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Yearend Sales of Losses in Real Estate Partnerships

Donald J. Weidner

YEAREND SALES OF LOSSES IN REAL ESTATE PARTNERSHIPS

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I. INTRODUCTION

YEAREND OFFERINGS OF partnership interests have become quite popular, particularly in the context of real estate partnerships structured to produce substantial tax losses in the initial years of operation. Generally, a limited partnership is formed with a promoter as a general partner and another promoter or a straw man as a limited partner,[1] and the partnership's transactions are structured to maximize and accelerate deductions. Shortly before yearend, investors searching for tax shelter are admitted as limited partners after having been offered the substantial inducement of an allocation of tax losses as if they had been partners for the entire year.

Neither the Code nor the Regulations specifically limits an incoming partner to a pro-rata share of the partnership's tax losses based on his period of ownership. Thus, unless a proration requirement can be inferred, an individual may become a partner for 1 day and share in tax losses for the entire year, a result that some commentators and practitioners defend.[2] This article will demonstrate that existing proration requirements can be interpreted to deprive yearend admittees of retroactive loss allocations, and will also suggest further arguments against granting yearend admittees the tax benefits they seek.

II. THE PRORATION REQUIREMENTS

Two existing proration rules can be interpreted to deny the yearend admittee the opportunity to share in partnership deductions incurred before his admission to the partnership. The first is the rule

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1. The Uniform Limited Partnership Act requires one general and one limited partner in a limited partnership from its inception. UNIFORM LIMITED PARTNERSHIP ACT § 1.

2. *See, e.g.*, Kanter, *Real Estate Tax Shelters*, 51 TAXES 770, 779-800 (1973).

that a partnership is deemed to be terminated for tax purposes if a 50-percent or greater interest in partnership capital and profits is sold or exchanged within a 12-month period.[3] If the admission of new partners brings the 50-percent rule into play, the partnership that incurred the losses will be deemed terminated for tax purposes, and the late-arriving investors will be deemed to be members of a new partnership rather than the one that incurred the losses. The second proration rule provides that partners who sell or exchange any part of their interests must prorate items of partnership income or loss with their transferees on the basis of their periods and extent of ownership.[4] This rule applies even if the initial partnership has not been terminated for tax purposes. Because both rules relate directly to the taxable years of partnerships and partners, a brief introduction to the manipulation of taxable years is in order.

The relative taxable years of partnerships and their members have long been manipulated to achieve tax advantages. The partnership is a tax-reporting but not a tax-paying entity, and may have a different taxable year than its partners. A partner must include in his individual tax return his distributive share of partnership income, gain, loss, deduction or credit[5] for any partnership year ending with or within his taxable year.[6] Until the enactment of the 1954 Code, any 12-month period could be selected as a partnership's taxable year. Income received by a partnership might not be taxed for as many as 23 months after receipt. A common tax postponement strategy was to adopt a January 31st fiscal year for partnerships whose individual members reported on a calendar year basis.[7] Under this arrangement, the partnership's income for the 11-month period of February 1st to December 31st would not be reported by the individual partners until the end of the following December.[8]

The 1954 Code created two simple rules to deal with the problem. First, a partnership "may not change to, or adopt, a taxable year other than that of all its principal partners unless it establishes, to the satisfaction of the Secretary or his delegate, a business purpose therefor."[9] A

3. INTERNAL REVENUE CODE OF 1954, § 708(b)(1)(B) [hereinafter references to the Code will be by section number only].

4. §§ 706(c)(2)(A), (B).

5. § 702(a).

6. § 706(a).

7. Horn, *Taxable Years of Partners and Partnerships*, N.Y.U. 19TH INST. ON FED. TAX. 297 (1967).

8. Taxpayers soon learned, however, that manipulating the taxable years of partners and partnerships to postpone the reporting of income could result in unexpected bunching of income on the death of a partner. *See* Jackson, *et al.*, *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1196 (1954), for a discussion of the controversy on this point prior to the enactment of the Code. The Code now provides that the taxable year of a partnership will not close prematurely with respect to a partner who dies. § 706(c)(2)(A)(ii).

9. § 706(b)(1). A newly formed partnership may adopt a calendar year without

corresponding rule provides that a partner "may not change to a taxable year other than that of a partnership in which he is a principal partner unless he establishes, to the satisfaction of the Secretary or his delegate, a business purpose therefor."[10] Once a taxable year has been established by a partnership, it continues until permission to change is obtained or until some event gives the partnership the right to choose a new taxable year.

Until just before the passage of the 1954 Code, partnerships were electing new taxable years when they were dissolved under local law. "Under the 1939 Code and the easy-going administrative policy of the Service as it related to partnerships, a sale of a partnership interest was considered generally to effect a termination of the old and the birth of a new partnership for Federal income tax purposes."[11] In 1953, however, the Service ruled that a change in the membership of a partnership resulting from the retirement, death, or addition of a partner does not terminate the partnership for tax purposes.[12] Therefore, partnership returns "should continue to be filed on the basis of the annual accounting period previously established by the partnership."[13]

A. The 50-Percent Termination Rule

The 1954 Code retained the philosophy of this ruling and eliminated the opportunity for partners to terminate their partnership for tax purposes by selling a partnership interest or admitting a new partner.[14] The Code clearly distinguishes termination for tax purposes from dissolution under state law.[15] It provides that a partnership shall not be terminated for tax purposes unless no part of its business "continues to be carried on by any of its partners in a partnership," or unless "within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits."[16]

securing prior approval from the Commissioner if its principal partners are not all on the same taxable year. Treas. Reg. § 1.706-1(b)(1)(ii) (1956).

10. § 706(b)(2). "Principal partner" is defined as "a partner having an interest of 5 percent or more in partnership profits or capital." § 706(b)(3).

11. Horn, *supra* note 7, at 310.

12. Rev. Rul. 144, 1953-2 CUM. BULL. 212-13. This ruling applies to limited as well as general partnerships. Rev. Rul. 54-484, 1954-2 CUM. BULL. 242.

13. Rev. Rul. 144, *supra* note 12, at 213.

14. § 706(c)(1):

> Except in the case of a termination of a partnership and except as provided in paragraph (2) of this subsection, the taxable year of a partnership shall not close as a result of the death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership.

The exceptions in paragraph (2) are discussed *infra*. In general, they concern the closing of a partnership's taxable year with respect to a selling partner, but not termination of the partnership itself, which is governed by § 708.

15. Treas. Reg. § 1.706-1(c)(1) (1956).

16. §§ 708(a), (b)(1).

The basic purpose of the 50-percent rule was to prevent the manipulation of taxable years discussed above. Under the bill as reported by both the House and the Senate, the partners could agree that the partnership would not terminate—that is, its taxable year would not close with respect to the remaining partners—upon the sale or exchange of a 50-percent or greater interest.[17]

> This election was eliminated by the Conference Committee in order to prevent the postponement of income that could result if an interest in a fiscal year partnership were sold to an individual on a different tax year. As the lesser of two evils, the partnership year must close, with the resultant bunching of the remaining partners' incomes, and the partnership must then adopt a new taxable year consonant with the principal partner provisions of Section 706(b).[18]

Therefore, when the 50-percent rule applies, the partners cannot treat the partnership as continuing for tax purposes.[19] The rule is broad in scope; it covers all sales or exchanges within any period of 12 consecutive months, including those to other members of the partnership.[20]

When a new partner purchases an existing partnership interest, there is clearly a "sale or exchange" within the meaning of the 50-percent rule. The critical question is whether the admission of an additional partner also constitutes a sale or exchange. The Regulations provide that admission of a new partner is not a sale or exchange within the meaning of the 50-percent rule[21] unless property is contributed by one partner and the same or other property is distributed to another partner within a short period,[22] in which event the transaction is treated as an exchange of property between the partners.[23] For example, if *D* is admitted to *ABC* partnership upon making a $10,000 contribution to capital, and shortly thereafter *A* withdraws from the partnership and receives a $10,000 distribution, the transaction will be

17. H.R. REP. No. 1337, 83d Cong., 2d Sess. 67 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 91 (1954).

18. Jackson, *et al.*, *supra* note 8, at 1198.

19. The 50-percent rule has acquired new significance since the Tax Reform Act of 1969, which restricts the availability of certain accelerated depreciation methods to "first users." §§ 167(c)(2), (j)(2)(A)(ii). If a partnership is terminated for tax purposes by operation of the 50-percent rule, it may no longer be entitled to use the method of accelerated depreciation it was using before termination.

20. Treas. Reg. § 1.708.1(b)(1)(ii) (1956).

21. *Id.*

22. Treas. Reg. § 1.731-1(c)(3) (1956).

23. J. PENNELL & J. O'BYRNE, FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS 128-29 (1970):

> [T]here is a note of warning by reference to Treasury Regulation 1.731-1(c)(3) that a contribution by a new partner and a related distribution to an old partner may not disguise what is in reality a purchase. . . . Presumably, then, the contribution and distribution in rapid succession also may be treated as a "step transaction" resulting in the same consequences—including termination—as would a sale of an interest. . . .

recognized as a sale by *A* of his partnership interest to *D*.[24]

An *actual* distribution should not be needed to trigger this turnaround distribution exception. *Crane v. Commissioner*[25] established that relief from liabilities, including nonrecourse liabilities, is treated as a distribution of cash, at least when the liability is included in the taxpayer's depreciable basis.[26] The Code now specifically provides that any decrease in a partner's share of partnership liabilities "shall be considered as a distribution of money to the partner by the partnership."[27] As a corollary, any increase in his share in partnership liabilities "shall be considered as a contribution of money by such partner to the partnership."[28]

Under these rules, a new partner makes a constructive contribution of cash to the extent he is allocated a share of existing partnership liabilities and the existing partners receive a corresponding constructive distribution of cash.[29] In a limited partnership, new limited partners are automatically allocated a share in the nonrecourse[30] liabilities of the partnership "in the same proportion as they share the profits."[31] As a result, when a new limited partner is admitted to a partnership which has nonrecourse liabilities, he makes a constructive contribution and the old partners receive a constructive distribution of cash. In other words, a constructive turnabout distribution takes place. Arguably, this constructive turnabout distribution is sufficient to make the admission of a new partner an "exchange" within the meaning of the 50-percent rule.

At first glance, this argument may seem forced, but it is neither farfetched nor extreme when compared to other consequences of shifts in proportionate shares of nonrecourse liabilities. For example, the constructive distribution that takes place when a partner is relieved of a share in partnership liabilities is a taxable event. If a limited partner

24. *But see* Kaster, *Real Estate Limited Partnerships Special Tax Allocations*, N.Y.U. 31ST INST. ON FED. TAX. 1799, 1814 (1973):

> [I]t is possible that without regard to elapsed time, payment of newly contributed funds to a partner, other than in his capacity as a partner, might not constitute a "distribution," for example, use of the contributed funds to make payments to a partner's contracting company under an existing agreement to construct an improvement for the partnership.

