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ORGANIZING A LIMITED PARTNERSHIP TO ACHIEVE REAL ESTATE INVESTMENT OBJECTIVES IN INDIANA

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As interest in real estate investment has become more widespread among investors, considerable attention has been directed toward the organizational vehicles available to implement their investment objectives. Where the prospective investment group is small, the limited partnership has become the most commonly utilized organizational form. The primary reason for this choice has been that the limited partnership provides the most favorable tax treatment, while avoiding many of the drawbacks incident to the use of other organizational forms.

The favorable tax treatment results basically from the fact that the limited partnership allows investors to realize relatively diverse investment objectives, such as the realization of current income or the creation of a tax shelter. Current income, of course, is realized when the current operating revenues of the venture exceed the current costs of its operation. A tax shelter is created, on the other hand, when the deductible items flowing from the investment—primarily depreciation and interest expense—exceed its cash flow. This excess "shelters" other income of the investor because it is deductible from his gross income. The investor in this way avoids present taxation at his current tax rate, which will be a significant advantage to the high bracket taxpayer. When the investment is eventually sold, moreover, the proceeds will be realized at capital gains rates. Thus, to the extent that the gain is not recaptured, the investor will have converted dollars taxable currently at ordinary income rates into dollars taxable in the future at capital gains rates.[1]

Though the limited partnership is a commonly utilized organizational form for real estate investment, it does pose many problems from a planning point of view. In order to clarify some of these problems, and to point out solutions where they are needed, this article shall review the considerations that will lead a relatively small group of investors seeking these two objectives to select the limited partnership as an organizational

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1. *See* Berger & Kanter, *Incorporation of Real Estate Syndicates is Creating Unusual Investment Vehicle,* 16 J. TAX. 224 (1962). *See generally* Aronsohn, *Tax Planning for Acquisitions and Operation of Investment Real Estate by Groups of Investors,* TULANE 18TH ANNUAL TAX INST. 572, 578-81 (1968) [hereinafter cited as Aronsohn]; McKee, *The Real Estate Tax Shelter: A Computerized Expose,* 57 VA. L. REV. 521 (1971).

form,[2] and then consider the various problems consequent upon its organization.

FORMS OF ORGANIZATION FOR REAL ESTATE INVESTMENT

As is true in any type of business enterprise, there are several organizational forms available to facilitate real estate investment. A prerequisite to a choice among them, however, is the recitation of the function that must be served by any real estate investment vehicle. As minimal requirements, any form of organization must perform at least four functions for its investors. First, it must permit the borrowing of significant amounts of capital. Since one of the chief advantages of real estate investment is the financial leverage which may be obtained by the use of borrowed funds, a structure which limits borrowing ability will not be desirable. Second, the organizational form must provide the investors with limited liability —limited, that is, to their investment. This is especially important in a real estate project requiring substantial debt financing. Third, since a principal benefit of real estate investment comes from the tax benefits that it may produce, the vehicle must allow those benefits to pass through to the investor without being first taxed, or taken, at the entity level. Finally, the investors will want to avoid, as much as possible, administrative reporting and disclosure requirements at both the federal and state level.[3]

With these criteria in mind, attention may be directed toward a relatively brief analysis of each of the available forms of organization.

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2. Before choosing a form of organization, the alert planner should review the relevant provisions of the Tax Reform Act of 1969, which have made real estate investment somewhat less attractive for many types of investors. These provisions include those relating to the permissible methods of depreciation, INT. REV. CODE of 1954, § 167; the extent of depreciation recapture, *id.* §§ 1245 & 1250; the new tax preference items, *id.* §§ 56-58 (primarily those for accelerated depreciation of real property, *id.* § 57(a)(2), for capital gains, *id.* § 57(a)(9), and for excess investment interest, *id.* § 57(a)(1)); the limitation on the investment interest deduction, *id.* § 163(d); and the maximum earned income tax, *id.* § 1348. *See generally* Doyle, *Effect of 1969 Tax Reform Act on Future Real Estate Tax Shelter Transactions,* 34 J. TAX. 102 (1971) [hereinafter cited as Doyle]; Gould, *Trends in Tax Planning for Real Estate Investments,* 50 TAXES 732 (1972) [hereinafter cited as Gould]; Katcher, *Tax-Sheltered Investments in Real Estate Under the 1969 Tax Reform Act,* 23 U. SO. CAL. 1970 TAX INST. 587; Ritter & Sunley, *Real Estate and Tax Reform: An Analysis and Evaluation of the Real Estate Provisions of the Tax Reform Act of 1969,* 30 MD. L. REV. 5 (1970).

These provisions provide both tax traps and tax advantages, so that the alert planner will need to analyze his clients' particular circumstances with considerable detail before choosing an organizational form, or, in fact, before recommending real estate investment as a means of accomplishing their investment objectives.

3. These four functions are considered in Sonfield, *The Texas Limited Partnership as a Vehicle for Real Estate Investment,* 3 ST. MARY'S L.J. 13 (1971) [hereinafter cited as Sonfield].

Subchapter C Corporation

The first form of organization that should be considered, is the normal Subchapter C corporation[4]—that is, the ordinary corporate form —whose use as a means of holding investment property is a common practice. Its basic advantages are those that are inherent in the corporate form of organization: limited liability, centralized management, continuity of life and free transferability of interest.[5] There are, in addition, the advantages of avoiding the consequences of the death of an individual who holds real property, such as estate and inheritance taxes, and the ability to borrow at rates that would be considered usurious if charged to individuals or unincorporated entities.[6]

The disadvantages which stem from use of the Subchapter C corporation, however, are significant. As a separate taxable entity, its use precludes the pass-through of tax shelter benefits to individual shareholders, which will frustrate one of the primary investment objectives of most investors.[7] It also raises a wide range of limitations imposed by the Internal Revenue Code.[8] Primary among these are the personal holding company,[9] collapsible corporation,[10] and unreasonable accumula-

4. The "Subchapter C" designation is used because the corporate tax rules are contained in §§ 301-395 of the Internal Revenue Code, which collectively comprise Subchapter C of the Code.

5. Aronsohn, *supra* note 1, at 584-86.

6. *See, e.g.*, ILL. ANN. STAT. ch. 74, § 4(a) (Smith-Hurd 1966). The restrictions posed by usury laws may be responsible for the use of the "straw corporation" as a means of holding title to real property. *See* Morris, *New Developments in Packaging the Real Estate Venture for Private Investors*, TULANE 20TH ANNUAL TAX INST. 147, 150-51 (1971) [hereinafter cited as Morris].

7. Aronsohn, Kurtz & Kronovet, *Advantages and Disadvantages of Various Ways of Holding Real Estate; Partnerships, Subchapter S Corporations, Real Estate Investment Trusts, Real Estate Straws: A Panel*, N.Y.U. 28TH INST. ON FED. TAX. 145, 148 (1970) [hereinafter cited as *Advantages and Disadvantages*].

8. Though there are many disadvantages, there are also a few tax advantages. Probably the most important of these is that no gain or loss is recognized to either the transferor or the corporation if property is transferred to the corporation by one or more persons solely in exchange for stock or securities, and such persons immediately thereafter control eighty per cent of the corporation's voting stock. INT. REV. CODE of 1954, §§ 351(a), 358(a), 362(a). This need not be a factor in choosing between the corporation and the partnership, however, since § 721 of the Code provides for nonrecognition in the case of property contributed in return for an interest in the partnership. *Id.* § 721.

