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Realty Shelter Partnerships in a Nutshell

Donald J. Weidner*

I. Introduction

There continues to be heated discussion about tax reform in the area of real estate tax shelters. In the past few years, the Internal Revenue Service has taken what many feel to be substantively unsupportable moves against the use of real estate partnerships to deliver tax shelter to high bracket investors. The purpose of this Article is to explain the Service's actions against realty partnerships in the context of current manipulations of the partnership form.

II. The Essence of Tax Shelter

A. *In General*

The term "tax shelter" is usually used in one of two ways.[1] The first definition of a tax shelter is an investment through which one pays tax on less cash than one receives. In this sense, a tax-exempt bond is considered a tax shelter because no tax need be paid on its interest income. In an investment in depreciable real estate, a tax shelter in this sense exists in any year in which the depreciation deduction claimed exceeds the amount of cash spent to retire the principal on the outstanding indebtedness.

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[1] The focus of this Article is on investments in partnerships holding depreciable interests in real estate. For a broader discussion of tax shelters and the need to match investor characteristics with those of a particular shelter, see Calkins & Updegraft, *Tax Shelters*, 26 Tax Law. 493 (1973).

Stated differently, taxable income will be less than the net amount of cash actually received whenever the deduction for the non-cash expense of depreciation exceeds the amount of money actually spent to amortize the indebtedness, a cash expense for which there is no corresponding deduction.[2] Thus, no matter what the other income and expense items in connection with a property, if depreciation is $100 and debt amortization is $80, taxable income will be $20 less than cash received. If there is an overall cash loss, the tax loss will be $20 greater than the cash loss.

Investment advisors who specialize in partnership syndications, however, are likely to respond that their clients who seek "tax shelter" are using the term in a more narrow sense. High-bracket investors seek *surplus* losses that can be used to offset their income from other sources, not merely a stream of income sheltered from tax as in the case of a municipal bond. Cash flow, indeed, may be of little or no immediate interest. An investment in real estate is a tax shelter in this sense whenever the depreciation deduction is greater than the sum of net cash flow plus the amount of principal paid on indebtedness—when, after all the net cash flow and non-deductible expenditures for debt amortization are "sheltered" from tax, there will be surplus losses.

Real estate tax shelters would not be as popular as they are if an investor were permitted to deduct losses only up to the amount of his actual cash investment in an enterprise. Under the Internal Revenue Code, however, the amount of borrowed funds used to acquire a depreciable asset is included in the asset's depreciable cost, or basis, even if the borrower incurs no personal liability on the indebtedness and the only security for repayment is a mortgage of the property acquired. Stated differently, investors may treat the entire cost of a depreciable asset as a depreciable investment by them, even if the asset is acquired entirely with borrowed funds, and even if the asset-acquisition loans are fully non-recourse. The effect of this rule is that investors may claim depreciation and other deductions far in excess of the amount of their actual cash investment.

B. *Partnerships in Particular*

Realty shelters in the more narrow sense are ineffective unless the individual members of the organization holding the de-

[2] This analysis can be further refined. The essential point is that there is a gap between actual cash expenditures for which there is no current deduction and fictional deductions that are available without actual cash expenditures. Thus, it would be more precise to say that there will be tax shelter in the first sense whenever the fictional depreciation deduction for a non-cash expense exceeds the sum of the non-deductible expenses for debt amortization and capital improvement.

preciable interest may report its surplus losses. Partnerships are tax-reporting, but not tax-paying, entities, and income is taxed to the individual partners with no taxation at the partnership level. Surplus partnership losses, unlike corporate losses, are "passed through" to the individual partners for their use in offsetting income from other sources. However, certain elections are made at the partnership level that bind all the partners, such as the choice of method of computing depreciation. In sum, the partnership computes and reports its various items of income, gain, loss, deduction, and credit, and the individual partners report their allocable shares.

A partner may not deduct his share of partnership losses below his basis in his partnership interest.[3] A partner's initial basis in his partnership interest is the amount of money he contributes to the partnership, plus the adjusted basis of any property he contributes.[4] However, the Code specifically provides that a partner shall be treated as having contributed additional money to the partnership to the extent he shares in partnership liabilities.[5] Under the Treasury Regulations, general partners in a general partnership are automatically allocated a share of partnership liabilities in the same proportion as they share in partnership losses. The Regulations further specify that in the case of a limited partnership, the limited partners may share in partnership liabilities for basis purposes, but are only deemed to share in those liabilities that are fully non-recourse as to the partners and to the partnership.[6] Such non-recourse liabilities are automatically shared by the limited partners in the same proportion they share in profits.[7] The effect is that limited partners may deduct partnership losses far in excess of their cash and property investment in the partnership, provided they share in non-recourse liabilities for basis purposes. Because it is critical to an effective limited partnership tax shelter that liabilities be non-recourse, the partnership agreement should be drafted as a counseling document

[3] Losses that are currently non-deductible for lack of basis are not permanently lost; in effect, they are placed in a suspense account and become deductible in later years to the extent of subsequent increases in the partner's adjusted basis for his partnership interest. INTERNAL REVENUE CODE of 1954, § 704(d) [hereinafter cited as CODE].

[4] CODE § 722.

[5] CODE § 752(a) provides:

> Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

[6] Treas. Reg. § 1.752-1(e) (1956).

[7] *Id.*

that will clearly alert the client that both initial and subsequent financing must be non-recourse.

What many investors fail to realize is that there is a corollary treatment of liabilities in later years that can result in unanticipated tax liability. Under the Code, a partner is treated as having received a distribution of cash to the extent his share in partnership liabilities is decreased,[8] even though those liabilities are non-recourse. Just as a limited partner automatically receives a share of non-recourse liabilities upon receipt of an interest in profits, he is automatically relieved of his share of partnership liabilities when he parts with his profits interest. Thus, a limited partner who sells or abandons his partnership interest will be charged with a constructive distribution of cash to the extent he is relieved of his share of non-recourse liabilities.[9] The constructive distribution of cash does not retroactively destroy the tax shelter benefits. The partnership losses reported by the limited partner before his withdrawal presumably were used to offset his ordinary income from other sources, whereas the gain on the constructive distribution of cash is capital gain.[10] Even if the recapture provisions require that part or all of what would otherwise be capital gain be treated as ordinary income, the withdrawing partner will have received, in effect, an interest free loan from the Treasury, in the amount of deferred taxes, for the period of deferral. In addition, the losses may have been timed and claimed in years of greatest income from other sources to maximize their benefit under the graduated tax rates.[11] Finally, the withdrawal and resulting constructive distribution may be timed in a year in which offsetting losses are available.

[8] CODE § 752(b) provides:

> Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

[9] Rev. Rul. 74-40, 1974-1 CUM. BULL. 159:

> Situation 3. Instead of selling his interest L withdraws from the partnership at a time when the adjusted basis of his interest in the partnership is zero and his proportionate share of partnership liabilities, all of which consist of liabilities on which neither he, the other partners nor the partnership have assumed any personal liability, is $15,000.
>
> Accordingly, L is considered to have received a distribution of money from the partnership of $15,000 and realizes a gain of $15,000 determined under the provisions of section 731(a) of the Code.

[10] This is true except insofar as CODE § 751 applies.

[11] The partnership interest may have been acquired at the end of the partner's taxable year to obtain a retroactive allocation of preadmission partnership losses. See Section VIII *infra.*

III. Key Unsuccessful Challenges

The ability to report ordinary loss deductions far beyond actual economic investment by treating acquisition liabilities as part of depreciable basis is, therefore, central to real estate tax shelters. The Service has lost major challenges to tax shelters in cases that have involved two closely related critical factors: the claim to a depreciable interest by a taxpayer who does not appear to bear the economic burden of depreciation, and the inclusion in depreciable basis of liabilities that appear to exist in form but not in economic reality.[12] Two stunning cases indicate the difficulty in separating and treating these issues and the consequent continued availability of tax shelter not only in excess of, but independent of, actual economic investment.

In *Manuel D. Mayerson,*[13] the taxpayer "purchased" what had been an unprofitable office building by making a minimal down payment and giving for the overwhelming bulk of the purchase price a note the terms of which merit consideration. First, although "interest" payments were to be made monthly, no repayment of principal was required until the expiration of ninety-nine years. Second, the note provided that it was non-recourse as to principal. Thus, the seller could not hold Mayerson personally liable for his promise to pay the principal amount of the note, but was confined to seeking satisfaction out of the property mortgaged as security—which in this case included no property other than that allegedly sold. Third, however, the note was *with* recourse as to the monthly interest payments as they accrued, but for no more, not even for accelerated interest payments on default. Finally, the note provided for substantial discounts if it were paid within three years from the initial closing date. In fact, five years after the closing, Mayerson retired the note with a payment of only sixty percent of its face amount.

The Service's position was "essentially that the purchase-money mortgage . . . was a nullity and that a capital investment in the subject property had not occurred."[14] In economic reality and for tax purposes, the Service claimed, the arrangements were nothing other than a lease with an option to purchase. Because

[12] See David F. Bolger, 59 T.C. 760 (1973).

> In this connection, we note that the position of the lessor is sometimes also discussed in terms of his not having any basis. What is more, such discussion sometimes confuses the two questions, i.e., existence of a depreciable interest and the measure of basis, of which respondent's briefs herein furnished an excellent example.

Id. at 769, n.8.

[13] 47 T.C. 340 (1966).

[14] *Id.* at 349.

the note was with recourse only as to interest payments already accrued, Mayerson could walk away from the property at any time with no more personal liability than had he been a tenant-at-will. Moreover, since the note was a standing note which required no amortization payments, Mayerson had no equity buildup from repayment of principal to defend or subject to risk of loss.

The Tax Court held for Mayerson, even though it accepted that "depreciation is not predicated upon ownership of property but rather upon an investment in property" and that "the benefit of the depreciation deduction should inure to those who suffer an economic loss caused by wear and exhaustion of the business property."[15] The court did not make clear how the initial sale put Mayerson in the position of one who would "suffer an economic loss" by immediate actual depreciation of the structure, but stressed that both parties intended a sale, not a lease, and that Mayerson expended substantial sums on repairs and improvements in the years immediately following the closing. Mayerson's "investment" in the property included the "valid debt obligation" created by the purchase-money note. The court said that in light of the frequency of non-recourse financing of real estate, and in light of the Supreme Court's decision in *Crane v. Commissioner*,[16] the lack of personal liability would not prevent the note obligation from being included in basis.[17] Nor would the fact that no principal was required to be repaid for ninety-nine years change the result. Although the ninety-nine year term did "seem unusually long," mortgagees frequently "waive payments of principal on income-producing properties in distress or incentive situations."[18] Moreover, the court sustained depreciation deductions that had been claimed on the full face amount of the note, despite the note's provisions for substantial discounts on early repayment and despite the fact that the note had been retired at a discount of over a third of its face amount. The subsequently "negotiated" purchase price was treated

[15] *Id.* at 350.

