UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 51 | Number 4

Article 4

3-1-1973

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THE REAL ESTATE VENTURE AS A TAX SHELTER

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The favorable economic conditions which have existed for the past several years and continued high federal and state income taxes have caused an increasing number of high-income taxpayers to seek out "tax shelter" investments.[1] As a result there has been a proliferation of publicly and privately offered real estate, timber,[2] cattle and farming operations,[3] oil and gas,[4] cable television, and equipment-leasing[5] investments, all geared toward generating the largest paper tax loss possible for the investors and yet holding out the promise of capital gains upon ultimate disposition of the property.

Because the tax shelter concept is often misunderstood, a simple example would appear helpful:[6] Taxpayer, Dr. *A*, has earnings in 1971 from his profession totaling 100,000 dollars, personal deductions of 20,000 dollars, and a potential tax liability of 33,340 dollars. Along with other similarly situated taxpayers, *A* invests 30,000 dollars in February, 1971, in a real estate tax shelter. The real estate project is a 136-unit apartment complex and costs the investor group 2,200,00 dollars, of which 500,000 dollars was to be paid in cash with the balance represented by a nonrecourse mortgage. The apartment project was completed in September, 1971, and for the remainder of the year generated 12,500 dollars of net cash flow. However, through various means, including a wrap-around mortgage[7] and prepaid interest expense, the project showed a tax loss in 1971 of 350,000 dollars. *A*'s share of the cash

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[1]"A [tax] shelter is a tax preference provided by Congress. A [tax] gimmick is simply a shelter which Congress did not foresee. Both are to be distinguished from a loophole, which is an unintended shelter." *Tax Shelter for the Individual: A Panel Discussion,* N.Y.U. 28TH INST. ON FED. TAX. 1009 (1970).

[2]*See, e.g.,* Georges, *Timber as a tax shelter: What are the benefits and are there drawbacks?,* 36 J. TAX. 364 (1972).

[3]*See, e.g.,* Durham, *Farms and Farming: Gentlemen Farmers, New Hobby Loss Rules; Holding Period; Etc.,* N.Y.U. 29TH INST. ON FED. TAX. 1527 (1971).

[4]*See, e.g.,* Romak, *Natural Resources Including Oil and Gas; Timber: Who and How, the Economics, the Risks and the 1969 Act,* N.Y.U. 29TH INST. ON FED. TAX. 1569 (1971).

[5]*See, e.g.,* Goldstein, *Equipment Leasing After the 1969 Act,* N.Y.U. 29TH INST. ON FED. TAX. 1589 (1971).

[6]The example is based upon an actual syndicated real estate project, but may not necessarily be representative of all offerings available in the field.

[7]*See* note 106 *infra*; text accompanying note 105 *infra.*

flow amounts to 750 dollars, his investment credit was 250 dollars, and his share of the loss amounts to 22,000 dollars. For 1972, *A*'s projected share of cash flow is 2,400 dollars plus losses of 12,000 dollars. Dr. *A*'s share of the project loss for 1971 of 22,000 dollars would be available to offset his income from his profession and, along with the investment credit, would reduce his tax liability to 20,790 dollars. This would result in a net tax saving to the taxpayer of 12,500 dollars. In addition, the 750 dollar cash flow would be received tax-free.

The sheltering of the investor's income is the primary characteristic of the tax shelter. However, many tax shelter investments, particularly the real estate venture, offer the additional benefit of cash-flow distributions to the investors, which are distributed to the investors tax-free when they do not exceed losses. In the example, Dr. *A*'s anticipated share of cash flow for 1972 is 2,400 dollars, all of which would be tax-free and would be in addition to his anticipated direct tax savings of approximately 6,000 dollars through deduction of his share of the losses.

From the investor's standpoint, return on an investment in a tax shelter is measured by three factors: (1) the tax loss that is passed through to him as an individual investor and that is available to offset other income; (2) cash flow which is distributed to him tax-free; and (3) the amount of gain which will be realized upon ultimate sale of the investment.[8] Obviously, the higher the individual investor's tax bracket, the greater are the benefits to be derived from this type of investment. While the Tax Reform Act of 1969 has imposed a fifty-percent limit on taxation of earned income, this limitation is not applicable to investment income.[9] Thus, effective tax brackets in excess of fifty percent will continue to be common for taxpayers who have substantial investment income.

Of the many different types of tax shelter investments currently available to high bracket taxpayers, the one most commonly encountered by attorneys in North Carolina is the real estate partnership. While the basic rules for structuring a real estate tax shelter have crystalized, there are still many pitfalls which can trap the unwary investor.

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[8]There are other nontax attributes which are important to the prospective investor of a real estate limited partnership. Among the most important of the nontax factors are the extent of exposure to personal liability or financial loss and the degree to which continued professional management of the real estate project will be provided. In many instances these factors may override one or more tax considerations.

[9]INT. REV. CODE OF 1954, § 1348(b)(1).

The purpose of this article is to highlight those areas of the tax law which are most important in determining whether a particular real estate tax shelter will produce the expected tax benefits to the investors.

SELECTION OF OWNERSHIP VEHICLE

The determination of the owning entity in any tax shelter is critical. Since the primary objective of the tax shelter is to allow a flow-through of losses and other tax incidents to the individual investors and to avoid the possibility of tax at both the entity level and the investor level, the choice of entity is in most instances reduced to some form of partnership agreement.

The corporation offers limited liability to the investors but is generally not suitable as a tax shelter. The Subchapter C corporation[10] pays income tax at the corporate level on its earnings and profits. Any losses generated by the real estate investment in the corporation would be available only to offset current corporate earnings, or as carry-backs or carry-forwards to offset current corporate earnings, or as carry-backs or carry-forwards to offset other income of the corporation in prior or subsequent years. Distributions of income by the corporation would be out of the after-tax dollars and would be subject to additional taxation at the shareholder-investor level.

Sections 1371 to 1379 of the Internal Revenue Code of 1954 (Subchapter S) provide an election whereby certain corporations and their shareholders may elect to be taxed as a small business corporation. These provisions, in simplified form, provide that the corporate income will be taxed directly to the shareholder (with the exception of capital gains in certain situations)[11] and that the losses of the corporation will be deductible at the shareholder level up to the extent of the shareholders' investment in the corporation.[12] However, the availability of the Subchapter S corporation in the tax shelter area is severely restricted by the limitations imposed on passive income. Section 1372(e)(5)(A) of the Code provides that a Subchapter S corporation cannot have more than twenty percent of its gross income represented by passive income. The term "passive income" is defined as gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or

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[10] INT. REV. CODE OF 1954, §§ 301-95.
[11] INT. REV. CODE OF 1954, § 1378.
[12] INT. REV. CODE OF 1954, § 1374(c).

securities.[13] The operation of a real estate project such as an apartment or office building generally cannot qualify for Subchapter S treatment due to the "passive" nature of the rents.[14] Furthermore, under Subchapter S, losses can be utilized at the shareholder level only to the extent of funds actually invested by the shareholder in the corporation.[15] Since many highly leveraged real estate projects will generate losses in excess of cash invested, the use of a Subchapter S corporation may result in the loss of substantial deductions.

A partnership will usually best fulfill the objectives of the investors. The partnership, unlike the corporation, is not a taxable entity,[16] but is instead a conduit through which income tax attributes of the enterprise are passed to the individual partners. While a general partnership may be utilized in certain special circumstances as the owning entity, in most instances the investors are unwilling to be exposed to the liability which is entailed in participation in a general partnership. Because of the unlimited liability of all partners in a general partnership, a properly structured limited partnership is believed to best fulfill the objectives of the investor seeking a real estate tax shelter.

THE LIMITED PARTNERSHIP

The limited partnership, a statutorily created entity, is simply a partnership with two classes of partners: at least one general partner and any number of limited partners.[17] The limited partners under the statute enjoy the unique position of not being liable for the obligations of the limited partnership in excess of their capital contribution to the limited partnership. The basic nontax characteristics of a limited partnership may be summarized as follows.

A limited partner is not liable to the creditors of the partnership in excess of his agreed contribution to the limited partnership unless, in addition to the exercise of his rights and powers as granted to him in

[13] Treas. Reg. § 1.1372-4(b)(5) (1959).

[14] It is understood, however, that some rulings have been issued by the Internal Revenue Service approving a Subchapter S election in the case of a corporation owning and operating shopping centers and related type real property investments. The apparent key to such rulings has been the providing of substantial service by the managing corporation.

[15] INT. REV. CODE OF 1954, § 1374.

[16] INT. REV. CODE OF 1954, § 701.