25. 331 U.S. 1 (1947).

26. A new partner's basis in his partnership interest is the amount of money plus the adjusted basis of any property he contributes to the partnership. § 722.

27. § 752(b).

28. § 752(a).

29. *See* Rev. Rul. 74-40, 1974 INT. REV. BULL. No. 4, at 11.

30. In the case of a limited partnership, the partnership liability must be nonrecourse to enable the limited partners to share in it for basis purposes. Treas. Reg. § 1.752-1(e) (1956). Of course it is critical to share in partnership liabilities for basis purposes because a partner may not deduct his share of partnership losses below his basis in his partnership interest. § 704(d).

31. Treas. Reg. § 1.752-1(e) (1956).

simply withdraws from the partnership, he is treated as having received a distribution of cash to the extent that he is relieved of nonrecourse liabilities.[32] So, too, original partners must pay capital gains tax on the constructive distribution that results from the admission of new partners, to the extent that the distribution exceeds their bases in their partnership interests.[33] In short, because a new limited partner is automatically allocated a share of the partnership's nonrecourse liabilities, the original partners are deemed to receive a distribution of cash for basis purposes. They should also be deemed to receive a distribution within the meaning of the Regulations dealing with the 50-percent rule, since these Regulations treat the admission of a new partner as an exchange of an existing interest when a turnabout distribution is present.

Assuming that the 50-percent rule applies, the question is whether a 50-percent interest in both capital and profits has been shifted. The sale of a 40-percent interest in capital and a 60-percent interest in profits, for example, will not bring the rule into play.[34] The problem is that clear definitions of "capital" and "profits" do not exist, although these are key concepts in partnership taxation.[35] The Regulations reflect a fairly simple model which includes only two basic allocations: one defining the partners' shares in operating income or loss (profits); and one defining the partners' shares in the underlying partnership assets (capital). Because real estate partnerships frequently use more elaborate allocation systems, determining whether a 50-percent interest in profits and capital has been shifted may be difficult.

Real estate partnerships typically use three basic allocations: net cash flow;[36] proceeds of refinancing or sale; and taxable income or loss. Net cash flow will be greater than taxable income whenever the depreciation deduction exceeds debt amortization.[37] Many partnerships strive for positive cash flow coupled with tax losses that can be allocated

32. Rev. Rul. 74-40, 1974 Int. Rev. Bull. No. 4, at 11.

33. § 731.

34. Treas. Reg. § 1.708-1(b)(1)(ii) (1956).

35. "[A]s a practical matter, it is frequently difficult to accurately characterize the interest received by the syndicator as either an interest in profits or an interest in capital. . . ." Ben-Horin, *Real Estate Syndications, Limited Partnerships*, U. So. Cal. 1972 Tax Inst. 71,85. *See also* Aronsohn, *Admission of a New Partner for Cash, Property or Services*, 23 Tax Law. 325, 331-32 (1970).

36. Basically, net cash flow is cash-in minus cash-out. For example, in the case of an apartment or office building, net cash flow is total rent receipts less expenses for maintenance, real estate taxes, and debt service.

37. Because depreciation is a deduction for a non-cash expenditure and debt amortization is cash expenditure for which there is no deduction, a partnership's taxable income is its net cash flow less depreciation plus debt amortization. Therefore, in any year in which a partnership's depreciation deduction is greater than its expenditure for debt amortization, its taxable income will be less than its net cash flow. If the depreciation deduction is greater than the sum of net cash flow and debt amortization, the partnership will have tax losses at the same time it has a positive cash flow.

to the partners and used to shelter income from other sources. Separate allocations of net cash flow and taxable income or loss are used to allocate tax benefits and cash benefits to different partners. For example, a promoter-partner who desires a substantial share of net cash flow may be quite willing to pass most or all of the tax losses to his investor-partners. Similarly, a separate allocation of the proceeds of refinancing or sale can be used to give promoter-partners a greater share in cash benefits than they get of tax losses.[38]

Which of the three allocations just mentioned is the allocation of "profits" referred to in the basis and termination rules? At first glance, the answer seems to be the partnership's allocation of net cash flow. But the Regulations define the partners' ratio for sharing "the general profits or losses of the partnership" as the ratio for sharing "the taxable income or loss of the partnership as described in section 702 (a)(9)."[39] If the Regulations are correct in indicating that "profits" is primarily a tax concept, not a cash concept, the partnership's allocation of taxable income or loss is the allocation of profits. The 50-percent termination rule would therefore apply if the newly admitted partners are allocated more than 50 percent of the partnership's taxable income or loss, even if they are allocated less than 50 percent of the net cash flow.

The Regulations may be misleading, however, because they were not drafted with separate allocations of net cash flow and taxable income in mind. "Profits" may be primarily a cash concept, not a tax concept. If so, net cash flow would initially appear to be the best measure of profits. In some partnerships, however, the financing arrangements are such that most of the cash generated by the business is used to retire debt service. Consequently, the allocation of net cash flow has little or no significance to any of the partners. Instead, the important cash interest takes the form of equity buildup, which is allocated by the partners' ratio for sharing the proceeds of refinancing or sale.[40]

Determining whether a 50-percent interest in capital has been transferred is generally easier than determining whether an interest in profits has been shifted. In most cases, an interest in capital is generally understood to be an interest in partnership assets. Thus, an interest in capital has been found to have been transferred when the capital account of one partner was debited in favor of the capital account of

38. See the discussion of three-way allocation systems *infra* at text accompanying notes 120-23.

39. Treas. Reg. §§ 1.704-1(b)(1), (2) (1956).

40. In any event, consistency should be required of the partners. If they claim more than a 50-percent interest in profits in order to increase their bases in their partnership interests, they should be held to have received the same interest in profits for the purposes of the termination rules.

another partner,[41] and when a partner received the right to share in partnership assets on dissolution.[42] It will usually be clear whether the limited partners have received a 50-percent interest in partnership assets on liquidation. Complications can arise, however, if the ratio for sharing the proceeds of refinancing differs from the ratio for sharing the proceeds of sale, or if the allocation ratio shifts after a certain amount of profit is distributed.

Real estate partnerships can generally avoid the 50-percent rule by passing the newly admitted partners less than a 50-percent share in the proceeds of refinancing and sale.[43] In at least some cases, however, the rule will effectively prevent promoters from completely changing the composition of the partnership while avoiding termination. The change should not be considered immune from the rule simply because it is accomplished by the admission of new partners rather than the sale of existing interests.

B. *The Liquidation-of-Interest Provisions*

If a partner sells or liquidates his entire interest in the partnership, the partnership's taxable year is closed with respect to him.[44] Termination has two basic consequences. First, the partner must include in his gross income his distributive share of partnership income, gain, loss, deduction, or credit for that portion of the partnership's taxable year that ends with the disposition of his entire interest. To avoid an interim closing of the partnership's books, his distributive share of those items may be estimated "by taking his pro rata part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year."[45] Proration may be based on the portion of the taxable year that has expired or on any other reasonable measure.

The second consequence is that the transferee must include in his income all items of partnership income for the remainder of the partnership taxable year.

41. Harry W. Lehman, 19 T.C. 659 (1953), *accord*, Treas. Reg. § 1.721-1(b)(1) (1956); Pennell, *Tax Considerations in Organizing a Partnership*, U. So. CAL. 1973 TAX INST. 333, 353.

42. Leonard A. Farris, 22 T.C. 104, 111-13 (1954).

43. *See also* Kaster, *supra* note 24, at 1814:

> Even if admission of a new partner causes a termination. it is possible that part of the expenses incurred by the terminated partnership may be claimed by the new investor. The possible accomplishment of this is in the nature of the resurrection of a deduction rather than a retroactive allocation. The theory is that the investor has acquired a portion of a capitalized expense not entirely deducted by the terminated partnership as of the date of its termination. If the acquisition theory is valid, it would support deduction only of the unamortized portion of capitalized items such as financing fees.

44. § 706(c)(2)(A)(i). The taxable year does not close with respect to the remaining partners unless § 708 applies.

45. Treas. Reg. § 1.706-1(c)(2)(ii) (1956).

> Any partner who is the transferee of such partner's interest shall include in his taxable income, as his distributive share of items described in section 702(a) with respect to the acquired interest, the pro rata part (determined by the method used by the transferor partner) of the amount of such items he would have included had he been a partner from the beginning of the taxable year of the partnership.[46]

In short, when a partner sells his entire interest in the partnership, he cannot shift to the buyer his share of partnership losses for the portion of the partnership year he was a partner. He must report those losses himself; the buyer must report the partnership income and loss attributable to the remainder of the partnership year.

Although the mechanism is not the same, proration is also required when a partner sells less than his entire interest in the partnership. The Code 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.[47]

The legislative history of this provision contains repeated statements that proration is required when a partner's interest is "reduced."[48]

The basic question, therefore, is whether the admission of additional partners reduces the interest of the original partners within the meaning of this provision. The proper answer appears to be that the proration requirement does apply to the admission of a new partner.[49] Partial sale of an existing partnership interest is so similar to the admission of a new partner that a partial sale can almost always be structured in the form of an admission of a new partner.[50] Consider the following:

> *Example 1.* General partner *A*, through a straw man, owns nine limited partnership interests in a partnership of which he is a general partner. Under the partnership agreement, limited partners are allocated 90 percent of all the economic and tax consequences of the partnership. At year end, eight of the nine limited partnership interests are sold to investors.
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> *Example 2.* General partner *A* establishes a limited partner-

46. *Id.*
47. § 706(c)(2)(B). The Regulations contain only one short paragraph concerning the disposition by a partner of less than his interest in the partnership. Treas. Reg. § 1.706-1(c)(4) (1956).
48. *See, e.g.*, S. REP. No. 1622, 83d Cong., 2d Sess. 92 (1954).
49. J. PENNELL & J. O'BYRNE, *supra* note 23, at 129.
50. 2 S. SURREY, *et al.*, FEDERAL INCOME TAXATION 127 (1973).

> ship with a straw man as the sole limited partner. Under the partnership agreement, the limited partners as a class are allocated 90 percent of all the economic and tax consequences of the partnership. At yearend, eight more limited partners are admitted.

Proration would clearly be required in example 1, since an existing partnership interest has been sold. The question is whether the proration requirement can be avoided by casting the transaction in the form of example 2. Even if a sale of an existing partnership interest is hard to find in example 2, the unavoidable conclusion is that the general partner's interest has been reduced within the meaning of the statute. In both examples the general partner has parted with 80-percent of all the economic and tax consequences of the partnership.