[16] 331 U.S. 1 (1947). *Crane* established that relief from liabilities, including non-recourse liabilities, is treated as a distribution of cash in the context of a system that includes those liabilities in depreciable basis.

[17]

> Taxpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property. The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability.

47 T.C. at 352.

[18] *Id.* at 346.

as a bonus discount for early repayment. The court concluded that "the cost basis at the time of purchase should be the nondiscount price."[19]

David F. Bolger[20] involved "a fairly typically structured tax shelter of industrial real estate" that was sustained over the objection of four dissenting judges.[21] The Service challenged ten different transactions arranged by Bolger in the same basic pattern.[22] First, a financing corporation would be formed with an initial capitalization of $1,000, the shareholders of which were the investors who would ultimately receive title to the property and claim deductions as owners of depreciable interests. The corporation would then purchase a building that a commercial concern was prepared to lease immediately. On occasion, the seller of the building would become the lessee. Then, typically on the same day as the building purchase, the corporation would sell its own negotiable interest-bearing notes for the full amount of the purchase price to an institutional lender pursuant to a note purchase agreement that secured the notes by a first mortgage and by an assignment of the lease, the term of which was equal to or greater than the maturity of the note.[23] The corporation would then transfer the property to its investor-shareholders subject to both the long-term lease and the financing on which none of the investors assumed any personal liability.[24]

The commercial tenants occupied the premises under "net" leases with fixed annual rent.[25] However, the rental payments were only slightly more than the amount required to pay the debt service due on the mortgage. Under the provisions of the mortgage and lease assignment, the lessees were obligated to pay the rent directly to the mortgagee, who would distribute any excess over

[19] *Id.* at 354.

[20] 59 T.C. 760 (1973). An excellent discussion of this case is Lurie, *Bolger's Building: The Tax Shelter That Wore No Clothes*, 28 TAX L. REV. 355 (1973).

[21] Weinstein, *The* Bolger *Case Is a Warning to Tax-Shelter Investors*, 2 REAL ESTATE L.J. 595 (1973).

[22] Neither the Service nor the taxpayer sought separate treatment for the individual transactions.

[23] The financing corporation was also obligated to pay all the lender's out-of-pocket expenses, including legal fees.

[24] The documentation included an "assumption agreement" under which the transferee-investors were required to assume all the obligations of the corporation under the lease and mortgage. The agreement provided, however, that the transferees incurred no personal liability by reason of the assumption. In short, they "assumed" nothing.

[25] The leases provided that the lessees would pay all operating expenses, including taxes, insurance, and repairs. Thus, the rent paid to the lessor was "net" to him.

debt service to the corporation.[26] Finally, the lessee's rental obligation was to continue even if the building were destroyed, but in that event the lessee had the further right to purchase the building for an amount approximately equal to the sum required to repay the mortgage financing.[27]

In short, the "lessees" looked more like the mortgagor-owners of the property than did Bolger and his fellow transferees, although the latter claimed the interest and depreciation deductions as mortgagor-owners. The assignments of the leases to the lenders obligated the tenants to pay directly to the lenders the full amount of debt service on the purchase money loans, whereas the investors had no personal liability on those obligations. The personal liability of the commercial and manufacturing lessees was critical to the lender's security for repayment, and the liability of those claiming depreciation was nonexistent. Because the rents were fixed, the lessee retained all the benefits of increases in the operating income of the property. On the other hand, the investors were to receive only whatever nominal amounts were left over after the lessees' fixed rent payments were paid to and applied by the lender. The economic benefit the investors would receive would be in the buildup of equity in the property which would come under their control (a) at the expiration of the primary lease, which was typically twenty-five to twenty-eight years; or (b) at the expiration of the renewal options exercisable by the lessee, which were typically for three to five successive five-year terms at reduced rent. In short, control of the properties was not likely to come into the hands of the investors for some time, although there was a possibility of sharing in refinancing proceeds.

The Service, however, did not argue that the lessees were the ones entitled to the depreciation deductions. Rather, it argued that the depreciable interest vested in the corporation and did not pass to Bolger and the other transferees. The argument for denying Bolger the benefit of the deductions was that

> because of the long-term leases and the commitments of the rentals to the payment of the mortgages by virtue of the assignments of the leases which were consummated prior to the execution of deeds, the conveyances by each

[26] The corporation was required to remain in existence and to refrain from engaging in any other activity.

[27] Refusal to accept the offer of purchase would terminate the lease. The lessee was permitted to sublease the premises or any portion thereof, and he was permitted to assign his interest in the lease, provided that the sublessee or assignee promised to comply with the terms of the mortgage and the lease, and further provided that the lessee remain personally liable for the performance of all its obligations under the lease.

> corporation transferred only a reversionary interest in the buildings and that consequently petitioner did not acquire a present interest in the properties which may be depreciated for income tax purposes.[28]

The Tax Court accordingly defined the two basic issues as (1) whether the corporation or its stockholder-transferee-investors should be treated as entitled to a depreciable interest and (2) whether, if the transferees were the holders of a depreciable interest, their bases in that interest included the amount of financing. The Tax Court found that the depreciable interest was held by Bolger and his fellow investors and concluded that, under the interpretation of *Crane* enunciated in *Mayerson,* the investors could include the amount of liabilities in their depreciable bases.

IV. The Limited Partnership

In part because of its defeats in challenges to the underlying transaction in cases like *Mayerson* and *Bolger,* the Service has launched a series of attacks against the vehicle most commonly used to deliver surplus losses to high-bracket investors: the partnership and, in particular, the limited partnership. There is a greater likelihood that the Service will be more successful in such litigation because partnership tax doctrine is relatively undeveloped and was not designed to deal with current realty shelters. Subchapter K was drafted with the "ma-and-pa" grocery store more in mind than anything resembling publicly syndicated partnerships, offered and sold with computer printouts of depreciation and amortization schedules demonstrating post-tax return on investment to participants in different income brackets. The Regulations provide little additional guidance, and judicial development of some of the major provisions of Subchapter K has just begun. Given that the Service is relatively unfettered by established partnership doctrine, the limited partnership in particular stands ripe for attack for the very reason that it is so much more popular than the general partnership—it offers investors a pass-through of losses while providing a freedom from personal liability that appears extremely corporate.

The "corporateness" of the limited partnership form becomes even more clear from an historical perspective. Limited partnership acts in this country[29] antedated general corporation acts by

[28] 59 T.C. at 768 (footnote omitted).

[29] Limited partnerships, which were also originally referred to in this country as "special partnerships," were not an American invention:

> In the French law, partnerships are distinguished into three sorts. * * * (2.) Partnerships *in commandité,* or *in commendam,* that is, limited partnerships, where the contract is between one or more

several decades.[30] At a time in which corporate charters were difficult to obtain, creditors who wanted more than a fixed rate of interest on their investment, or more "interest" than usury laws would permit, were subject to the risk of judicial imposition of personal liability as "partners" based on profit sharing. The solution was found in the early limited partnerships acts, which provided in short, that if one were really an outside creditor, and if that fact were made clear to the world at large, he could share in profits free from personal liability. Thus, a passive investor who followed the statutory procedure for informing the world of the nature and extent of his limited interest would be free from the personal liability of a partner. The early acts were strictly construed by the courts, which imposed full liability for minor failures in compliance. The Uniform Limited Partnership Act now provides that personal liability will not be imposed because of technical deviations from statutory requirements[31] and continues the themes of passive investment and formal notice to the world.[32]

A. *Formation and Notice to the World*

Unlike a general partnership, a limited partnership will not spring into existence as a matter of law. Under the Act a limited partnership "is formed if there has been substantial compliance in good faith" with the Act's filing requirements.[33] Section 2 requires that a certificate of limited partnership be filed containing

> persons, who are general partners, and jointly and severally responsible, and one or more other persons, who merely furnish a particular fund or capital stock, and thence are called *commandataire*, or *commendataires*, or partners *in commandité;* the business being carried on under the social name, or firm of the general partners only, composed of the names of the general or complementary partners, the partner *in commandité* being liable to losses only to the extent of the funds or capital furnished by them. * * * Similar distinctions are adopted in many other foreign countries, and in the Laws of Louisiana. Special partnerships *in commandité* have also been recently introduced into the jurisprudence of several States in the Union. But the regulations applicable to such partnerships vary in different countries and States, and are strictly local, and therefore seem unnecessary to be brought further under examination in the present Commentaries.

J. STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP 127-28 (6th ed. 1868) (citations omitted).

[30] *See generally* A. BROMBERG, PARTNERSHIP § 26, at 143-44 (1968).

[31] UNIFORM LIMITED PARTNERSHIP ACT § 11 [hereinafter cited as ULPA].

[32] ULPA §§ 10, 6.

[33] ULPA § 2(2).

certain specified information.[34] In essence, the certificate must identify the general and limited partners and detail the nature and extent of the interests of the limited partners and the extent to which new limited partners may be admitted. Thus, for example, the certificate must state how much, when, and under what circumstances the limited partners must contribute, the share of profits or other compensation by way of income that each limited partner will receive by way of his contribution, and any limited partner's right to demand property other than cash in return for his contribution. A major inconvenience of the limited partnership form is that the certificate must be amended to reflect changes in the required information. The partnership agreement should be drafted to remind the client that improper or misleading notice to the world, either as a result of omissions or false statements in the certificate,[35] or by improper use of the surname of a limited partner in the partnership name,[36] can result in the loss of limited liability.

B. *The Limited Partner as Passive Investor*

A limited partner may contribute cash or other property, but not services, for his interest in the partnership.[37] Although limited partners "*as such* shall not be bound by obligations of the partnership,"[38] a limited partner may lose his limited liability if he takes part in the "control" of the business.[39] A disadvantage of the limited partnership form is uncertainty about what constitutes "control" within the meaning of the Act. The statute does not say that a limited partner who exercises control will automatically lose his limited liability. It simply provides that he *may* lose it. In short, the wording of the Act does not require strict application of the "control" provision, and courts may take into account considerations of third party reliance in determining whether to deny limited liability to a limited partner who has arguably exercised control.[40]

[34] Under the ULPA as enacted in some jurisdictions, a certificate must be filed in more than one place. *See, e.g.*, CONN. GEN. STAT. ANN. § 34-10(1)(b) (Supp. 1975); NEV. REV. STAT. § 88.030(1)(b) (1973).

[35] ULPA § 6.

[36] ULPA § 5.

[37] ULPA § 4.

[38] ULPA § 1 (emphasis added).

[39] "A limited partner *shall not become liable* as a general partner *unless*, in addition to the exercise of his rights and powers as a limited partner, *he takes part in the control* of the business." ULPA § 7 (emphasis added).

[40] *See* Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471 (1969).