[17] UNIFORM LIMITED PARTNERSHIP ACT § 1.

the agreement of limited partnership, he takes part in the active control and management of the partnership's business and affairs.[18]

The general partner is responsible for the management and control of the business except to the extent limited partners are granted certain voting privileges in the agreement of limited partnership.[19]

A limited partner's interest in the limited partnership is personal property and may or may not be assignable depending upon the terms of the limited partnership agreement. In most instances, because of certain federal income tax regulations,[20] a limited partner is permitted to assign only his interest in the earnings and profits of the limited partnership, but such assignee does not become a substitute limited partner.[21]

The death, retirement, bankruptcy, or withdrawal of the general partner generally dissolves the limited partnership. However, the agreement of limited partnership may contain provisions for the continuation of the partnership by a newly designated general partner.[22]

The death of a limited partner does not affect the existence of the limited partnership.[23]

THE ASSOCIATION-PARTNERSHIP CONCEPT

The use of the limited partnership as the owning entity in a real estate tax shelter may raise the question of whether the limited partnership will be treated as a partnership for tax purposes or will be considered an "association," which is taxable as a corporation.

For purposes of federal income taxation the term "corporation" is defined to include associations and joint stock companies.[24] Consequently, an unincorporated organization such as a limited partnership may be treated under the income tax regulations as a corporation if it is found to have more corporate characteristics than noncorporate characteristics. The regulations list six major characteristics ordinarily found in a corporation: (a) associates; (b) an objective to carry on business and divide the gains therefrom; (c) centralization of manage-

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[18] *Id.* §§ 1, 7.

[19] *Id.* § 9.

[20] Treas. Reg. § 301.7701-2(c) (1960).

[21] UNIFORM LIMITED PARTNERSHIP ACT § 19.

[22] *Id.* § 20(a).

[23] *Id.* § 21.

[24] INT. REV. CODE OF 1954, § 770(a)(3). *See also* Morrissey v. Commissioner, 296 U.S. 344 (1935).

ment; (d) continuity of life; (e) free transferability of interests; and (f) limited liability.[25]

A limited partnership[26] will not be classified as an association and taxed as a corporation unless it has more corporate than noncorporate characteristics. Characteristics common to both a limited partnership and a corporation will not, however, be considered. Thus, though a limited partnership has associates and an objective to carry on business and divide gains therefrom, these characteristics are not considered because they are common to both corporations and partnerships.[27] A mathematical test is applied to the four remaining characteristics of centralization of management, continuity of life, free transferability, and limited liability: if the limited partnership possesses three or more of the four characteristics, it will be taxed as a corporation.[28] The determination of whether the limited partnership will be treated as a partnership for tax purposes is thus basically a factual question and requires a careful examination of the limited partnership agreement.

Centralization of management exists when there is a "concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organizations."[29] A limited partnership organized under a statute corresponding to the Uniform Limited Partnership Act generally does not have centralized management.[30] However, the regulations caution that centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners.[31] While the centralized management concept should not be a problem in the ordinary limited partnership organized under the Uniform Limited Partnership Act, this question must be given careful consideration in a real estate syndicate in which the general-partner developer retains only a nominal interest in the limited partnership and the balance is sold to the limited-partner

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[25] Treas. Reg. § 301.7701-2 (1960).

[26] The rules applicable to classification of a limited partnership, for tax purposes, as a partnership, as opposed to an association, are equally applicable to general partnerships, joint ventures and similar unincorporated associations.

[27] Treas. Reg. § 301.7701-2(a)(3) (1960).

[28] *Id.*

[29] Treas. Reg. § 301.7701-2(c)(3) (1960).

[30] Treas. Reg. § 301.7701-2(c)(4) (1960).

[31] *Id.*

investors. In such a situation the limited partnership will be considered to have centralized management.[32]

A limited partnership is considered to have continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization.[33] Conversely, continuity of life does not exist if the retirement, death, insanity, withdrawal, or bankruptcy of the general partner causes an automatic dissolution of the limited partnership unless the remaining general partners or limited partners agree to continue the partnership or designate a substitute general partner.[34] Because of the provisions of the Uniform Limited Partnership Act providing for dissolution on the death, withdrawal, bankruptcy, etc., of the general partner,[35] the regulations conclude that a limited partnership subject to a statute patterned after the Uniform Limited Partnership Act lacks continuity of life since a member of the limited partnership, the general partner, has under local law the power to dissolve the organization.[36] In the typical real estate partnership, however, the limited-partner investors will want some assurance that the limited partnership will continue even after the death, disability, etc., of the general partner. What provisions can then be incorporated in the limited partnership agreement to assure continuation of the venture even upon the death of the general partner without creating the continuity of interest condemned by the regulations?

It is clear that the limited partnership agreement can provide that the remaining general and limited partners may elect to continue the partnership and the partnership will not be considered to have the corporate characteristic of unlimited life.[37] It would also appear to be permissible to provide that when all general partners die, withdraw, etc., the remaining limited partners may elect to designate a new general partner and continue the venture. While the draftsman of a limited partnership agreement has considerable leeway in avoiding the continuity-of-life characteristics, it should be noted that the Internal Revenue Service takes the position that a limited partnership with a fixed life possesses continuity of life since it continues for a fixed period of time, even

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[32]*Id.*

[33]Treas. Reg. § 301.7701-2(b)(1) (1960).

[34]*Id.*

[35]UNIFORM LIMITED PARTNERSHIP ACT § 20.

[36]Treas. Reg. § 301.7701-2(b)(3) (1960).

[37]Rev. Rul. 54-484, 1954-2 CUM. BULL. 242.

though not an unlimited period of time, if, under applicable local law, no member has the power prior to such date to dissolve the organization.[38]

The corporate characteristic of free transferability of interest exists if each partner, or those partners owning substantially all of the interest in the limited partnership, have the power, without the consent of other partners, to substitute for themselves in the same organization a person who is not a partner of the limited partnership.[39] There is no free transferability of interest, however, if, under local law, a transfer of a member's interest results in the dissolution of the old organization and the formation of a new organization.[40] Restricting free transferability may not be desirable from an investor standpoint and is one of the greatest disadvantages to doing business in the limited partnership form. Fortunately, there are several alternatives available to the careful draftsman to avoid some of the impact of this limitation. For example, the limited partnership agreement may provide that an individual limited partner may transfer *only* his interests in the profits and losses of the limited partnership to a third party but, such third party will not become a "substituted limited partner" unless the general partner consents. This has the effect of permitting each individual investor some freedom to dispose of his interest yet does not create the corporate characteristic of free transferability. However, it should be noted that the assignee of a limited partner's interest in the profits and losses is not entitled to any of the special rights afforded a limited partner, such as the right to inspect the books and records of the limited partnership.[41]

At one time the imposition of a right of first refusal in the general partner to purchase a limited partner's interest was thought sufficient to eliminate the free transferability characteristics. However, the regulations classify this as a modified form of free transferability.[42] In recent years there has been an attempt to avoid this corporate attribute by prohibiting all transfers to a substituted limited partner but making an exception in the case of the limited partner's spouse, his estate, and other members of his immediate family. It is understood that the Internal Revenue Service also views this as a limited form of transferability

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[38]Treas. Reg. § 301.7701-2(g), example (5) (1960).
[39]Treas. Reg. § 301.7701-2(e)(1) (1960).
[40]*Id.*
[41]UNIFORM LIMITED PARTNERSHIP ACT § 19(3).
[42]Treas. Reg. § 301.7701-2(e)(2) (1960).

which can be sufficient to cause the limited partnership to be taxed as a corporation, if other corporate attributes are present.

A limited partnership is considered to have the corporate characteristic of limited liability if under local law there is no member of the limited partnership who is personally liable for the debts of or claims against the organization.[43] In the case of a limited partnership organized under a statute corresponding to the Uniform Limited Partnership Act, personal liability exists with respect to each general partner and thus the corporate characteristic of limited liability is avoided.[44] The regulations, however, contain a caveat that the limited liability characteristic will be deemed to exist in a limited partnership if the general partner, whether an individual or a corporation, has no substantial assets (other than his interest in the partnership) which can be reached by a creditor of the organization and is merely a dummy acting as the agent of the limited partners.[45]

THE CORPORATE GENERAL PARTNER

The provisions requiring a substantial worth in both the individual and corporate general partner have probably caused more concern in recent years than any other aspect of the association-partnership problem.