C. *Arguments Against Proration*

In part because the admission of new partners so clearly constitutes a reduction in interest within the meaning of the Code, the advocates of retroactive allocation have not based their arguments on the history, structure, or interpretation of the provisions just discussed. Generally, their argument has been that the proration requirements are overriden by other provisions. Override is generally discussed in the context of the disposition-of-interest provisions and not in connection with the 50-percent rule, which is largely ignored, for two reasons. The first is that the constructive distribution analysis suggested above has received little attention in the literature.[51] The second is the common assumption that the first year of partnership existence is a grace period during which membership may be enlarged without causing termination under the 50-percent rule.[52]

1. Section 761(c)

The primary argument made by opponents of mandatory proration is that retroactive allocation of losses to late-admitted partners is specifically authorized by section 761(c):

> 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.

In short, retroactive loss allocations to new partners are said to be au-

51. *But see* Parker & Lee, *Constructive Cash Distributions in a Partnership: How and When They Occur*, 41 J. TAXATION 88 (1974), in which the authors conclude that the constructive cash distributions on the admission of new partners were not intended to result in termination.

52. *See* P. ROHAN, REAL ESTATE FINANCING § 2.025, at 2-15 n.25 (1973).

thorized by the rule that modifications of partnership agreements relate back to the beginning of the taxable year.[53]

Smith v. Commissioner[54] is one of the cases cited as authority for this proposition. In 1954 two brothers, Morris and Hyman Smith, entered into an oral partnership agreement to engage in the manufacture and sale of electrical equipment. They agreed to contribute one-half of the capital each and to share profits and losses equally. In early 1957 they had a falling-out, and began a series of negotiations that concluded in an agreement that Hyman would buy out Morris' interest. According to the Tax Court, the basic issue was how the parties had agreed to allocate the taxable income for the partnership's final year. Hyman argued that the original agreement to report equal shares remained unchanged. Morris, however, asserted that the original agreement had been orally amended to provide that Hyman would be allocated all the partnership's profits for the final year. The Tax Court agreed with Morris.[55]

The court of appeals affirmed the Tax Court's finding that Hyman had agreed to render the entire net income of the partnership for that year taxable to him. The court said that this agreement related back to the beginning of the partnership's taxable year by virtue of section 761(c),[56] rejecting Hyman's argument that Morris "could not avoid his tax by a retroactive sale of his partnership interest."[57] The court also rejected Hyman's argument that the retroactive allocation should be disregarded because it was made for the principal purpose of avoidance or evasion of tax.[58] The court found no evidence that Morris had such a purpose when the modification was made. According to the Tax Court, Hyman's "real motive was to become the sole owner of the company's net profit for the period."[59]

For our purposes, *Smith* is fairly inconclusive. Although *Smith* did hold that a retroactive amendment could alter tax liability, it involved two individuals who had been partners for several years, rather than a yearend admittee. Therefore, there was no question of allocating losses incurred before the taxpayer's admission. Furthermore, because the parties bargained over actual economic profits and losses, not

53. Smith v. Commissioner, 21 CCH TAX CT. REP. No. 294, at 1563, 1567 (1962), *aff'd*, 331 F.2d 298 (7th Cir. 1964).
54. *Id.*
55. Hyman's promise to report any partnership income had not been stated in the written buy-out agreement because Hyman and his attorney, who had denied Morris access to the partnership books and records, had persuaded Morris that there would be no profits in order to induce Morris to sell his interest to Hyman at a lower price. *Id.* at 1568.
56. 331 F.2d at 301.
57. *Id.* at 300.
58. § 704(b)(2). *See* text accompanying notes 124-45 *infra*.
59. 21 CCH TAX CT. REP. No. 294, at 1568 (1962).

merely over tax consequences, the conclusion that the arrangement had substantial economic effect seems inescapable.

Town and Country Plymouth, Inc. v. United States,[60] another widely cited case, provides even less authority for retroactive loss allocations to late-admitted partners. *Town and Country* involved a limited partnership formed in 1960 to develop and manufacture an automatic pinspotting machine for bowling alleys. The partnership agreement was executed by six general partners, who contributed services and know-how, and numerous limited partners who contributed all the capital of the partnership. The general partners had no obligation to contribute toward losses as long as the partnership assets were sufficient to pay them. The agreement further provided that profits would be divided between the general and the limited partners in a ratio of 51 to 49, but did not mention a division of losses. A loss was incurred during 1960. Because the agreement did not specify that this loss was to be charged to the limited partners, the partnership agreement was amended to that effect.

During the summer of 1961, the plaintiff purchased the interest of one of the limited partners for $2,500, and shortly thereafter made a $72,000 cash contribution to the capital of the partnership. Throughout 1961, the partnership continued to incur losses resulting from cash expenditures made entirely out of the capital contributions of the limited partners. No demand was ever made that the general partners contribute toward the rapidly mounting losses, and no such contribution was ever made by a general partner. Cash expenditures made by the general partners were treated as loans to the partnership that were repaid by the issuance of stock after incorporation.

In early 1962, prior to the time for filing the partnership's 1961 return, a retroactive amendment to the partnership agreement was adopted "for the purpose of recording the parties' understanding that losses for the previous year were to be charged solely to the capital accounts of the limited partners."[61] Plaintiff was allocated 49 percent of the loss, because its capital contribution was 49 percent of the total capital contribution of the limited partners. In a brief and unreasoned opinion, the district court concluded that the plaintiff was entitled to deduct the loss allocated to it by the partnership agreement.

Town and Country is weak authority for retroactive allocations of losses to late-admitted partners for several reasons. The court's opinion fails to mention the fact that the plaintiff and its transferor had prorated the losses between themselves.[62] The Service complained that

60. 2 CCH 1967 STAND. FED. TAX REP. (67-2 U.S. Tax Cas.) ¶9680, at 85,274 (C.D. Cal. 1961).

61. *Id.* at 85,276.

62. McGuire, *Retroactive Allocations Among Partners: The Rodman Decision,* 52 TAXES 325, 330 (1974).

the limited partners as a class had been retroactively allocated a greater share of losses than profits, and disallowed plaintiff's deduction to the extent it was based on an allocation of more than 49 percent of total loss to the limited partners. The court apparently found that the alleged retroactive amendment was retroactive only insofar as it reduced to writing the agreement the parties had had all along. Nor does retroactivity appear to be an issue with respect to the plaintiff, since all the losses allocated to the plaintiff were apparently incurred after its admission to the partnership. The opinion suggests that the tax losses allocated plaintiff were those it bore economically. Therefore, the decision is simply an affirmation of the rule that deductions for cash expenditures can be allocated to the partners shouldering them economically, when the principal purpose is not tax avoidance.[63]

The latest decision in the area and the one most clearly in point is *Norman Rodman*,[64] in which the Tax Court held that a late-admitted partner had 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 November 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 22-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 Service alleged and proved that the intent had been to retroactively amend the joint venture agreement to allow him to share in the entire year's profits and losses. In the venture's partnership return for 1956, he had been allocated 22 percent of the venture's losses for the entire year, and he had filed his individual return on the same basis. The Service merely wanted to tax him for the same share of what it determined to be a gain rather than a loss for the entire year. The court held that the Service could hold the son responsible for a share in partnership gain for the entire year, in accordance with the amended agreement of the parties.

Although some defenders of retroactive loss allocation rely on *Rodman*, it is weak precedent for a variety of reasons. First, the court clearly stated that proration was required with respect to the partner who withdrew.[65] Second, although the interests of the three remain-

63. For example, a partner who undertakes to pay all 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 the avoidance or evasion of tax. Treas. Reg. § 1-704-1(b)(2), Example (5) (1964).

64. 32 CCH TAX CT. MEM. No. 277, at 1307 (1973).

65. *Id.* at 1320.

ing partners were reduced, the court did not discuss the applicability of section 706(c)(2)(b), which would appear to require proration. The court's precise reasoning is unclear. Numerous other issues were involved, and both the court[66] and subsequent commentators[67] have noted that the case was poorly litigated. In short, the court did not deal satisfactorily with the issue of retroactivity. Third, the extent to which retroactivity was actually involved is unclear, for the government concluded that Rodman "was active in the joint venture prior to the date when he was allegedly brought into the venture."[68] Fourth, the government, not the taxpayer, attempted to establish retroactivity—and of taxable income, not tax losses. Perhaps the court felt that since the son had claimed losses for the entire year, holding him responsible for the entire year was not unfair when the losses were redetermined to be gains. Finally, the *Rodman* holding is questionable insofar as the son wound up with a share of the tax burden greater than his share of the economic benefits. Nevertheless, *Rodman* remains at least some authority for the proposition that the requirement to prorate upon the reduction of a partnership interest can be superceded by 761(c).[69]

2. *Section 704(b)(2)*

A related argument against mandatory proration is that retroactive loss allocations are a legitimate exercise of the flexibility allowed by section 704(a), which generally provides that allocations of items of income, gain, loss, deduction or credit are to be determined by the partnership agreement. Stated differently, the argument is that retroactive allocations of losses, if they are subject to scrutiny at all, are special allocations that will be disregarded only if their principal purpose is tax avoidance or evasion.[70]

At first glance, conceding that a practice is subject to a limitation, especially such a broad limitation, might seem a peculiar way to defend

66. For example, the court stated: "Neither party has raised section 704(e) despite its apparent applicability." *Id.* at 1319.

67. One of the more astute commentators on real estate partnerships has examined the arguments in *Rodman* and concluded that the Service's position was poorly and incorrectly argued. McGuire, *supra* note 62, at 326-28.

68. *Id.* at 325 n.3.

69. The Committee on Partnerships of the American Bar Association's Section on Taxation has recently recommended that the Code be amended to provide

> . . . that in the case of the disposition of less than the entire interest of a partner in a partnership and in the case of the reduction of the interest of a partner, the partner's varying interests in the partnership during the taxable year shall be computed as if the partnership taxable year had closed as to such partner on the date of the sale, exchange or reduction and without regard to any provision of the partnership agreement which seeks to vary this result in all cases where the principal purpose of the provision is tax avoidance or evasion.

ABA Comm. on Partnerships, *Tax Section Recommendation, No. 1974-6, Report of the Committee on Partnerships*, 27 TAX. LAW. 839, 851-52 (1974).

70. § 704(b)(2).

the practice. Nevertheless, this is a sensible position for the advocates of retroactive allocations. It really concedes nothing, because no one has ever suggested that retroactive allocations are exempt from the limitations of 704(b)(2). More importantly, uncertainties about the application of the principal purpose limitation have prevented it from becoming an effective weapon against tax avoidance schemes. In short, the section 704 argument is an attempt to create a safe harbor within the virtually nonexistent limitations of 704(b)(2).