The peculiar nature of limited partnerships under local law continues to present questions under the Code, which has no separate limited partnership classification. In *Meyer v. Commissioner*,[41] it was recently held that an exchange of a general partnership interest for a limited partnership interest was not an exchange of like-kind properties, even though both partnerships owned and rented apartments in the same area:

> A general partner has a broad spectrum of rights and liabilities while a limited partner is largely shielded from liability and his rights are generally limited to a right to inspect the partnership books, to an accounting, to have the partnership dissolved in certain situations and, under certain circumstances, to withdraw his contribution to the partnership. . . . He may not actively participate in running the business and his liability is generally limited to the amount of his investment.[42]

In conclusion, insofar as limited partnerships were originally created to avoid the common law of partnership liability when the corporate form was not readily available, insofar as the nature of a limited partner's rights and liabilities is "of a different nature and character" from those of a general partner, and insofar as the principal advantage of the limited partnership form after the enactment of general corporation acts lies in its treatment as a partnership for tax purposes, it is not surprising that the Service has suggested that certain limited partnerships be classified as corporations for tax purposes.

V. Federal Income Tax Classification

A. *Unreliability of the Regulations*

Two points should be emphasized at the outset of a discussion of the classification Regulations. First, under the Regulations, an organization may be taxed as a corporation even if it is a partnership under local law. Federal law determines the standards for tax classification, while local law determines whether the federal standards are met.[43] Second, the Regulations cannot currently be viewed as completely controlling with respect to tax classification. An organization may qualify as a partnership under the Regulations and still have no assurance that it will be so classified for tax purposes. The Service would prefer to withhold partnership

[41] 503 F.2d 556 (9th Cir.), *aff'g per curiam* 58 T.C. 311 (1974).

[42] 503 F.2d at 557-58 (citations omitted).

[43] Treas Reg. § 301.7701-1(c) (1965).

classification from limited partnerships that appear extremely corporate and is attempting to work around the present classification Regulations, which are heavily biased toward partnership classification of all partnerships, general or limited, under Uniform Acts.[44] The Regulations, originally based on the opinion in *Morrissey v. Commissioner*,[45] were amended in an attempt by the Treasury to make it extremely difficult for professional associations to achieve corporate classification. The battle with the professional associations is over, but the Service is saddled with Regulations extremely biased toward partnership classification.[46] A brief review of the Regulations will reveal the bias and highlight the significance of the Service's recent actions.

B. The Regulations

The Code definition of a "partnership" is a negative one,[47] embracing groups that are not, for tax purposes, trusts, estates,

[44] A few states authorize a form of organization known as a "partnership association" or a "limited partnership association." Prior to the adoption of the current classification Regulations, the Regulations provided that such organizations were taxable as corporations. Treas. Reg. § 39.3797-6 (1955). The current Regulations treat partnership associations in the section captioned "Partnerships" and do not flatly state that they are taxable as corporations, but merely provide that they, like other organizations, must run the "corporate characteristics" gamut to determine their classification. Treas Reg. § 301.7701-3(c) (1960). In Rev. Rul. 71-434, 1971-2 CUM. BULL. 430, the Service applied the "corporate characteristics" test to an organization formed as a partnership association under Ohio law and concluded that the organization was taxable as a corporation.

[45] 296 U.S. 344 (1935). In *Morrissey*, the Court found a "trust" to be an association taxable as a corporation.

[46]

> Clarity on the corporate-noncorporate characterization has not been promoted by the curious but economically understandable role reversal which has occurred. In the 1920-30s the tax authorities were seeking corporate treatment of many unincorporated organizations which resisted it. In the 1950-60s the tax authorities were resisting corporate treatment of many unincorporated organizations which sought it. In each period, of course, it was a matter of which form produced higher taxes for the organizations involved.

A. BROMBERG, PARTNERSHIP § 24, at 140 (1968).

[47]

> The term *"partnership" includes* a syndicate, *group*, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and *which is not,* within the meaning of this title, *a trust or estate or a corporation;* and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

CODE § 7701(a)(2) (emphasis added). *See also* CODE § 761(a), (b).

or corporations.[48] Under the Regulations, "corporate characteristics" are the basis for distinguishing a partnership from an association taxable as a corporation. Six "major characteristics" ordinarily found "in a pure corporation" tend to distinguish the corporate form from other organization forms. These corporate characteristics include (1) associates; (2) an objective to carry on business and divide the gains therefrom; (3) coninuity of life; (4) centralization of management; (5) liability for corporate debts limited to corporate property; and (6) free transferability of interests. Because the first two characteristics are "generally common to both corporations and partnerships," tax classification depends on the presence of the last four.[49] Furthermore, the Regulations provide that an unincorporated organization will "not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics."[50] The basic rule is that partnership classification is available whenever any two of the last four corporate characteristics are avoided. Although the Regulations state that "other factors" in addition to these "may be found in some cases which may be significant in classifying an organization as an association, a partnership, or a trust," there is no suggestion as to what those "other factors" might be.[51]

1. Centralization of Management

Centralized management is present if any person or group "has continuing exclusive authority to make the management decisions necessary to the conduct of the business" such that the persons "resemble the directors of a statutory corporation."[52] Those having the authority need not be members of the organization,[53] but must have

[48] "Corporation" is broadly defined to include "associations, joint-stock companies and insurance companies." CODE § 7701(a)(3). See also Treas. Reg. § 301.7701-(c) (1965), which provides:

> The term "corporation" is not limited to the artificial entity usually know as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint-stock company, and an insurance company.

[49] Treas. Reg. § 301.7701-2(a)(2) (1965).

[50] *Id.* § 301.7701-2(a)(3).

[51] *Id.* § 301.7701-2(a)(1).

[52] *Id.* § 301.7701-2(c)(1). The Regulations further provide that organizations "composed of many members" generally are centrally managed.

[53] *Id.* § 301.7701-2(c)(2):

> Centralized management can be accomplished by election to office, by proxy appointment, or by any other means which has the effect of concentrating in a management group continuing exclusive authority to make management decisions.

> continuing *exclusive* authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization. Thus, there is not centralized management when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal.[54]

Exclusivity of management authority is flatly deemed absent in general partnerships because of the "mutual agency relationship" among general partners. An agreement among the partners to vest management powers exclusively in a select few "will be ineffective as against an outsider who had no notice of it" and is insufficient to constitute centralized management.

Even though limited partners may not exercise "control" over the business, limited partnerships generally do not have centralized management. However, "centralized management ordinarily does exist in such a limited partnership if *substantially* all the *interests* in the partnership are owned by the limited partners."[55] It is not clear what "interests" are significant, for example, in net cash flow, capital, or taxable income or loss. Nor is there any indication in the Regulations when "substantially all" the interests are owned by the limited partners, although there appears to be some informal understanding that centralized management is eliminated when the general partners own at least twenty percent of all the interests in the partnership.[56]

2. *Limited Liability*

Limited liability is present "if under local law there is no member who is personally liable for the debts of or claims against the organization."[57] Personal liability exists with respect to each general partner in a general partnership. Similarly, personal liability exists with respect to each general partner in a limited partnership except

> 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

[54] *Id.* § 301.7701-2(c)(3) (emphasis added).

[55] *Id.* § 301.7701-2(c)(4) (emphasis added).

[56] Sexton, *Qualifying as a Partnership for Tax Purposes*, 1974-2 N.Y.U. 32D INST. ON FED. TAX. 1447, 1459.

[57] Treas. Reg. § 301.7701-2(d)(1) (1965). Even if a person who is personally liable for the obligations of the organization is the beneficiary of an indemnification agreement, personal liability still exists with respect to that member if the member remains personally liable to creditors. *Id.* This is true whether or not the indemnifying party is a member of the organization.

> *and when* he is merely a "dummy" acting as the agent of the limited partners.[58]

The general partner must have no substantial assets *and also* must be merely a "dummy" before the corporate characteristic of limited liability will be present. Limited liability may not even be deemed to exist with respect to a corporate general partner with insubstantial assets. Personal liability exists with respect to a corporate general partner

> when the corporation has substantial assets (other than its interest in the partnership) which could be reached by a creditor of the limited partnership. . . . In addition, although the general partner has no substantial assets (other than his interest in the partnership), personal liability exists with respect to such general partner when he is not merely a "dummy" acting as the agent of the limited partners.[59]

It would seem impossible for a limited partnership to have the corporate characteristic of limited liability because there will be personal liability as to general partners who are not "dummies," whether they have substantial assets or not; if they are "dummies," personal liability will exist with respect to the limited partners for whom they act.[60]

3. *Free Transferability of Interests*

Free transferability of interests is present if each of the members of the organization "or those members owning substantially all of the interests in the organization have the 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."[61]

[58] *Id.* § 301.7701-2(d)(2) (emphasis added).

[59] *Id.* As to what constitutes "substantial assets," the Regulations state:

> [I]f the organization is engaged in financial transactions which involve large sums of money, and if the general partners have substantial assets (other than their interests in the partnership), there exists personal liability although the assets of such general partners would be insufficient to satisfy any substantial portion of the obligations of the organization.

Id.

[60]

> Notwithstanding the formation of the organization as a limited partnership, when the limited partners act as the principals of such general partner, personal liability will exist with respect to such limited partners.

Id.

[61] *Id.* § 301.7701-2(e)(2). If the right to substitute is subject to a right of first refusal in the other members,

> it will be recognized that a modified form of free transferability of

The member must be able to transfer, without consent, "all the attributes of his interest in the organization."[62] Free transferability does not exist when a member can assign his right to share in profits "but cannot so assign his right to participate in the management of the organization."[63] Furthermore, even though the agreement provides for the transfer of a member's interest, "there is no power of substitution and no free transferability of interest 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 organization."[64]

The corporate characteristic of free transferability can be eliminated in a wide variety of situations at little or no cost. Because of the "control" limitation, limited partners generally have very little right to participate in management and are generally only entitled to an accounting and the right to inspect and copy the partnership books. Therefore, little, if anything, is lost to the transferee who does not become the full substitute of a limited partner. Further, restrictions on transfer may be necessary for reasons apart from the classification Regulations—for example, to assure continued availability of a private placement or intrastate exemption to the state or federal security laws, and to avoid automatic termination for tax purposes.

4. Continuity of Life

An organization has continuity of life "if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization."[65] Dissolution is defined as "an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law."[66] Thus, dissolution is defined as a mere technical reconstitution of the organization under local law so that, theoretically, a new organization continues the business. Termination of the business is not required to eliminate continuity

> interests exists. In determining the classification of an organization, the presence of this modified corporate characteristic will be accorded less significance than if such characteristic were present in an unmodified form.

Id. How much "less significance" will be accorded is not clear.

[62] *Id.* § 301.7701-2(e) (1).

[63] *Id.* Under the ULPA, a limited partner may not assign all his interest unless given a right to do so in the certificate or unless all the members consent. ULPA § 19. Therefore, he may assign only his interest in profits and losses and not his interest in management.

[64] Treas. Reg. § 301.7701-2(e) (1) (1965).

[65] *Id.* § 301.7701-2(b) (1).