While the limited partnership fulfills the objectives of limited liability insofar as the limited partner is concerned, the general partner, often the developer or syndicator of the project, would also like to be afforded similar treatment. The most obvious means of avoiding personal liability in the general partner and yet retaining the favorable tax treatment of a partnership is by use of a corporation as the sole general partner. In early attempts at the use of this device the corporation was generally organized with a nominal amount of capital and its sole purpose was to serve as the general partner. In the event that the investments of the limited partnership became unprofitable, the creditors of the limited partnership would have recourse only against the "dummy" corporation. In reality, no one was liable for the debts of the limited partnership. Because of such abuses, the Service formulated informal guidelines several years ago establishing minimum capitalization requirements for

[43]Treas. Reg. § 301.7701-2(d) (1960).
[44]Treas. Reg. § 301.7701-2(d)(1) (1960).
[45]Treas. Reg. § 301.7701-2(d)(2) (1960).

the corporate general partner.[46] The Service indicated that it would rule that a limited partnership was subject to corporation taxation when the sole general partner was a corporation unless (1) the limited partners did not own directly or indirectly more than twenty percent of the stock of the corporate general partner and (2) the corporate general partner maintained a net worth equal to fifteen percent of partnership capital in cases in which such capital was less than 2.5 million dollars, or ten percent of the total partnership capital in cases in which the capital exceeds 2.5 million dollars.[47]

In response to an increasing number of ruling requests and the need for clarification in this area, the Internal Revenue Service in January, 1972 issued Revenue Procedure 72-13,[48] formally setting forth what had been the informal ruling policy of the Service in past years. Because of the increased use of corporate general partners and the importance of falling within the guidelines of Revenue Procedure 72-13, this procedure should be examined carefully.

The revenue procedure provides that the Service will consider a request for a ruling on the classification of an organization as a partnership when the sole general partner is a corporation under the following circumstances:

> (1) The limited partners will not own directly or indirectly more than twenty percent of the stock of the corporate general partner or an affiliate corporation. For purposes of determining stock ownership, the attribution rules of section 318 of the Code are applicable.
> (2) The purchase of a limited partner's interest does not entail either a mandatory or discretionary purchase of any type of security of the corporate general partner or its affiliates.
> (3) The net worth of the corporate general partner, computed on the basis of the current fair market value of the corporation's assets, is at all times equal to at least fifteen percent of the total contributions made to the partnership by the partners (both general and limited) where such total is less than 2,500,000 dollars, and ten percent of such contributions where in excess of 2,500,000 dollars. In computing the corporate general partner's net worth, its interest in the limited part-

[46] *See, e.g.*, 25 TAX LAWYER 179 (1971); MORTGAGE & REAL ESTATE EXECUTIVES REP., Oct. 30, 1970, at 2.

[47] 25 TAX LAWYER 179 (1971).

[48] 1972 INT. REV. BULL. No. 2, at 26. For a recent discussion of Rev. Proc. 72-13 *see* Weiler, *Limited partnerships with corporate general partners: Beyond Rev. Proc. 72-13*, 36 J. TAX. 306 (1972).

nership and accounts and notes receivable from the limited partners is excluded.[49]

It should first be pointed out that Revenue Procedure 72-13 does not have the effect of disqualifying all limited partnerships with corporate general partners from partnership tax treatment when the corporate general partner does not meet the criteria set forth. Rather, the procedure sets forth certain criteria which, under normal circumstances, must be met if a favorable tax ruling is to be issued. In addition, the procedure will not be applied when a limited partnership has, in addition to a corporate general partner, an individual general partner, though for ruling purposes the Service will most likely require proof of financial worth of the individual general partner.[50] Apparently, an advance ruling could be obtained on the status of a limited partnership in an appropriate fact situation even if the net worth, stock ownership, and other conditions in Revenue Procedure 72-13 are not met. It would be expected, however, that the time involved in securing such a ruling would be greater than if the conditions set forth in the ruling were met. Furthermore, it should be noted that the failure of the Service to issue a favorable ruling does not mean the organization will be taxed as an association.

Although the procedure does not so state, in order to obtain a favorable ruling the limited partnership apparently must not only meet the requirements of the procedure, it must also have not more than two of the four relevant corporate characteristics as interpreted by the regulations.

The net worth requirements of Revenue Procedure 72-13 will probably be the most troublesome aspect of the Service's announced position. Under the procedure the corporate general partner must at all times meet the net worth requirements computed on the basis of the current fair market value of the corporation's assets. Thus the limited partnership, even after receipt of an initially favorable ruling from the Service, always runs the risk of subsequent disqualification should the net worth of the corporate general partner drop below the required minimum. The fact that the net worth requirement is based upon fair market value may create serious problems in valuation. Furthermore,

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[49]1972 INT. REV. BULL. NO. 2.

[50]It is understood that in connection with several recent private ruling requests a statement of the net worth of the individual general partner has been required. The apparent basis is Treas. Reg. § 301.7701-2(d)(2) (1965).

should a revenue agent, on audit, disagree with the corporation's own valuation of its assets or an appraiser's valuation, the limited partnership may well have to shoulder the burden of proving the worth of its corporate general partner.

The net worth percentage required by the procedure is applied to the "total contributions" to the limited partnership rather than to the value of the partnership.[51] Presumably, "contributions" has the same meaning as this term is used to determine contributions to partnership capital generally under Subchapter K.[52]

The procedure is unclear whether a binding obligation of the limited partners to contribute additional capital in specified amounts is to be considered a "contribution" for purposes of applying the net worth test. If there is, in fact, a binding commitment, it would appear that the corporate general partner would be required to base its net worth upon capital committed or subscribed for as well as the actually paid-in contributions. Logically, contingent commitments should be excluded. To the extent that the capital contributions of the limited partnership are reduced by reason of losses incurred by the partnership and taken as deductions by the partners, it is generally thought that the net worth requirements will be geared to the total contributions to the limited partnership without reduction.

When the corporate general partner has interests in more than one limited partnership, the procedure concludes that the net worth requirement must at least be as great as the sum of the net worth requirements set forth in the procedure for each of the separate limited partnerships.[53] In addition, the corporation's interests in each of the other limited partnerships are excluded in computing the net worth of the corporate general partner in each limited partnership. The literal language of the revenue procedure excludes the corporate general partner's interest as a general partner and its interest as a limited partner in any other limited partnership in computing the net worth. The basic purpose of the net worth test is to ensure the existence of a general partner, in substance as well as in form, that has assets sufficient to satisfy the partnership's obligations. In effect, the regulations require the numerical equivalent for corporations of the requirement for individual general

[51]Rev. Proc. 72-13, § 2.02, 1972 INT. REV. BULL. NO. 2, at 27.
[52]*See* INT. REV. CODE OF 1954, §§ 721-22.
[53]Rev. Proc. 72-13, § 2.03, 1972 INT. REV. BULL. NO. 2, at 27.

partners—that they not be judgment-proof and have a substantial worth.

The twenty percent limit on direct and indirect ownership[54] in the corporate general partner by the limited partners must also be carefully monitored. The broad attribution rules of section 318 of the Code, which are applicable, could easily cause an unknown violation. The procedure is not, however, clear as to whether the "stock" referred to in the procedure is to be limited to voting stock or whether it encompasses any and all types of equity-type securities, such as nonvoting common stock, preferred stock, or convertible debt. Caution would dictate giving this requirement a wide berth by taking appropriate steps to ensure that the limited partners can in no circumstances be considered to own more than twenty percent of all classes of securities combined.[55]

The developer who wishes to serve as the corporate general partner may be unable to meet the net worth requirements because of particularly large liabilities and problems in valuing existing assets. The latter is a common occurrence for a real estate developer. In such a case, consideration should be given to the formation of a subsidiary corporation that could be capitalized with sufficient cash to meet the net worth requirement. The cash paid into the subsidiary could be retained in a certificate of deposit during the life of the limited partnership, and the net worth tests of the procedure would be met at all times. The developer's financial position would not be adversely affected since a consolidated financial statement would incorporate the net worth of the subsidiary general partner.[56] Under the literal language of the procedure this method would appear to be permissible. Furthermore, the funds retained in the separate entity would in fact be available to the general creditors of the limited partnership, and the basic purpose of the net worth requirements of Revenue Procedure 72-13 will have been satisfied.[57]

[54]Presumably the prohibition upon the twenty percent ownership by the limited partners is to guard against the possibility of a sham partnership. This could result when a group of individuals organized a corporation to serve as the corporate general partner, owned all of the stock of the corporate general partner, and were in turn all of the limited partners of the limited partnership.

[55]The possibility of application of the thin incorporation doctrine to the corporate general partner could produce some interesting results. Conceivably, the Service could take the position that loans from limited partners to the corporate general partner constituted a so-called second class of stock and, if the debt were large enough, the twenty percent rule could be violated.

[56]It is understood that some private rulings have been issued approving the use of a subsidiary corporation as the sole corporate general partner.