One uncertainty about the principal purpose limitation is whether it applies only to allocations of specific items of partnership income or loss, or whether it also applies to allocations of total partnership income or loss. In *Jean V. Kresser*,[71] the Tax Court raised but did not reach the question, which it said was a difficult one. The court did, however, express sympathy for the position that allocations of total partnership income or loss, as opposed to allocations of specific items, are not subject to the principal purpose limitation of 704(b)(2).[72] If allocations of total income or loss are exempt from the limitation, late-admitted partners could be brought within the exemption by retroactively allocating total partnership income or loss for the entire year. In the great majority of real estate partnerships, such an allocation costs nothing because no taxable income is generated during the initial years.[73]

Finally, even when a particular allocation is subject to the principal purpose limitation, the scope of this limitation is unclear.[74] The only decision to disregard an allocation on the basis of 704(b) is

71. 54 T.C. 1621 (1970).

72. *Id.* at 1631 n.5.

73. Nor is it clear whether allocations of taxable income or loss are subject to the principal purpose limitation, even if they control the allocation of all of the tax benefits and none of the economic benefits. See text accompanying notes 121-22 *infra*.

74. The Regulations state the following are among the relevant circumstances in determining whether the principal purpose of an allocation in a partnership agreement is the avoidance or evasion of federal income tax:

> Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has "substantial economic effect", that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences; whether related items of income, gain loss, deduction, or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation.

Treas. Reg. § 1.704-1(b)(2) (1956). The examples included in the Regulations to illustrate the application of these six tests indicate that the presence or absence of any one factor will not necessitate the recognition or disregard of an allocation. All the surrounding facts must be considered, and that an allocation results in a tax saving to all partners involved does not necessarily mean it will be disregarded. Similarly, just because the parties would not have entered a transaction without a particular allocation does not mean it will be found to have substantial economic effect apart from tax consequences. The six tests are best viewed as interrelated avenues of inquiry to help determine all the economic consequences of a particular allocation.

Stanley C. Orrisch,[75] which involved such a clearcut violation of 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 were equal partners. One year, when the Crisafis had substantial tax losses from other sources, the agreement was changed to allocate to the Orrisches all the depreciation deductions of the partnership. The court found that this shift in the allocation of depreciation deductions, although reflected by a charge against the Orrisches' capital account, would have no effect on any of the nontax arrangements of the parties, not even on the division of the proceeds of sale of partnership property. The basic test for determining whether the principal purpose of an allocation is tax avoidance is whether it has "a substantial economic effect, and is not merely a device for reducing the taxes of certain partners, without actually affecting their shares of partnership income."[76] The court said that the allocation of all the depreciation deductions to the Orrisches would be disregarded because it did not "actually affect the dollar amount of the partners' share of the total partnership income and loss independently of tax consequences."[77]

A yearend admittee might argue that the retroactivity of a loss allocation has a substantial economic effect if it is used for more than determining tax losses. In response to the objection that a real estate partnership in the construction phase has nothing to distribute but losses, two further arguments might be made. First, since liabilities are not always known with certainty, newly admitted partners are putting their capital at risk for liabilities from the entire year's operations. In a sense, there is retroactivity of risk. Second, the allocation ratio has substantial economic effect because it affects the allocation of any future profits. The upshot is that the principal purpose limitation seemingly offers no real test of the validity of retroactive loss allocations, for it is at best a vague check on the partners' power to determine allocations by agreement.

In summary, commentators have expressed a wide range of opinion concerning the applicability of the proration requirements.[78] Some

75. 55 T.C. 395 (1970), *aff'd*, ¶ 73-556, 31 P-H AM. FED. TAX REP. 1069 (9th Cir. 1973) (per curiam).

76. S. REP. No. 1622, 83d Cong., 2d Sess. 379 (1954).

77. 55 T.C. at 404.

78. To require proration in the case of the partner admitted at yearend would establish the same kind of requirement of proration of losses that exists in the case of the subchapter S corporation. The shareholder of a subchapter S corporation is entitled to deduct his prorata share of the corporation's net operating loss for his taxable year in which or with which the taxable year of the corporation ends. § 1374(c):

> [A] shareholder's pro rata share of the corporation's net operating loss is the sum of the portions of the corporation's daily net operating loss attributable on a pro rata basis to the shares held by him on each day of the taxable year. For purposes of the preceding sentence, the corporation's daily net operating loss is the corporation's net operating loss divided by the number of days in the taxable year.

have asserted that retroactive allocations of losses are permitted whether the late admittee is admitted as an additional partner or as the transferee of an existing partnership interest.[79] Others have asserted that proration is not required in the case of the admission of a new partner, even if it is required in the case of a transferee.[80] Still others have taken the position expressed in this article that the rules requiring proration when a partnership interest is reduced apply whether the reduction is effected by a direct sale or by admission of a new partner, and that these proration rules are not overridden by the more general provisions of 761(c) and 704(a).[81]

III. THE PRIMACY OF LOSSES

It is common knowledge among lawyers and accountants that yearend admittees to real estate partnerships are interested primarily, if not exclusively, in acquiring tax losses that can be used to offset their income from other sources. Indeed, the principal selling document is often a computer print-out that indicates the amount of the retroactive loss allocation and projects a schedule of future losses and how long it will take investors in different brackets to recoup their investments through loss allocations.

The purpose of this section is twofold. First, it will examine the principal techniques used by promoters to generate and accelerate losses for investors seeking tax shelter. Second, it will consider whether the peculiarly loss-oriented nature of the real estate partnership suggests additional arguments that could be used to challenge some or all of the tax benefits sought by yearend admittees.

A. The Generation of Losses

1. Limitations on Prepaid Interest

The relatively recent crackdown on the deductibility of prepaid interest has resulted in more aggressive use of other techniques to generate and accelerate deductions. Section 163(a) of the Code provides a deduction for "all interest paid or accrued within the taxable year on indebtedness," and prepayment of interest has long been used to accelerate deductions into the early years of an investment. Prior

79. Kanter, *Real Estate Tax Shelters*, 51 TAXES 770, 799-800 (1973).

80. Halperin & Tucker, *Tax Consequences of Operating Low Income Housing (FHA 236) Programs*, 36 J. TAXATION 80, 82 (1972):

> To overcome this [the application of the proration requirements of § 706] and permit a partner coming in late in the year to be entitled to tax losses from an earlier period, it would appear that the partner should be admitted as a new partner as opposed to his purchasing a partnership interest from one of the other partners.

81. J. PENNELL & J. O'BYRNE, FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS 129 (1970); McGuire, *Retroactive Allocations Among Partners: The Rodman Decision*, 52 TAXES 325-30 (1974).

to 1968, cash basis taxpayers commonly took advantage of this provision by prepaying and immediately deducting up to 5 years of interest.[82] In 1968, however, the Service issued a Revenue Ruling sharply limiting deductions of prepaid interest.[83]

The Ruling is based on the authority of the Service to require a taxpayer to adopt an accounting method that clearly reflects income.[84] It states that prepayment of interest for a period extending more than 12 months beyond the end of the current taxable year will automatically be regarded as a "material distortion of income."[85] It further provides that prepayments for periods of 12 months or less will be considered on a case-by-case basis to determine whether a material distortion of income has resulted.[86] If a material distortion has resulted, the taxpayer will be required to deduct the prepaid interest in the years in which it would have become due, rather than the year in which it was paid. In short, the Ruling places a cash basis taxpayer on the accrual basis with respect to the prepaid interest.[87]

82. After decisions in the Tax Court unfavorable to the Service on the issue of the deductibility of prepaid interest, the Commissioner issued I.T. 3740, 1945 CUM. BULL. 109, in which he ruled that a cash basis taxpayer could properly deduct a 5-year interest payment in the year of disbursement.

83. Rev. Rul. 68-643, 1968-2 CUM. BULL. 76.

84. The source of the authority to reallocate the deduction for prepaid interest is § 446(b), which permits the Service to order a recomputation of taxable income if the method of accounting used by the taxpayer "does not clearly reflect income." Therefore, the Ruling limiting the deductibility of prepaid interest states that "[w]here a material distortion of income has been found to result from the deduction of prepaid interest, the Service will require the taxpayer to change his method of accounting with respect to such prepaid interest in order to allocate it over the taxable years involved." Rev. Rul. 68-643, 1968-2 CUM. BULL. 76, 77.

85. The conclusive nature of the presumption in the case of prepayments for periods greater than 12 months has been criticized as exceeding the authority of the Commissioner insofar as it deprives the taxpayer of the opportunity to rebut the assertion of material distortion. Gabinet, *The Interest Deduction: Several New Installments in a Continuing Saga*, 21 CASE W. RES. L. REV. 466, 474-75 (1970).

86. There is presently some question whether and to what extent the Service has retreated from the conclusive presumption of material distortion in the case of prepayments covering a period greater than 12 months. Rev. Rul. 69-582, 1969-2 CUM. BULL. 29, which was reported as a modification of Rev. Rul. 69-643, concerned a "loan processing fee" of $1,200 paid and deducted by a cash-basis borrower in connection with a loan for the purchase of a personal residence. Without referring to the presumption in cases of prepayments covering more than 12 months, which was obviously involved, the Ruling concluded that the prepayment did not constitute a material distortion of income. It is not clear whether the Ruling simply provides an exception in the case of a purchase of a personal residence, whether it is an indication that the presumption will not be applied in cases of de minimus point payments, or whether it modified Rev. Rul. 68-643 to permit the deduction of points generally. Gabinet, *supra* note 85, at 476. *Cf.* Rev. Rul. 69-188, 1969-1 CUM. BULL. 54, 55 (points can be deducted if given for use of money; if payment for lender's services, must be capitalized).

87. Two additional arguments have been made in support of the ruling. The first is that the prepayment of interest should be treated as a nondeductible capital expenditure because it results in the acquisition by the borrower of an intangible asset, a right to use money that extends beyond the year in which the prepayment is made. The second is that prepayment, where refundable, is really only a deposit that is not deductible

The Ruling states that the factors to be considered in determining whether income has been materially distorted include the amount of income in the taxable year of payment, the income of previous taxable years, the amount of prepaid interest, the time of payment, the reason for prepayment, and the existence of a varying rate of interest over the term of the loan. These factors have been criticized as being overly general and providing little concrete guidance.[88] Furthermore, some question exists whether the material distortion of income test will be applied at the partnership level or on a partner-by-partner basis. To the dismay of partnership syndicators, the Service has indicated it will apply the distortion test at the partnership level.[89] Consequently, the amount of the individual partner's outside income presumably will not be taken into account.

The test will be difficult to apply to real estate partnerships in their initial year of operation. Not only will determining the extent of distortion be difficult without previous years to provide a basis for comparison, but in all likelihood no taxable income will be earned either in the initial year or for the first few years thereafter. The rate at which the partners recover their capital investment through tax losses may be an important consideration. Whether prepayment is structured for the benefit of the lender or the tax advantage of the partners may also be important. If, for example, a lender requires payment of points in order to increase its rate of return while staying within the usury laws, this requirement could cut against a finding of material distortion of income accounting methods. Even if the Service applies the distortion test very tolerantly within the 12-month period, the presumption of distortion raised by prepayment for a greater period assures continued aggressive exploration of other techniques to increase and accelerate deductions.