9. The Code provides that a corporation may be a personal holding company if five or fewer shareholders own more than fifty per cent of its stock, and at least sixty per cent of its adjusted ordinary gross income is "personal holding company income." INT. REV. CODE of 1954, § 542(a). Basically, "personal holding company income" is passive income such as dividends, interest, royalties, and, in some cases, rent and personal service income. *Id.* § 543. If a corporation is deemed a personal holding company, it will be subject to a seventy per cent tax on all undistributed income in addition to its ordinary corporate tax and surtax. *Id.* § 541. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 8.20-.25 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE]; Greenberg, *Forms of Organi-*

tion of income rules.[11] In addition, many states have enacted special franchise taxes which tax the privilege of a corporation to do business in that state,[12] and others have adopted a tax upon the amount of outstanding corporate indebtedness,[13] all of which simply add further disadvantage to the corporate form of organization.[14]

Thus, although the Subchapter C corporation has many non-tax advantages, it is generally unsuited for use as a means of real estate investment because of its severe tax disadvantages.[15]

Subchapter S Corporation

A second potential form of organization is the Subchapter S corporation,[16] which, if qualified, may elect to have its income taxed directly to the shareholders without tax at the corporate level.[17] In addition, most

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zation for Holding and Developing Real Estate, N.Y.U. 29TH INST. ON FED. TAX. 1129, 1135 (1971) [hereinafter cited as Greenberg]; Loening, *Personal Holding Companies: Re-Viewing an Old Problem; New Implications,* N.Y.U. 29TH INST. ON FED. TAX. 815 (1971).

10. Although the collapsible corporation rules in § 341 are quite complex, their basic principle is that gain realized by a shareholder in a transaction that would normally produce capital gain will be considered the sale of a non-capital asset if the corporation was formed with a view to effecting such sale before the corporation had realized a substantial part of the income to be derived from its activities. INT. REV. CODE of 1954, § 341. *See generally* BITTKER & EUSTICE, *supra* note 9, ¶¶ 12.01-.09; Greenberg, *supra* note 9, at 1136.

11. To prevent shareholders from allowing the corporation to accumulate all its income, which they may later "bailout" at capital gain rates, the Code provides that any corporation formed or availed of for the purpose of avoiding income tax to its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed shall be subject to a special accumulated earnings tax. INT. REV. CODE of 1954, § 532. The accumulation of earnings and profits "beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax" to shareholders. *Id.* § 533(a). Although accumulations for amortization of mortgage indebtedness, capital improvements and future real estate investments may qualify as reasonable needs of the business, the fact that a corporation is "a mere . . . investment company" is prima facie evidence of a purpose to avoid income taxation. *Id.* § 533(b). If the requisite tax avoidance purpose exists, the corporation is taxed at a rate of 27½ per cent on its "accumulated taxable income" not in excess of 100,000 dollars, and 38½ per cent on its "accumulated taxable income" in excess of 100,000 dollars. *Id.* § 531. "Accumulated taxable income" is defined in § 535. *See generally* BITTKER & EUSTICE, *supra* note 9, ¶ 8.09.

12. *See, e.g.,* N.Y. TAX LAW § 209 (McKinney 1966).

13. *See, e.g.,* TEX. TAX-GEN. art. 12.01 (1969).

14. Although Indiana does have a corporation fee act, IND. CODE § 23-3-2-2 (1971), IND. ANN. STAT. § 25-602 (1972), the taxes it requires are no more than nominal payments and will hardly deter the use of the corporate form.

15. *See* Hall, *Use of Limited Partnership to Invest in Depreciable Realty,* 21 MERCER L. REV. 481, 490 (1970).

16. This designation arises from the special rules in §§ 1371-78 of the Internal Revenue Code, which collectively comprise Subchapter S of the Code.

17. To be eligible for the election, the corporation must be a "small business corporation," as defined by § 1371(a) of the Internal Revenue Code. Thus, to be eligible a corporation must not (1) be a member of an affiliated group as defined in § 1504, (2) have more than 10 shareholders, (3) have a shareholder (other than an estate)

tax benefits will pass through to shareholders with the same characterization that they would have had at the corporate level.[18] The Subchapter S corporation, therefore, provides the ordinary corporate benefits of limited liability, while allowing a favorable pass-through of financial results, all of which make it an attractive vehicle for real estate investment.

The major obstacle to the use of Subchapter S is the rule, designed to limit its use to corporations having substantial "operating" as opposed to "investment" income,[19] that an election shall terminate automatically if the corporation has "passive investment income" in excess of twenty per cent of its gross receipts for any taxable year.[20] Passive investment income is in turn defined to include "rents,"[21] which are "amounts received for the use of, or right to use, property (whether real or personal) of the corporation."[22] Although most forms of rental income will thus bear the taint of passive investment income, the regulations do provide that the taint may be avoided in the case of the rental of rooms or space if the corporation provides "significant services" to its renters.[23] To provide the requisite significant services, the corporation will be required to render its tenants services not usually or customarily rendered in the rental of similar rooms or space.[24] There is, unfortunately, relatively little authority indicating when the "significant service" exception is satisfied, and that which is available is not encouraging to those seeking Subchapter S treatment.[25]

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who is not an individual, (4) have a nonresident alien shareholder, or (5) have more than one class of stock. INT. REV. CODE of 1954, § 1371(a). *See* BITTKER & EUSTICE, *supra* note 9, ¶ 6.02.

18. Thus, earnings and profits, whether or not they are distributed, INT. REV. CODE of 1954, § 1373(a), and capital gains both retain their corporate character in the shareholders' hands. *Id.* § 1375(a)(1). It is to be noted, however, that gain on § 1231 property loses its special identity at the shareholder level, where it is reported as a simple long-term capital gain. *See* BITTKER & EUSTICE, *supra* note 9, ¶ 6.06. Although net operating losses also pass through with the usual carryback and carryover of § 172, to the extent of the shareholder's adjusted basis in his stock and any indebtedness of the corporation to him, long-term capital losses do not. *Id.* ¶ 6.07. Since earnings and profits are computed at the corporate level, depreciation allowances are exhausted at the corporate level, making them unavailable to shareholders as a means of offsetting other personal income.

19. BITTKER & EUSTICE, *supra* note 9, ¶ 6.03, at 6-13.

20. INT. REV. CODE of 1954, § 1372(e)(5).

21. *Id.* § 1372(e)(5)(C). *See also* Bramlette Building Corp. v. Commissioner, 424 F.2d 751 (5th Cir. 1970).