[57]For a comprehensive discussion of the partnership corporation problem *see* Driscoll, *The*

BASIC PROBLEMS

In a highly leveraged real-estate limited partnership, the anticipated losses during the initial years of operation will exceed the capital contributed by the limited-partner investors. In order for the limited partners to realize the full benefits of their investment, it is necessary that these losses be available to offset or shelter other income. The Code provides that a partner whether general partner or limited partner, may not deduct losses to the extent that the same exceed basis in the partnership.[58] No problem is encountered with a general partnership since each of the general partners are liable for all partnership debt and are therefore entitled to increase their basis in the partnership by their pro rata share of debt.[59] In the case of a limited partnership, however, the regulations provide that a limited partner's share of partnership liabilities for purposes of determining basis in the partnership may not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement.[60] Accordingly, under normal circumstances the limited partners would be entitled to deduct losses of the partnership only up to their basis in the partnership. Section 1.752-1(e) of the regulations, however, contains an important exception:

> [W]here none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability . . . in the same proportion as they share the profits.

Thus, in the situation in which no partner, either the general partners or any of the limited partners, is personally liable on a particular debt of the limited partnership, each partner is entitled to include a portion of the debt in such partner's basis as determined by the ratio of his share of the profits.

The availability of nonrecourse or no-liability financing has in-

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Association Problem in Joint Ventures and Limited Partnerships, N.Y.U. 17TH INST. ON FED. TAX. 1067 (1959). Fox, *The Maximum Scope of the Association Concept*, 25 TAX. L. REV. 311 (1970).

[58] INT. REV. CODE OF 1954, § 704 (d); Treas. Reg. § 1.704-1(d)(1) (1956). *See also* Curtis W. Kingbay, 46 T.C. 147 (1966).

[59] INT. REV. CODE OF 1954, § 752(a).

[60] Treas. Reg. § 1.752-1(e) (1956).

creased in recent years, and FHA mortgages and conventional lenders now frequently grant exculpatory clauses in mortgages on apartments and office buildings. A purchase-money mortgage in North Carolina or the acquisition of property "subject to" an existing mortgage will also qualify under the regulations.[61]

In those situations in which no-liability financing is not available to the limited partnership, only the general partner will be liable on the partnership debt and entitled to include such liability in his basis. Similarly, if a limited partnership assumes a liability so that the general partner becomes personally liable, only the general partner's basis would be increased by the amount of such liability. Consider the situation in which the limited partnership secures financing of which the general partner must guarantee twenty-five percent of the indebtedness with the balance being without recourse. It can be argued that since seventy-five percent of the face amount of the loan is without liability, that portion should be added to the limited partners' basis. However, the regulations speak of debt with respect to which "none of the partners have any personal liability."[62] Since the general partner has part liability, the debt probably will not qualify. However, if the general partner should subsequently be released from liability, the debt should then be available to increase the limited partner's basis pro rata.

It has been suggested that the insufficient basis problem can be overcome by providing in the limited partnership agreement that each of the limited partners will be obligated to the limited partnership for a specific dollar amount (the amount of the anticipated basis deficit), but that such indebtedness will be payable only at the time the partnership does not have sufficient funds to make the payments on its permanent financing or other mortgage indebtedness. Since this liability would exist in favor of the partnership it would appear that this would offer a possible solution. However, it is quite possible that such an obligation in many instances would be viewed with some hesitation by the limited partners.

It has also been thought that an agreement between the general partner and the limited partners under which the limited partners agree

[61]In the case of a "purchase money mortgage" the seller-mortgagee has recourse only against the property and not against the purchaser-mortgagor. This should satisfy the "no liability" requirement of the Regulations. Similarly, when real property is acquired "subject to" a mortgage (as opposed to assuming a mortgage), no liability exists as to the purchaser. Again, the "no liability" test of the Regulations should be satisfied.

[62]Treas. Reg. § 1.752-1(e) (1956).

to indemnify and hold harmless the general partner for any payments exceeding his pro rata share of the liabilities of the partnership should be sufficient to increase the basis of the limited partners. However, the Internal Revenue Service has ruled to the contrary.[63]

Two recent rulings present interesting interpretations of the effect of nonrecourse loans on basis. In many gas and oil limited partnerships, as well as some involving real property, the general partner will make personal loans to the limited partnership on a nonrecourse basis in an attempt to induce investors to participate in the project. Repayment of the loans presumably would come out of the cash flow or tax savings inuring to the benefit of the limited partners. In Revenue Ruling 72-135[64] the Service held that a nonrecourse loan from a general partner to the partnership or limited partners actually constitutes an equity investment by the general partner and cannot create basis for the limited partners. In a subsequent ruling, Revenue Ruling 72-350,[65] the Service expanded on this doctrine and held that an inadequately secured loan, made on a nonrecourse basis to the partnership, does not create basis to the limited partners. The rationale of Revenue Ruling 72-350 would seem highly questionable. While obligations with no personal liability may be challengeable on the grounds of no bona fide debt, the conclusion under the regulations and existing case law seems to be clear that such nonliability-type obligations in fact increase basis.[66]

Should a situation arise in which the limited partners are unable to increase their basis sufficiently to utilize all losses, the question arises as to when and by whom this loss is taken. Section 1.704-1(d)(1) of the regulations provides that a partner's share of losses in excess of his basis will be allowed in any future year when his basis has been increased in an amount sufficient to absorb the loss. If the limited partnership con-

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[63] Rev. Rul. 69-223, 1969-1 CUM. BULL. 184.

[64] 1972 INT. REV. BULL. No. 13, at 16.

[65] 1972 INT. REV. BULL. No. 30, at 8.

[66] See Manuel D. Mayerson, 47 T.C. 340 (1966), where in the case of a 99-year no-liability purchase money mortgage (which exceeded the basis of the particular property by $300,000) the government sought to exclude the mortgage from the depreciable basis on the theory that no obligation to pay was created because of the absence of a personal liability. The Tax Court, however, ruled in favor of the taxpayer. The *Mayerson* case was acquiesced in by the Service in Rev. Rul. 69-77, 1969-1 CUM. BULL. 59, but with the caveat that it was only as to the particular facts and circumstances of that case. In view of the Service's litigating position in the *Mayerson* case, and the approach taken in Rev. Rul. 69-77 it is possible that a nonrecourse loan considerably in excess of the basis of the property may be attacked by the Service in an attempt to exclude the same from the partners' basis. *See also* Crane v. Commissioner, 331 U.S. 1 (1947).

tinues without any increased capital contribution by the limited partner and eventually is liquidated, the logical result under the regulations would be that the general partner would be entitled to the losses unused by the limited partners.[67]

Partnerships that have so-called sub-partners or sub-ventures raise a special basis problem. In an effort to avoid local securities laws, many limited partnerships are organized with a small number of limited partners who in turn sell or sub-venture their interests in capital and profits to others. A sub-partner's ability to deduct partnership losses is limited to his basis. It is not clear from the regulations under section 752 of the Code whether members of sub-partnerships include a proportionate share of the prime partnership's nonrecourse liability in their basis. A private ruling issued to the National Housing Partnership Corporation[68] indicated that the sub-partnership is deemed to have a proportionate share of the prime partnership's liabilities, and it follows logically that the sub-venturers may include a proportionate share in their basis.

SPECIAL ALLOCATIONS

One of the principal advantages to operating in partnership or limited partnership form is the considerable flexibility available in allocating items of income or loss disproportionately among the partners.[69]

In an effort to make a particular real estate investment attractive to the limited partners and to reduce the limited partners' risks to the greatest extent possible, special allocations of cash flow, losses, or particular items of losses such as depreciation and interest deductions may be made to the limited partners during the construction period and the initial years of operation of the project when tax losses are most likely to be the greatest. Through use of special allocations the limited partners will be able to recover a large portion of their investment through tax saving during the initial years of the partnership.

The most common allocation seen in the syndicated limited partnership is an allocation of all losses (or possibly all depreciation) of the limited partnership to the limited partners for a specified number of years or until such time as the total amount of the losses allocated to

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[67]Treas. Reg. § 1.752-1(e) (1956).

[68]The private ruling is a public document on file in the office of the Securities and Exchange Commission as an exhibit to the National Housing Corporation's registration statement. The ruling is reprinted in PLI, JOINT VENTURES IN REAL ESTATE 461 (Real Estate Series Vol. 26, 1970).

[69]*See* INT. REV. CODE OF 1954, § 704(a).

the limited partners is equal to twice the capital contributions of the limited partners. Using such an allocation, the limited partners in the fifty percent tax bracket would have recovered their entire investment through tax savings.

