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NEW DEVELOPMENTS IN THE TAXATION OF REAL ESTATE PARTNERSHIPS*

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I. INTRODUCTION

The 1969 TRA has had a material and adverse impact on the use of accelerated depreciation deductions and other tax benefits derived from investing in real estate. However, on balance it appears that the real estate partnership syndicate has fared reasonably under the 1976 TRA as opposed to other kinds of tax shelter partnerships. Indeed, what is most striking to this observer is not what the Act does but what it fails to do with respect to partners seeking a tax haven by investing in income-producing real estate. In the past the House Ways and Means Committee recurrently attempted to curtail real estate and other shelters by eliminating so-called “artificial accounting losses.” Under their proposed system known as “L.A.L.” write-offs such as accelerated depreciation, and interest and taxes paid during construction, could not exceed the annual income from the activity to which they relate. For example, accelerated depreciation on a building would be allowed as a deduction only to the extent of income from real estate, and therefore any excess deduction or loss could not be used to reduce the individual or partner's ordinary income from wages or dividends. However, because of its complexity and adverse economic impact the Senate Finance Committee abandoned L.A.L. and settled for relatively milder curbs including the so-called “at-risk” provisions (new Code §§ 464, 465) which are aimed primarily at tax shelters other than real estate. S. Rep. No. 94-938, 94th Cong; 2d Sess. 39 (1976).

Essentially, the TRA of 1976 has changed the taxation of real estate partnerships in four major respects: (1) the use of special and retroactive allocations, Code § 704(b)(1) as amended; (2) the write-off of organization and syndication fees, new Code § 709; (3) the deductibility of so-called “guaranteed payments,” Code § 707(c), as amended, and (4) the right of limited partners to take deductions and losses in excess of the amount of investment they have at risk in the partnership.

The first three changes will be discussed by the next speaker, Jack Sexton, so that my comments will apply only to this last change wrought by the Act. (Comment to Audience: I think the reason why I'm speaking first is that we want you to hear the good news before we tell you about the bad news.)

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*Based upon materials and presentation by Mr. Madison as a part of a special program on the effects of the 1976 Tax Reform Act for the meeting of the Real Property, Probate and Trust Law Section in Boston, Massachusetts on October 21, 1977.
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A. Importance of Add-On to Basis Rule

As you know corporate losses may not be deducted by shareholders except for those owning stock in a subchapter S corporation. By contrast, the ability of partners to deduct their distributive share of partnership losses has been a keystone of partnership taxation. 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. Code §§ 705, 722. However, under prior law if the partnership obtained nonrecourse financing a partner's adjusted basis in his partnership interest would also include his share of the liabilities of the partnership regardless of the nature of the partnership activity. Code § 752. By contrast, the liabilities of a subchapter S corporation increase a shareholder's adjusted basis in his stock to the extent that the liability is owed to that particular shareholder. Code §§ 1374(c)(2), 1376.

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. Essentially, there are four reasons. First, if the partnership obtains nonrecourse financing the partnership itself acquires basis and depreciable interest in the property equal to the full purchase price even though the partners limit their personal exposure in the transaction to whatever cash or other property they contribute at the front end. Second, since partners are not allowed under sec. 704(d) to deduct any portion of their share of depreciation and other 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. Third, since 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 operation or loan proceeds) in excess of their actual cash or property investment in the partnership. Fourth, any "cash flow" sheltered from partnership taxation is treated as a return of capital in the hands of a distributee partner, and as such reduces his adjusted basis. Code §§ 705(a)(2); 733. Accordingly, the "Achilles heel" of a limited partner in a leveraged real estate partnership has been his inability to add to his tax basis his share of partnership indebtedness in respect to which the partnership is personally liable.

B. Rationale for Basis Rule Is "Crane Doctrine"

The so-called Crane Doctrine first enunciated in Crane v. Commissioner, 331 U.S. 1 (1947) 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. Secondly, 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, the equating of personal liability with the absence of that liability under the Crane Doctrine seems responsive to the reality that personal liability is somewhat meaningless because of corporate ownership, use of straw men and the fact that only 7 percent of the dollar amount of deficiency judgments are ever realized according to one study dealing with foreclosure. Prather, A Realistic Approach to Foreclosure, 14 Business Lawyer 132 (1958).

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. However a special rule has existed 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 nonrecourse financing then all partners, including limited partners, shall be considered as sharing such liability in the same proportion as they share profits.