22. Treas. Reg. § 1.1372-4(b)(5)(vi) (1969).

23. *Id.*

24. *Id.*

25. In Bramlette Building Corp. v. Commissioner, 424 F.2d 751 (5th Cir. 1970), it was held that a corporation did not remove the taint from the rents it received from rental of its office building, when it merely sought to attract other tenants who would aid the existing tenants' businesses, and furnished porter, maid, and repair services. These were not sufficiently "significant services" because they did not differ from those furnished in similar office buildings. Similarly, in City Markets, Inc. v. Com-

Even if the passive income termination rule can be overcome, the Subchapter S corporation is still somewhat less attractive than the partnership form because of the difference in deductibility of net operating losses. In both the Subchapter S corporation and the partnership, a shareholder or partner may deduct losses only to the extent of his basis.[26] In the case of the partnership, basis may include a pro rata share of partnership liabilities[27]—that is, mortgage indebtedness—but in the Subchapter S corporation only indebtedness of the corporation to the stockholder may be used to increase the basis.[28] This distinction makes the Subchapter S corporation even less attractive as a basic vehicle for real estate investment.[29]

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missioner, 433 F.2d 1240 (6th Cir. 1970), the corporation operated a farmers market, which rented space to produce vendors and other types of small business. Its provision of garbage can spraying, occasional alteration of booths to suit tenants' needs, pest control and like services were not so significant that its rental income was "rents." Although the court did find that advertising in the yellow pages and the maintenance of a billboard were not "usually and customarily rendered in connection with the rental of commercial property," *id.* at 1242, these services did not alone possess the required significance. *See also* Max Feingold, 49 T.C. 461 (1968); Alexander, *Real Estate Syndication and the Effects of the Tax Reform Act of 1969*, 25 U. MIAMI L. REV. 197, 215-16 (1971) [hereinafter cited as Alexander].

Although they do not deal with "significant services" or the rental of "rooms or space," several revenue rulings do shed some light on this problem. It has been ruled that amounts received by an electing corporation from the short-term leasing of motor vehicles are not "rents" where the corporation is required by the lease to furnish all upkeep and maintenance functions. Rev. Rul. 65-40, 1965-1 CUM. BULL. 429. *See also* Rev. Rul. 65-83, 1965-1 CUM. BULL. 430; Rev. Rul. 64-232, 1964-2 CUM. BULL. 334. Similarly, the lease of a farm under a share-farming agreement does not give rise to "rents" where the corporation actively participates in the work and management of the farm. Rev. Rul. 61-112, 1961-1 CUM. BULL. 399. These rulings might be interpreted to mean that "rents" are not received when the corporation is "actively" conducting business, and not simply "passively" collecting rental income.

26. INT. REV. CODE of 1954, §§ 704(d), 1374(c)(2).

27. *See* Treas. Reg. § 1.752-1(e) (1956). The loss deductibility rules are considered in length at notes 110-15 *infra* & text accompanying.

28. INT. REV. CODE of 1954, § 1374(c)(2)(B).

29. *See Advantages and Disadvantages*, *supra* note 7, at 153-54. *See also* Blum, *Tax Considerations in Financing Real Estate Transactions*, 47 TAXES 844, 846 (1969).

These problems with the Subchapter S corporation may be circumvented if the theory of a recent Tax Court case is viable. In David F. Bolger, 59 T.C. No. 75 (1973), a corporation was formed to hold real estate "leaseback" properties and to obtain financing to cover the full purchase price of such properties. In order to obtain funds, the corporation would issue notes to a lending institution. As security for the notes, the corporation would execute a mortgage and an assignment of its lease, and would convey all of its interest in the property to a trustee under a deed of trust. The corporation would then deed the property to its shareholders, who executed an assumption agreement in favor of the financing institution involved and agreed to be bound by the deed of trust and assignment. However, the shareholders did not assume any personal obligation for the payment of principal or interest on the notes, or for any monetary judgment; their liability was limited to the property. When a shareholder sought to claim depreciation on his property, the IRS denied the deduction. In upholding the taxpayer, the Tax Court held that the shareholder had a depreciable interest in the property, since he had acquired legal title and full beneficial interest from the corpora-

Real Estate Investment Trust

The real estate investment trust (REIT) is a valuable means of facilitating real property investment, but because of its relatively rigid contours it is quite impractical for small groups of investors. To qualify, the organization must, basically, be an unincorporated trust or association,[30] which would normally be taxable as a corporation,[31] and which has 100 or more beneficial owners[32] whose ownership must be evidenced by transferable shares.[33] The basic advantage of the REIT is that it is taxed under a "conduit" principle, similar to that applied to regulated investment companies,[34] so that its distributed income is taxed only to the distributees,[35] and capital gains distributions may retain their character in the distributees' hands.[36] Thus, the REIT has several advantages for many groups and purposes, but it is not available as a real estate investment device to groups of less than 100.[37]

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tion. More significantly, however, the court allowed the shareholder to include the unpaid balance of the mortgage in his basis for depreciation purposes, although he was not personally liable on the notes secured in part by the mortgage.

By this scheme, then, the taxpayer was able to use the corporation to achieve limited liability, to acquire full non-recourse financing, and to avoid usury law restrictions. In addition, he achieved a viable tax shelter. In effect, the taxpayer obtained one of the primary benefits of the Subchapter S corporation (*i.e.*, pass-through of depreciation deductions). This benefit was obtained despite the fact that it would have been unavailable if the corporation had received the rental income since in that case the income would almost certainly have been considered passive investment income. *See* notes 19-25 *supra* & text accompanying. In addition, the taxpayer received the added benefit, not available to shareholders of Subchapter S corporations, of being able to use the corporation's mortgage indebtedness to increase his basis for deduction purposes. *See* notes 27-28 *supra* & text accompanying.

Bolger poses a scheme of great potential interest to investors. However, since it also poses, in the words of Judge Tannenwald, "a bitter pill for [the Commissioner] to swallow," it is almost certain that the IRS will continue to attack this type of scheme. Indeed, such attack is given some force by the dissents of Judges Scott, Quealy, Goffe and Wiles in *Bolger*, who would employ the "step transaction" doctrine to preclude successful implementation of the plan.

30. INT. REV. CODE of 1954, § 856(a).

31. *Id.* § 856(a)(3).

32. *Id.* § 856(a)(5).

33. *Id.* § 856(a)(2). There are also several other limitations, which are listed in § 856(c) of the Code. *See generally* Aldrich, *Real Estate Investment Trusts: An Overview*, 27 BUS. LAW. 1165 (1972) [hereinafter cited as Aldrich]; Epstein, *State Securities Regulation of Real Estate Investment Trusts*, 23 U. FLA. L. REV. 514 (1971); Sobieski, *State Securities Regulation of Real Estate Investment Trusts*, 48 VA. L. REV. 1069 (1962); Comment, *The Real Estate Investment Trust—Arkansas Considerations*, 24 ARK. L. REV. 453 (1971).

34. *See* INT. REV. CODE of 1954, §§ 851-55.

35. This treatment will apply, however, only if the REIT distributes ninety per cent of its "real estate investment trust taxable income" (defined in INT. REV. CODE of 1954, § 857(b)(1)), and complies with other requirements of the Code and regulations. *Id.* §§ 857(a)(1), (2). *See* Aldrich, *supra* note 33.