Section 704(a) of the Code provides that a partner's distributive share of income, gain, loss deduction, or credit is determined by the partnership agreement, except as otherwise provided by section 704. Section 704(b) of the Code provides that a partner's distributive share of any *item* of income, gain, loss deduction, or credit shall also be determined in accordance with his distributive share of taxable income or loss, unless the partnership agreement provides otherwise with respect to particular items or unless the principal purpose of any provision in the partnership agreement with respect to allocation of any particular item is the avoidance or evasion of tax.

Section 1.704-1(b)(2) of the regulations sets forth considerations which are deemed to be relevant in determining whether or not a particular allocation is for the purpose of avoidance or evasion of federal income taxes: whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has "substantial economic effect"; 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.

The Senate Finance Committee Report dealing with section 704[70] of the Code indicated that a special allocation of certain *items* would be recognized if the allocation had *substantial economic effects.* While the regulations list six criteria to be examined and weighed in each case involving a special allocation, the Tax Court has adopted a view similar to the Senate Finance Committee and has concluded that the presence of a "substantial economic effect" is the primary criterion for the recognition of a special allocation.[71]

A literal reading of sections 704(a) and 704(b) would seem to indicate that the two provisions have different application. While section 704(a) appears to allow unlimited latitude in the allocation of income and loss among the partners, section 704(b) imposes restrictions on the

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

[71]Stanley C. Orrisch, 55 T.C. 395 (1970).

allocation of individual *items* of income or loss such as interest, depreciation, etc.

It can be argued that under the provisions of section 704(a) the partnership agreement can provide for any allocation of taxable income or loss, commonly referred to as "bottom line" allocations, (as opposed to an *item* of income or loss, such as depreciation) to the partners without regard to the economic effect of such allocation.[72] However, two recent Tax Court decisions,[73] one involving an attempted allocation of income and loss and the other involving an attempted allocation of items and the provisions of section 704(b) cast doubt on this conclusion.

In *Stanley C. Orrisch*[74] two partners owned two apartment projects. Under an oral partnership agreement they agreed to share equally the profits and losses from the venture, which was done for the first three years. In the fourth year the partners agreed that thereafter all depreciation would be allocated to partner B but that gain or loss from the partnership business, computed without regard to depreciation, would be divided equally. It was further agreed that if the property were subsequently sold at a profit, the specially allocated depreciation would be "charged back" to partner B's capital account and partner B would pay the tax on the gain attributable thereto. The modification of the original partnership agreement was also oral.

The Tax Court in *Orrisch* concluded that the principal purpose of the special allocation of all the depreciation deduction to the one partner was the avoidance of income tax and was therefore prohibited under the express provisions of section 704(b). In reaching this conclusion, the court relied heavily upon the report of the Senate Finance Committee accompanying the bill finally enacted as the 1954 Code and the reference in this report to the need of "substantial economic effect." The petitioners in *Orrisch* argued that the allocation had substantial economic effect in that it was reflected in the capital accounts of the partners. The regulations provide that an allocation has economic effect if it "may actually affect the dollar amount of the partners' shares of the

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[72]*See* Koff, *Partnerships and the Special Allocation: The Winds of Change*, 50 TAXES 5 (1972); Long, *Tax shelters in real estate partnership: An analysis of tax hazards that still exist*, 36 J. TAX. 312, 315 (1972); McGuire, *When will a special allocation of deductions among partners be recognized?*, 37 J. TAX. 74, 75 (1972).

[73]Stanley C. Orrisch, 55 T.C. 395 (1970); Jean v. Kresser, 54 T.C. 1621 (1970).

[74]55 T.C. 395 (1970).

total partnership income or loss independently of tax consequences . . . ."[75] The court concluded that the agreement in *Orrisch* did not meet this test. The agreement, the court said, in effect resulted only in offsetting tax consequences, the relinquishment of a current depreciation deduction by partner A in exchange for the exoneration from all or part of the capital gain tax when the property is sold. The court then indicated that to find any economic effect to the special allocation agreement apart from the tax consequences, it was necessary to determine who was to bear the economic burden of the depreciation if the building should be sold at a loss. The court concluded that the partners contemplated an equal division of the partnership assets upon dissolution with adjustment only for disparities in cash contributions or withdrawals. Thus, the special allocation did not actually affect the dollar amount of the partners' share of the total partnership income or loss independently of tax consequences.

While *Orrisch* involved an attempt to allocate an individual item of partnership income or loss (that is, depreciation) the *Jean v. Kresser* case,[76] also decided in 1970, involved an attempt to allocate the *total income* of the partnership to a single partner. In *Kresser* an oral modification of an oral partnership agreement allocated all of the taxable income of the partnership to one partner, who had a net operating loss that was about to expire. The taxable income so allocated was to be restored to the other partners in future years. In holding against the taxpayer's special allocation, the Tax Court stated:

> It is quite true, as petitioners contend, that the partners may readjust their respective partnership shares of income and that, apart from the provisions of section 704(b)(2), effect will be given to the partners' agreement and their modifications thereof. . . . Moreover while one of the purposes of the statute was to provide flexibility to a certain extent . . . that would enable the partners to shift their tax burdens . . . the modifications contemplated must at least be bona fide. Thus, although the partners are to be permitted to readjust their distributive shares *inter sese,* such readjustments must be real, and we are therefore faced with the threshold question on this issue as to whether there was any genuine readjustment of the partners' distributive shares. In our view of the record the evidence indicates the contrary and certainly does not establish that there was any such bona fide reallocation.[77]

[75]Treas. Reg. § 1.704-1(b)(2) (1956).
[76]54 T.C. 1621 (1970).
[77]*Id.* at 1630-31.

The *Kresser* case is interesting in that it seems to avoid the question of whether or not an allocation of taxable income or loss under section 704(a) is granted the seemingly unlimited latitude which the literal language of section 704(a) provides. In effect, *Kresser* simply said there was no modification of the partnership agreement. In addition, the court, in a footnote, specifically disclaimed any attempt to pass upon the Service's argument that section 704(b)(2)—the tax avoidance or tax evasion prohibition—was applicable to the particular facts of this case. In this footnote the Tax Court stated:

> While we are fully prepared to accept the contention that the principal purpose of the alleged modifications was the 'avoidance or evasion' of tax on Appleton within the meaning of sec. 704(b)(2), we are faced with the petitioners' troublesome argument that sec. 704(b)(2) applies only to 'items' of income, etc., dealt with in pars. (1) through (8) of sec. 702(a) and does not govern par. (9) relating to the composite of all of the partnership's income (sometimes referred to as its 'ordinary income') which is here involved. The point is not without difficulty. Although there is general language in *Smith v. Commissioner*, 331 F.2d 299, 301 (C.A. 7), in accord with the Government's argument, the structure of the statute itself and language in the legislative history should seem to give support to petitioners' position. See S. Rept. No. 1622, 83d Cong., 2d Sess., p. 379. However, in view of our conclusion that there was not in fact a bona fide realloccation of income among the partners, we do not reach the question whether sec. 704(b)(2) is applicable to sec. 702(a)(9).[78]

The footnote in *Kresser* offers a strong argument in support of the position that section 704(a) provides greater latitude on the allocation of income and losses, as opposed to allocation of items of income and losses under section 704(b). However, the later *Orrisch* decision and the emphasis placed by the Tax Court on the importance of economic effect cannot be ignored. Consequently, until the Service or the courts offer further clarification it would appear necessary to recognize a possible application of the *Orrisch* standard before providing for special allocations and to structure the proposed allocations in such a way that the substantial economic effect can be demonstrated.[79] Caution would fur-

[78] *Id.* at 1631 n.5.

[79] An example of a special allocation which was upheld is set forth in Rev. Rul. 66-187, 1966-2 CUM. BULL. 246 (1966). There, one partner's capital contribution consisted of municipal bonds and the agreement among the partners provided that the interest earned on those bonds was to be credited specially to his account. The Service concluded that the transaction had substantial economic effect and was therefore permissible.

ther dictate that the partnership agreement take a less aggressive position with respect to special allocations in an effort possibly to avoid an unwanted audit of a partnership return.[80]

A special allocation of profits or losses will also affect the basis of the partners receiving such special allocations to the extent that such basis is the result of nonrecourse liability. For example, assume a partnership composed of A and B, in which seventy-five percent of the profits were allocated to A and twenty-five per cent to B during the first five years, and fifty percent to each partner thereafter. The partnership has actual capital contributions of 10,000 dollars from each partner and has nonrecourse debt of one million dollars. If the partnership agreement is drawn so that the special allocation is upheld, during the first five years of the partnership's existence partner A will have a basis equal to his original capital contribution of 10,000 dollars plus seventy-five percent of the nonrecourse debt, or an additional 750,000 dollars. Logic would further dictate that there would be a readjustment of basis beginning with the sixth year. Query, however, what would be the effect upon the individual partners if, after the expiration of five years, partner A's share of the partnership's losses for the five year period equals 760,000 dollars? Beginning with the sixth year A would have deducted 250,000 dollars more than his basis in the sixth year but exactly equal to his basis in the fifth year. It would appear under section 752 and section 1.752-1(a) of the regulations that in the sixth year A would be treated as having received a taxable distribution to the extent of the 250,000 dollars.

