receive the benefit of appreciation in land value in times of inflation.

By contrast, if the corporate form were used, the corporation could use accelerated depreciation both to shelter its cash inflow of $17,787 and produce an internal loss of $23,643; however, its earnings and profits, if totally disgorged as a dividend distribution, would be only reduced by straight line depreciation ($25,000). Accordingly, only $16,430 of the cash outflow to shareholders would be sheltered from ordinary income treatment. Of most significance is the fact that only the corporation can avail itself of the $23,643 loss which cannot be passed through to its shareholders.

However, "all that glitters is not gold." Observe that the amount of the depreciation deduction and resultant shelter will decrease each year as the depreciable basis of the property declines by the amount of the accelerated depreciation taken the year before. Also, under a customary constant payment mortgage arrangement, the shelter will decrease as the percentage of each payment allocable to deductible interest decreases and the percentage allocable to non-deductible amortization increases. For example, by the end of year number seven depreciation would be $36,755, interest $67,316 and amortization $14,896.

To some degree the problem of the disappearing shelter can be mitigated by refinancing the mortgage to de-escalate the amount of nondeductible amortization, or by selling the over-depreciated property and using the proceeds to fund the acquisition of some substitute property. This would start the depreciation cycle anew since the partnership would obtain a new depreciation basis equal to the cost of the newly acquired property. In addition, to the extent that the depreciation recapture provision Sec. 1250 is not applicable, any gain realized on the disposition would be treated as long term capital gain. Therefore, ordinary depreciation losses taken during the early years of ownership are effectively converted into deferred long-term capital gain.

[B] Basis Problem Caused by Recourse Financing.

As previously noted in both a general and limited partnership, a partner is not permitted to deduct his share of partnership losses to the extent it exceeds his basis in his partnership interest. In addition, any "cash-flow" sheltered from partnership taxation is treated in the hands of a distributee partner as a return of his capital, and as such reduces his adjusted basis in

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his partnership interest. Ordinarily these rules will not adversely affect a general partner in a leveraged partnership since his adjusted basis not only includes the amount of cash and adjusted basis of property contributed but also his share of partnership liabilities.

This is so because of the so-called Crane Doctrine first enunciated in *Crane v. Commissioner* which provides that when property is acquired for cash and a mortgage, the cost tax basis of the property includes the mortgage indebtedness whether or not the purchaser is personally liable under the mortgage. For example where real estate of a value, say, of $100,000 is acquired by a taxpayer who pays $20,000 and assumes an $80,000 mortgage for which he is personally liable, or by a taxpayer who pays $20,000 but only takes subject to the mortgage so that he is not personally liable—the tax basis for the purchaser in both instances is $100,000 for purposes of computing his depreciation and gain or loss on the sale or exchange of the realty. The assumption underlying the Doctrine is that the taxpayer will later have to invest an additional amount equal to the indebtedness in order to retain the property, and hence at the start he is given credit in his basis for such assumed later investment. Further, this approach permits depreciation at a rate consistent with the market value of the property when acquired, and affords competitive equality with other taxpayers owning unencumbered property. Otherwise, in our example the taxpayer would be allowed a depreciation deduction in year number one based on his equity in the property of about $20,000 rather than based on its $100,000 intrinsic value. Moreover, he would be entitled to more depreciation toward the end as the debt is paid even though the value of the property is declining. Finally, equating personal liability with the absence of that liability under the Crane Doctrine seems responsive to the reality that personal liability under the Crane Doctrine is somewhat meaningless because of corporate ownership, the use of straw men and the fact that only seven percent of deficiency judgment dollar amounts are ever realized, according to a recent study dealing with foreclosure.

Under Sec. 752 the position of a general partner under the Crane Doctrine is identical to that of someone who individually purchases an undivided interest in the property. As previously noted, his adjusted basis in his partnership interest for purposes of the Sec. 704(d) loss limitation not only includes the amount of cash and adjusted basis of property contributed but also his share of partnership liabilities.

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9 Int. Rev. Code of 1954, § 705(a)(2); 733.
10 331 US 1 (1947).
However a special rule exists for the limited partner. Under Reg. Sec. 1.752-1(e) a limited partner's share of partnership liabilities for the purpose of increasing his adjusted basis shall not exceed the amount of future capital contributions which he is obligated to make. However, where none of the partners have any personal liability with respect to a partnership liability, as in the case of non-recourse financing, then all partners, including limited partners, will be considered as sharing such liability in the same proportion as they share profits.