36. INT. REV. CODE of 1954, § 857(b)(3)(B).

37. Greenberg, *supra* note 9, at 1146.

Illinois Land Trust

The so-called Illinois Land Trust is a means of facilitating the holding and conveyancing of real property that is available in many states. Basically, it is an arrangement under which legal and equitable title is transferred to a trustee—usually a corporate fiduciary—while the beneficiaries, whose interest is personalty, retain the exclusive power to direct and control the trustee, to manage the property and to receive its earnings and proceeds.[38] It has the virtue of avoiding dower claims and estate and inheritance tax liens,[39] as well as allowing the beneficiaries to remain anonymous.[40] In addition, since the trust is not generally regarded as a separate taxable entity,[41] there will be no effect upon the tax treatment of the beneficiaries.[42]

Thus, the Illinois Land Trust poses several organizational advantages, and is clearly permissible in Indiana.[43] For small groups of investors, however, the flexibility and familiarity of the limited partnership will make it the preferable organizational vehicle.

General Partnership

Traditionally, partnerships were unattractive means of holding real property because title was required to be held in the names of all the partners individually. With the removal of that hindrance,[44] the partnership form has become a popular means of holding real estate. Its attraction stems primarily from the significant tax advantages that it provides its partners. Under the partnership tax rules, each partner is taxed in full for his distributive share of all items of income, gain, loss, deduction or credit.[45] The distributive share of each partner may, in turn, be fixed by

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38. *See* ILL. ANN. STAT. ch. 29, § 8.31 (Smith-Hurd 1972). *See generally* G. BOGERT, TRUSTS & TRUSTEES § 250 (2d ed. 1964); Doyle, *supra* note 2.

39. Greenberg, *supra* note 9, at 1154-55.

40. *Id.* at 1155. This virtue, however, has been recently removed in Illinois. ILL. ANN. STAT. ch. 29, § 8.32 (Smith-Hurd 1972).

41. Rev. Rul. 63-16, 1963-1 CUM. BULL. 350. *But cf.* Del Mar Addition v. Commissioner, 113 F.2d 410 (5th Cir. 1940).

42. The trust is required only to file a separate notice of fiduciary relationship. INT. REV. CODE of 1954, § 6903.

43. *See* IND. CODE § 30-4-2-13 (1971), IND. ANN. STAT. § 31-1413 (Supp. 1972) (bars application of the Statute of Uses to defeat the trustee's equitable title). Earlier doubts as to its legality in Indiana were expressed in Note, *Illinois Land Trusts in Indiana,* 3 VAL. L. REV. 298 (1969).

44. The Uniform Partnership Act provides that the partnership may hold and convey real property in its own name, and that the partners' interest in the partnership is considered personalty. UNIFORM PARTNERSHIP ACT §§ 8, 10, 26. These provisions have been adopted in Indiana. IND. CODE §§ 23-4-1-8, 23-4-1-10, 23-4-1-26 (1971), IND. ANN. STAT. §§ 50-408, 50-410, 50-426 (1964).

45. INT. REV. CODE of 1954, §§ 701, 702.

the partnership agreement,[46] so long as the allocation is not principally for the purpose of tax avoidance or evasion, and has a business purpose or substantial economic effect.[47] This flexibility, of course, sharply differentiates the partnership from the Subchapter S corporation, where each shareholder must report his pro rata share of the net income without any ability to specially allocate particular items.[48] In addition, use of the partnership form avoids the corporate tax hazards of the personal holding company and accumulated earnings rules, and the impact of the "collapsibility" rules is much less stringent.[49]

Although these tax advantages may be attractive, the general partnership is not really suitable for real estate investment for several major reasons. First, the partnership itself lacks any real continuity, since death, withdrawal or bankruptcy will cause dissolution.[50] Second, a partnership, like an individual, but unlike a corporation, is subject to applicable usury laws,[51] and is thus effectively precluded from borrowing the capital necessary for successful real estate investment. The chief drawback, however, is that the general partnership form subjects its partners to unlimited liability for all debts and obligations of the partnership.[52] Thus, the general partnership would not provide the requisites of limited liability and facilitation of borrowing, though it would provide a pass-through of tax benefits.

Limited Partnership

The limited partnership is the half-way house between the partnership and corporation, enjoying most of their advantages, while avoiding most of their drawbacks.[53] This results from its basically two-class struc-

46. *Id.* § 704.

47. Treas. Reg. § 1.704-1(b)(2) (1964).

48. The Code provides that each shareholder in a Subchapter S corporation "shall include in his gross income . . . , the amount he would have received as a dividend, if on such last day there had been distributed *pro rata* . . . an amount equal to the corporation's undistributed taxable income. . . ." INT. REV. CODE of 1954, § 1373(b). A similar rule is provided for net operating losses. *Id.* § 1374(c)(1). *See generally* BITTKER & EUSTICE, *supra* note 9, ¶ 6.05.

49. Section 751 of the Code defends against the use of a "collapsible" partnership. *See* A. WILLIS, PARTNERSHIP TAXATION §§ 20.17-.18 (1971) [hereinafter cited as WILLIS].

50. IND. CODE § 23-4-1-31 (1971), IND. ANN. STAT. § 50-431 (1964).

51. *See* note 6 *supra*.

52. IND. CODE § 23-4-1-15 (1971), IND. ANN. STAT. § 50-415 (1964). It is to be noted that the joint venture is simply a general partnership organized for a specific purpose, and is also a possible vehicle for real estate investment. *See* Aronsohn, *The Real Estate Limited Partnership and Other Joint Ventures*, 1 REAL EST. REV. 43 (1971); Sonfield, *supra* note 3, at 16.

53. *See* Aronsohn, *supra* note 1, at 586-89. The early history of the limited partnership in Indiana is discussed in Brown, *The Limited Partnership in Indiana*, 5 IND. L.J. 421 (1930).

ture where limited partners have a status essentially resembling that of a corporate shareholder, while general partners retain the characteristics of a partner in a general partnership. The limited partnership resembles the general partnership to the extent that death, bankruptcy or incompetency does not affect the partnership's real property, since the partnership interest is personalty,[54] and because death of a general partner will ordinarily cause dissolution.[55] It tends to resemble a corporation in that (1) the partnership agreement may provide for continuity if the business is continued by the remaining partners after an act of dissolution;[56] (2) death of a limited partner has no effect upon the continuation of the business;[57] and (3) use of a corporate general partner will permit avoidance of the limitations imposed by applicable usury laws.[58] Despite this two-class structure, the limited partnership is taxed as a partnership, so that it retains the significant tax advantages of the partnership rules.

The limited partnership, if it has a qualifying corporate general partner, thus, meets all of the essential criteria for the choice of an organizational vehicle. It will protect the limited partners with limited liability, it will allow the necessary acquistion of capital, and it will both provide the requisite pass-through of tax benefits and allow great flexibility in their allocation. For these reasons, and because of the drawbacks of the other forms, the limited partnership has been the common choice for relatively small groups of investors where no business consideration requires the utilization of a corporation.[59]

Organizational Problems of the Limited Partnership

Having now seen why the limited partnership is the most popular of the organizational vehicles for real estate investment, attention should now be directed toward the kinds of problems that are encountered in its organization.