In drafting any limited partnership agreement, the prudent draftsman should project the actual economic effect of any special allocations and any basis adjustments and should include in these projections not only the first few years of operation, but also an ultimate sale, both at a loss and at a profit, in order to determine whether the special alloca-

[80] In many instances some nontax significance to the allocation can be created so as to give substantial economic effect to the allocation. For example, assume *A* and *B* each own fifty percent of a partnership which has a depreciation deduction of 100,000 dollars, and it is desired that the entire 100,000 dollars of depreciation be allocated to *A*. This arrangement would appear to be acceptable to the Service if *A* is also chargeable under the partnership agreement with the first 100,000 dollars of actual cash loss, if any, upon the sale of the real estate, and is likewise allocated the first 100,000 dollars of capital gains (or depreciation recapture) if it is sold as a profit. This would seem to give economic effect to the allocation and would satisfy the provisions of the Regulations. In most cases the likelihood of *A* actually losing money on such an investment would be remote and in view of the substantial tax benefits *A* would most likely be willing to go along with the allocation.

tions will accomplish their intended purpose, and to verify the presence of economic substance to the allocation.[81]

FURTHER PROBLEM AREAS

There are other problems that can be encountered by investors or developers in the organization and operation of the real estate limited partnership. While these matters are of lesser importance they do arise frequently and should not be overlooked.

Syndicator's Fees. It is quite common for the syndicator or promoter of a real estate tax shelter to receive an interest in the earnings and profits of the partnership as his fee for selling the limited partnership interests to investors. This has long been viewed as a nontaxable transaction since such an interest in earnings was considered incapable of present valuation.[82] This position finds some support in section 721 of the Code and the regulations issued thereunder.[83] It should be noted, however, that it is clear that if the promoter receives a capital interest in the partnership (that is a capital account), the interest is immediately subject to taxation.[84] The recent case of *Sol Diamond*[85] casts doubt on the nontaxability of an earnings interest received by a promoter. In *Diamond* the taxpayer received an interest in the profits for services performed by him in arranging financing for the purchase of real property. Three weeks later he sold his interest in the partnership and claimed a short-term capital gain. The court held that the promoter received taxable income when he received his profit interest even though the taxpayer did not receive a capital interest. The court rejected the

[81]For a complete discussion of the question of special allocations from a balance sheet standpoint *see* McGuire, *supra* note 72.

[82]*See* Nassau, *Tax Considerations In Writing a Partnership Agreement: Suggested Clauses,* N.Y.U. 26TH INST. ON FED. TAX. 125, 129 (1968); Rabinowitz, *Realty syndication: An income tax primer for investor and promoter,* 29 J. TAX. 92, 98 (1968); *cf.* United States v. Frazell, 335 F.2d 487 (5th Cir.), *rehearing denied,* 339 F.2d 885 (5th Cir. 1964), *cert. denied,* 380 U.S. 961 (1965).

[83]Treas. Reg. § 1.721-1(b)(1) (1956) covers the situation in which a partnership interest is received for services and makes the following distinction between a capital interest in the partnership and an interest in the profits: "To the extent that any of the partners gives up any part of his right to be repaid his contribution (*as distinguished from a share in partnership profits*) in favor of another partner as compensation for services . . . section 721 does not apply." (emphasis added.)

[84]*See* United States v. Frazell, 335 F.2d 487 (5th Cir.), *rehearing denied,* 339 F.2d 885 (5th Cir. 1964), *cert. denied,* 380 U.S. 961 (1965); Treas. Reg. § 1.721-1(b)(1) (1956).

[85]56 T.C. 530 (1971).

taxpayer's argument that under the regulations the receipt of an interest in partnership profits is subject to taxation only upon receipt of partnership income:

> Relying upon these provisions [Treas. Reg. 1.721-1(b)(1) (1956)], petitioners contend that when a taxpayer receives a partnership interest as compensation for services he is required to account for that interest at once as ordinary income if he acquires an interest in partnership capital, but not if he receives only the right to share in the partnership's future profits and losses. It is true that the regulations make section 721 inapplicable in the case of a taxpayer who has received an interest in the capital contribution made by another partner . . . . But the effect of the first parenthetical clause in the second sentence of these regulations, (as distinguished from a share in partnership profits), upon which petitioners place their sole reliance, is obscure. Certainly, unless section 721 of the Code grants the relief which petitioners seek, they are left subject to section 61. Yet nothing in the foregoing regulations explicitly states that a partner who has received a partnership interest like the one before us in exchange for services already performed comes within the provisions of section 721. The parenthetical language does not so state. At most, it excludes that type of situation from the rule which the regulations affirmatively set forth in respect of readjustments of capital interests, but it does not deal one way or the other with situations described in the parenthetical clause.[86]

The effect of *Diamond* as a precedent is unclear, because of its particular facts and because there was an element of "assignment of income" present. Apparently, the result of that case would have been avoided if the interest received by the promoter had not been solely for services rendered in connection with originally promoting the transaction, but had been for management services that were to be performed during the subsequent operation of the project.[87]

Transfer of Property to the Partnership. Gain or loss is normally not recognized by the partnership or any individual partner on the contribution of property to a partnership.[88] Any proposed transfer of mort-

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[86] *Id.* at 545-46. *See also* Proposed Treas. Reg. § 1.721-1(b)(1), 36 Fed. Reg. 10799 (1972).

[87] For a good discussion of the promoter's fee *see* Ben-Horin, *Real Estate Syndications, Limited Partnerships*, U. SO. CAL. 1972 TAX INST. 71, 82-91.

[88] INT. REV. CODE OF 1954, § 721. Under sections 1245(b)(3) and 1250(b)(3) of the Code no depreciation recapture takes place upon the transfer. In addition, under § 722 of the Code an individual's basis in the partnership is equal to his basis in the property which he contributed to the partnership. If the property transferred to the partnership entails substantially unrealized appreciation, then under § 704(c)(2) of the Code and Treas. Reg. § 1.704-1(c)(2) (1956) gain upon

gaged property to a partnership should, however, be examined carefully. Note the following possibility: Investor A transfers land worth two million dollars to a limited partnership subject to a mortgage liability of one million dollars in exchange for a fifty percent interest as a limited partner. A's basis in the land is 200,000 dollars. The mortgage indebtedness of one million dollars is assumed by the partnership. The transfer of the property to the limited partnership produces no gain to A and his basis for the land becomes the basis for his limited partnership interest.[89] However, the liability assumed by the limited partnership is treated the same as a distribution by the partnership of cash to A under section 752(b) of the Code.[90] The constructive distribution reduces A's basis for his partnership interest,[91] and gain is recognized to the extent the distribution exceeds A's basis. In the example above, A's basis was 200,000 dollars and the liability assumed was one million dollars, resulting in recognizable gain of 800,000 dollars.[92] In addition, since the partnership assumed A's obligation, A as a limited partner would not be entitled to include any portion of the mortgage in his basis for his partnership interest. Had the partnership acquired the property subject to the mortgage instead of assuming A's liability so that no personal liability would exist, A would not have been required to recognize gain at the time of the contribution.[93]

Depreciation. The successful real estate tax shelter is dependent upon accelerated depreciation to a great extent. The Tax Reform Act of 1969[94] imposed restrictions on accelerated depreciation. New residential properties, which would include apartment buildings, are still entitled to use the double-declining-balance and sum-of-the-year-digits methods, the most liberal of the depreciation methods.[95] Owners of new office buildings and like property are entitled to use a 150 percent declining balance.[96] However, owners of used residential property are limited to a 125 percent declining balance or straightline depreciation,

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a subsequent sale by the partnership directly attributable to such appreciation generally should be allocated to the partner who contributed property.

[89] INT. REV. CODE OF 1954, §§ 721-22.

[90] *Cf.* Magnolia Dev. Corp., 29 P-H Tax Ct. Mem. 1032 (1960).

[91] INT. REV. CODE OF 1954, § 733.

[92] *See* INT. REV. CODE OF 1954, § 731(a)(1).

[93] Treas. Reg. § 1.752-1(e) (1956).

[94] Pub. L. No. 91-172, 83 Stat. 487 (codified in scattered sections of INT. REV. CODE OF 1954).

[95] INT. REV. CODE OF 1954, § 167(j)(2).