Example: Returning to our tax shelter example, G is a general partner and L is a limited partner in a partnership formed to acquire an apartment building costing one million dollars. Each makes a cash contribution of $100,000 and the balance of the construction costs. Under the terms of the partnership agreement they are to share profits equally but L's liabilities are limited to the extent of his contribution. Neither the partnership nor any of the partners assume any liability on the mortgage.

Result: The basis of G and L for their partnership interest is increased from $100,000 to $500,000 because each partner's share of the partnership liability has increased by $400,000. However, had G assumed personal liability by not insisting upon an exculpatory provision in the mortgage note, G's basis for his interest would have increased by $800,000 and L's basis would remain at $100,000.

In a leveraged partnership such as the one in our hypothetical example, this failure to increase L's basis could be disastrous. Because each year L's basis is being reduced by his share of losses and tax-free cash-flow, under Sec. 705 his basis would be reduced to zero by year number seven assuming the net cash yield to him remains at $8,894 per annum. Consequently, thereafter he would be precluded from deducting his share of losses under Sec. 704(d) and start realizing gain on the distribution of cash-flow. Whereas had the financing been non-recourse his tax basis at the end of year number seven would be a whopping $389,387.

The avowed rationale for the difference in result is that when recourse financing is used the general partner is obligated to outsiders for the entire mortgage liability, whereas a limited partner is liable only to the extent of his actual capital investment. However, given the rationale for the Crane Doctrine, query as to whether this distinction makes any sense. As previously noted, the Crane Doctrine itself acknowledges the meaninglessness of distinguishing between a personal and no-personal liability mortgage. In addition, would not a limited partner like L in our example feel essentially the same economic compulsion to have the mortgage debt paid in order to keep his share of the partnership property? Moreover, why shouldn't he be just as entitled to depreciation benefits as the individual who acquires property subject to a no-personal liability mortgage?
In any event, this basis rule which still applies to an investment partnership owning some income-producing realty is especially important for the leveraged tax-shelter syndicate because: (1) they frequently generate depreciation losses during the early years, and (2) cash-flow in excess of taxable partnership income is commonplace during the early years; yet, because the cash investment by the limited partners is often so small relative to debt financing, the limited partner's basis may be reduced to zero absent a liability "add-on" to basis.


Sec. 704(d) providing that a partner's distributive share of partnership loss will be allowed only to the extent of the adjusted basis of such partner's interest in the partnership has been amended by inclusion of the following sentence, effective for partnership taxable years beginning after December 31, 1976:

"For purposes of this subsection, the adjusted basis of any partner's interest in the partnership shall not include any portion of any partnership liability with respect to which the partner has no personal liability. The preceding sentence shall not apply with respect to any activity to the extent that Section 465 (relating to limiting deductions to amounts of risk in case of certain activities) applies nor shall it apply to any partnership the principal activity of which is investing in real property (other than mineral property)."

In effect this means that for tax years after December 31, 1976 a limited partner in a real estate investment partnership, which for example owns an apartment house, shopping center or some other income producing property for rental purposes, can still increase his basis by a share of the partnership liabilities if they are non-recourse. However, a limited partner in a partnership whose principal activity is the holding of real estate for sale to customers can not so increase his basis for purposes of the loss limitation under Sec. 704(d) even if the realty is acquired by means of non-recourse financing. On balance it would appear that the leveraged real estate partnership fares reasonably well under this new basis rule inasmuch as the opportunity for loss pass-through is obviously greater for the investor partnership than for the dealer partnership since the latter is not entitled to any depreciation write-off.

By contrast the leveraged partnership engaging in a Sec. 465 activity has been dealt a serious blow under the Tax Reform Act of 1976. Briefly, new Sec. 465 which overrides Sec. 704(d) prevents all taxpayers (other than corporations which are not Subchapter S corporations) from deducting losses in excess of their economic investment in four kinds of shelter activities. Covered activities are: (1) farming; (2) exploring for, or exploiting, oil and gas resources; (3) the holding, producing or distributing of motion picture films or video tapes; and (4) equipment leasing. Specifically, the amendment provides that the amount of any loss deductible in connection with one of these activities cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each such activity at the close of the taxable year. For purposes of this provision, a taxpayer is generally considered to be "at risk" with respect to an activity to the extent of his cash and the adjusted basis of other property contributed to the activity, as well as any amounts borrowed for use in the activity with respect to which the taxpayer has personal liability. As with a partnership, the amount of any loss which is allowable in a particular year reduces the taxpayer's risk investment (but not below zero) and in the case of a partnership, a partner's net "at risk" amount is reduced by non-taxable cash flow distributions.