Avoidance of "Association" Status

The first problem likely to be encountered is how to properly organize the limited partnership to ensure that it will qualify for the favorable federal income tax rules afforded to partnerships. This is a problem area because the Internal Revenue Service (IRS) has, in a detailed set of

54. Ind. Code § 23-4-2-18 (1971), Ind. Ann. Stat. § 50-138 (1964).
55. Ind. Code § 23-4-2-20 (1971), Ind. Ann. Stat. § 50-140 (1964).
56. *Id.*
57. Ind. Code § 23-4-2-21 (1971), Ind. Ann. Stat. § 50-141 (1964).
58. *See* note 6 *supra.*
59. *See* Aronsohn, *supra* note 1, at 586; Miller, *Real Estate Syndication Under the California Corporate Securities Law of 1968,* 16 U.C.L.A. L. Rev. 371, 388 (1969) [hereinafter cited as Miller]; Morris, *supra* note 6, at 152.

regulations,[60] set up several guidelines to ascertain when a partnership will be taxed as a partnership and when as an association—that is, as a Subchapter C corporation. Basically, this involves an analysis of the presence or absence in a partnership of the characteristics of a "pure" corporation: (1) associates, (2) an objective to carry on business, (3) continuity of life, (4) centralization of management, (5) limited liability and (6) free transferability of interest.[61] If such analysis shows that the entity more nearly resembles a corporation than a partnership, (i.e., it has more corporate than noncorporate characteristics,[62] omitting (1) and (2) because they are common to both[63]), it will be so treated for tax purposes.[64]

Inasmuch as associational status is to be avoided at all costs, it is imperative that the partnership agreement be drafted in such a way as to steer clear of the associational taint. This is not unduly difficult if the guidelines in the regulations are carefully kept in mind.

(1) Continuity of Life

According to the applicable Treasury Regulations, an organization is said to have continuity of life "if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution . . . ."[65] This characteristic, however, poses little difficulty to the limited partnership, since the regulations themselves provide that if it complies with a statute comparable to the Uniform Limited Partnership Act it lacks continuity of life.[66] That concession is made, presumably, because such a statute provides for dissolution upon retirement, death or insanity of a general partner absent authorization to continue the business in the partnership agreement or unanimous partnership consent to do so.[67]

Thus, continuity of life may be avoided either by not providing for continuity in the certificate, or by limiting the life of the partnership. In order to avoid the continuity characteristic, while satisfying the business objectives of the partners, the preferred approach will probably be to

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60. Treas. Reg. §§ 301.7701-1, 301.7701-2 (1965); Treas. Reg. §§ 301.7701-3, 301.7701-4 (1960).

61. *Id.* § 301.7701-2(a)(1). *See also* Morrissey v. Commissioner, 296 U.S. 344 (1935).

62. Treas. Reg. § 301.7701-2(a)(3) (1965). Thus, if a limited partnership has centralized management and free transferability, but not limited liability and continuity of life, *i.e.*, there is no predominance of corporate over partnership characteristics, it will be treated as a partnership for tax purposes. *Id.*

63. Treas. Reg. § 301.7701-2(a)(2) (1965).

64. *Id.* §§ 301.7701-2(a)(1), (b)(1).

65. *Id.* § 301.7701-2(b)(1).

66. *Id.* § 301.7701-2(b)(3).

67. *See* IND. CODE § 23-4-2-20 (1971), IND. ANN. STAT. § 50-140 (1964).

specify in the agreement that the death, insanity or retirement of either a general or limited partner will dissolve the partnership, but that the partnership may be reformed to continue its business upon a proper vote of the partnership. Such a provision is described as providing for "contingent continuity."[68]

(2) Centralization of Management

As a general proposition, centralized management is said to exist whenever there is a concentration of the exclusive authority to make independent business decisions—that is, those other than "ministerial decisions"—without the ratification of other members of the organization.[69] This rule clearly looks to the degree of management control present, which would seem necessarily to cloak the limited partnership formed under the Uniform Limited Partnership Act with centralized management—inasmuch as the general partners are vested with the management power,[70] and limited partners are barred from taking part in management upon risk of losing their limited liability.[71] The regulations go on, however, to provide that centralized management exists in a limited partnership, formed under a statute similar to the Uniform Limited Partnership Act, only if "substantially all the interests in the partnership are owned by the limited partners."[72]

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68. Rev. Rul. 54-484, 1954-2 CUM. BULL. 242; Glensder Textile Co. v. Commissioner, 46 B.T.A. 176, 185 (1942); WILLIS, *supra* note 49, § 1.05. This type of provision was evidently contemplated by the regulations, which specifically note that "there may be a dissolution . . . and no continuity of life although the business is continued by the remaining members." Treas. Reg. § 301.7701-2(b)(2) (1965).

69. Treas. Reg. § 301.7701-2(c)(3) (1965).

70. UNIFORM LIMITED PARTNERSHIP ACT § 9, which has been adopted in Indiana. IND. CODE § 23-4-2-9 (1971), IND. ANN. STAT. § 50-129 (1964).

71. UNIFORM LIMITED PARTNERSHIP ACT § 7, which has been adopted in Indiana. IND. CODE § 23-4-2-7 (1971), IND. ANN. STAT. § 50-127 (1964). *See generally* Sonfield, *supra* note 3, at 19-20.

72. Treas. Reg. § 301.7701-2(c)(4) (1965), which also notes that limited partnerships "generally do not have centralized management." *Id.*

Thus, although the general rule looks to management concentration, the specific limited partnership rule seems to look to proprietary control. This, of course, leaves room for considerable dispute. Do the regulations, for example, require both management and proprietary control, or one but not the other? The phraseology of the regulation does indeed present some "inherent and illogical contradictions," Stein, *Partnership Taxation for the Limited Partnership with a Corporate General Partner—It Can Be Done*, 25 U. MIAMI L. REV. 435, 444 (1971) [hereinafter cited as Stein], which are not at all clarified by the examples provided. One example notes that centralized management is present where three general partners contribute 300,000 dollars, thirty limited partners contribute five million dollars and the general partners, with unanimous consent, have exclusive management control; in this situation, the limited partners are said to have a substantial interest. Treas. Reg. § 301.7701-3(b)(2) (example 1) (1960). Another example says that centralization also exists where three general partners contribute 50,000 dollars, 900 limited partners contribute five million dollars, and the general partners have exclusive management control; under these circumstances, centraliza-

The centralization of management characteristic may, therefore, be avoided by insuring that the general partner has a sizeable capital interest in the limited partnership.[73] The difficulty, of course, is in ascertaining when a general partner's share is sufficient to negate the totality of the limited partners' ownership. This determination can be made only by analyzing the facts and circumstances of each case in terms of the authority that is available.[74]

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tion exists because of management concentration *and* the limited partners' substantial interest. *Id.* (example 2).

The apparent ambiguity of the regulations may be resolved in either of two ways. First, it could be argued that the regulations were purposefully vague, so that the Commissioner would have a ground upon which to attack similar organizations in contradictory manners—as has been done, for example, with professional associations and limited partnerships with corporate general partners. *See* Stein, *supra* at 436-37. A better resolution would be to take the regulations at their face value—that is, there is a general rule (management concentration) and a specific rule for limited partnerships (substantial interest ownership). The reason why limited partners are excluded from the general rule is that although the general partners in fact have management control, they are not analogous to a corporate board of directors, which is the benchmark of centralized management. Treas. Reg. § 301.7701-2(c)(1) (1965). The general partners act for themselves and not for the limited partners; thus, general partners are not the agents of the limited partners, as the corporate board of directors are of their stockholders. *See* Glensder Textile Co. v. Commissioner, 46 B.T.A. 176, 185 (1942); Aronsohn, *supra* note 1, at 590-91. Since limited partnerships are not subject to the general rule, the regulations adopted a specific rule to deal with them. The inquiry, therefore, is whether a "substantial interest" is present, and the example in the regulations referring to centralized management in a limited partnership as a consequence of both management concentration *and* substantial interest is superfluity to the extent that it connects management concentration to limited partnerships.