[66] *Id.* § 301.7701-2(b) (2).

of life, which may be eliminated even though the business may be continued indefinitely.[67] Even contractual obligations to continue the organization by the remaining members upon the death or withdrawal of any member will not result in continuity of life if, notwithstanding such agreement, the organization is dissolved under local law. Furthermore, notwithstanding an agreement to continue the organization for a stated period or until the completion of a stated transaction, if any member has the power under local law to dissolve the organization, continuity of life is eliminated. Therefore, partnerships corresponding to either of the Uniform Acts lack continuity of life.[68]

[67] This is so even though ULPA § 20 provides:

> The retirement, death or insanity of a general partner dissolves the partnership, unless the business is continued by the remaining general partners
>
> (a) Under a right so to do stated in the certificate, or
>
> (b) With the consent of all members.

[68] Treas. Reg. § 301.7701-2(b)(3) (1965). The Service took the position that the California Limited Partnership Act, CAL. CORP. CODE §§ 15,501 *et seq.* (West 1955), as amended in 1963, *id.* § 15,520 (West Cum. Supp. 1975), no longer corresponded to the ULPA, such that a California limited partnership necessarily had the corporate characteristic of continuity of life. Such a conclusion is critical to public limited partnerships, which normally have the corporate characteristics of centralization of management and free transferability of interests, and which will be taxed as corporations if they are deemed to have either of the two remaining corporate characteristics—limited liability and continuity of life. The thrust of the California amendments was to further a policy of investor democracy by mandating the right of limited partners to vote on certain matters affecting the basic structure of the limited partnership, such as the sale of all or substantially all the partnership assets and the election or removal of general partners. As a result of the uncertainty caused by the Service's position, the California legislature, effective November 1, 1973, re-amended the California Act so that the continuity of life provision is again identical with the ULPA provision. *Id.* § 15,520.5.

Notwithstanding the amendment to the California statute, the California Commissioner of Corporations has stated that he will continue to require provisions in the limited partnership agreement authorizing a vote of the limited partners to remove a general partner and accept a new general partner.

> With the 1973 amendment to the California Uniform Limited Partnership Act, the withdrawal of the general partner who is voted out will cause the dissolution of the organization, and there is no provision in the statute providing for continuity in that case. Thus, under the existing Regulations, continuity of life will not exist in a California limited partnership even if there is a provision in the partnership agreement for continuing the partnership where a general partner is voted out and a new general partner is voted in.

Sexton, *supra* note 56, at 1468.

On June 11, 1974, the Service ruled that the amended California Limited Partnership Act, which provides for dissolution of a partnership upon the retirement, death or insanity of a general partner, is a statute cor-

C. Revenue Procedure 72-13 and Beyond

In short, the Regulations are so biased in favor of partnership classification that draftsmen developed quick rules of thumb to eliminate at least two corporate characteristics to secure partnership classification. Into this rather pleasant world for limited partnerships, the Service dropped the bombshell of Revenue Procedure 72-13.[69] This procedure purports to do nothing more than state the conditions that must be met to obtain an advance ruling on the tax classification of a limited partnership whose sole general partner is a corporation.[70] Nevertheless, many practitioners have been compelled to treat the requirements of 72-13 as substantive and binding, not merely procedural. First, as a practical matter, some transactions would not be consummated without an advance ruling. Second, agents began to apply the 72-13 quidelines as substantive requirements on audit.[71] Third, some state securities agencies have begun to insist that the requirements of 72-13 be met on the ground that an offering is not sufficiently "fair, just and equitable" if the critical element of a partnership tax classification is unestablished. Finally, many practitioners are painfully aware that a limited partnership with a sole corporate general partner is functionally indistinguishable from a corporation apart from tax considerations. The basic objection to the 72-13 requirements is not that partnership classification is ultimately appropriate, but that the requirements are inconsistent with the Regulations and somewhat arbitrary. The three requirements are those of stock ownership, investment unit, and net worth.

1. Stock Ownership

The requirement that the "limited partners will not own, directly or indirectly, individually or in the aggregate, more than 20 percent of the stock of the corporate general partner or any affiliates"[72] is arguably relevant to the corporate characteristic

responding to the Uniform Limited Partnership Act. Thus, an association formed under the California Act as amended would lack the corporate characteristic of continuity of life. Rev. Rul. 74-320, 1974-2 CUM. BULL. 404-05. The ruling emphasizes that the Regulations require only a very technical kind of dissolution to eliminate continuity of life.

[69] Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

[70] The requirements of Revenue Procedure 72-13 are applied in any situation in which a limited partnership has no individual general partner.

[71] Welter, *Limited Partnerships With A Corporate General Partner—Rev. Proc. 72-13*, 5 TAX ADVISOR 329 (1972).

[72] Rev. Proc. 72-13, 1972-1 CUM. BULL. 735. For the purpose of determining stock ownership in the corporate general partner or its affiliates, the attribution rules of CODE § 318 apply.

of the Regulations.[73] If the limited partners own enough stock in the corporate general partner to control it, centralized management analogous to that placed in a corporate board of directors may be present. Continuity of life may be present if the limited partners can prevent the corporate general partner from dissolving or withdrawing from the partnership. Free transferability of interests is arguably present if the limited partners can force the general partner to approve transfers of interests. An attempt at limited liability is present if the corporate general partner is merely an agent controlled by the limited partners.[74] Consider the most clear-cut example of a corporate general partner wholly owned by the limited partners in proportion to their partnership interests. Avoidance of corporate tax and entitlement to pass-through of losses would be sought, in effect, by the device of dubbing the stockholders limited partners.

In part because the stock ownership requirement is fairly arguably related to the corporate characteristics in the classification Regulations, criticism has centered not so much on the fact that a stock ownership requirement is imposed as on the twenty percent figure. Some feel that the twenty percent limit on ownership of the stock of the general partner is too strict because the holders of only twenty percent of the stock of a corporation rarely control it, even though effective control is often present in the absence of absolute control.

2. *Investment Unit*

The requirement that the purchase of a limited partnership interest "does not entail a mandatory or discretionary purchase or option to purchase any type of security of the corporate general partner or its affiliates" is somewhat more elusive. The rationale appears to be that such a coupling makes it difficult for the Service to determine exactly what is being purchased. The prin-

[73] This requirement seems to assume a corporate general partner with only one class of stock.

[74] However, it is hard to imagine when there could be limited liability under the Regulations since they state there would be personal liability as to the limited partners who "control" a general partner. See text accompanying notes 37-40 *supra*. There is, however, one basic possibility that suggests itself. Under the Regulations, the personal liability of the limited partners in such a situation is based on local law. If, under local law, a reliance requirement were imposed before limited partners would lose their limited liability because of "control," then there might not always be personal liability resulting from an exercise of control. Consider, for example, the situation in which a limited partnership's asset is subject to a long-term net lease to a management company. The ability of the limited partners to control the relatively minor functions that might be undertaken by the general partner might be insufficient to support an imposition of personal liability on them.

cipal criticism of this requirement centers on the lack of its correlation with the twenty percent stock ownership limitation, insofar as the coupling of any purchase of any security of the corporate general partner with the purchase of a limited partnership interest is sufficient to preclude a favorable ruling. In any event, the investment unit requirement is not that controversial because the problem generally is easy to avoid.

3. Net Worth

The net worth requirement has caused the greatest controversy:

> If the corporate general partner has an interest in only one limited partnership and the total contributions to that partnership are less than $2,500,000 the net worth of the corporate general partner at all times will be at least 15 percent of such total contributions or $250,000, whichever is the lesser; if the total contributions to that partnership are $2,500,000 or more, the net worth of the corporate general partner at all times will be at least 10 percent of such total contributions.[75]

Although objections have been made that these requirements are inherently vague[76] and arbitrary,[77] the fundamental objection is that they are in direct conflict with the Regulations.

[75] Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

[76] The vagueness objection focuses on the uncertainty in computing the two central figures to the net worth requirement—total contributions to the partnership and the net worth of the corporate general partner. Revenue Procedure 72-13 does not elaborate on the computation of "total contributions" to the limited partnership. The Service apparently will exclude from the scope of the term "contributions" the value of services rendered or to be rendered by a general partner and loans made to the partnership. Weiler, *Limited Partnerships with Corporate General Partners: Beyond Rev. Proc. 72-13*, 36 J. TAXATION 306 (1972). As to the question of loans, debt-equity distinctions, although developed primarily in the corporate context, apply also to partnerships. Joseph W. Hambuechen, 43 T.C. 90 (1964). If a "loan" were treated as a contribution to capital for basis purposes, it would presumably be similarly treated in computing "total contributions" under Revenue Procedure 72-13. *See generally* Rev. Rul. 72-135, 1972-1 CUM. BULL. 200; Rev. Rul. 72-350, 1972-2 CUM. BULL. 394. It is also unclear whether the general partner must, from the outset, maintain its net worth in relation to the total contributions as they are made or to the total expected contributions. The contributions of the limited partners in real estate partnerships are frequently made on a staggered basis, like construction loans. It is not clear whether the general partner can satisfy Revenue Procedure 72-13 by maintaining the required percentage of contributions at any given point and increasing its net worth as contributions increase.

[77] When the corporate general partner has an interest in only one limited partnership, the partner's net worth does not include its interest in the

The net worth requirements bear directly on the corporate characteristic of limited liability. The Regulations state that when a corporation is the general partner personal liability exists as to the corporation if it has substantial assets other than its interest in the partnership. However, the Regulations further provide that the corporate characteristic of limited liability will not be present, even if the general partner has insubstantial assets, so long as the general partner is not merely a "dummy" acting as agent for the other partners.[78] The net worth requirement of 72-13 effectively eliminates the latter provision in the Regulations, at least insofar as it is being applied as a substantive requirement by agents on audit and state securities commissioners. To that extent, 72-13 does more than increase the difficulty of avoiding the corporate characteristic of limited liability. It is tantamount to a requirement that the corporate characteristic of limited liability must be in eliminated, and, as such, it is not in accord with the equal weight given each characteristic under the Regulations.

More recent actions by the Service have converted the uncertainty caused by Revenue Procedure 72-13 into fear of an all-out

limited partnership or any accounts or notes receivable from or payable to the limited partnership. If the corporate general partner has interests in more than one limited partnership, Revenue Procedure 72-13 seems to require that its net worth be computed without reference to *any* of its interests in any limited partnership or to any accounts or notes receivable from or payable to any limited partnership:

> If the corporate general partner has interests in more than one limited partnership, the net worth requirements explained in the preceding paragraph will be applied separately for each limited partnership, and the corporate general partner will have at all times (exclusive of any interest in any limited partnership and notes and accounts receivable from and payable to any limited partnership in which the corporate general partner has any interest), a net worth at least as great as the sum of the amounts required . . . for each separate limited partnership.

Rev. Proc. 72-13, 1972-1 CUM. BULL. 735. This latter rule has been criticized as an arbitrary exclusion of valuable assets of the general partner, particularly insofar as it eliminates from the computation assets in the form of limited partnership interests in limited partnerships in which the corporation is not a general partner.