Accordingly, returning to our tax shelter example and assuming that the partnership is engaged in a Sec. 465 activity rather than in the ownership of income producing realty, L, the limited partner would be considered at risk only to the extent of his $100,000 capital contribution even if the partnership had obtained an $800,000 no-personal liability mortgage. Consequently, L's amount at risk would be reduced to zero by the end of tax year number seven and L would thereafter be precluded from deducting his share of partnership losses unless he increased his at risk amount.

Observe that under both Sec. 704(d), as amended, and new Sec. 465 any losses which are disallowed can be deductible in subsequent years if the partner is able to increase his adjusted basis or at risk amount. Moreover, both of the loss-disallowance rules do not apply for other purposes in determining the tax basis of a partner's interest in his partnership interest.

\[16\] Id.
[D] IRS Ruling Policy.

(1) Rev. Ruling 69-223.17

This ruling involved a limited partnership under an agreement providing that G, the general partner, and L, the limited partner were to share, as between themselves, all losses and obligations of the partnership in proportion to their respective capital and profit interests; however, L would not be liable for any losses or obligations in excess of his initial capital contribution. The contract further provided that if G should be required to pay more than his pro rata share of partnership liabilities, L would indemnify and repay to G the excess amount so paid. The partnership acquired some real property and assumed personal liability on a mortgage sizeable in amount. Based on the indemnity agreement L argued that he be entitled to increase the basis in his partnership interest by his share of the liability. Taking a form over substance approach the Service ruled that the indemnity agreement was between the general and limited partners in their individual capacities and did not constitute an obligation of the limited partner to make a contribution to the partnership itself. As such under Reg. Sec. 1.752-1(e) only G was entitled to increase his basis and by the full amount of the mortgage liability.

However, in the legislative history attending the amendment of Sec. 704(d) the following statement is made by the Conference Committee Report:

"It is intended that in determining whether a partner has personal liability with respect to any partnership liability rules similar to the rules of Section 465 . . . will apply. Thus, for example guarantees and similar arrangements will be taken into account in determining whether there is personal liability."18

However, Sec. 465(b)(4) only provides that such arrangements as guarantees and stoploss agreements will be taken into account for purposes of reducing a taxpayer's at risk amount. In addition, the Senate Finance Committee report states that a taxpayer's capital is not at risk to the extent he is protected against economic loss by reason of insurance or indemnity from another individual. As a matter of logic and symmetry why shouldn't these arrangements be also taken into account for purposes of helping the partner who gives the guarantee or promise of indemnity by increasing his basis or at risk amount notwithstanding-

17 1969-1 C.B. 184.
ing recourse financing by the general partner? In any event, we will have to wait and see.

(2) Rev. Ruls. 72-135 and 72-350.

In 1972, the Service issued two rulings involving non-recourse loans. While both rulings dealt with and have particular application to limited partnerships engaged in oil and gas exploration, they are susceptible to a much broader application. In Rev. Rul. 72-135,19 the Service ruled that a non-recourse loan from the general partner to a limited partner or from the general partner to the partnership, would constitute a contribution to the capital of the partnership by the general partner, and not a loan, thereby precluding an increase in the basis of the limited partner's partnership interest with respect to any portion of such a loan. In Rev. Rul. 72-350,20 the Service ruled that a non-recourse loan by a non-partner to the limited partnership, which was secured by highly speculative and relatively low value property of the partnership, and which was convertible into a 25 percent interest in the partnership's profits, did not constitute a bona fide debt, but was, in reality, equity capital placed at the risk of the partnership's business. This, too, would preclude the loan from causing increases in the basis of the limited partner's interest.