[96] INT. REV. CODE OF 1954, § 167(j)(1).

and owners of used nonresidential property, such as an office building, are limited to straight-line depreciation.[97] New residential property will therefore often generate a larger loss for tax purposes than other types of property due to larger amounts of depreciation.

The availability of the accelerated method of depreciation is dependent upon whether the property is "new." The Internal Revenue Service takes the position that once an apartment unit or office building is occupied by one tenant the property no longer qualifies as new but is considered used property subject to the more restrictive depreciation methods. The timing of the organization of the limited partnership and its continuation as an entity are therefore extremely important if the desired tax consequences are to be achieved.

Section 708(b)(1)(B) of the Code provides that if more than fifty percent of the total interests in the capital and profits and losses of the partnership is sold within a twelve month period, the partnership terminates for tax purposes. Thereafter the venture will be considered as being carried on by a new partnership. In the event that there should be as much as fifty percent change in the partners in a given year the partnership will no longer be able to use the accelerated methods of depreciation.[98] The application of section 708 of the Code also would appear to dictate that the limited partners be admitted to the limited partnership prior to the date that the tenants occupy the premises. If the partnership is formed, tenant occupancy commences, and then substantially all the limited partners are brought in as investors, it is quite possible that the Internal Revenue Service would take the position that the admission of a substantial number of limited partners after occupancy in effect was a sale of an interest by the general partner. If more than a fifty percent interest was deemed to be sold, then a new partnership came into existence under section 708 (b)(1). This new partnership would likewise be a new owner and would not be permitted to utilize the accelerated depreciation methods.

Dealership Status. When the general partner or one of the limited partners is a real estate developer, the problem of creating or imputing dealership status from one partner to another or from one partnership

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[97] INT. REV. CODE OF 1954, § 167(i).

[98] Note, however, that Treas. Reg. § 1.708-1(b)(1)(ii) (1956) indicates that the admission of additional partners in exchange for capital contributions, even when the new partners receive an interest in excess of fifty percent, will not result in a termination of the partnership since no sale or exchange is deemed to be involved.

to another partnership is raised. This is of great importance to the investors since classification as a "dealer" in real estate eliminates capital gains treatment upon the ultimate sale of the partnership real estate.[99] In *Riddell v. Scales,*[100] the Ninth Circuit held that the intent of a dealer who organized the venture to hold his interest for sale to customers could not be imputed to other venturers. Accordingly, it follows that in determining dealer status, the purposes of the venture and the manner in which the investor holds his interest is controlling and "dealer" status will not be imputed. However, if the purpose of the venture is to develop and subdivide the partnership property, the venture itself will be a dealer and each partner's share of the income of the dealer-partnership will be taxed as ordinary income even though the individual limited partners are not dealers.[101]

Guaranteed Payments. In the promotion of a limited partnership tax shelter, care must be taken that no promises are made in presenting projections of income or cash flow to the investors that could be construed as guaranteed payment within the meaning of section 707(c) of the Code. Under that section a partnership agreement may provide for a guaranteed payment to one or more partners. These payments are regarded as distributions of ordinary income and the partnership is permitted an ordinary income deduction therefor.[102] If promised or guaranteed cash flow to the investors is treated as "guaranteed payments" within the meaning of section 707(c), the investors would be subject to ordinary income tax rather than the anticipated nontaxable cash flow distributions.

The Soft Dollar. In an effort to maximize investors' return promoters of tax shelters often attempt to convert the limited partners' investment into so-called "soft dollars," that is, dollars which will be immediately deductible. The developer of the property is often concerned only with total dollars received rather than the form in which the dollars are paid. Consequently, it may be possible to classify a portion of the purchase price as deductible expenditures. This may take the form of various types of interest payment (that is, points on mortgage loans and construction interest), wrap-around mortgages[103] (in which during the

[99]INT. REV. CODE OF 1954 §§ 1221(1)-(2).

[100]406 F.2d 210 (9th Cir. 1969).

[101]*See also* Barham v. United States, 301 F. Supp. 43 (M.D. Ga. 1969).

[102]Treas. Reg. § 1.707-1(c) (1956). *See also* F.A. Falconer, 40 T.C. 1011 (1963); Rev. Rul. 180, 1969-1 CUM. BULL. 183.

[103]*See* note 106 *infra.*

construction stage a nonrecourse mortgage is given by the purchasing limited partnership which in effect "wraps around" the existing construction loan thus enabling the partnership to have large interest expense for years of construction), management fees, prepaid interest,[104] and rent-up[105] expenses. In any limited partnership the use of such approaches, though very beneficial from the investor standpoint, should be carefully examined to make sure that they have economic significance and independent business basis apart from tax savings. A drastically structured partnership will invariably come under scrutiny by the Internal Revenue Service.[106]

DISPOSITION OF THE TAX SHELTER

Any analysis of a real estate tax shelter must consider the anticipated tax consequences of an ultimate disposition of the investment. One of the objectives of each investor in the tax shelter is appreciation of the property and the ultimate realization of capital gains. In all too many cases investors fail fully to comprehend the tax effects of a disposition of the real estate and are shocked to learn that the anticipated capital gains now take the form of substantial amounts of ordinary income. While it is not always possible to avoid the gain, it is important that the investor, at the time of his initial investment in the limited partnership, be made aware of the potential tax consequences upon a later disposition of the project.

As a general rule, the sale or exchange of a partnership interest will produce capital gain or loss under section 741 of the Code. Similarly, the sale of the partnership assets and dissolution of the partnership will

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[104]The use of prepaid interest has been a popular tax planning device in the tax-oriented investment field. For many years the Service appeared to permit the prepayment of interest for as many as five years in advance. I.T. 3740, 1945 CUM. BULL. 109. However, in Rev. Rul. 643, 1968-2 CUM. BULL. 76, the Service reversed its position and indicated that a deduction for prepaid interest will be considered as a material distortion of income if the interest is prepaid for a period extending more than twelve months beyond the end of the current year. It should be noted that under the ruling the prepayment of interest twelve months in advance is not granted absolute immunity; the Service still reserves the right to disallow this deduction if, under the particular facts and circumstances of the case, it is believed that a distortion of income will result.

[105]Expenses in advertising and promoting the project during the "rent-up" period may be a part of the purchase price where the seller guarantees a minimum occupancy percentage. Since these are deductible expenses the purchaser may wish to pay them direct and reduce the purchase price accordingly.

[106]For a discussion on some of the techniques currently used including wrap-around mortgages, *see* Nad, *Financing Techniques and Problems: Wrap-Around Mortgages, Unusable Interest Deductions, and Interest Subsidy*, N.Y.U. 29TH INST. ON FED. TAX. 1107 (1971).

also result in capital gain or loss.[107] While the basic rules are simple, the actual appliation can lead to some surprising results to the uninformed investor.

Either the sale of a partnership interest or the sale of assets by the partnership followed by liquidation will result in a substantial gain to the limited partner in most real estate ventures because of two factors: (1) the treatment of partnership debt as a distribution;[108] and (2) the effect of accelerated depreciation.[109]

When partnership assets are being sold subject to an existing mortgage liability, including a nonrecourse liability, the amount of the mortgage liability is considered proceeds of sale and is therefore a part of the gain.[110] Similarly, when a partner sells his interest, as opposed to the partnership selling assets, the gain realized for tax purposes includes his share of the partnership's mortgage liabilities.[111] As a result, the sale of a partnership interest for one dollar may result in a taxable gain of 100,000 dollars because of the partnership debt being assumed by the purchaser. Accordingly, in determining the tax effect of a proposed sale the debt structure of the limited partnership will be most important.

A real estate venture gains much of its tax advantages through the use of accelerated depreciation. Developers, in projecting the financial condition of the limited partnership over a number of years, have learned that somewhere between the sixth and eighth year of the normal apartment or office building project the partnership will begin to show income for tax purposes. At that point in time the depreciation and interest expenses have decreased to the point that the net operating revenues exceed them. At this point the tax shelter is generally sold. The anticipated capital gain is not always there, however. Under the depreciation recapture provisions of section 1245 of the Code (applicable to personal property, such as refrigerators, ranges, air conditioning units,

[107] INT. REV. CODE OF 1954, § 751. Note, however, that § 751 provides a provision analogous to the collapsible corporation provisions of § 341 of the Code. Section 751 imposes ordinary income treatment on the sale of a partnership interest in those situations in which the partnership has either unrealized receivables or substantially appreciated property. Treas. Reg. § 1.751-1(d)(1) (1956) in effect provides that where the fair market value of all inventory items exceeds 120 percent of partnership adjusted basis and ten percent of the fair market value of partnership property other than money, then the transfer of the partnership interest will result in ordinary income. *See, e.g.*, Freeland v. Commissioner, 393 F.2d 573 (9th Cir. 1968), *cert. denied*, 393 U.S. 845 (1968).