The relevant ownership interest is a capital interest, WILLIS, *supra* note 49, § 1.05, and not a management interest, as has been erroneously suggested. Stein, *supra* at 441-44. The error of thinking that the relevant ownership interest is a management interest is made by juxtaposing the general rule to the specific rule, and then concluding that if the limited partners have a "substantial interest" they also have "the exclusive authority to make independent business decisions." This, in turn, assumes that the "substantial interest" must be an interest in partnership management. But if the limited partners had the decision-making authority, they would then be taking part in the control of the business, which would cause them to lose their limited liability, IND. CODE § 23-4-1-7 (1971), IND. ANN. STAT. § 50-127 (1964), a result not likely to have been contemplated by the regulations. Though a substantial interest in management certainly bears on the presence, in fact, of limited liability, it should have no place in the centralization question. The regulations refer to a "substantial interest" that is "owned" by the limited partners, and would thus seem to refer to an interest in the partnership capital, or, possibly, partnership profits. *See* WILLIS, *supra* note 49, § 1.05. Thus, to focus on the degree of management control to answer the centralization issue is to err by treating the applicable regulation as a single rule, rather than as one general rule which has a specific adaptation for limited partnerships.

73. *See* WILLIS, *supra* note 49, § 1.05.

74. The most important authority is probably Glensder Textile Co. v. Commissioner, 46 B.T.A. 176 (1942), where the general partners had a 42 per cent interest. The court's holding that centralized management was not present can be interpreted to mean that 42 per cent is substantial and that 58 per cent was not substantially all. Similarly, it has been observed that the IRS will hold that a corporate general partner owns a "substantial interest" if it has a twenty per cent interest in the capital or profits of the limited partnership. Points to Remember, *Classification of Limited Partnerships: Rul-*

(3) Limited Liability

The corporate characteristic of limited liability exists only if no member of the partnership "is personally liable for the debts of, or claims against, the organization."[75] In the case of a limited partnership, personal liability will ordinarily exist in all general partners,[76] so that this characteristic will usually pose little difficulty. Danger will arise only if the individual general partner has no substantial assets, beyond a partnership interest, because he will then lose the personal liability.[77] In the ordinary limited partnership, then, this characteristic is avoided simply by insuring that the general partners have substantial assets.

(4) Free Transferability of Interests

This last corporate characteristic is present only if each partnership member has the power to substitute a nonmember in his place, with all the attributes of his prior interest, without the consent of the other members.[78] Since this is a matter of contract law, however, it may be easily avoided by providing in the partnership agreement that a transferee shall have an interest in partnership profits, but not in partnership management,[79] or that a transferee may become substituted only with the consent of the remaining partners.[80] If it is provided that a member may transfer his interest, but as a condition precedent the transferor must first offer his interest to the other members at its fair market value, there is present only a modified form of free transferability, which is of lesser weight in finding an associational status than would be an unmodified form.[81]

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ing Guidelines, 24 TAX LAW. 605, 606 (1971). There is, however, very little authority on this point, and the IRS might follow its position in the "C" reorganization area that the "substantially all" question is to be determined on a case-by-case approach. Rev. Rul. 57-518, 1957-2 CUM. BULL. 253. *See generally* BITTKER & EUSTICE, *supra* note 9, ¶ 14.14.

75. Treas. Reg. § 301.7701-2(d)(1) (1965).

76. *Id.*

77. *Id.* § 301.7701-2(d)(2). The general partner also loses personal liability if he is a "dummy" for the limited partners, *id.*, but when this is the case the limited partners concurrently become personally liable, thereby preventing the existence of the limited liability characteristic. *Id.* The limited liability rules as announced in the regulations are criticized in Aronsohn, *supra* note 1, at 593-94.

78. Treas. Reg. § 301.7701-2(e)(1) (1965).

79. *Id.*

80. *Id.* § 301.7701-3(2) (example 1). In Indiana, a transferee becomes a substituted partner—that is, one with all his predecessor's rights—only by consent of all partnership members, unless the certificate provides to the contrary. IND. CODE § 23-4-2-19(4) (1971), IND. ANN. STAT. § 50-139(4) (1964). If such consent is not given, and the certificate does not provide that consent is not necessary, the transferee has an interest in the profits, but not the management, of the partnership. IND. CODE § 23-4-2-19(3) (1971), IND. ANN. STAT. § 50-139(3) (1964).

81. Treas. Reg. § 301.7701-2(e)(2) (1960). The regulations also specify that factors in addition to the four discussed may be considered in some cases. *Id.* § 301.7701-

From this review of the corporate characteristics considered in deciding whether a partnership is to be taxed as a corporation, it should be apparent that the associational taint may be easily avoided by careful planning and drafting. In undertaking these procedures, the requirements of the limited partnership form must also be kept in mind to insure that a tax benefit is not accomplished at the sacrifice of one or another of the benefits of the limited partnership itself.

Problems Incident to Allocation and Basis

In most investment groups, the various members will have expressed different investment objectives: some will want only current income, while others will want both income and the benefits of a tax shelter. This can be accomplished without too much difficulty in the partnership form of organization, since one of its chief tax advantages, provided in § 704 of the Internal Revenue Code, is the ability to allocate partnership income, gain, loss, deduction or credit pursuant to the partnership agreement.[82] Thus, the partners may allocate specific items to reflect the property each has contributed,[83] or to otherwise satisfy the objectives of the individual partners. If, however, the principal purpose of such allocation is to avoid or evade federal income tax, it will be disregarded[84] and the allocation will be made in accordance with the ratio used to divide partnership profits and losses.[85]

The key, of course, is to determine when, in fact, an allocation is made for the principal purpose of evading taxation. The regulations provide six relevant circumstances which will be considered: (1) whether there is a "business purpose" for the allocation; (2) whether it has a substantial

2(a)(1). The only additional factor that appears to have been considered is the fact that real property is held in the partnership's name. *See* Aronsohn, *supra* note 1, at 591 n.32. Inasmuch as the Uniform Partnership Act specifically provides for the entity holding of real property, UNIFORM PARTNERSHIP ACT § 8 (adopted in Indiana, IND. CODE § 23-4-1-8(3) (1971), IND. ANN. STAT. § 50-408(3) (1964)), and its provisions apply to limited partnerships, except where they are inconsistent with the provisions of the Uniform Limited Partnership Act, UNIFORM PARTNERSHIP ACT § 6 (adopted in Indiana, IND. CODE § 23-4-1-6(2) (1971), IND. ANN. STAT. § 50-406(2) (1964)), this factor should not be material. *See* Glensder Textile Co. v. Commissioner, 46 B.T.A. 176, 186-87 (1942); Aronsohn, *supra* note 1, at 591 n.32.