Any procedure by which the general partner is exculpated from personal liability will protect the limited partner from losing the precious increase in his basis equal to his share of partnership liabilities. Such procedures include the following in order of preference:

(a) If a new mortgage is executed (including refinancing of an existing mortgage) the simplest technique in a jurisdiction which countenances personal liability would be to insert a provision in the note exculpating the general partners from personal liability on the debt. Such language as "the maker hereof shall not be subjected to personal liability"; "there shall be no right to a deficiency judgment";21 "recourse may be

19 1972-1 C.B. 200.
21 Obviously, in a jurisdiction that does not recognize deficiency judgment this language is not appropriate. In a jurisdiction which follows the "one-action" rule, like California, this language would suffice because the lender cannot sue upon the note or debt but must bring a foreclosure action (or sale by deed-of-trust trustee) along with an action for deficiency judgment if that be necessary. In other jurisdictions such language may not suffice since if the lender elects
had only against the secured property”; or other phraseology of similar import which clearly indicates that the parties intend non-recourse financing, will suffice. On the other hand if the property to be acquired is subject to an existing mortgage the partnership should take the property “subject to the mortgage” and not “assume” the mortgage by means of an assumption agreement; otherwise the general partners will at local law be personally liable based on privity of contract. Since it is ordinarily the income stream, and to a lesser extent the market value (based on comparable properties) which primes the mortgage and not the solvency of the makers of the note (especially when the loan amount is large) the lender will often go along with such exculpation of the general partners. If not—the following procedures can be attempted:

(b) The general partners or a nominee corporation can purchase the property and assume an existing mortgage; or in the event of new construction or refinancing, become personally liable on a new mortgage. In both cases the property can then be conveyed to the partnership subject to the mortgage but not assumed by the partnership.22

(c) The loan can be closed by the trustee of a land trust which can be used to hold the property for the benefit of the partnership.

(d) Periodically when the bases of the limited partners come close to being exhausted, the limited partners could agree to become liable to the lender or to the partnership for additional capital contributions to the extent by which future tax losses are expected to exceed the limited partner’s tax basis in his partnership interest. In exchange the limited partners would receive some “quid pro quo” from the general partners, or perhaps the general partners would agree to indemnify or reimburse the limited partners for any amount paid. This arrangement should withstand a “substance-over-form” attack by the Commissioner since the obligation of the limited partners would have economic reality if the general partners and partnership became insolvent. Analogously, a general partner is regarded as personally liable for the debts of the partnership for purposes of determining whether the entity lacks the corporate attribute of limited liability, and as such the entity is more

22 Cf. Rev. Rul. 69-223, 1969-1 C.B. 184 wherein the Service takes a “form over substance” approach by drawing a distinction between the obligation of a limited partner to contribute capital and his obligation under an agreement to indemnify the general partner. Similarly, a distinction can be drawn between a debt in respect to which the general partner is personally liable in his individual capacity and a debt of the partnership in respect to which he is personally liable in his capacity as general partner.
likely to be regarded under the Sec. 7701 Regulations as a partnership and not corporation for tax purposes.\textsuperscript{23}

If none of the above approaches is feasible, it should be remembered that if a limited partner's loss is disallowed under Sec. 704(d), such disallowed loss can, in a limited way, be carried forward against future partnership profits. Any loss disallowed under Sec. 704(d) is allowed as a deduction at the end of any succeeding taxable year of the partnership to the extent that the partner's adjusted basis for his partnership interest at the end of such year exceeds zero. In any succeeding year in which the partnership recognizes taxable income, the adjusted basis of each partner's interest in the partnership will be increased by the allocable share of such taxable income. If partnership distributions during such year do not otherwise reduce each partner's adjusted basis, the previously disallowed losses can be used to offset such taxable income. However, in order for the loss to be carried forward in this manner, it is essential that the partnership be continued for tax purposes and the limited partner remain as a partner.

III. Avoidance of Taxation as an "Association."

The second initial tax pitfall that must be overcome to utilize the limited partnership form effectively is to avoid characterization of the partnership as an "association" taxable as a corporation under Treas. Reg. Secs. 301.7701-2 through 301.7701-4. If a tax shelter enterprise is so characterized then partners in a limited partnership lose the loss pass-through advantage, are subjected to double taxation, and all of the other advantages associated with using the non-corporate form of ownership automatically disappear. To return to our tax-shelter example, the $23,643 loss in the first year could not be passed through to L and G, and in addition, only $16,430 of the cash outflow to these constructive shareholders would be sheltered from ordinary income treatment. Under the Regulations if the organization bears a closer resemblance to a corporation it will be treated as such for tax purposes notwithstanding its local law denomination as a partnership.\textsuperscript{24} The Regulations delineate six basic corporate characteristics: (1) associates; (2) objective to carry on a business and divide the gains therefrom; (3) continuity of life; (4) centralization of management; (5) limited liability; and (6) free transferability of interests.