Example: G is a general partner and L is a limited partner in a partnership formed to acquire an apartment building costing $1 million. Each makes a cash contribution of $100,000 and the partnership obtains a mortgage in the amount of $800,000 to fund 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.

Results: The basis of G and L for their partnership interest is increased from $100,000 to $500,000 since 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.

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 some individual who acquires property subject to a no-personal liability mortgage.

C. Changes in Basis Rule Under TRA of 1976

Sec. 704(d) providing that a partner's distributive share of partnership loss shall 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 limited 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).

An important aspect of this new basis rule is that it applies to both general and limited partnerships and to both general and limited partners. Accordingly, even a general partner in a limited partnership to which this provision applies will not be able to deduct losses against his share of non-recourse partnership liabilities unless the "principal activity" of the partnership is "investing in real property (other than mineral property)." However, neither the Code nor the Temporary Regulations define these phrases. A strict construction of the former might require the use of separate partnerships for new real estate activities and the fragmentation of existing multi-activity partnerships. Moreover, a literal construction of the latter phrase might not exculpate most real estate tax shelter partnerships which own improved realty such as an apartment house or shopping center since such property would arguably be used in a trade or business and not simply as a passive investment for the production of income. *Cf.* Code § 1221(2) and *Rothenberg* 48 TC 369 (1967); and *compare* Code § 162(a) with § 212(1), (2); *Higgins v. Com'r* 312 U.S. 212 (1941). Also query whether the literal language of sec. 704(d) would apply to dealer partnerships holding raw land and other realty for sale to customers.

However, it is clear from the floor debate that Congress intended to protect commercial and residential rental real estate, and both the House Conference Report (no. 94-1515, filed by the Conference Committee on 9/13/76 at p. 423) and General Explanation of the TRA of 1976 (prepared by the Joint Committee on Taxation staff and filed on 12/29/76) use the broader phrase "nor will it (the new basis rule) apply to any partnership the principal activity of which involves real property (emphasis added)." In-
 Indeed, the General Explanation indicates that the principal activities of a partnership would involve real property if substantially all of its activities involve the holding of real property for sale, for investment, or for deriving rental-type income. Such a flexible reading of sec. 704(d) would protect a major real estate tax incentive, which inducements are (as the Senate Committee Report points out at p. 8) essential to attract investment in an industry already suffering from a shortage of capital and high unemployment. Moreover, if the Service construes the phrase “investing in real property” narrowly it will create a vexing dilemma for real estate partnerships which wish to avoid sec. 704(d) and at the same time take advantage of those other Code sections (like sec. 163(d) dealing with excess investment interest) that confer preferential treatment to those taxpayers engaging in a trade or business.

Fortunately, this interpretational problem may be resolved in that the House Ways and Means Committee has proposed in H.R. 6715 a technical amendment of sec. 704(d) which would provide that a partnership could qualify for the exception to new basis rule if substantially all of its activities relate to the holding of real property (other than mineral property) for sale or rental, and make it clear that active as well as passive rental operations are excepted. However, even if this bill is enacted a few less serious ambiguities would still remain unresolved. For example, would a partnership be excepted from sec. 704(d) if it merely utilizes real estate to engage in the active conduct of a trade or business; as for example, one which owns and manages a hotel, motel, apartment house furnishing hotel services, or parking lot where in each case significant services are being rendered to the occupants. Or, would a two-tier partnership be covered by the new basis rule where only the bottom tier partnership is principally involved in real estate. As to the latter the General Explanation Staff Report indicates that the exception to sec. 704(d) would embrace indirect real property activity.

II. AT RISK PROVISIONS AND TAX SHELTER

A. At Risk Provisions Inapplicable to Real Estate

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 Code 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 or has pledged property (other than property used in the activity). Code sec. 465(b)(1)&(2). For example, if a partner uses personally-owned real estate to secure nonrecourse indebtedness and lets the partnership use the proceeds in an equipment leasing activity, the proceeds will increase the partner's at risk amount (to the extent of the net fair market value of his interest in the property). Like in 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. S. REP. No. 94-938, 94th Cong; 2d Sess. 45-51 (1976).

Observe also 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. Secondly, 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.