82. INT. REV. CODE of 1954, § 704(a).

83. The rules relating to contributed property are set forth at INT. REV. CODE of 1954, § 704(c).

84. INT. REV. CODE of 1954, § 704(b)(2).

85. Treas. Reg. § 1.704-1(b)(2) (1956). *See also* Rev. Rul. 68-139, 1968-1 CUM. BULL. 311; Smith v. Commissioner, 331 F.2d 298 (7th Cir. 1964); Jean V. Kresser, 54 T.C. 1621 (1970). *See generally* Gould, *supra* note 2; Koff, *Partnerships and the Special Allocation: The Winds of Change,* 50 TAXES 5 (1972) [hereinafter cited as Koff]; McGuire, *When Will a Special Allocation Among Partners be Recognized?,* 37 J. TAX. 74 (1972) [hereinafter cited as McGuire].

economic effect independent of tax consequences; (3) whether related items are subject to the same allocation; (4) whether it was made without recognition of normal business factors and only after the amount specially allocated could be reasonably estimated; (5) the duration of the allocation; and (6) its overall tax consequences.[86] There has, unfortunately, been no definitive case to explain which of these factors is paramount, though the Senate Report accompanying the introduction of § 704 in 1954 did indicate that the primary factor was the presence or absence of an economic effect from the allocation, independent of its tax consequences.[87] Probably the best that can be said of the tests set out in the regulations, is that each is simply one element of an entire picture,[88] and that the presence of one, or, conversely, all but one, should not be conclusive.[89] In other words, all the facts and circumstances relating to the allocation must be taken into account.

(1) Allocation of Depreciation

Where some members of a group investing in real estate seek current income while others seek tax shelter benefits—that is, where one group takes the bulk of the cash flow and the other receives a nominal return on their investment in return for a disproportionate share in the depreciation shelter[90]—the easiest way to achieve their objectives would be to allocate a large part of the income to one group and the remaining income and expense items, primarily depreciation, to the other. Central in this scheme, of course, would be the allocation of depreciation to the group seeking tax shelter benefits, since depreciation will ordinarily be the largest single expensible figure. Whether such an allocation can be properly made, however, is unclear.

Although there is very little authority on the allocation of depreciation in real estate partnerships, it has often been assumed that any such allocation would be difficult to justify in terms of a substantial economic effect independent of its tax consequences.[91] The Tax Court, however, has recently indicated that this is only the first difficulty. In *Stanley C. Orrisch*,[92] a partnership had been formed between family C and family O,

86. Treas. Reg. § 1.704-1(b)(2) (1956). The impact of each of these criteria is analyzed in Driscoll, *Tax Problems of Partnerships—Special Allocation of Specific Items*, 10 U. So. CAL. 1958 TAX INST. 421, 428-38 [hereinafter cited as Driscoll].

87. S. REP. No. 1661, 83d Cong., 2d Sess. 379 (1954). *See also* Rev. Rul. 66-187, 1966-2 CUM. BULL. 246.

88. *See* Driscoll, *supra* note 86, at 435. *See also* Stanley C. Orrisch, 55 T.C. 395 (1970).

89. WILLIS, *supra* note 49, § 19.03.

90. *See* Aronsohn, *supra* note 1, at 607; Driscoll, *supra* note 86, at 438.

91. WILLIS, *supra* note 49, § 19.09; Aronsohn, *supra* note 1, at 609.

92. 55 T.C. 395 (1970).

to invest in residential apartment buildings. The partners, C and O, agreed to share profits and losses equally. For the first three years of its operation, the partnership suffered net operating losses, largely because of the use of accelerated depreciation. Inasmuch as partner C had no net income —the result of deductible losses from other businesses—O and C then agreed to specially allocate all depreciation to O, with gain and loss, computed without regard to depreciation, to be divided equally. They also agreed that in the event of sale, the depreciation should be "charged back" to O's capital account.

On these facts, the Tax Court agreed with the Commissioner's conclusion that the depreciation allocation was made for the principal purpose of avoiding taxation, and that, therefore, the depreciation would be allocated in accordance with the division of profits and losses generally. The court noted that the tax avoidance purpose was plain from the fact that depreciation was the only item specially allocated—both income and operating expenses from the buildings were divided equally. Because the depreciation figure did not vary, the partners also ran afoul of the rule which taints allocations made after the amount allocated can be easily estimated. In addition, the partner who received no depreciation, C, had no taxable income from which to deduct the depreciation figure, and he was protected from capital gains tax in the event of sale because of the depreciation "charge back." These factors made it "unmistakably clear," the court said, "that the agreement did not reflect normal business considerations but was designed primarily to minimize the overall tax liabilities of the partners."[93] Thus, *Orrisch* may be said to stand for the rule that a depreciation allocation must have a substantial independent economic impact as well as a business purpose,[94] in order to be given its intended effect.

Although there is room in *Orrisch* for a permissible allocation,[95] it is far from clear whether such an allocation could be accomplished with any degree of certainty as to its viability.[96] This is especially true in light of the IRS's reluctance to grant favorable rulings in this area.[97]

93. *Id.* at 401.

94. This rule had been suggested in previous commentary. *See* Driscoll, *supra* note 86, at 429.

95. *See* Long, *Tax Shelter in Real Estate Partnership: An Analysis of Tax Hazards that Still Exist,* 36 J. TAX. 312, 314-15 (1972) ; Shapiro, *Tax Planning for Equity Financing by Real Estate Developers,* 50 TAXES 530, 538-40 (1972).

96. The lack of certainty in this area has been attributed either to the fact that special allocations are seldom made, or to the IRS's failure to challenge them. WILLIS, *supra* note 49, § 19.13. *Orrisch* may indicate, at the very least, that the latter is not a proper assumption.

97. In Rev. Rul. 68-139, 1968-1 CUM. BULL. 311, the IRS ruled that it would recognize an agreement whereby two of three investors who contributed all the money for an

(2) How the Allocation Objectives May Be Accomplished

Assuming that no rational group of investors would pursue a course that would invite tax litigation, it will be prudent to look into other means of accomplishing their allocation objectives. Instead of allocating depreciation, a better approach may be to allocate profits and losses, and not depreciation as such, since profit and loss allocations are not themselves required to meet the principal purpose test of § 704(b).[98] Unfortunately, profit and loss allocation will not have the desirable result of channeling cash flow to one group while the tax shelter covers the other group of investors. Under such an allocational scheme, each partner would simply receive a given share of an aggregate figure, instead of receiving, as his investment objectives would require, a dissimilar piece of the aggregate itself.

The desired allocation may, however, be accomplished by careful planning. One such plan might, for example, be that a limited partnership be established with a corporate general partner which would make a Subchapter S election. Those investors who seek current income could then become shareholders of the corporate general partner, and those seeking tax shelter benefits would become the limited partners. The corporate general partner would, furthermore, negotiate a management contract with the partnership, which would call for reasonable compensation to manage all investment properties of the partnership. It would also manage any other outside properties it could handle and lease equipment and furnishings to the partnership, the tenants of its properties, or any other potentially profitable lessee.[99]

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oil and gas partnership were entitled to a 3/32d working interest in the leases and to all drilling and development cost deductions. The IRS tempered its ruling by stating that the allocation would not be recognized if its principal purpose was tax avoidance. The reluctance of the IRS to rule categorically in this context indicates the uncertain ground upon which any allocation will rest.