Since the first two characteristics are common to both corporate and partnership organizations, an unincorporated organization will be taxed as a corporation only if it possesses more

\textsuperscript{23} Treas. Reg. § 301.7701-2(d).

\textsuperscript{24} Treas. Reg. § 301.7701-1(c).
than two of the remaining four corporate attributes. Normally, a general partnership possesses none of these four attributes except that sometimes a large partnership will delegate broad administrative responsibility to an executive committee. However, because each partner may nonetheless bind each other if he acts within the scope of his authority such delegation probably does not constitute "centralized management" and the Regulations so suggest. Accordingly, this pitfall is mainly associated with using the limited but not general partnership as the ownership vehicle.

[A] Continuity of Life.

An organization does have continuity of life if the death, insanity, bankruptcy, retirement or expulsion of any member will not cause a dissolution of the organization. The converse is also true so that if "any member has the power under local law to dissolve the organization, the organization lacks continuity of life." Of most significance is the way in which the Regulations define "dissolution": "... an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law." Thus the Regulations seem to apply a "form over substance" approach; namely, that continuity of life does not necessarily depend upon whether the organization continues. What is determinative is whether a dissolution, in its technical sense, occurs; namely, whether the organization as originally constituted is replaced with an organization having a different (albeit slightly so) constituency if any of the specified contingencies should occur. This view is confirmed by the Tax Court in the case of Phillip G. Larson. In that benchmark decision, which is on appeal before the Ninth Circuit, a California limited partnership agreement provided that the partnership would be dissolved on the bankruptcy of the general corporate partner. The court held that even though such bankruptcy would probably not terminate the partnership, since a general partner could be replaced by a bare majority of the limited partner, continuity of life did not exist because a technical dissolution would occur. Accordingly, continuity of life generally does not exist if death of a member or some other contingency occurs which causes dissolution even

\[25\] Treas. Reg. § 301.7701-2(a)(2).
\[26\] Treas. Reg. § 301.7701-2(c)(4).
\[27\] Treas. Reg. § 301.7701-2(b)(1).
\[28\] Treas. Reg. § 301.7701-2(b)(3).
\[29\] Treas. Reg. § 301.7701-2(b)(2).
though the remaining members agree to continue. Conversely, continuity of life may exist even if the organization is for a stated duration if none of the members has the power at local law to dissolve the organization during the interim in contravention of the organizational agreement.  

**Draftsmanship Suggestions:** It follows from the above that merely limiting the duration of a limited partnership will not *per se* remove this taint because under U.P.A. Sec. 31 (which applies to all partnerships except when inconsistent with the U.L.P.A.) such a fixed term partnership can be terminated at will only by *all* of the general partners. However, the Regulations curiously set forth a less than full-dissolution test in respect to limited partnerships; namely, that if the retirement, death, or insanity of a general partner of a limited partnership causes a dissolution of the partnership, *unless the remaining general partners or all remaining members agree,* continuity of life does not exist. By contrast, Sec. 20 of the U.L.P.A. states that a dissolution takes place "unless the business is continued by the remaining general partners (a) Under a right to do so stated in the certificate, or (b) With the consent of all members." Consequently, the partnership agreement could contain language permitting the limited partnership to forego dissolution if a majority of general partners agree. A fortiori, the more constraining and less desirable alternative of having all partners agree to a continuation eliminates continuity of life and the Regulations so acknowledge this fact. Finally, the last alternative: automatic continuation by virtue of a right to do so stated in the certificate, is probably the least desirable since the Regulations do not expressly exculpate this alternative, the least flexible of all.