However, there are significant differences between the two rules. For example, whereas sec. 704(d) does not expressly preclude a partner from increasing his loss-allowance basis from contributions financed through nonrecourse indebtedness of the partner (even if secured by his partnership interest), sec. 465(b)(4) provides that such contributions financed on a nonrecourse basis do not increase the taxpayer's at risk amount. General Explanation at p. 37. Also, unlike the at risk rules, sec. 704(d) does not refer to risk-limiting devices (such as guarantees, stop loss agreements, insurance or indemnity against economic loss or personal mortgage liability) nor to loans from interested or related persons as limitations upon the partner's ability to increase his adjusted basis for loss purposes. Sec. 465(b)(4); (b)(3). However, both the Conference Report (at p. 423) and General Explanation (at p. 96) invite such an expansive construction by the Service in that they provide 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 may be taken into account..."

Another significant difference is that while the amendatory language in sec. 704(d) applies to corporate partners, sec. 465 does not apply to corporate taxpayers (other than subchapter S corporations and personal holding companies). Sec. 465(a). Consequently, since 704(d) as amended expressly does not apply its new basis rule "with respect to any activity to the extent that section 465... applies" the question arises as to whether corporate partners in a partnership engaged in a section 465 activity (such as equipment leasing, and operating equipment) then the new basis rule would apply to the extent of liabilities incurred with respect to the second activity. This view has been
confirmed by Temp. Reg. § 7.704-1(d)(3) which also indicates that the exclusion would apply to a corporate partner even if all the partners are not corporations. Adopted 12/17/76 by T.D. 7445.

Finally, both the Conference Report (at p. 423) and the General Explanation (at p. 97) make it clear that both the new basis rule under sec. 704(d) and the at risk rules of sec. 465 could apply to a partnership carrying on more than one activity. For example, a partnership involved in equipment leasing (to which the at risk rules apply) could also be indebted on a nonrecourse basis with respect to an activity (such as the owning of mineral property) that is unrelated to the equipment leasing activity. In such instance, separate computations for purposes of allowing losses would have to be made under both sections 465 and 704(d).

B. How Tax Shelter Works

Since the basis problem most often arises in the context of a leveraged real estate limited partnership owning some income-producing real estate, the following is an example of how the tax shelter principle works. To obtain financial leverage a syndicate will customarily fund its acquisition or improvement of rental 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 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 to not only 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. IRC § 1250.

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 $1 million. 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 10 percent annual constant, with constant annual payment of $82,212 to be applied first to interest at 9 3/4 percent on the unpaid balance and then to amortization or repayment of principal. Assume the venture yields a free and clear return of 10 percent (or $100,000 net rent after payment of 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 per cent 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</td>
<td>$100,000</td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>73,643</td>
</tr>
<tr>
<td>Mortgage amortization</td>
<td>8,570</td>
</tr>
<tr>
<td></td>
<td><strong>82,213</strong></td>
</tr>
<tr>
<td>Net Cash flow</td>
<td>17,787</td>
</tr>
<tr>
<td></td>
<td><strong>123,643</strong></td>
</tr>
</tbody>
</table>

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 nondeductible mortgage amortization by nearly $42,000. Assuming 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 would accordingly be $29,607 or about 15 percent of their net $200,000 investment. Moreover, the true economic return is even higher when the equity buildup 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 to both 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 only be 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 nondeductible 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.

C. Results Under New Rules

In a leveraged partnership such as the one in our hypothetical example this failure to increase L’s basis under the new rule could be disastrous. Since 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 nonrecourse his tax basis at the end of year number seven would be a whopping $389,387.

Consequently, this basis rule which still applies to a limited 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, since 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.

Finally, returning to our tax shelter example and assuming 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.

III. CASE LAW AND I.R.S. RULINGS


This case is a splendid example of how poor tax planning can cause disastrous results for a taxpayer under the basis rule we’ve been discussing. Kingbay involved a limited partnership formed to construct apartment houses for rental purposes. The petitioners, Mr. and Mrs. Kingbay, were the limited partners, who owned all the stock of the corporate general partner, Kingbay Properties, Inc. The corporation was nominally capitalized in the sum of $1,000 and had contributed a mere $100 to the limited partnership whereas the limited partners had each made contributions to the capital of the partnership totalling $29,950.