Revenue Procedure 72-13 also requires that a corporation, when it is the sole general partner of more than one limited partnership, must maintain at all times a net worth as great as the sum of the amounts required with respect to each limited partnership. This rule has been criticized as encouraging the formation of a single, large, limited partnership in order to bring the ten percent figure into operation, since several small limited partnerships would each be required to meet the fifteen percent requirement which applies when total contributions are less than $2,500,000.

[78] See the discussion of the corporate characteristic of limited liability in text accompanying notes 57-60 *supra.*

war on realty shelter partnerships. In Revenue Procedure 74-17, the Service announced "certain conditions" under which it would not issue advance rulings "concerning classification of organizations which raise factual questions as to whether their 'principal purpose' is the reduction of Federal taxes."[79] Revenue Procedure 74-17 contains a direct disclaimer of a kind not included in Revenue Procedure 72-13:

> These operating rules do not define, as a matter of law, whether the principal purpose of the organization is the reduction of Federal taxes, nor whether participants in an organization are partners or whether such an organization is a partnership, nor do they define any other terms used in the Internal Revenue Code, Income Tax Regulations, Procedure and Administration Regulations, or Revenue Rulings.[80]

Nevertheless, the requirements clearly set out the kinds of factors that Commissioner Alexander had mentioned as susceptible to challenge.[81]

> .01 The interests of all of the general partners, taken together, in each material item of partnership income, gain, loss, deduction or credit is equal to at least one percent of each such item at all times during the existence of the partnership. In determining the general partners' interests in such items, limited partnership interests owned by the general partners shall not be taken into account.
>
> .02 The aggregate deductions to be claimed by the partners as their distributive shares of partnership losses for the first two years of operation of the limited partnership will not exceed the amount of equity capital invested in the limited partnership.
>
> .03 A creditor who makes a nonrecourse loan to the limited partnership must not have or acquire, at any time as a result of making the loan, any direct or indirect interest in the profits, capital, or property of the limited partnership other than as a secured creditor.[82]

In short, the Service has identified several characteristics of realty partnerships that may subject them to challenge under partnership doctrine and under more general principles of tax avoidance. Paragraph .01 is aimed at allocation systems, of the type discussed below, that produce dramatic separations of economic

[79] Rev. Proc. 74-17, 1974-1 Cum. Bull. 438.

[80] *Id.* at 439.

[81] *See* 40 J. Taxation 37 (1974).

[82] Rev. Proc. 74-17, 1974-1 Cum. Bull. 438, 439.

benefits from tax benefits and raise questions about the existence of a partnership and about the "principal purpose" of partnership allocations. Paragraph .02 is a suggestion that a result-oriented approach may be applied to the "principal purpose" limitation on partnership allocations and can also be interpreted as raising fundamental issues about whether a partnership has been entered into for "profit." Paragraph .03 suggests that non-recourse "loans" made to the partnership by participants will be scrutinized more carefully to determine whether they may be used to increase basis or to support claims of guaranteed payments.

Early this year, the Service issued Revenue Procedure 75-16, a "checklist outlining required information that is frequently omitted from requests for rulings" on tax classification.[83] The information now required to obtain a classification ruling includes many items that, until recently, practitioners had not considered relevant to the issue of tax classification. The required information includes net worth representations as to all general partners, not merely corporate general partners, a detailed description of "creditors' interests" and "benefits," and a detailed description of the partnership's method of allocating profits and losses, including the economic significance, if any, of negative capital accounts. In effect, those seeking classification rulings must now disclose factors that will alert the Service to potential challenges to some or all of the partnership's characteristics and transactions on issues other than classification. In addition, it has recently been reported that the Service has taken the position on audit that the non-recourse nature of a major portion of a limited partnership's liabilities, coupled with a lack of substantial assets on the part of its corporate general partner, will cause a limited partnership to have the corporate characteristic of limited liability.[84] The net effect of these recent actions is that counsel must be much more cautious about relying on "the letter of the law" as it has been written until recently and more concerned about the economic realities of proposed partnership arrangements.

VI. Partnership Allocations

Flexibility in allocating various economic and tax consequences of operations among partners has long been considered a prime advantage of the partnership form. Section 704 broadly states that a partner's share of income, gain, loss, deduction, or credit may be determined by the partnership agreement, except that allocations that are made for the "principal purpose" of

[83] Rev. Proc. 75-16, 1975 Int. Rev. Bull. No. 10, at 59.

[84] *Point to Remember No. 1,* 28 Tax Law. 409 (1975).

the avoidance or evasion of tax shall be disregarded and reallocated according to the partner's ratio for sharing "taxable income or loss of the partnership, as described in section 702(a)(9)."[85] Thus, for example, a partner who undertakes to pay all partnership research and experimental expenditures may be allocated the deductions for the full amount of those expenditures, provided the allocation is not made for the principal purpose of tax avoidance or evasion.[86]

In the real estate area, a great deal of advantage has been taken of the ability to allocate items of deduction and loss, and the Service has recently refused to rule on whether the "principal purpose" limitation has been violated.[87] Partners, particularly in real estate partnerships, rarely have one, flat, over-all percentage interest. A partner may have several ratios for sharing different items of partnership income, gain, loss, deduction, or credit, and the ratios may change over time. The benefit of depreciation deductions, for example, is frequently allocated specially. Many real estate partnerships use three basic allocations to separately allocate cash benefits and surplus losses: (1) net cash flow; (2) taxable income or loss; and (3) proceeds in the event of refinancing or sale. These three allocations operate *concurrently*, not alternatively.

The following hypothetical demonstrates the use of a three-way allocation system to allocate to limited partners a greater share in tax losses than they have in cash benefits. A limited partnership is formed with general partner *G* and limited partners *A* and *B*. The partnership agreement provides that the net cash flow from the enterprise will be allocated 50% to *G* and 25% each to *A* and *B*. The partnership agreement also provides that the proceeds of any refinancing or sale will be allocated 60% to *G* and 20% each to *A* and *B*. The partnership agreement further provides that the taxable income or loss of the partnership will be allocated among the partners in proportion to their initial contributions to capital. *G* makes no initial contribution to capital and *A* and *B* each make an initial contribution to capital of $5,000. An apartment house is acquired for $100,000, paid for with the initial contributions to capital and the proceeds of a $90,000 non-recourse loan.

The partnership thus has three different allocation ratios, all or none of which could be brought into play in a particular year, depending on the results of partnership operations:

[85] CODE § 704(b).

[86] Treas. Reg. § 1.704-1(b)(2), Example (5) (1964).

[87] Rev. Proc. 74-22, 1974-2 CUM. BULL. 476.

	Net Cash Flow	Proceeds of Refinancing or Sale	Taxable Income or Loss
G	50%	60%	0%
A	25%	20%	50%
B	25%	20%	50%

Consider the effect of such an allocation system in a typical year in which there is a tax shelter in our second sense and in which there is no refinancing or sale of the property.[88] If rent receipts are $10,000, real estate taxes are $700, maintenance expenses are $300, debt amortization is $2,000, and interest paid on indebtedness is $6,000, the net cash flow from the operation of the property is $1,000. If the depreciation deduction in the same year is $12,000, the partnership has a $9,000 tax loss for the year computed as follows:

$$TI = NCF - \text{Depreciation} + \text{Debt Amortization}$$
$$TI = 1{,}000 - 12{,}000 + 2{,}000$$
$$TI = (9{,}000).$$

Under the hypothetical partnership agreement, the net cash flow will be allocated according to the 50-25-25 ratio specified in the partnership agreement and the tax loss will be reported by the partners according to the 0-50-50 ratio of their initial contributions to capital. In summary, as a result of the year's operation, the partners are allocated the following:

Shares of Net Cash Flow		Shares of Partnership Tax Losses
G	$500	$ 0 loss deduction
A	250	4,500 loss deduction
B	250	4,500 loss deduction

The attractiveness of this kind of arrangement to a promoter who wants to pass the bulk of tax losses to his investor-partners is clear. By allocating tax losses according to initial capital contributions, *G* has established a fixed ratio that passes to the limited partners the benefit of all depreciation and other deductions beyond those necessary to shelter from tax the net cash flow and debt amortization of the partnership. In an apparent desire to conceal the extreme separation of tax and economic consequences that three-way systems can effect, they are frequently drafted in ways that are extremely difficult for the uninitiated to decipher. For example, the "taxable income or loss" and "net cash flow" allocations may be carefully defined but never so labeled.

[88] See section II *supra.*

It has never been decided whether allocations of "taxable income or loss" are subject to the "principal purpose" limitation of Code section 704(b)(2), and the Committee on Partnerships of the American Bar Association's Tax Section recommended last summer that Subchapter K be amended specifically to make allocations of "taxable income or loss" subject to the principal purpose limitation.[89] This suggestion would not necessarily accomplish anything, because it is not clear how the principal purpose limitation would be applied. One basic problem is that standards for the application of the principal purpose limitation have never been developed. The only decision that disregarded an allocation on the basis of section 704(b)(2) is *Stanley C. Orrisch*,[90] which involved such a clear-cut violation of section 704(b) that it offers little insight into the scope of the principal purpose limitation. *Orrisch* involved two husband and wife couples, the Orrisches and the Crisafis, who had been equal partners in the ownership of two apartment houses. In a year in which the Crisafis had substantial tax losses from other sources, they changed their agreement and allocated the Orrisches all the depreciation deductions of the partnership. The Orrisches' capital account was lowered by the amount of all the depreciation deductions allocated to them, with the result that their account was far below that of the Crisafis. The court found that the charges against the Orrisches' capital account had no economic significance. The shift in the allocation of depreciation deductions, although reflected as a charge against the Orrisches' capital account, had no effect on any of the non-tax arrangements of the parties, not even on the division of the proceeds from the sale of the partnership property. The basic test for determining whether the principal purpose of an allocation is for the avoidance or evasion of tax is whether it has "substantial economic effect and is not merely a device for reducing the taxes of certain partners without actually affecting their shares of partnership income . . . ."[91] Since the allocation of all the depreciation deductions to the Orrisches did not "actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences,"[92] it was disregarded and reallocated according to "taxable income or loss, as described in section 702(a)(9),"

[89] ABA Committee on Partnerships, *Report of the Committee on Partnerships, Tax Section Recommendation No. 1974-5*, 27 TAX LAW. 839, 847 (1974).

[90] 55 T.C. 395 (1970), *aff'd per curiam* P-H 1973 FED. TAXES ¶ 28, 566 (31 Am. Fed. Tax R.2d ¶ 73-556, at 73-1069) (9th Cir., Mar. 30, 1973).

[91] S. REP. No. 1622, 83d Cong., 2d Sess. 379 (1954).

[92] Treas. Reg. § 1.704-1(b)(2) (1964).

that is, according to the parties' 50-50 ratio for sharing the general profits or losses.