2. *Guaranteed Payments*

A major reaction to the restrictions on the deductibility of prepaid interest has taken place in the area of compensation of promoter-part-

until consumed. For an analysis of these two supporting rationalizations see Gabinet, *supra* note 85, at 472-86.

88. Kanter, *supra* note 79, at 791-92, adds that:

> Further confusion has been added by recent technical advice issued by the IRS to the District Director in Los Angeles dealing specifically with prepaid interest in a real estate tax shelter investment. In that instance, not only was it concluded that a prepayment of interest for a period of less than 12 months after the end of the taxable year of prepayment would be considered a material distortion of income, but it was further concluded that the determination of the material distortion would be made at the *partnership* rather than the *individual* level. This does not necessarily preclude also determining that there is a material distortion of income at the individual partner level. (Emphasis in original.)

89. For an examination of the controversy and the conclusion that the distortion test should be applied at the partnership level in all cases see Comment, *The Material Distortion of Income Test as Applied to Prepaid Interest and Points Paid by Partnerships*, 1973 DUKE L.J. 1318 (1973).

ners. The Code provides that payments to a partner for services or for the use of his capital constitute "guaranteed payments," which are deductible by the partnership as if they were made to a nonpartner, provided they are determined without regard to the income of the partnership.[90] In an attempt to maximize the loss deductions available to the investor-partners, real estate partnerships are documented to characterize as much as possible of the cash paid to promoters as guaranteed payments deductible by the partnership. Less attractive options include having the promoters receive compensation in ways not deductible by the partnership, such as by sale of an asset to the partnership at a profit,[91] and by giving them a more substantial share of the net cash flow or proceeds of refinancing or sale.[92]

At first glance, the intensified use of the guaranteed payment provision may not seem particularly offensive. Because the cost of the deduction by the partnership is that the promoter must report the guaranteed payment as ordinary income, the situation could initially be viewed as an inoffensive trade-off with little loss to the Treasury. The problem is that numerous real estate promoters with substantial amounts of extra tax losses for which they have no need, seek out "investors" in desperate need of tax shelter. In short, the guaranteed pay-

90. § 707(c).

91. Assuming the requisite holding period and that the promoter is not a "dealer," he would realize long-term capital gain on the transaction if the sales price bears a reasonable relationship to the actual value of the asset transferred. The partnership, on the other hand, would not be able to deduct immediately the payment to the promoter, but would have to depreciate or amortize it. If, on the other hand, the purchase price were so inflated that it reflected in part the value of the syndicator's services to the partnership, a portion of the ostensible gain on the sale would be taxed to the syndicator as disguised compensation. Ben-Horin, *Real Estate Syndications, Limited Partnerships,* U. So. Cal. 1972 Tax Inst. 71, 83.

92. If the promoter were to accept an interest in the partnership rather than immediate cash payments, his objectives might be to ultimately realize capital gain on the disposition of the partnership properties, and to defer recognition of ordinary income until actual distribution of the profits. Ben-Horin, *supra* note 91, at 83:

> Timing can be of critical importance in this context. Under one technique, the syndicator will acquire his partnership interest for a nominal consideration, reflecting the then nominal capitalization of the partnership, prior to the transfer of the investment property to the syndicate. Investor participation, at a price substantially higher than that paid by the syndicator, takes place in conjunction with the subsequent acquisition of the property. The resulting instant appreciation of the syndicator's retained partnership interest has been held free from tax, although the issue presented is surely not free from doubt.

Another problem with receiving a partnership interest for services is the decision in Sol Diamond, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974), in which it was held that the taxpayer's receipt of a profits interest for past services constituted ordinary income to him when it was acquired. Before *Sol Diamond*, it generally had been believed that "a profits interest received in exchange for services, whether past or future, was not intended to be a taxable event under the regulations." Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The Diamond Case,* 27 Tax L. Rev. 161, 181 (1972). Practitioners are hoping that *Diamond* is limited to receipts of interests for services performed in the past and are documenting transfers of interest in terms of continuing obligations, such as for supervision.

ment provision enables investors to assign their income to promoters who have surplus losses.

There are several forms of purported guaranteed payments. One basic approach is to compute the amount of cash the promoter would expect to receive, and characterize payments to the promoter in that amount as compensation for services rather than as a distributive share of net cash flow.[93] These payments are variously described as fees for brokerage services, sales efforts, or management and supervision. Another approach is to have the promoters make interest-bearing loans to the partnership, rather than contributions to partnership capital. In this way, the partnership will claim deductions for the "interest" payments to the promoter, who may make only a nominal payment designated a contribution to capital.

One objection to many purported guaranteed payments is that they represent disbursements that should be capitalized rather than immediately deducted. No authority exists for the surprisingly prevalent practice of deducting guaranteed payments to a partner that would clearly have to be capitalized if made to a nonpartner.[94] Except for carrying charges, (certain taxes, interest, etc.), and ground rent, expenses incurred during construction by the single purpose partnership normally should be capitalized. For example, a payment to a partner for supervising the construction of an apartment building is a capital expenditure and should not be claimed as a current deduction by the partnership.[95]

Some guaranteed payments claimed "for the use of capital" represent attempts to characterize payments to the promoter as deductible interest payments rather than distributive shares of partnership profits. In addition to being subject to the objections discussed above, many "loans" to partnerships that form the basis for claims of guaranteed payments are clearly subject to attack as being equity rather than debt. The doctrinal distinctions between debt and equity are extremely com-

93. The allocation of cash to the promoter partners as guaranteed payments often has an additional purpose beyond that of generating deductions. Many partnerships use separate allocations of net cash flow, proceeds of refinancing or sale, and taxable income or loss. If the allocation of taxable income or loss is unrelated to the allocations of the cash benefits of the enterprise, it may be regarded as a special allocation that is subject to the principal purpose limitation. Bringing the partnership's allocation of taxable income or loss in line with its allocation of net cash flow makes the conclusion less likely that the allocation of taxable income or loss is a special allocation with no substantial economic effect. Kaster, *Real Estate Limited Partnerships Special Tax Allocations*, N.Y.U. 31st INST. ON FED. TAX. 1799, 1810 (1973).

94. Some of the more sophisticated practitioners in the area have expressed amazement at the extent to which partnerships have gone in claiming guaranteed payment deductions. *See, e.g.*, Kaster, *supra* note 93, at 1811-12.

95. The American Bar Association has recently recommended that § 707(c) be amended to make clear that it does not permit a current deduction for what would otherwise be a capital expenditure. ABA COMM. ON PARTNERSHIPS, *Report of the Committee on Partnerships, Tax Section Recommendation No. 1974-7*, 27 TAX LAW. 839, 862 (1974).

plicated and fall outside the scope of this article. Although debt-equity doctrines have been developed primarily in the corporate context, the Tax Court has stated emphatically that they apply to partnerships as well.[96] More recently, the Service has issued several pronouncements concerning partnerships that distinguish debt from equity for basis purposes.[97] The Service could certainly incorporate more of the debt-equity doctrines from the corporate area into the partnership area.[98]

Finally, many purported guaranteed payments are made with regard to income, thus falling outside the statutory definition of a guaranteed payment. Admittedly, the "without regard to income" test is sometimes difficult to apply to real estate partnerships. The income concept is readily applied to mercantile and service businesses in which taxable income and cash profits generally approximate each other. In real estate partnerships, however, cash flow and taxable income are rarely the same. If the test is taxable income, it is inapplicable to partnerships in the construction phase and during the first few years of accelerated depreciation.

If, however, "without regard to income" means "without regard to the availability of surplus cash," the test has important application to current practice. Many tax advisers now tell their clients that a payment can qualify for deduction as a guaranteed payment even if it is conditioned on the availability of net cash flow. A distinction should be made between cumulative and noncumulative rights. If the right to receive a payment continues as an obligation of the partnership if no available cash flow is available to pay it, a guaranteed payment deduction clearly is available. On the other hand, if the right to the payment is noncumulative, guaranteed payment treatment is clearly inappropriate. A further distinction might be made between a percentage of gross and a percentage of profits. Although the practice of claiming a partnership deduction for percentage-of-net-profit payments is nowhere specifically prohibited, it apparently falls outside the purpose of the provision.[99]

3. *Standing Mortgages*

The standing or term mortgage is also receiving increased attention as a result of the limitations on deductions for prepaid interest. A standing mortgage is one that involves no repayment of principal

96. Joseph W. Hambuechen, 43 T.C. 90, 100-01 (1964).

97. Rev. Proc. 72-135, 1972-1 CUM. BULL. 200; Rev. Rul. 72-350, 1972-2 CUM. BULL. 394. *See also* Shop Talk, J. TAXATION 62, 64 (1974).

98. *See* § 385, which deals with corporations, for factors that could be applied to partnerships.

99. S. REP. No. 1622, 83d Cong., 2d Sess. 387 (1954); *cf.* 2 S. SURREY, *supra* note 50, at 122 (1973).

until the end of the loan period. The principal amount due is said to "stand" because only interest payments are made until payment of the balance, the "balloon," ultimately becomes due. Standing mortgages are currently attractive to promoters anxious to increase interest deductions and decrease nondeductible payments to retire principal.[100]

The use of a standing mortgage was challenged in *Manuel D. Mayerson*,[101] in which the taxpayer "purchased" an office building by making a minimal downpayment and giving a nonrecourse "purchase money" note that required annual interest payments of $18,000 but no repayment of principal for 99 years. The note was in the face amount of $322,500, but could be satisfied by payment of $275,000 within the first year or $298,750 within the two succeeding years. The taxpayer did not exercise either of these options but did "negotiate" a reduced purchase price of $200,000 approximately 5 years after the signing of the note. The Service treated the purported sale as a lease with an option to purchase and disallowed the depreciation deductions claimed by the taxpayer. The Tax Court allowed the deductions.

The court said that under *Crane v. Commissioner*,[102] the nonrecourse nature of the obligation would not prevent it from being included in the taxpayer's depreciable basis in the building. Moreover, a valid debt obligation could exist even though no principal was required to be repaid for 99 years, an unusually long term which was never expected to run its course. In finding a valid debt obligation, the court stressed that the parties had dealt at arms length and had never intended anything other than an absolute sale. It said that nonrecourse standing purchase-money mortgages were not uncommon in connection with the type of transaction under consideration—the sale of an unprofitable office building for which conventional financing was unavailable.[103]

Mayerson involved not only a subsequent reduction in purchase price but also a liberal interpretation of "genuine indebtedness" that has been a great comfort to many real estate practitioners. *Mayerson* does not, however, sanction some of the more recent attempts to use standing mortgages to increase and accelerate deductions. At most, *Mayerson* offers protection for standing mortgages used in arms-length transactions when conventional financing is unavailable. Currently, some developers to whom conventional financing is available are at-

100. Prior to the depression, standing mortgages were much more common than they are today, and were used extensively to finance personal residences. After it became tragically apparent that homeowners cannot pay off "balloons" in severe economic downturns, standing mortgages virtually disappeared from residential home financing.