During 1958, 1959 and 1960 the partnership purchased land and constructed apartments borrowing nearly a million dollars from Curtis Kingbay and about $800,000 from third-party mortgagees. In neither instance were the loan advances expressly made nonrecourse.
During 1959 and 1960 the partnership incurred losses and the petitioners' distributive shares of these losses exceeded their adjusted bases in their partnership interests. The Service disallowed the excess losses on the ground that a limited partner's ability to deduct losses is limited by the amount of his adjusted basis in his partnership interest which cannot be increased by partnership liabilities in respect to which the partnership (and general partner) has personal liability. The taxpayers argued that their loan advances were in reality capital contributions (which would have increased their bases under Code § 722); and alternatively, that the corporate general partner was but a dummy partner so that in substance no partner was personally liable for the mortgage indebtedness. The Tax Court rejected both arguments and in response to the former, pointed out that "repayments of the advances were regularly made and notes were given." As to the latter the Tax Court opined that the corporation had been formed for legitimate business purposes including the taxpayers' desire to be insulated from personal liability for partnership debts and consequently refused to disregard the corporation as an entity separate from its stockholders (46 T.C. at 153, 154). Incidentally, the "association" problem under the § 301,7701Regs. and Rev. Proc. 72-13 is also strongly suggested by the facts in the case.


This ruling involved a limited partnership under a 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(c) only G was entitled to increase his basis and by the full amount of the mortgage liability.

However, as noted earlier, 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 (at p. 423).

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 (at p. 49). 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 recourse financing by the general partner. In any event, we will have to wait and see.

C. Rev. Rules 72-135 and 72-350
In 1972, the Service issued two rulings involving nonrecourse 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. Rule 72-135 (1972-1 C.B. 200), the Service ruled that a nonrecourse 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 (1972-2 C.B. 394), the Service ruled that a nonrecourse loan by a nonpartner 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 bases of the limited partners' interest.

D. Direct Attacks Against the Crane Doctrine Itself
Notwithstanding unsuccessful attacks by the Commissioner against applying the Crane Doctrine to the use of nonrecourse financing, recent case law suggests that the Doctrine has its obvious threshold limits. For example, the Tax Court reaffirmed the Crane rule in both Manuel Mayerson (47 T.C. 340, 1966) and recently David F. Bolger (59 T.C. 760, 1973) where the respective taxpayers had a nominal and zero cash investment in the properties besides being exculpated from personal liability on their mortgages on the assumption that a capital investment equal to the mortgages would eventually occur. The Service later acquiesced in the Mayerson decision because the property had been acquired at its fair market value in an arm's length transaction but warned that it would not recognize transactions designed to artificially inflate the depreciation deduction Rev. Rule 69-77, 1969-1 C.B. 59.

However, in Franklin Estate v. Com'r, 544 F 2d. 1045, 1976, affg. 64 T.C. 752, 1975, the Ninth Circuit disallowed depreciation and interest deductions to a nonrecourse purchaser of some motel property leased back to the seller notwithstanding a $75,000 payment by the purchaser because the unpaid balance of the purchase price (and purchase money indebtedness) exceeded the fair market value of the property during the 10 year pre-balloon payment period. Unlike in Mayerson and Bolger the taxpayer had failed to prove that the $1,244,000 purchase price had any relationship to the actual value of the property that would yield an equity in the property
which the purchaser could not prudently abandon. Consequently, this failure to show a net investment or equity in the property prompted the court to treat the transaction as but a 10-year option to purchase the property rather than as a genuine purchase funded by real indebtedness.

Therefore, the careful use of nonrecourse financing under the Crane Doctrine still appears to be a valuable tax planning tool but beware that even without further legislative restrictions on the doctrine, the Service will undoubtedly continue its attempt in the courts to curtail the benefits wrought by Crane.

IV. TAX PLANNING SUGGESTIONS FOR THE REAL ESTATE INVESTMENT PARTNERSHIP

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"; "recourse may be had only against the secured property"; or other phraseology of similar import which clearly indicates that the parties intend nonrecourse financing, will suffice. Obviously in a jurisdiction that does not recognize deficiency judgments this language is not necessary. In a jurisdiction which follows the "one-action" rule like California this language is necessary; although the lender cannot sue upon the note or debt, he can also request a deficiency judgment in a foreclosure action (or sale by deed-of-trust trustee) if that be necessary. Finally, observe that the "no deficiency judgment" language may not suffice in most jurisdictions since if the lender elects not to foreclose but to sue for each installment on the note as it becomes due, arguably some personal liability still exists.

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.

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.

(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 indemnity 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 is more likely to be regarded under the sec. 7701 Regulations as a partnership and not corporation for tax purposes. Tres. Reg. § 301.7701-2(d).

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.