Allocations of "taxable income or loss" are often difficult to attack under the principal purpose limitation. Care has usually been taken to relate the allocation of taxable income or loss to some economic aspect of the partnership, such as initial contribution to capital. Furthermore, it is difficult to determine how an allocation of taxable income or loss in a partnership agreement should be reallocated in the event it is disregarded. Section 704(b) provides that if an allocation does not pass muster under the principal purpose limitation, it will be disregarded and reallocated according to the partners' ratio for sharing "taxable income or loss of the partnership, as described in section 702(a) (9)." This presented no difficulty in *Orrisch* because the parties had one, flat, 50-50 ratio for sharing everything but depreciation deductions. However, consider the conundrum presented an eager tax collector who would like to disregard an allocation of "taxable income or loss" and is faced with the rule that disregarded allocations are to be reallocated in accordance with "taxable income or loss." The answer, in short, to the difficulty in applying this reallocation mechanism is that "taxable income or loss, as described in section 702(a)(9)" was intended to be the partners' ratio for sharing the overall profits and losses of the enterprise. Therefore, if it is decided that the partners' allocation of taxable income or loss should be disregarded because it controls tax losses and nothing more and is for the principal purpose of avoidance or evasion of tax, the losses should be reallocated according to the ratios that control the partners' shares in the economic consequences of the enterprise. Note that this could be the ratio for sharing net cash flow, the ratio for sharing proceeds of refinancing or sale, or a combination of both. For safety's sake, allocations of taxable income or loss should be given some economic significance other than their relation to initial contribution to capital. The *Orrisch* court rejected the petitioners' argument that they could be specially allocated all the depreciation because they had contributed more money to the partnership than their partners and would continue to do so. Therefore, a special allocation of tax benefits should conservatively be correlated with some economic component of what the partners take *out* of a partnership, not simply with what they put *in*.

The above hypothetical represents an extreme situation in which the general partners as a group have no interest in the operating profits or losses of the partnership. During 1973 the Service began to focus on what it considered to be a problem in the tax classification of a limited partnership in which the general partners have a minimal interest. There is a substantial argument that a person who has a zero interest in the profits or losses of the partnership is not a partner. Several cases have considered the presence or absence of an interest in the profits of a partnership an important indicator of the status of a taxpayer as a partner.[93] Even if the general partner remains liable for partnership obligations under state law, it is hard to distinguish him from a third-party guarantor if he does not share in profits. A decision that a "general partner" is not a partner because he has no interest in profits may not result in classifying the organization as an association. Under local law there appear to be two basic possibilities: (1) a limited partnership is nonetheless formed because there has been "substantial compliance in good faith" with the Act's filing requirements; or (2) the "limited partners" have failed to create a limited partnership and have created a general partnership. Under the first possibility, limited liability, which Revenue Procedure 72-13 indicates is so critical, is present.

The Service's concern about this issue was officially presented in Revenue Procedure 74-17, in which it refused to rule on tax classification unless the combined interest of all the general partners in each item of partnership income, gain, loss, deduction, or credit is at least one percent of each item throughout the life of the partnership.[94] This would directly affect the hypothetical just discussed but is not that significant because, with one exception, it is easy to comply with at little cost by careful drafting. The exception is that state securities agencies may require that a priority on cash return be given to the investor-partners. The result is that there may be years in which all the cash flow goes to the limited partners and none to the general partners. Presumably, the imposition of such a priority will not preclude an advance ruling, especially if cash flow is not considered an item of "income, gain, loss, deduction or credit" within the meaning of Revenue Procedure 74-17.[95]

[93] *See, e.g.*, Paul J. Kelly, 29 CCH Tax Ct. Mem. 1090 (1970); Hyman Podell, 55 T.C. 429 (1970); S. & M. Plumbing Co., 55 T.C. 702 (1971).

[94] Rev. Proc. 74-17, 1974-1 Cum. Bull. 438.

[95] For further discussion of special allocations and the "principal purpose" limitation, see Kaster, *Real Estate Limited Partnerships Special Tax Allocations*, 1973-2 N.Y.U. 31st Inst. on Fed. Tax. 1799; McGuire, *When Will a Special Allocation Among Partners Be Recognized?*, 37 J. Taxation 74 (1972); Weidner, *Passing Depreciation to Investor-Partners*, 25 S.C.L. Rev. 215 (1973).

VII. Compensating the Promoter-Partner

A. *Guaranteed Payments*

A major reaction to the restrictions on the deductibility of prepaid interest[96] has taken place in the area of compensation of promoter-partners. The Code provides that payments to a partner for services or for the use of his capital constitute "guaranteed payments" that are deductible by the partnership as if they were made to an outsider, provided they are "determined without regard to the income of the partnership."[97] In an attempt to maximize loss deductions, realty partnerships are documented to characterize as much as possible of the cash distributed to promoter-partners as deductible guaranteed payments for their services or for the use of their capital.[98] Because the recipient of the guaranteed payment must report it as ordinary income, intensified use of the guaranteed payment provision to generate partnership deductions could initially be viewed as an inoffensive trade-off with little loss to the Treasury. The reason the practice is offensive from a revenue-raising point of view is that the "guaranteed payments" are commonly made to promoter-partners who have substantial losses from other sources, and shelter-seeking investors are allocated the bulk of the partnership deduction. In effect, the guaranteed payment provision enables investors to assign their income to promoters who can absorb taxable income because of surplus losses from other sources.

The surprisingly prevalent practice of immediately deducting alleged guaranteed payments that would clearly be required to be capitalized if made to an outsider was recently laid to rest in *Jackson E. Cagle, Jr.*[99] In 1968 a promoter and two investors formed a partnership to deal in commercial property. By separate agreement the partnership agreed to pay the promoter-partner a management fee of $110,000, of which $90,000 was to be paid on or

[96] *See* Rev. Rul. 68-643, 1968-2 Cum. Bull. 76; G. Douglas Burck, 63 T.C. 556 (1975).

[97]

> *To the extent determined without regard to the income of the partnership,* payments to a partner for services or for the use of capital *shall be considered as made to one who is not a member of the partnership,* but only for the purpose of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).

Code § 707(c) (emphasis added).

[98] Less attractive options include having the promoters receive compensation in ways not deductible by the partnership, such as the sale of an asset to the partnership at a profit or the receipt of a more substantial share of net cash flow or proceeds of refinancing or sale.

[99] 63 T.C. 86 (1974).

before December 31, 1968. The partnership claimed a deduction for the expenditure and distributed the resulting losses to the investor-partners. The court rejected the contention that payments falling within the definition of section 707(c) are automatically deductible and held that such payments must "run the gauntlet of section 162(a) in order to be deductible."[100] The court looked to the nature of the services performed and held that the expenditures were so related to the construction of a capital asset that they had to be capitalized.

Even more significant than the *Cagle* conclusion that capital expenditures cannot be made currently deductible by the use of section 707(c), a holding anticipated by most tax practitioners, is the very recent decision in *Edward T. Pratt*,[101] in which the court disallowed claims for guaranteed payments for services on the ground that they were based on "income." The taxpayers in *Pratt* were the cash-basis general partners of two accrual-basis limited partnerships, each formed for the purchase, development, and operation of a shopping center. Each limited partnership agreement obligated the general partners to expend their "best effort" to the management of the partnership. In return, the general partners as a class were to receive "a fee of five (5%)per cent of the initial Gross Base Lease Rentals . . . and then . . . ten (10%) per cent of all overrides and/or percentage rentals." The taxpayers agreed to divide the fees equally, the managerial services were performed, and the management fees were equally credited to accounts payable to them. The fees, which were reasonable in amount, were accrued and deducted annually by each partnership but were not paid to or reported by the taxpayers in the three years in question.[102]

The Tax Court held that the management fees did not qualify as guaranteed payments because they were based on "income."[103]

[100] *Id.* at 94.

[101] 64 T.C. No. 17, CCH Tax Ct. Rptr. Current Regular Dec. No. 33, ¶ 189, at 2583 (May 8, 1974).

[102]

> The amount of management fees accrued by each of the partnerships in each of the years indicated is a reasonable and proper fee to pay for the services of managing a shopping center of the type of Parker Plaza and Stephenville. A like amount of fees would have had to be paid to a third party, not a general partner, as a fee for managing the shopping centers had such shopping centers been managed by a third party.

Id. at 2585.

[103]

> The amounts of the management fees are based on a fixed percentage of the partnership's gross rentals which in turn constitute partnership income. To us it follows that the payments are not de-

The holding that a fee in the form of a share of *gross* rentals is based on "income" will come as a shock to many who have interpreted the "determined without regard to the income of the partnership" language of section 707(c) to mean determined without regard to the availability of *net* income. Because the payments were based on gross income, the partnership, and hence the other partners, could be bound to pay the fees if other expenses exhausted partnership receipts. The court specifically found that all the partners intended the fees to be fully paid, and that the taxpayers could legally have caused the two partnerships to pay them. Unlike the charges to capital accounts in *Orrisch,* the credits to accounts payable in *Pratt* had economic significance. Therefore, the taxpayers presumably could have withheld current distributions to the limited partners until they had been paid and, if net receipts were insufficient, could have satisfied their claims out of the proceeds of refinancing or sale. *Pratt* would be less of a surprise if there were any indication in the opinion that the underlying leases were net leases. In that event, the fees would have been based on and payable out of surplus cash and would have looked less "guaranteed" by the partnership and more like an attempt to transform distributive shares of partnership income into deductible form.

The *Pratt* court rejected the argument that the management fees were deductible by virtue of the section 707(a) provision that a transaction between a partner and his partnership "other than in his capacity as a member of such partnership" shall "be considered as occurring between the partnership and one who is not a partner." Without deciding "whether a continuing payment to a partner for services was ever contemplated as being within the provisions of section 707(a)," the court concluded that section 707(a) would in no event apply to the instant case, because the taxpayers

> were to receive the management fees for performing services within the normal scope of their duties as general partners and pursuant to the partnership agreement. There is no indication that any one of the petitioners was engaged in a transaction with the partnership other than in his capacity as a partner.[104]

This rationale has tremendous potential impact because section 707(c) can be interpreted as a qualification of section 707(a) that is fully subject to the "other than in his capacity as a member of

termined without regard to the income of the partnership as required by section 707(c) for a payment to a partner for services to be a "guaranteed payment."

Id. at 2588.

[104] *Id.* at 2589.

the partnership" requirement.[105] Therefore, *Pratt* may be pointed to as authority for the proposition that general partners in a limited partnership cannot claim guaranteed payments for performing their essential duties under the partnership agreement; that, in reality, they are merely attempting to generate deductions by altering the form of distribution of their partnership income.