101. 47 T.C. 340 (1966).

102. 331 U.S. 1 (1947).

103. In Rev. Rul. 69-77, 1969-1 CUM. BULL. 59, the Service emphasized that the fair market value of the property had not been put in issue in *Mayerson* and that it would construe the decision narrowly.

tempting to use long-term standing mortgages or a series of short-term standing mortgages to increase interest deductions and decrease the nondeductible expenditure for debt amortization. If the parties do not intend that the sale will ever be fully consummated, the position asserted by the Service in *Mayerson* is appropriate: the transaction is actually a lease with an option to purchase and the "interest" payments are actually lease payments. Depreciation deductions should be unavailable but the "interest" payments would presumably be deductible as rent. Any "downpayment" should be treated as a premium for a favorable lease, which must be capitalized and amortized over the lease term.[104] If, on the other hand, a consummated sale is intended and if the parties agree at the outset that the payment of the stated principal will ultimately be forgiven, the arrangement is actually a self-amortizing loan that has been documented as a standing loan to qualify the total debt service payments as deductible interest.[105]

Mayerson suggests an additional abuse of the standing mortgage to increase early depreciation deductions. The court sustained depreciation deductions claimed on the basis of the full face amount of the note, even though the note contained substantial discounts for early payment and even though subsequent negotiation had reduced the amount necessary to retire the note by more than a third. The court held that the note's fluctuating amount did not render the full face amount too indefinite to be included in basis as an enforceable and binding personal obligation, and refused to limit retroactively the amount included in basis to the amount eventually required to repay it. The subsequently negotiated purchase price, like the reduced prices specified in the note for early payment, was treated as a bonus discount for early payment. The court concluded that "the cost basis at the time of the purchase should be the nondiscount price."[106]

Can a buyer eager for early deductions agree with the seller to sign a standing note at an inflated face amount, while providing in the note a bonus discount for early repayment that is actually the agreed-upon purchase price, and then claim that the full face amount of the note is properly included in depreciable basis? Or can the face amount of the note be inflated without any stated discount for early payment but accompanied by an understanding that a reduced purchase price will subsequently be negotiated? *Mayerson* suggests these techniques but leaves uncertain the extent to which they can be employed success-

104. *See* Leonard Marcus, 30 T.C.M. 1263 (1971), in which the taxpayer was not allowed to include in his depreciable basis in bowling alleys, nonrecourse obligations in face amounts significantly in excess of the original offering prices of his vendors, that had periods of repayment well in excess of the useful life of the properties purchased. *See generally* M. DeMatteo Constr. Co. v. United States, 433 F.2d 1263 (1st Cir. 1970); *and* World Publishing Co. v. Commissioner, 299 F.2d 614 (8th Cir. 1962).

105. Stated differently, the "interest" payments would be considered combined payments of principal and interest.

106. 47 T.C. at 354.

fully. At the very least, the full face amount of the note should not be included in basis to the extent that the parties understood it was inflated.[107]

4. *Wraparound Mortgages*

The wraparound mortgage has also received a good deal of attention recently as a device for increasing early interest deductions.[108] A wraparound mortgage is a junior mortgage that includes in its face amount the amount of senior financing encumbering the property pledged as security.[109] Wraparounds are usually used when existing financing either cannot be prepaid, can be prepaid only upon payment of a substantial penalty, or carries an advantageous interest rate.[110] Typically, the borrower makes payments to the wraparound lender on the basis of the full face amount of the wraparound loan, and the wraparound lender services the senior debt out of these payments. The lender, therefore, can increase the return on the money it actually advances—the spread between the senior financing and the face amount of the wraparound loan—by charging a higher rate of interest on the full face amount than maintains on the senior financing, without assuming liability on the latter.[111]

Consider how purchasers of encumbered property have used wraparound mortgages to accelerate deductions. Ordinarily, a seller of property initially requests the purchaser to take over existing financing and to make an additional cash payment to purchase the equity. The

107. The court relied on Blackstone Theater Co., 12 T.C. 801 (1949), *acquiesced in*, 1949-2 CUM. BULL. 1, for the proposition that the depreciation deductions claimed by the taxpayer would not be retroactively reduced because the note obligation included in depreciable basis was subsequently discharged for much less than its face amount. The taxpayer in *Blackstone* had purchased a building in 1941 when it was subject to $120,950 in tax liens. Between 1941 and 1945 it lacked the funds to satisfy those liens but acquired additional backing late in 1945 and satisfied the liens at a foreclosure proceeding in 1946 for $50,220. The Service contended that its depreciation deductions for years prior to 1946 should be recomputed, but the court held that these depreciation deductions would not be "retroactively reduced." *Blackstone*, therefore, deals neither with a pre-arranged reduction in the amount of an obligation, nor with a situation in which the taxpayer continued to depreciate on the basis of the full amount of an obligation that he had funds to satisfy at less than the stated amount.

108. Although wraparound mortgages have only very recently received any currency in the United States, they have been extensively used in Canada for over 30 years, where they are known as blanket mortgages. Gunning, *The Wrap-Around Mortgage . . . Friend or U.F.O.?*, 2 REAL EST. REV. 35, 36 (1972). Wraparound mortgages have also been referred to in this country as overlapping deeds of trust and all-inclusive loans.

109. For a good introduction to wraparound mortgages see 3 POWELL ON REAL PROPERTY ch. 37B (P. Rohan ed. 1973).

110. Hershman, *Usury and "New Look" in Real Estate Financing*, 4 REAL PROP. PROBATE & TRUST J. 315, 323-24 (1969).

111. For examples indicating favorable yields that can be obtained by wraparound lenders in refinancing and sale situations see Nad, *Financing Techniques and Problems: Wrap-Around Mortgages, Unuseable Interest Deductions, and Interest Subsidy*, N.Y.U. 29TH INST. ON FED. TAX 1107, 1109-10 (1971).

purchaser responds with an offer to give the seller a wraparound note including both the face amount of existing financing and the cash balance, at a higher rate of interest than the existing financing. He will attempt to persuade the seller to accept a lower total purchase price by demonstrating the more attractive yield of the wraparound. The seller would report a smaller amount realized, taxable as long-term capital gain except to the extent of recapture, but would have to report the additional interest at ordinary income rates.[112] If the seller agrees to the reduced price, the purchaser will be giving up a higher basis in the property, part of which, presumably, would have been attributable to nondepreciable land. He will, however, have structured a transaction that provides the basis for a claim to greater interest deductions. To put icing on the cake, the purchaser probably will prepay a year's interest on the wraparound obligation.[113]

James A. Collins[114] is the leading case on the deductibility of interest payments under a wraparound mortgage. In 1962, the taxpayers, husband and wife, won $140,000 in the Irish Sweepstakes. They were approached by a real estate company that read of their winnings. On November 12, 1962, they signed a "Deposit Receipt and Purchase Contract," offering to purchase an apartment building listed with the company at a total price of $168,000, of which $63,000 was to be paid in cash and placed in escrow. The taxpayers were "to purchase property on contract *subject to existing loan of $105,000,*" which bore interest at the rate of 7.2 percent. The final provision was that "purchase must be *completed prior to Dec. 31, 1962* and escrow closed."

In the first week of December, the parties signed a second purchase contract that contained somewhat different financing terms. It specified a lower total purchase price but provided for a wraparound note to the purchasers at a higher rate of interest than the existing financing. The total price was stated to be $158,000, $19,315 of which was to be paid in cash as a downpayment. The balance due was stated to be $139,485, payable in installments of $830 per month, with interest at the rate of 8.4 percent.

The transaction as finally consummated gave the sellers the same amount of cash at the closing as the initial proposal. The payments on the wraparound note were equal to the debt service on the senior financing. The final contract, which was recorded on December 12, reflected an outstanding loan of $104,204.86, with interest at the rate of 7.2 percent per annum, payable in monthly installments of $827.

112. For a discussion of the tax problems confronting a seller who becomes a wraparound mortgagee see Barnett, *Use of the Wrap-Around Mortgage in Realty Sales: The Tax Advantages and Problems*, 40 J. TAXATION 274, 275-76 (1974).

113. *See* McGuire, *Limited Partnerships: Steps that Can Be Taken To Overcome Problems in the Area,* 34 J. TAXATION 235, 236 (1971).

114. 54 T.C. 1656 (1970).

The sellers were to make these payments when due. The taxpayers were to receive a deed to the property only when they had paid the entire amount due under the final contract, or by assuming the senior financing at any point after the balance due under the wraparound note was equal to the balance on the existing financing. The cash downpayment of $19,315 was to be placed in escrow. Finally, and most importantly, the taxpayers were also to place a prepayment of interest in escrow:

> IN ADDITION TO THE ABOVE DOWN PAYMENT AND CHARGES IN THIS ESCROW, the buyer herein is to deposit into escrow the interest on within mentioned contract for first 5 years, which is $48,299.70, but in consideration of such prepayment of interest, sellers herein are allowing a discount of $4,000.00 to said buyers and buyers are to place the sum of $44,299.70 into escrow, prior to close thereof.[115]

The sellers of the property, also husband and wife, reported this sum of $44,299.70 as prepaid interest[116] on their 1962 tax return. Because of a large rental loss they claimed the same year, the sellers had no tax liability in 1962.

The Service argued that the December 12 contract was a sham and lacked economic substance, and that "no true indebtedness was created and there was no bona fide interest paid, and what was called payment of interest was merely part of the downpayment." Taxpayers had been represented by a certified public accountant "who had represented other sweepstakes winners in their tax matters." Prior to the signing of the November 12 contract, the accountant had made clear that

> . . . a subsequent contract would be worked out which would give sellers the same cash payment of at least $63,000 but the contract would call for a lower purchase price, lower downpayment, and installment payments with interest over a 5-year period and the prepayment of this interest. It was the C.P.A.'s task to work up the figures to be contained in the contract which would provide for the payment to sellers of at least $63,000 but the contract would recite that part of this amount would be downpayment on the purchase price and part prepayment of interest.[117]

The Tax Court accepted the Service's argument and disallowed the deduction for prepaid interest.[118] The court said that the fact that the

115. *Id.* at 1660.