**[B] Centralization of Management.**

Of all the disqualifying corporate attributes this would appear to be the most difficult to avoid because by definition the general partners must have the “exclusive authority” to make management decisions on behalf of the limited partners. Otherwise

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31 Treas. Reg. §§ 301.7701-2(b)(3); 301.7701-2(f) ex. (5).
32 By negative in tenure a majority would appear sufficient since “all” modifies “members” but not the phrase “general partners” in Treas. Reg. § 301.7701-2(b)(1).
33 The Regulations state that a limited partnership subject to the U.L.P.A. lacks continuity of life presumably because Sec. 20 requires consent of all members to continue absent an agreement to the contrary. Treas. Reg. § 301.7701-2(b)(3).
34 Treas. Reg. § 301.7701-2(c)(3) defines centralized management as the “concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization.”
the limited partners who choose to partake in management decision-making would expose themselves to outside contract and tort liability.\textsuperscript{35} However, in addition to the "exclusive authority" definition of centralized management the Regulations also curiously state that while a limited partnership subject to the U.L.P.A. generally does not have centralized management, "... centralized management ordinarily does exist in such limited partnership if \textit{substantially all} the interests in the partnership are owned by the limited partners."\textsuperscript{36} Obviously in most limited partnerships, especially the public ones, the limited partners do own a substantial portion of the capital and/or profit share since use of the limited partnership is ordinarily designed to raise a maximum (not minimum) amount of venture capital from outside investors who become the limited partners. This sentence in the Regulations is apparently an attempt to correlate the present Regulations with the Regulations under the 1939 Revenue Code\textsuperscript{37} and prior case law, notably \textit{Glendser Textile Co.},\textsuperscript{38} which defined centralized management as management in a representative capacity. For example, in \textit{Glendser Textile} the Board of Tax Appeals held that general partners collectively owning a five-twelfths interest in the partnership were not analogous to corporate directors and did not manage in a representative capacity since by owning such a sizeable interest they presumably were acting mainly for their own benefit and not as representatives of the limited partners. Accordingly, by negative inference the Regulations suggest that this corporate attribute may be avoided if the limited partners do not own a "substantial" share of profits and/or capital. This view is confirmed by dictum in the \textit{Larson} case.\textsuperscript{38a} However, what does the term "substantial" mean? Is centralized management avoided only if a substantial share is owned by the general partners, or is it sufficient for the general partners to own so much that the balance owned by the limited partners is "insubstantial"? For example, if as \textit{Glendser Textile} suggests five-twelfths or approximately 40 percent is substantial must the limited partners own no more than 60 percent, or must they own less than 40 percent to render their interest insubstantial? Unfortunately, the only example in the Regulations suggests the obvious, that 94 percent ownership is substantial.\textsuperscript{39} On this point perhaps one must of necessity be guided by the informal past experience of tax practitioners which apparently is that the Revenue Service will conclude that limited partners do \textit{not} own substantially all of the interests if the general partners own a 20 percent or

\begin{footnotes}
\item[36] Treas. Reg. § 301.7701-2(c)(4).
\item[38] 46 B.T.A. 176, 183 (1942) \textit{acq.}
\item[39] Treas. Reg. § 301.7701-3(b)(2) ex. (1).
\end{footnotes}
greater interest in partnership capital or profits.\textsuperscript{40} To be on the safe side, however, the general partners if possible should own 40 percent of the partnership. In a recent \textit{court of claims} case, \textit{Zuckman v. U.S.}\textsuperscript{41} the Court concluded that centralized management did not exist since the general partner owned a 62 percent interest in the partnership. Finally, if as is often the case the general partners are to receive an extra share of capital or profits once the limited partners recoup their capital outlay, the tax advisor should be alert to the fact that the 20 to 40 percent limitation may inadvertently be exceeded by the general partners.\textsuperscript{42}

[C] \textit{Limited Liability}.

In contrast to centralized management, limited liability would appear to be the corporate characteristic easiest to avoid since by definition the general partners are personally liable to outsiders.\textsuperscript{43} Under the Regulations an organization does not possess limited liability so long as \textit{any} member is personally liable for the debts of or claims against the organization.\textsuperscript{44} However, in the case of a limited partnership the Regulations further provide that limited liability does exist "... with respect to a general partner when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when he is merely a "dummy" acting as the agent of the limited partners."\textsuperscript{45} Taken literally, this sentence in the Regulations appears to be meaningless because if the general partner were merely an agent controlled by the limited partners the organization no doubt would be treated at local law as a general partnership, and not as a limited partnership, thus exposing all the partners to personal liability under a "mutual-agency" theory. Accordingly, this corporate attribute would appear to be present in a limited partnership if the general partner has no substantial assets even if he is not a mere "dummy." However, in \textit{Larson} the court siding with the taxpayer, construed this language in the Regulations literally and held that limited liability did not exist because the general partner had not been a dummy of the limited partners even though the organization did not own substantial assets during the years in issue.\textsuperscript{45a}

\textsuperscript{40} \textit{E.g.}, 2 A. \textsc{Wills}, \textsc{Partnership Taxation} ¶ 57.06 (2d ed. 1976); \textit{Point to Remember No. 5}, \textsc{The Tax Lawyer} \textbf{179} (1971).