Pratt also involved guaranteed payments for the use of capital. The taxpayers had loaned funds to both partnerships and had received in return notes, secured by deeds of trust, wherein the partnerships agreed to repay principal plus interest at the rate of seven percent per annum without regard to partnership receipts or income. In the years in question, the partnerships did not pay the interest but credited it to the accounts payable to the taxpayers, who did not include the amounts as interest income in those years. As with the credits for management fees, the parties intended the interest payments to be made and the taxpayers had the right to cause payment. The Service, however, did not dispute that the interest payments were guaranteed payments. Rather, it sought to hold the taxpayers to the Regulation that recipients must report the guaranteed payments in the year when accrued by the partnership, whether the payments are actually made or not.[106] The taxpayers argued that the application of such a Regulation to cash-basis partners was an "overextension" of the Commissioner's authority, but the court applied the Regulation.

Although the guaranteed payment treatment for use of capital was not directly threatened by the *Pratt* decision, this victory by the Service in the area of guaranteed payments for services may lead to a more direct assault on guaranteed payments for capital. Many partnership agreements contain elaborate provisions for various types of loans from partners to the partnership. Many of these provisions are simply attempts to generate guaranteed payment deductions for "interest" payments to partners which would otherwise be received by them in the form of distributive shares of partnership income. The underlying "loans" may be vulnerable to the challenge that they are, in economic reality, contributions to capital rather than loans to the partnership.[107] There-

[105] *See* Treas. Reg. § 1.707-1(a) (1958):

> (a) *Partner not acting in capacity as partner.* A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money . . . by the partner to the partnership . . . and the rendering of services . . . by the partner to the partnership.

[106] *See id.* § 1.707-1(c).

[107] *See* Joseph W. Hambuechen, 43 T.C. 90, 100-01 (1964).

fore, no guaranteed payment for "interest" could be claimed by the partnership.

One final point should be made regarding guaranteed payments. In *Cagle* the deduction from the guaranteed payment was allocated to the two investor-partners. This is what is commonly done when there is a promoter-partner who has surplus losses from other sources. He can absorb the taxable income that must be reported by the recipient of a guaranteed payment and will allocate his share of the corresponding partnership deduction to his investor-partners in need of tax shelter. However, guaranteed payments are often made to a partner who does not want to absorb taxable income. There are situations in which such a partner is specially allocated the entire corresponding partnership deduction so he will not have to pay tax on the guaranteed payment.[108] There is no authority precisely on point, but it would appear that such an allocation violates the "principal purpose" limitation[109] because it allocates the deduction away from those who bear the economic burden of the expense.

B. *Receipt of a Profits Interest*

A common practice in the real estate area is for lawyers, accountants, architects, and other professionals to take a "piece of the action" in the form of a profits interest in lieu of or in addition to immediate cash payment for services rendered. The popularity of the practice was explained in large part by the assumption that the receipt of a profits interest in a partnership is not a taxable event. Section 721 provides that no gain or loss will be recognized to a partnership or its partners on "a contribution of property to the partnership in exchange for an interest in the partnership."[110] However, the Regulations under section 721 also mention the receipt of a partnership interest in exchange for *services*:

[108] *See* Cowan, *Receipt of a Partnership Interest for Services*, 1974-2 N.Y.U. 32D INST. ON FED. TAX. 1501, 1521-22. *See also* Boffa, *Tax Problems in Compensating the Joint Venture Partner*, 1 J. REAL ESTATE TAXATION 131, 142 (1974), in which the author suggests that promoter-partners who must include in income the value of profits interests received in exchange for services be specially allocated the corresponding deduction to which the partnership is entitled.

[109] *Compare* Treas. Reg. § 1.721-1(b)(2) (1956). When a partner receives an interest in a partnership in exchange for services rendered to a partner, "it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter." *Id.* If it is for services rendered to the partnership, "it is a guaranteed payment for services under section 707(c)." *Id.*

[110] *Id.* § 1.721-1(a) states that section 721 "shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by section 707."

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) . . . . To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services, . . . section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.[111]

This language was widely interpreted to mean that the receipt of an interest in partnership *capital*[112] in exchange for services was a taxable event, but the receipt of an interest in the partnership *profits* in exchange for services was not a taxable event. The latter proposition has been defended on the basis of the parenthetical in the above-quoted Regulation that excepts he receipt of a profits interest from the declaration of the taxability of a receipt of a capital interest. Under the "no taxable event" interpretation, the recipient obtains a zero basis in his partnership interest,[113] must subsequently report as ordinary income his allocable share of the partnership profits, and pays capital gain on the sale of the interest.

To the disbelief of many, the Tax Court in *Sol Diamond*[114] rejected the contention that section 721 requires nonrecognition of a receipt of an interest in partnership profits in exchange for services. Diamond was a mortgage broker who obtained numerous loans for experienced builders from a savings and loan association. Diamond received commissions from the borrowers, several of

[111] *Id.* § 1.721-1(b)(1).

[112] The interest in partnership "capital" described in the Regulations is the right to be repaid contributions to capital. Many assume that this is adjusted by shares of profits and losses of the partnership. *See, e.g.*, Cowan, *supra* note 108, at 1513-14, wherein the author states:

> The litmus test of an interest in capital at any moment of time within the meaning of Section 721 can be phrased as follows: Convert all of the partnership assets into cash at then fair market values, pay off all liabilities, and distribute the balance. The amount that each partner would receive is his interest in capital. A partner's capital account, then, is the value of his equitable interest in the net assets of the partnership. A profits interest, on the other hand, is a right to share in future changes of net worth, either by way of outside income or by way of changes in the values of partnership assets.

[113] The zero basis would be increased to the extent he shares in partnership liabilities.

[114] 56 T.C. 530 (1971), *aff'd* 492 F.2d 286 (7th Cir. 1974).

which he split with certain officers of the savings and loan association. Diamond received the interest in question from a Mr. Kargman, an experienced syndicator, as compensation for obtaining one hundred percent financing of the purchase price of an office building. It was agreed that Kargman would pay all acquisition costs above the amount of financing, and that Kargman and Diamond would share profits in a 40-60 ratio, respectively, and would be "chargeable with all losses in the same proportions."[115] Net proceeds of any subsequent sale of the building were to be divided in the same ratio, after first being applied to reimburse Kargman for any acquisition expenditures he incurred. Diamond was not obligated to contribute any acquisition costs nor was he obligated to provide further services. Three weeks after closing the purchase of the building, Diamond sold his interest for $40,000 and subsequently reported that amount as a short-term capital gain from the sale of a partnership interest.[116]

The Tax Court could not resist denying Diamond capital gains treatment for the receipt of $40,000 for services performed just a few weeks earlier. It concluded that a contribution of services was not a contribution of "property" within the nonrecognition provisions of section 721. As to the parenthetical in the section 721 Regulations, which according to popular belief mandated nonrecognition of the receipt of a "profits" interest for services, the court said its effect is "obscure." The court concluded that the "opaque draftmanship" in the Regulations was insufficient to override the general rule that the fair market value of property received for services must be included in gross income.[117] In so doing, the court did not discuss the difficult question of whether the interest involved was an interest in "capital" or "profits" and substantially lessened the importance of the distinction by its summary dismissal of the section 721 Regulations.[118]

[115] 56 T.C. at 537.

[116]

> In the case of a sale or exchange of an interest in a partnership . . . gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).

CODE § 741.

[117] CODE § 61(a); Treas. Reg. § 1.61-2(d)(1) (1966).

[118] The Tax Court did leave open the possibility of future application of the parenthetical:

> Regardless of whether there may be some kind of equitable justification for giving the parenthetical clause some limited form of affirmative operative scope, as perhaps where there is a readjustment of partners' shares to reflect services being performed by one of the partners, we cannot believe that the regulations were ever intended to

An important question not directly presented by the facts nor discussed in the Tax Court's opinion is whether a service partner who reports as ordinary income the value of the partnership interest when received must again pay ordinary income tax on his distributive shares of partnership profits as they are earned. For example, if a partner must include in ordinary income the fair market value of the right to receive $1,000 a year for several years in the future, will he again be taxed at ordinary income rates on the $1,000 payments as they are actually received? Or can the basis obtained in his interest by paying tax on its fair market value be amortized as the profits are earned? In affirming the Tax Court, the Seventh Circuit addressed the objection that there will be double taxation if the right to share in future profits and the subsequent receipts of those profits are both taxed. The court said that the "absence of a recognized procedure for amortization [did not] militate against the treatment of the creation of the profit share as income."[119] However, the court found a need for "the promulgation of appropriate regulations to achieve a degree of certainty" in this matter.[120]

Vestal v. United States[121] throws substantial doubt on the extent to which a taxpayer may report a low market value in the year of receipt based on the contingent nature of future profits and subsequently report any gain on disposition as appreciation in value of a capital asset. Vestal knew assignees of an oil and gas lease who were attempting to sell limited partnership interests to raise money to drill additional wells required of them by the lease assignment. In 1962, he contacted four investors who supplied the remaining needed funds, became limited partners, and agreed to pay him a finder's fee. Each agreed in writing to convey to Vestal one-eighth of his limited partnership interest upon recovery of his investment in the partnership, plus six percent interest compounded semi-annually. Two years later, the general partners sold the partnership's assets, and the purchase price was paid in three yearly installments. The four investors, after receiving their share of the purchase price and deducting the amount of their investment plus interest, issued checks to Vestal totaling $139,730 for one-eighth of the remaining balance.

bring section 721 into play in a situation like the one before us.
56 T.C. at 546.

[119] Diamond v. Commissioner, 492 F.2d 286, 290-91 (7th Cir. 1974), *aff'g* 56 T.C. 530 (1971).

[120] Peter P. Risko, 26 T.C. 485 (1956), has been cited as authority for the proposition that the amount included in income may be amortized when the partnership has a determinable life.

[121] 498 F.2d 487 (8th Cir. 1974), *rev'g* 73-1 U.S. Tax Cas. ¶ 9260 (W.D. Ark. 1973).

The district court had concluded that the compensation agreements gave Vestal an interest in a capital asset which had a fair market value of $29,375 when executed in 1962 and should have been reported in that year. Vestal had not reported the value of the interests in 1962, and the statute of limitations had run against the government for that year. The court directed that the gains from the 1964 disposition be taxed at long-term capital gains rates, using the $29,375 value which should have been reported in 1962 as the basis in computing the gain.

The Eighth Circuit Court of Appeals reversed, accepting the Government's position that the interests obtained by Vestal in 1962 "were contingent, conditional, and speculative, and as a matter of law, did not constitute income taxable to Vestal in 1962."[122] The court admitted that Vestal's rights had value in 1962, but said that "such recognition does not support a view that Vestal received income under the federal tax laws." Clearly the court did not want to encourage taxpayers to undervalue contingent interests received for services and subsequently claim capital gains treatment on disposition.[123]

Diamond was not cited to the *Vestal* court until Vestal's petition for rehearing, in which he raised it as authority for the proposition that the value of his interest was income in 1962. The court denied the petition and said that the effect of its decision was to tax Vestal upon his acquisition of "the actual joint venture interests" and was consistent with the decision in *Diamond* that the taxable event was "when the parties actually acquired the building to be held as a joint venture."[124] However facile the court's reconciliation of the two cases, they both clearly indicate strong opposition to capital gains treatment of compensation for services. In *Diamond*, both the Tax Court[125] and the Seventh Circuit suggested "the possibility that Diamond would not in any event be entitled to

[122] 498 F.2d at 490.