116. At the time, it was common practice to deduct up to 5 years of prepaid interest, under authority of I.T. 3740, 1945 CUM. BULL. 109. When I.T. 3740 was revoked by Rev. Rul. 68-643, 1968-2 CUM. BULL. 76, the latter stated that "this Revenue Ruling will be applied without retroactive effect to interest prepayments for periods not in excess of five years made prior to November 26, 1968." *Id.* at 77-78.

117. 54 T.C. at 1662.

118. The transaction we find to be a sham is not the acquisition of the apartment house but the prepayment of interest and the loan agreement. We accept the contention that the motivating factor in the purchase of the apartment house was eco-

seller reported the amount labeled interest as interest income "is not significant—especially since he had a large loss that year."

The *Collins* court could easily find that no genuine indebtedness existed because the seller testified that he did not understand the taxpayers to have been indebted to him. Even without such direct testimony, use of a wraparound loan can suggest an absence of genuine indebtedness. For example, suppose the seller continues to retire the senior indebtedness, and the purchaser pays interest only on a 60-year nonrecourse note in connection with property having a useful life of less than 60 years. The likelihood that the principal will never be paid indicates a lack of genuine indebtedness, although some interpretations of *Mayerson* could preclude such a finding. Even if the indebtedness is valid under *Mayerson,* the payments could be found to be something other than interest. In *Collins,* the court could have said that the "interest" payment was, in reality, a part of the downpayment. The Service could argue that the increased yield attributable to the difference in interest rates between the underlying obligation and the wraparound note is a payment of principal to the seller.[119]

5. *Three-Way Allocation Systems*

After the maximum amount of deductions has been generated, partnership promoters frequently employ an allocation system that is designed to give yearend admittees a greater proportionate share of the losses than they have of cash benefits. As indicated above, the basic approach is to employ three primary allocations: one for net cash flow, one for proceeds in the event of refinancing or sale; and one for taxable income or loss. By using different allocation ratios, the three are distributed differently. Often, all the cash benefits of the enterprise are distributed under the first two allocations, and the taxable income or loss allocation controls only the allocation of tax losses. Thus, the yearend admittee can be allocated a greater percentage of tax losses than of cash benefits. The result is often that the yearend admittee is al-

> nomic gain. It is the terms used to support the deduction of prepaid interest . . . which we consider to be a sham.

Id.

119. Finally, the court could have said that the deduction for prepaid interest would be disallowed because the prepayment of interest did not represent "purposive economic activity." As set out more fully below, such a statement is analytically distinct from a "sham" analysis, though the court's opinion did not adequately distinguish the two. The *Collins* court said that the situation before it was indistinguishable in principle from that in the *Goldstein* case, to be discussed below, and cited the Tax Court's opinion in that case, which disallowed an interest deduction on the ground that there was a "sham," or nongenuine indebtedness. The problem is that, on appeal, the Second Circuit said that a "sham" analysis was improper in *Goldstein,* but that interest deductions should, nevertheless, be disallowed because they did not support "purposive economic activity."

located all the tax losses for the entire year, but little of the cash benefit.[120]

These allocation systems are difficult to attack under the principal purpose limitation of section 704(b)(2). First, care is usually taken to relate the allocation of taxable income or loss to some economic aspect of the partnership, such as initial contribution to capital. Second, 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. The Code 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)."[121] Consider the dilemma presented the eager tax collector who would like to disregard the allocation of taxable income or loss, but is faced with the rule that disregarded allocations are to be reallocated in accordance with taxable income or loss. The escape from this dilemma lies in the fact 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.[122] Therefore, if the partners' allocation of taxable income or loss is disregarded because it controls only tax losses and is for the principal purpose of tax avoidance, the losses should be reallocated according to the partners' shares in the economic consequences of the enterprise.[123]

B. *Other Arguments Against the Yearend Admittee*

1. *Tax Avoidance Motive in General*

Gregory v. Helvering[124] is generally considered the classic Su-

120. For a detailed hypothetical fully explaining this result see Weidner, *Passing Depreciation to Investor-Partners*, 25 S.C.L. REV. 215, 227-29 (1973). A partial response to such allocation systems is contained in Rev. Proc. 74-17, 1974 INT. REV. BULL. No. 22, at 17, in which the Service stated that it will not issue advance rulings or determination letters unless the following conditions are satisfied:

> .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' interest 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.

121. § 704.

122. Treas. Reg. §§ 1.704-1(b)(1), (2) (1956). The Committee on Partnerships of the Section of Taxation of the American Bar Association has recently recommended that the Code be amended "to provide specifically that the tax avoidance limitation of section 704(b)(2) is to apply not only to the allocation of items described in section 702(a)(1) through (8), but also to the allocation of taxable income or loss, as described in section 702(a)(9)." Committee on Partnerships, *supra* note 95, at 847.

123. For further discussion of the problems concerning three-way allocation systems see Weidner, *supra* note 120.

124. 293 U.S. 465 (1935). The taxpayer in *Gregory* wanted stock held by her

preme Court statement that tax benefits will not be denied simply because they motivated a transaction. Nevertheless, the Court held that the absence of a business purpose will result in denial of the tax benefits of Code provisions premised on commercial transactions.[125] Beyond the business purpose cases is a further line of cases disallowing interest deductions in a variety of tax avoidance schemes. These cases can be viewed as an even stronger basis for a general theory of tax avoidance because the interest deduction is not premised on a business or commercial transaction.[126] A deduction is available, for example, for interest on money borrowed for purely personal purposes.

Knetsch v. United States[127] is the leading Supreme Court decision on the interest deduction. It concerned an arrangement in which the taxpayer borrowed from an annuity company at 3.5 interest to purchase annuity contracts that yielded 2.5 interest.[128] The Court said that under *Gregory* it was irrelevant that the taxpayer entered the transactions only to secure interest deductions.[129] Nevertheless, it held that

corporation transferred to her without having the distribution taxed as a dividend. In an attempt to avail herself of the nonrecognition of gain provisions applicable to a corporate reorganization, she created a third corporation, transferred the shares to it, and immediately caused it to be dissolved and to distribute the shares to her. The Court said the transaction would not be disregarded simply because its ulterior purpose was to escape payment of a tax. The transaction was taxed as a dividend because the corporation created and immediately dissolved had "no business or corporate purpose" but was a "contrivance" set up "not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner." *Id.* at 469.

125. For a collection and discussion of the cases see Young, *The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAW. 275 (1969). In Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949), Judge Learned Hand stressed that the doctrine of *Gregory* is not limited to corporate reorganization cases:

> It has a much wider scope; it means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial and industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.

126. Some Code provisions deny tax advantages to arrangements undertaken for particular motives or purposes. For example, an allocation in a partnership agreement will be disregarded if its principal purpose is the avoidance or evasion of tax. Other provisions, although not explicitly referring to motive or purpose, premise the availability of a tax advantage on activity of a particular type. Depreciation deductions, for example, are available only with respect to property used in a trade or business or held for the production of income. Finally, there are provisions that on their face allow tax advantage independent of motive or purpose. The deduction for interest paid on indebtedness is, of course, a prime example.

127. 364 U.S. 361 (1960).

128. The transaction was actually far more complicated but is noted here because there was no possibility of economic gain aside from the tax consequence.

129. A variant on the scheme used in *Knetsch* was to bring in a third party lender, usually a bank. In Weller v. Commissioner, 270 F.2d 294 (3d Cir. 1959), *cert. denied*, 364 U.S. 908 (1960), the taxpayer purchased an annual premium annuity policy and paid the first premium. Thereafter, he borrowed to increase the policy's cash or loan value, then borrowed the increase in value to pay off the loan undertaken to create that value, and claimed interest deductions for payments made on the loans on the policy. Stated differently, he borrowed at 4% to obtain a discount of less than 3% for prepayment. Stated one last way, he immediately recouped most of the alleged

no indebtedness had been created for tax purposes because the transaction was a sham that offered the taxpayer "nothing of substance" beyond an interest deduction. *Knetsch* left unclear whether the reason the interest deductions were disallowed was that no genuine indebtedness had been created under local law, or whether the reason was that a genuine indebtedness had been created that served no function other than to generate interest deductions.[130] Stated differently, the Court left unclear whether the transaction was a sham because the legal relationships purportedly created were found not to exist, or because those relationships existed but served no economic function other than tax avoidance.

In *Goldstein v. Commissioner*,[131] the Second Circuit stated unequivocally that interest on an indebtedness enforceable under local law is not deductible if it does not involve "purposive economic activity." In 1958, Tillie Goldstein won $140,218 in the Irish Sweepstakes. Her son Bernard, a certified public accountant, arranged two similar transactions with the aid of an attorney to invest her winnings and minimize the tax consequences of the sudden increase in income. First, with the assistance of a brokerage house, Mrs. Goldstein borrowed $465,000 from the First National Bank of Jersey City to purchase 1½ percent Treasury notes in the face amount of $500,000. These notes were promptly pledged as collateral to secure the loan. At the same time, again with Bernard's help, Mrs. Goldstein obtained a $480,000 loan from the Royal State Bank of New York to purchase a second block of Treasury notes, at 1½ percent in the face amount of $500,000, which she pledged as security for the Royal State loan. Late in December 1958, Mrs. Goldstein prepaid $81,396.61, the interest that would be due on the loans if they were to remain outstanding until maturity.

The Second Circuit rejected the Tax Court's conclusion that both transactions were shams that created no genuine indebtedness.[132] It

prepayments of interest by borrowing on the increase in cash surrender value the payments caused. The circuit court found the Tax Court's conclusion that the only purpose of the transactions was the creation of a tax deduction correct, and emphasized the mere fact that "there may be an obligation which is valid under local law is not determinative of whether there is a true indebtedness within the meaning of Section 163." 270 F.2d at 298.

130. The latter seems to be the correct interpretation. *See* Blum, *Knetsch v. United States: A Pronouncement on Tax Avoidance*, 1961 SUP. CT. REV. 135, 149. The incorporation of this vague standard into the interest deduction was resisted by the three dissenting Justices who protested that the majority had disallowed Knetsch's deduction "because the annuity device was devoid of commercial substance." 364 U.S. at 371 (Douglas, J., dissenting).

131. 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).