\textsuperscript{41} 524 F.2d 729 (Ct. Cl. 1975).

\textsuperscript{42} If so perhaps the partnership agreement could be amended (retroactively if necessary) by means of Int. Rev. Code of 1954, § 761(c) to eliminate some other corporate attribute.

\textsuperscript{43} U.L.P.A. §§ 1,9.

\textsuperscript{44} Treas. Reg. § 301.7701-2(d)(1).

\textsuperscript{45} Treas. Reg. § 301.7701-2(d)(2) (emphasis added).

While the Regulations do not define what “substantial assets” mean they state that the test is met even if the assets of such general partners are insubstantial relative to the total undertaking of the partnership. Moreover, an indemnity agreement whereby the limited partners agree to reimburse the general partner for payments made to outsiders will not negate personal liability so long as the general partner remains liable at local law to outside creditors notwithstanding such agreement. Accordingly, it is appropriate for the tax advisor representing a general partner not to object to language in the partnership agreement whereunder the limited partners agree to reimburse the general partner for amounts paid over and above his proportionate ratio for sharing partnership losses (and liabilities).

Finally, observe that if the partnership is forced to use non-recourse financing in order to assure the limited partners of an increased tax basis in their partnership interest—to absorb their distributive share of basis-reducing tax free distributions of cash or losses—this should not automatically impose the corporate attribute of limited liability on the partnership because the general partner still remains personally liable for the tort and other contract obligations of the partnership. Perhaps the problem might be more acute if the partnership owns unimproved land since potential tort and contract liability (other than mortgage debt) is arguably marginal. However, the need for increasing the tax bases of the limited partners is less since non-income producing property does not generate depreciation, operating and other losses to which the bases limitation applies.

[1] Corporate General Partner. When a corporation is the sole general partner of a limited partnership a stricter standard must be met. Otherwise the tax law would be sanctioning favorable partnership tax treatment for an organization all of whose individual members (like stockholders) would be shielded from outside liability to creditors. Under Revenue Procedure 72-13 the Revenue Service will not issue advance rulings in respect to classification treatment unless certain specified conditions are met.

[D] Free Transferability of Interests.

The Regulations provide that free transferability in the corporate sense exists “if each of its [the organization’s] members owning substantially all of the interests in the organization have the

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46 Id.
47 Treas. Reg. § 301.7701-2(d)(1).
power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization." Moreover, for this power of substitution to exist "the member must be able, without the consent of other members, to confer upon his substitute all of the attributes of his interest in the organization." Under Sec. 19 of the U.L.P.A. an assignee does not become a "substituted limited partner" entitled to demand an accounting and/or inspection of partnership books unless all of the remaining partners consent, or unless the assignor is so empowered by the certificate to convey this right. In addition, under Sec. 20 of the U.L.P.A. the retirement of a general partner dissolves the partnership, unless the business is continued by the remaining general partners under a right to do so stated in the certificate, or with the consent of all members.

**Draftsmanship Suggestions:** Based on the foregoing, if the limited partners own a substantial share of partnership profits and capital the partnership agreement should provide that any assignee cannot become a full limited partner unless all or a specified percentage of the general partners and/or limited partners agree. However, caution should be taken that the consent clause does not state that such consent may not be unreasonably withheld. Such was the case in the Larson decision wherein the Court held that such an atypical circumscription of consent would be based on a standard of reasonableness and not abolish free transferability of interests. Certainly, the automatic right to become a substituted limited partner should not be specified in the certificate filed with the local authorities. Conversely, if the general partners own the substantial interests the Agreement should provide that in the event a general partner retires or withdraws from the partnership the remaining general partners or perhaps majority thereof must consent to any substitution in the event the partnership is not dissolved as a consequence of such substitution. In the latter case this protective language may not be necessary since the attribute of continuity of life would ordinarily not exist.