[123]

> Undervaluation would allow compensatory income taxable at ordinary rates to be treated as capital appreciation upon taxpayer's actually receiving the performance promised him by the contract. When dealing with a situation such as the present where taxpayer holds an executory contingent contract payable in the future, the tax laws should not be construed so stringently, on the one hand, so as to require a taxpayer to pay an income tax on its estimated value; nor should they be construed so loosely, on the other, as to permit him to establish a basis for those same contract rights in the absence of a showing that there was an actual trading or marketing of those rights.

Id. at 493-94 (citation omitted).

[124] *Id.* at 496 (order on petition for rehearing).

[125] 56 T.C. at 547, n.16.

capital gains treatment of his sale of a right to receive income in the future, but did not decide the question."[126]

Service partners may find some relief from *Diamond* and *Vestal* under section 83, added by the Tax Reform Act of 1969. Section 83, although debated and passed in the context of corporate executive compensation, can readily be interpreted to apply to partnership transactions as well. Indeed, the Proposed Regulations under section 721 indicate that section 83 will be applied to partnership transactions.[127] Section 83 provides that the fair market value of property transferred in connection with services is taxable at ordinary income rates at the time of receipt if the property is either transferable or not subject to a substantial risk of forfeiture. If the interest is nontransferable and forfeitable when received, it is taxable when it first becomes either transferable or nonforfeitable.[128] However, even if the interest is forfeitable and not transferable, the recipient may elect to pay ordinary income tax on the value of the interest in the year in which it is received.[129] The advantage of this election is that subsequent increases in value prior to the lapse of the restrictions will be taxed only as a capital gain upon disposition of the property.[130]

[126] 492 F.2d at 287.

[127] Proposed Treas. Reg. § 1.721-1(b)(1)(i), 36 Fed. Reg. 10,799 (1971).

> If the partnership interest is transferred after June 30, 1969 (except to the extent paragraph (b) of § 1.83-8 applies), then the transfer of such interest in partnership capital shall be treated as a transfer of property to which section 83 and the regulations thereunder applies.

The Proposed Regulations restate the parenthetical in the present section 721 Regulations that was at issue in *Diamond.* See notes 114-18 *supra.* Because *Diamond* ignored the parenthetical and the distinction between capital and profits for the purposes of section 721, it would seem that the Proposed Regulations, published prior to *Diamond,* cause all receipts of partnership interests for services to be governed by section 83.

[128] CODE § 83(a).

[129] CODE § 83(b).

[130]

> *If this election is made,* section 83(a) and the regulations thereunder, do not apply with respect to such property, and except as otherwise provided in section 83(d)(2) and the regulations thereunder, *any subsequent appreciation in the value of the property is not taxable as compensation.* In computing the gain or loss from the subsequent sale or exchange of such property, its basis shall be the amount paid for the property increased by the amount included in gross income under section 83(b).

Proposed Treas. Reg. § 1.83-2(a), 36 Fed. Reg. 10,789-90 (1971) (emphasis added). However, if such election is made and "such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture." CODE § 83(b). For further discussion of the applicability of section 83 to receipts of partnership interests, *see* Cowan, *supra* note 108, at 1527-40.

VIII. Preadmission Losses

In a sense, the ultimate rub of the present-day realty tax shelter is the fairly common practice of admitting shelter-hungry investors to partnerships at the end of the year and giving them an allocation of losses as if they had been partners for the entire year. Many defend the practice and, at the same time, advise their clients to refrain from flaunting its existence. For example, some practitioners will counsel their clients to avoid written predictions of preadmission losses to year-end admittees. The two basic arguments made in defense of the practice are that (1) it is a legitimate exercise of the flexibility offered by section 704(a) to determine partnership allocations in the partnership agreement and (2) it is specifically authorized by the rule of section 761(c) that amendments to partnership agreements relate back to the beginning of the taxable year.[131]

The first argument is that retroactive allocations of losses, if they are subject to scrutiny at all, are special allocations which will be disregarded only if they violate the "principal purpose" limitation of section 704(b)(2). At first, it might seem peculiar to defend a practice by asserting that it is subject to such a broadly-stated limitation. Nevertheless, this is an understandable position for advocates of retroactive loss allocations. It concedes nothing, because no one has ever suggested that retroactive allocations are exempt from the principal purpose limitation. More importantly, uncertainties about the application of the principal purpose limitation have delayed its development as an effective rationale against partnership tax avoidance schemes. It is fairly easy to provide at least a paper correlation between the retroactivity of the loss allocation and some economic incident of the partnership and claim that is sufficient under the sparse law on point. In short, the argument is an attempt to create a safe harbor within the virtually nonexistent limitations of section 704(b)(2).

The argument based on section 761(c) finds some support in the recent case of *Norman Rodman*,[132] in which the Tax Court required a late-admitted partner to report his share of partnership gain on the basis of the full taxable year. The joint venture in *Rodman* was formed in 1955 with four equal participants. On No-

[131]

> For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners or which are adopted in such other manner as may be provided by the partnership agreement.

Code § 761(c).

[132] 32 CCH Tax Ct. Mem. 1307 (1973).

vember 2, 1956, one of the participants withdrew by selling his entire interest to the remaining participants. Three days later, the son of one of the remaining participants was admitted as a twenty-two percent participant. A deficiency was assessed at the venture level for 1956, and the question was whether the Service could hold the son liable for the deficiency as if he had participated for the entire year.

The son argued that his share of profits and losses was intended to begin with his admission to the venture. The Servcie alleged and proved that the intent had been to retroactively amend the joint venture agreement so that the son would share in the entire year's profits and losses. Indeed, on the venturer's 1956 partnership return, the son had been allocated twenty-two percent of the partnership losses for the entire year, and he had filed his individual return on the same basis. The Service merely wanted to hold him responsible for the same period for what it determined to be a gain rather than a loss, and the court held it could.

The commentators generally agree that *Rodman* is weak authority for retroactive allocations of preadmission losses.[133] First, the court clearly stated that proration of income or loss was required with respect to the partner who withdrew. Second, the court did not satisfactorily discuss the issue of retroactivity, and its precise reasoning is unclear.[134] Although the interests of the three remaining partners were reduced upon the son's admission, the court did not mention section 706(c)(2)(B), which would appear to require proration. Third, the extent to which retroactivity was actually involved is unclear, because the government concluded that Rodman "was active in the joint venture prior to the time he was allegedly brought into the venture."[135] Fourth, the government, not the taxpayer, attempted to establish retroactivity—of taxable income, not tax losses. The court may have felt that because the son had claimed losses for the entire year, it was not unfair to hold him to his claim to the entire year when the losses were determined to be gains. Finally, the holding is questionable insofar as the son bore a share of the tax burden greater than his share of economic benefits.

In short, despite *Rodman*, there remains a clear possibility that either one of two provisions may be applied to deprive year-

[133] Cowan, *Allocating the Tax Shelter Retroactively: The* Rodman *Case,* 2 J. REAL ESTATE TAXATION 5 (1974); Koff & Hammer, *Retroactive Allocations: The Case Against* Rodman, *id.* at 18; McGuire, *Retroactive Allocations Among Partners: The* Rodman *Decision,* 52 TAXES 325 (1974); Weidner, *Year-end Sales of Losses in Real Estate Partnerships,* 1974 U. ILL. L.F. 533.

[134] In fairness to the court, it should be pointed out that the court and subsequent commentators have noted that the case was poorly litigated.

[135] McGuire, *supra* note 133, at 325 n.3.

end admittees the benefit of retroactive allocations of preadmission losses. First, section 708 provides that a partnership is terminated for tax purposes if there is a "sale or exchange" of fifty percent or more of the total interest in partnership capital and profits. This provision clearly separates termination of a partnership for federal income tax purposes from dissolution under local law.[136] If the admission of new partners constitutes such a "sale or exchange," the newly admitted partners will be members of a new partnership, rather than the one that incurred the losses. Even if there is no termination under section 708, proration may be required. Section 706(c)(2)(B) provides that the taxable year of the partnership shall not close with respect to a partner who sells or exchanges less than his entire interest in the partnership,

> or with respect to a partner whose interest is *reduced,* but such partner's distributive share of items described in section 702(a) shall be determined by taking into account his *varying interests in the partnership during the taxable year.*[137]

In short, it can be argued that the interests of initial partners are "reduced" when newly admitted partners are passed shares in net cash flow, proceeds of refinancing or sale, etc., such that year-end admittees may only share in the partnership losses for the period of the year during which they were members. The general policy against trafficking in tax losses would support the conclusion that these two proration requirements apply to year-end admittees and are not superseded by the more general provisions of sections 704(a) and 761(c).[138]

IX. Conclusion

In the early part of the nineteenth century, limited partnership statutes were enacted to give profit-sharing passive investors a corporate-type freedom from enterprise liability prior to the general availability of the corporate form. The Code has no separate classification for limited partnerships, which will be governed by the partnership provisions of Subchapter K unless they are classified as corporations for tax purposes. The present classification Regulations are remnants of the attempt to deny corporate classification to professional associations and are heavily biased

[136] See Treas. Reg. § 1.706-1(c)(1) (1956).

[137] Code § 706(c)(2)(B) (emphasis added).

[138] The refinement of the rules concerning retroactive allocation is presently under the consideration of the House Ways and Means Committee.

toward classifying as a partnership for tax purposes anything that is a partnership, general or limited, under local law.

The Service, however, has issued a series of Revenue Procedures that indicate that partnership classification may be withheld from limited partnerships that do not have general partners with substantial assets, that employ allocation systems that do not accord all partners significant shares in all items of income and loss, and that utilize deduction-generating and accelerating devices to such an extent as to suggest that the partnership is primarily for the purpose of generating and distributing tax losses rather than for economic profit. The basic reason for going beyond the Regulations is the tremendous popularity of limited partnerships to deliver tax losses to high-bracket limited partners who have all the limited liability of the corporate form and who nevertheless claim the pass-through of losses available to partnerships. Furthermore, limited partners deduct tax losses far in excess of their economic investment because of a Regulation stating that limited partners may claim partnership losses beyond cash investment to the further extent they share in partnership liabilities that are fully non-recourse. The Treasury has considered withdrawing this Regulation, but has not yet done so. The idea will continue to have appeal until some sort of reform is enacted, or until the popularity of the limited partnership somehow wanes. In the meantime, the Service can be expected to become more strict in its requirements that something approaching significant personal liability be present, on the use of certain devices to generate and accelerate losses, such as guaranteed payments and prepayments of interest, on allocation systems designed to distribute tax benefits independent of economic benefits, and on retroactive allocations of preadmission losses.