132. The Second Circuit stated four basic factors supporting its conclusion that a genuine indebtedness had been created. (1) Mrs. Goldstein was personally liable on the notes she gave each bank. (2) Both banks "were independent financial institutions; it cannot be said that their sole function was to finance transactions such as those

agreed with the dissent in the Tax Court that "these loan arrangements were . . . regular and, moreover, indistinguishable from any other legitimate loan transaction contracted for the purchase of Government securities."[133] Nevertheless, it disallowed the interest deductions. It based its decision on the finding that the transactions had been entered into "without any realistic expectation of economic profit and solely in order to secure a large interest deduction,"[134] and said that tax consequences alone were insufficient to sustain an interest deduction. The court based its holding on the underlying purpose of the interest deduction—the "Congressional policy of encouraging purposive activity to be financed through borrowing." This policy would be frustrated if deductions were allowed "for interest paid on funds borrowed for no purposive reason, other than the securing of a deduction," and transactions would be encouraged "that have no economic utility and that would not be engaged in but for the system of taxes imposed by Congress."[135] Because the court found "no prospect" of economic profit, the case did not specify the probability of eventual profit necessary to prevent a finding of nonpurposive activity. Cases since *Goldstein* have indicated that the purposive-activity requirement is not satisfied by a profit that could not have been reasonably anticipated at the inception of the transaction.[136] None, however, has retreated from the basic position that the motive of a particular taxpayer in entering a transaction is not sufficient reason for disallowing tax benefits.[137]

2. *The Yearend Admittee*

Suppose Mrs. Goldstein had decided to become a yearend admittee to a real estate partnership and that her accountant approached a

before us." 364 F.2d at 737. (3) The loan transactions did not return the parties to their original positions for over a year. (4) Both banks possessed substantial control over the future of their respective loan arrangements.

133. 364 F.2d at 737.

134. 364 F.2d at 740. The Second Circuit said that the Tax Court had properly rejected the contention that Mrs. Goldstein "intended a sophisticated, speculative, sortie into the market for government securities." *Id.* at 739. The most damaging evidence introduced was a set of computations that had been made by Bernard contemporaneously with the commencement of the transactions that "almost conclusively" established that an "economic loss" had been anticipated from the outset. *Id.*

135. *Id.* at 741, 742. The court admitted that the underlying purpose of the interest deduction "is difficult to articulate because this provision is extremely broad: there is no requirement that deductible interest serve a business purpose, that it be ordinary and necessary, or even that it be reasonable." *Id.* at 741.

136. In Estate of Frank Cohen, 29 CCH TAX CT. MEM. 1221 (1970), the "reasonable expectation of economic profit" requirement was applied to disallow interest deductions stemming from a transaction that actually produced a profit potential. The court said that "the transaction per se was of sufficient substance to avert a finding of sham," *id.* at 1227, but disallowed the deduction on the ground that the taxpayer "could not . . . *reasonably* expect the transaction to have an appreciable effect on his beneficial interest." *Id.* at 1228 (emphasis in original).

137. *See also* Gabinet, *supra* note 85, at 470 n.18; Herbert Enoch, 57 T.C. 781, 796 (1972).

promoter of real estate partnerships that specialize in maximum accelerated loss deductions. Suppose further that the accountant selected a partnership for her on the basis of a computer print-out that offered a substantial retroactive allocation of pre-admission losses[138] and a schedule of future losses. Because retroactive loss allocation would serve the same function as prepayment of interest, and because the Service has recently expressed concern over uneconomic tax shelter arrangements,[139] this alternative investment by Mrs. Goldstein may be subject to a similar attack.

Although *Goldstein* dealt with the interest deduction, it can be read as authority for the larger principle that taxpayers will not be permitted to purchase tax losses without also acquiring a reasonable possibility of economic profit. The question then becomes whether the yearend acquisition of a real estate partnership interest differs significantly from the alleged attempts of sweepstakes winners to speculate in the short-term paper markets. One major difference is that profit potential cannot easily be disproved in the acquisition of real estate partnership interests. Limited partners may be entitled to share in all the cash flow that is generated over an unlimited period of time and in the appreciation in value of the partnership assets. The variables affecting profit potential are much greater and can operate over a longer period of time in limited partnership cases than in Treasury bill cases.

Nevertheless, many real estate partnerships offer the limited partners no possibility of appreciation in value of an underlying asset nor any possibility of an increase in cash return. The possibility of profit from residual value may be effectively eliminated when the partnership asset is a building constructed on leased land. Similarly, many real estate partnerships enter management agreements or leases that assign any increase in cash flow to a management company, frequently an affiliate of the promoter general partner. Consider the following arrangement which has been frequently used in real estate syndications.[140] The asset

138. Some attorneys concerned over the validity of retroactive loss allocations are advising their clients to refrain from documenting their predictions of preadmission losses to prospective investor-partners.

139. In Rev. Proc. 72-9, 1972-1 CUM. BULL. 718, 720, the Service indicated it will not issue advance rulings or determination letters on the "results of transactions which lack bona fide business purpose or have as their principal purpose the reduction of Federal taxes." More recently, Commissioner Alexander has specifically indicated that limited partnerships with little or no expectation of economic profit will come under attack. *See "Uneconomic" Tax Shelter Arrangements Hit by Commissioner Alexander*, 40 J. TAXATION 37 (1974). Most recently, the Service has refused to issue advance rulings or determination letters with respect to "[w]hether the principal purpose of any provision in the partnership agreement, with respect to a partner's distributive share of any item of income, gain, loss, deduction, or credit, is the avoidance or evasion of Federal Income Tax." Rev. Proc. 74-22, 1974 INT. REV. BULL. No. 35, at 16. *See also* Rev. Proc. 74-17, *supra* note 120.

140. *See, e.g.*, Graybar Building Associates, *Prospectus*, March 10, 1958, *reprinted in part in* P. DAVID, URBAN LAND DEVELOPMENT 44-60 (1970).

the partnership acquires is the lease of an office building. The partnership pays a substantial premium for the acquisition of the leasehold interest and amortizes the amount over the lease term. It subleases to a management company which pays a fixed rent to the partnership and is therefore entitled to retain any increase in cash flow resulting from increased profitability of the building. When the partnership is so structured, the purpose of economic profit can more easily be eliminated because the limited partners are purchasing nothing more than a schedule of losses and a modest cash return. Thus the investment in Treasury bills is more closely approximated.

One problem in applying the purposive-activity requirement to the yearend admittee is that section 702(b) uses an entity rather than an aggregate theory of partnerships to determine the character of items of income and loss reported by the individual partners: "The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share . . . shall be determined as if such items were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership." The yearend admittee may argue with some validity that this provision precludes the imposition of the purposive economic activity test on the individual partner if the test is satisfied by the partnership.[141]

One argument that could be made in response is that the yearend admittee is not a member of the partnership for tax purposes. A collection of individuals who clearly constitute a partnership for purposes of state law may fail to qualify as a partnership for tax purposes.[142] For example, if a dummy corporation with insubstantial assets is the sole general partner in what is clearly a valid limited partnership under state law, the organization may be taxed as an association.[143] The argument can be made that the yearend admittee is not a partner for tax purposes because he does not have "an objective to carry on business and divide the gains therefrom."[144] Again, this argument can be

141. Treas. Reg. § 1.702-1(b) (1956) provides, in part, as follows: "[A] partner's distributive share of gain from the sale of depreciable property used in the trade or business of the partnership shall be considered as gain from the sale of such depreciable property in the hands of the partner."

142. Treas. Reg. § 301.7701-1(b), (c) (1965).

143. *See generally* Treas. Reg. § 301.7701-2(d)(2) (1965); Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

144. Treas. Reg. §§ 301.7701-2(a)(1), (2) (1965).

The SEC's proposed guide for the preparation of registration statements relating to interests in real estate limited partnerships states:

> G. Section 183. The possible impact of this Code section on investors lacking a profit objective in investing in any tax shelter program which is expected to generate annual tax losses for tax purposes for a period of years should be discussed. The discussion should note that the section may apply to the partners of a partnership not withstanding any profit objective the partnership itself may be deemed to have.

Securities Act Release Nos. 5465 and 10663 (March 1, 1974). This statement was a made more persuasively in the context of partnerships using leasing or other arrangements that tend to deprive limited partners of potential profit.

The argument that some limited partners are not partners for tax purposes can be restated in terms of debt-equity principles, which are applicable to partnerships as well as to corporations. If the yearend admittee risks his capital and shares in whatever net cash flow and asset appreciation is generated, arguing that he is not a partner for tax purposes is difficult. If, on the other hand, the limited partner receives only a maximum schedule of cash flow payments, a strong argument can be made that for tax purposes he is a lender charging contingent interest, not a partner. This argument is strongest when the limited partner receives a guaranteed return, whether the guarantee takes the form of a promise of the promoter-partner or of a net lease from the promoter's management company.

The strongest challenge to the yearend admittee, however, focuses more narrowly on the retroactive loss allocation and stresses that promoters are using such allocations to "traffic" in tax losses. An argument can be made that, in economic reality, two separate things have been purchased: first, a tax loss in the amount of the retroactive allocation; second, a prospective interest in a real estate partnership, the purchase of which was a condition to the purchase of the losses. Judicial recognition of this reality could be used in one of two ways: first, to directly disregard the loss allocation because it violates fundamental principles against trafficking in losses; or second, to consider the policy against trafficking sufficient reason to resolve any ambiguity in the Code and Regulations against the yearend admittee. In other words, economic reality can be used to bolster the arguments made in this article that the admission of yearend admittees is covered by existing proration requirements, and that those requirements are not overriden by the general flexibility given partners under sections 761 and 704.[145]

IV. Conclusion

Two existing proration requirements can be applied to deprive the yearend admittee to a real estate partnership of the benefit of a retro-

surprise because the Service had never announced that it would apply § 183 to real estate tax shelters. *See generally* Lee, *A Blend of Old Wine in a New Wineskin: Section 183 and Beyond*, 29 Tax L. Rev. 347 (1974).

145. Before specific legislation dealing with the problem was passed, corporations with income to offset often sought out and acquired other corporations that had accumulated substantial net operating losses carryovers and claimed these losses against their own income on a post-affiliation consolidated return. The Supreme Court disallowed such a deduction from a transaction antedating legislative resolution of the problem. Woolford Realty Co. v. Rose, 286 U.S. 319, 329-30 (1932). For a discussion of trafficking in corporate losses see B. Bittker & J. Eustace, Federal Income Taxation of Corporations and Shareholders ¶¶ 15.24, 16.02 (1971).

active loss allocation. The first is the rule that a partnership is terminated for tax purposes if a 50-percent or greater interest in both capital and profits is sold or exchanged within a 12-month period. The constructive turnabout distribution that takes place when new limited partners are admitted is sufficient to render this admission an "exchange" within the meaning of this rule. An even stronger argument can be made under the second rule, which requires proration whenever a partner's interest is reduced. In the type of transaction under consideration, the interest of the general partner is reduced at yearend as shares in profits, capital, and tax losses are shifted to the newly admitted partners.

Because the arguments on the basis of these two proration rules are so strong, the advocates of retroactive loss allocations have not cast their arguments in terms of the history or interpretation of those rules. Rather, they vaguely assert that the proration rules are somehow overridden by a general authorization of retroactive amendments to a partnership agreement and by the general discretion of partners over allocation. Such override is unsupported by any clear authority. Moreover, the general policy against trafficking in tax losses should be enough to resolve whatever ambiguity exists in favor of a determination against override.