[108] *See* INT. REV. CODE OF 1954, § 752.

[109] *See* INT. REV. CODE OF 1954, §§ 1245, 1250.

[110] INT. REV. CODE OF 1954, § 752; Treas. Reg. § 1.752-1(d) (1956).

[111] Treas. Reg. § 1.752-1(d) (1956).

and carpeting)[112] and section 1250 of the Code (applicable to depreciable real property),[113] some or all of the gain on the sale that would otherwise be taxed as a capital gain is converted into ordinary income.

Under the provisions of section 1250, as it existed prior to the Tax Reform Act of 1969, if real property were held for twelve months or less and were sold after December 31, 1963, the entire amount of post-1963 depreciation claimed would have been recaptured as ordinary income to the extent of the gain recognized. If the property were held for more than twelve months but no more than twenty months, the entire *excess* of accelerated depreciation over straight-line depreciation would have been recaptured as ordinary income.[114] If the property were held for more than twenty months but less than 120 months (ten years), the excess of accelerated over straight-line depreciation would have been recaptured, but the amount of such recapture would have been reduced by a percentage that would be equal to one percent per month for every month the property was held after twenty months. In no case could the amount of recapture have exceeded the gain on the sale reduced by the same percentage.

The Tax Reform Act of 1969 revised the depreciation recapture rules of section 1250. Whereas under the pre-1969 statute a ten-year holding period would eliminate the ordinary gain resulting from recapture, under the revised recapture rules a sixteen-year, eight-month (200-month) holding period is required to eliminate recapture.[115] In the case of nonresidential properties (such as an office building), the excess of depreciation claimed over straight-line depreciation will be ordinary income, and there is no longer a reducing percentage based upon years of ownership.[116] In the case of residential real property (such as an apartment) sold during the first one-hundred months, the entire excess of depreciation claimed over straightline depreciation is recaptured as ordinary income (but not in excess of the gain recognized). If the property is sold during the second one hundred months, the amount of recapture is reduced by a percentage equal to one percent a month for each month after the first one hundred months.[117]

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[112] INT. REV. CODE OF 1954, § 1245(a)(3).
[113] INT. REV. CODE OF 1954, § 1250(c).
[114] INT. REV. CODE OF 1954, § 1250(a) (repealed 1969).
[115] INT. REV. CODE OF 1954, § 1250(a)(1)(C)(iii).
[116] INT. REV. CODE OF 1954, § 1250(a)(1)(C)(v).
[117] INT. REV. CODE OF 1954, § 1250(a)(1)(C). Special rules are provided in the case of certain government sponsored or subsidized housing projects. For example, an FHA-236 housing project

The 1969 Act also provides transitional rules to take into account depreciation deducted prior to and after December 31, 1969.[118]

While there are no clear-cut answers to avoiding the tax which seems inevitable upon disposition and over which the limited partners may have no control, there are some possibilities available. The partnership can be incorporated at that point in time when the partnership begins to show a profit for tax purposes. Ownership can then be retained more easily over a number of years, after which the corporation could be merged or sold, and the anticipated capital gains realized.[119] This solution is not without problems. While transfers to a corporation solely in exchange for voting stock normally are tax-free under section 351 of the Code, the existence of excessive debt in the partnership will cause problems.[120] To the extent that the assets to be transferred to the corporation are subject to a liability that exceeds the owner's basis in the property, section 357(c) of the Code requires that such excess be treated as taxable "boot." The liabilities-in-excess-of-basis rules of section 357 of the Code will find frequent application in the incorporation of a tax-oriented real estate investment because of the accelerated depreciation methods so commonly used.

Another approach to solving the dilemma of the profitable partnership is to refinance partnership projects when the partnership begins to show a profit for tax purposes. Upon refinancing the partners would generally be able to withdraw tax-free the mortgage funds in excess of the principal balance owed on the indebtedness and to realize the benefits of the appreciation in value of the project without present tax consequences.[121] In addition, the increased interest on the new mortgage may have the effect of converting the profitable partnership into a deficit operation, thus retaining its basic tax shelter characteristics.

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is still subject to the old ten-year recapture rules instead of the extended 16-year 8-month rule. INT. REV. CODE OF 1954, § 1250(a)(1)(C) (ii).

[118]INT. REV. CODE OF 1954, § 1250(a).

[119]However, the collapsible corporation provisions of § 341 of the Code will have to be examined carefully to determine possible application.

[120]As to the possible ways in which assets can be transferred by the partnership to a corporation, and the tax effect of each method, see Rev. Rul. 239, 1970-1 CUM. BULL. 74; Rosen, *New partnership incorporation ruling may create unforeseen problems in many areas*, 33 J. TAX. 329 (1970).

[121]The financing or refinancing does not involve a sale or exchange of partnership assets and therefore does not give rise to a taxable event. The distribution of excess funds generated by the refinancing to the extent not in excess of a partner's basis is likewise a nontaxable event at the partner level.

There are two other methods of disposing of depreciable property by the limited partnership so that the depreciation recapture is deferred and the owner's return is maximized. The conventional installment sale of property with payments in the year of sale not exceeding thirty percent of the selling price represents a relatively simple method of disposing of the depreciable property.[122] By utilizing the installment-sale approach, the investor group will not be saddled with an excessive tax burden in any single year but will have the opportunity of spreading the resulting gain over a period of years. In computing the projected results of the installment sale, it should be noted that indebtedness on the property is included in the sale price and constitutes a payment in the year of sale to the extent that the indebtedness exceeds the basis.[123] Thus, once again, the indebtedness of the partnership is extremely critical in determining the tax impact of the disposition method.

Section 1031 of the Code also offers a possible approach to the disposition of the partnership's tax-oriented investment. In simplified form, section 1031 provides that no gain or loss is recognized when property held for investment is exchanged solely for property of a "like kind" which is also to be held for investment. Under sections 1245(b)(3) and 1250(d)(4) of the Code, no depreciation recapture is due upon the exchange. The regulations under section 1031 describe "like kind" property as having the same nature or character, and the illustrations in the regulations indicate a liberal approach to the "like kind" determination. For example, city real estate is treated as "like" a farm or ranch.[124] The principal problem with utilization of section 1031 is that if the exchange of properties involves liabilities that follow the property, the transferor is deemed to have received taxable "boot" in the amount of such liabilities.[125] By treating the amount of any liabilities assumed in connection with the exchange as money received, the usefulness of section 1031 to the real estate limited partnership is severely restricted. However, this particular provision of the Code should not be overlooked. For example, it would appear that the problems arising because of partnership debt may be avoided if the mortgage holder permits a substitution of the newly acquired property for the old as security for the indebtedness.

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[122] INT. REV. CODE OF 1954, §§ 453-56. Under Treas. Reg. §§ 1.1245-6(d)(1) (1965), 1.1250-1(b)(6) (1971), recapture income may be reported on the installment method.

[123] INT. REV. CODE OF 1954, § 752; Treas. Reg. § 1.752-1(d).

[124] Treas. Reg. § 1.1031(a)-1(b) (1956).

[125] Treas. Reg. § 1.1031(d)-2 (1956).

During the past ten years there has been an increased effort by the Internal Revenue Service and Congress to reduce the benefits of the various forms of tax shelter investments. The adoption of the depreciation recapture rules applicable to personal property in 1962, followed by the real property depreciation recapture rules in 1964, had only a limited effect on the tax-oriented investment. However, the substantial restrictions imposed on the use of accelerated depreciation methods and the stricter depreciation recapture rules arising under the Tax Reform Act of 1969 have unquestionably adversely affected tax-oriented real estate investments.[126] It is difficult to say what the future holds, but it would appear that some form of tax shelters in the real estate area will continue to be desirable in spite of further anticipated action by Congress to reduce the favorable tax treatment now available. With continued demands for housing, particularly in the area of low-income housing, it appears that Congress will continue to provide tax concession, as evidenced by certain provisions of the Tax Reform Act of 1969,[127] in order to induce private enterprise to invest funds in such ventures.

By giving careful attention to the structuring of the limited partnership and by evaluating the potential tax effects of a sale of the property in future years, high-income taxpayers can expect to continue to realize substantial benefits from this type of investment.

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[126] For a discussion of the Tax Reform Act of 1969 and its impact on tax shelter investments see Katcher, *Tax-Sheltered Investments in Real Estate Under the 1969 Tax Reform Act*, U. SO. CAL. 1971 TAX. INST. 587.

[127] *See, e.g.*, INT. REV. CODE OF 1954, §§ 167(k), 1250(a)(1)(C)(ii).