Finally, observe that the Regulations recognize that a "modified" form of free transferability exists if each member can transfer his entire interest only after he has first offered such interest to the other members at its fair market value. If such modified

49 Treas. Reg. § 301.7701-2(c)(1).
51 Treas. Reg. § 301.7701-2(e)(1) provides that free transferability is not present if under local law a transfer of a member's interest results in the dissolution of the old organization and the formation of a new one.
52 Treas. Reg. § 301.7701-2(b)(1).
53 Treas. Reg. § 301.7701-2(c)(2).
transferability exists based on a buy-sell or right-of-first refusal provision such attribute is accorded less weight than full free transferability in any determination of classification. However, in most cases a buy-sell agreement will only restrict the alienability of a general partner's interest and in a partnership where the limited partners own substantially all of the profits and capital, such restriction would probably be disregarded in its entirety.

[E] Ruling Policy.

Notwithstanding the detailed definitional description of the various corporate attributes, total reliance thereon for ruling purposes would be misplaced inasmuch as the Regulations state that other factors may be relevant in arriving at any classification determination and such determination will depend upon the particular circumstances of each case. Moreover, if a tax ruling is not obtained a legal opinion as to partnership status is required by federal and/or state regulatory authorities, and such ruling will aid the sponsors in marketing investment shares. Accordingly, a favorable ruling is highly beneficial, although in recent times the Service has vacillated as to what the threshold requirements are, if any, over and above compliance with the Regulations. However, in a speech on November 15, 1973 by Commissioner Donald C. Alexander to the Cleveland Tax Institute notice was given that the following requirements have to be met in order to obtain a favorable ruling:

1. The general partners must have at least a one percent interest in material items of income, gain, loss, deduction and credit;
2. Such interest must be owned at all times during the partnership term;
3. Because at local law the same person may simultaneously own interests as both a general and limited partner, the minimum interest must be owned by persons in their capacity as general partners.

54 Treas. Reg. § 301.7701-2(a)(1).
55 Commissioner Alexander's remarks were in part as follows: "we feel that a partnership must have a viable general partner, which means that the general partner must have a real interest in the affairs of the partnership. This interest must be something more than a set fee for performing certain services. If the partnership venture is a success, the general partner should also share realistically in the profit—if it fails, the general partner should also share realistically in the loss.

Based upon this truism, we have concluded that, for rulings purposes, the general partner must have at least a one percent interest in each material item of income, gain, loss, deduction and credit, at all times during the existence of the partnership. Furthermore, this interest must be as a general partner."
This one percent test was formally adopted on May 3, 1974 in Revenue Procedure 74-17. Since cash-flow is not referred to in Commissioner Alexander’s remarks and is but an accounting concept which has no direct bearing on taxable income or loss, any cash-flow preference to limited partners whereby general partners in a particular year are precluded from receiving cash should not adversely affect the chances of obtaining a favorable ruling. In Revenue Procedure 74-17 there is a suggestion that rulings will not be granted in the event deductible losses allocable to partners during the first two years of the partnership term exceed their cash investment; however, as of this date such requirement is not being enforced. In addition, the Procedure requires that a creditor making a non-recourse loan to the limited partnership must not receive 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. This third requirement may well affect institutional lenders who, when mortgage money is tight, often demand a joint venture position. Moreover, if the phrase “other than as a secured creditor” is read too cursorily by the Service other kinds of so-called “equity kickers” may be in jeopardy, as well.

Lastly, if the syndicate applies for a ruling it should at the same time seek an opinion as to the status of investors as partners (as opposed to employees or creditors where those classified as “limited” receive a preferential recoupment of their capital plus an interest return or where a put is exercisable by the investors) and the status of a special allocation of income or deduction items under Sec. 704(b).

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56 1974-1 C.B. 438; see also Rev. Proc. 72-13, 1972-1 C.B. 735 mentioned supra at p. ——; and Rev. Proc. 75-16, 1975-10 I.R.B. 59 which sets forth a checklist outlining required information in connection with a ruling request concerning the classification of an organization as a limited partnership.

57 For example, lenders will often demand a percentage of the borrowers’ gross or net income in addition to a fixed interest rate as consideration for making the loan.