98. The Tax Court's opinion in Jean V. Kresser, 54 T.C. 1621 (1970), indicates that the principal purpose test does not apply to loss allocations. Although the court did not reach a decision on the question, it did note that the language and legislative history of § 704 support the argument that the principal purpose test is inapplicable to loss allocations. *Id.* at 1631 n.5. *See also* 6 J. Mertens, Law of Federal Income Taxation § 35.29 (1968); Aronsohn, *supra* note 1, at 610; Driscoll, *supra* note 86, at 438-39; Koff, *supra* note 85, at 8 n.8. *But cf.* McGuire, *supra* note 85, at 76.

99. The attempted use of a Subchapter S corporation as the general partner would, of course, raise the question of whether the twenty per cent passive income termination rule would preclude Subchapter S status. This rule was already analyzed in considerable detail with regard to the choice of organizational form, *see* notes 20-25 *supra* & text accompanying, and that discussion will answer the present inquiry without much difficulty.

Inasmuch as any real estate investment partnership will produce income which will be defined as "rents" for purposes of the passive investment income rule, it is almost certain that the corporation's share in the partnership profits will be passive investment income. *See* notes 20-25 *supra* & text accompanying. Thus, the corporation will be re-

This framework, if permissible, would meet the investment objectives of the two groups of investors. Thus, on any particular real estate investment a large part of the cash flow, after payment of mortgage and other financial commitments, could be paid to the corporate general partner pursuant to the management contract, as well as by its share in the profits of the partnership, so that its shareholders would be able to realize their current income objectives. Since the management fee paid to the corporate general partner would add to the already high expense items of the limited partnership, which would be the primary result of accelerated depreciation and interest deductions, the partnership would then be likely to have a substantial net operating loss, despite a possibly positive cash

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quired to include its allocable share of the gross receipts of the partnership in determining whether it has received more than twenty per cent passive investment income.

To minimize the possibility of violating the passive income taint, the corporation could simply see to it that it got a lesser percentage allocation in the partnership agreement in return for a proportionately larger management fee. The "non-rent" status of management fees is indicated by Rev. Rul. 61-112, 1961-1 CUM. BULL. 399, where a Subchapter S corporation had leased farms on a "share-farming" arrangement, and the president of the corporation made all management decisions. Placing heavy emphasis on the performance of the management functions, the IRS held that the amounts received by the corporation did not constitute "rents" within the meaning of § 1372(e)(5). This is the proper result, since the performance of management duties is the antithesis of "passive" income because it involves the "active" conduct of business, against which the passive income rule was not directed. *See* note 19 *supra* & text accompanying. To insure its compliance with the passive income termination rule, therefore, the corporation should insure that its management fees would exceed eighty per cent of its total income.

A similar result is reached with regard to the leasing of equipment and furnishings by the general partner to the partnership, as well as to other lessees. The IRS has taken the position that the leasing of personalty where maintenance services are also provided does not result in the receipt of "rents." *See* Rev. Rul. 70-206, 1970-1 CUM. BULL. 177; Rev. Rul. 65-83, 1965-1 CUM. BULL. 430; Rev. Rul. 65-91, 1965-1 CUM. BULL. 431.

If a Subchapter S election is made by the corporate general partner, attention should also be given to the use of "§ 1244 stock." Basically, § 1244 provides that a loss of no more than 25,000 dollars on stock issued by a qualifying "small business corporation" pursuant to a plan, to an individual or partnership, will be treated as an ordinary income loss, rather than as a capital loss. INT. REV. CODE of 1954, §§ 1244(a)-(b). To qualify as a "small business corporation," the sum of the aggregate amount of stock offered plus the aggregate value of money and other property received by the corporation must not exceed 500,000 dollars, and the sum of the aggregate amount offered plus the equity capital of the corporation must not exceed one million dollars. *Id.* § 1244(c)(2).

The chief limitation on the use of § 1244 stock is that the receipt of more than fifty per cent of gross receipts from rents, interests and other "investments" items will preclude application of the favorable loss rules. *Id.* § 1244(c)(1)(E). As previously discussed, however, the corporate general partner may be able to avoid the receipt of passive income, and thereby moot the fifty per cent rule. More important, though, is the fact that even if the fifty per cent rule is violated, the shareholders would lose nothing; the stock would simply lose its § 1244 status, and take on the "capital" character that it would have had in any event. *See* BITTKER & EUSTICE, *supra* note 9, ¶ 4.09. *See also* Bledsoe & Beck, *Two Problems Under Section 1244: Real Estate Investments and Partners as Stockholders,* 16 J. TAX. 7 (1962); Tigner, *Organizational Forms for Real Estate Ventures: Selected Tax Considerations,* 2 MEMPHIS ST. U.L. REV. 259, 274-75 (1972) [hereinafter cited as Tigner].

flow. This would create the tax shelter sought by the limited partners.

Having proposed this framework as one means of meeting the allocation objectives of the common group of real estate investors, the next step is to analyze its several components to see whether it will satisfactorily accomplish the respective investment objectives.

a. Payment of Management Fees to the General Partner

As noted, one means of paying current income to the shareholders of the corporate general partner would be to negotiate a contract between the limited partnership and the corporation for a management fee, which would be in addition to the corporation's share of partnership profits and losses. Such an arrangement is sanctioned by the tax code, which provides in § 707(c) that payments made by a partnership to a partner for services rendered shall be treated as if they were made to a nonpartner, so long as they are not determined by reference to the income of the partnership[100]—that is, the payments must be fixed and guaranteed and not determinable in accordance with partnership income or profit.[101] If the payment is based upon partnership profit, it will be treated as a part of the partner's distributive share, rather than as a deductible expense of the partnership. On the other hand, if the payment is guaranteed, it will be treated as salary income to the recipient and as a business deduction to the partnership.[102] To insure that the payment is, indeed, salary, and not merely a part of the partner's distributive share, the "guarantee" should be placed in the partnership agreement.[103]

The effect of § 707(c) and the potential benefits of such a management contract arrangement may be illustrated by Revenue Ruling 56-675,[104] where a partnership was formed by three persons, each of whom contributed equally to its capital in return for a one-third interest in profits and losses. The partners then selected one partner to act as manager, and he was given a guaranteed sum for management services. This was held to be a guaranteed payment within § 707(c). The payment, how-

100. Foster v. United States, 221 F. Supp. 291, 295 (S.D.N.Y. 1963), *aff'd on other grounds,* 329 F.2d 717 (2d Cir. 1964); F. A. Falconer, 40 T.C. 1011, 1015 (1963).

101. This treatment only applies for the purposes of § 61(a) (relating to gross income) and § 162(a) (relating to trade and business expenses). INT. REV. CODE of 1954, § 707(c). But in Armstrong v. Phinney, 394 F.2d 661 (5th Cir. 1968), the court allowed the partnership a § 119 deduction for meals and lodging for the expenses of a partner whom the court treated as an employee. In light of the express language of § 707(c), however, the case seems to be based upon a rather slim foundation. *See* WILLIS, *supra* note 49, § 16.02.

102. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 387 (1954).

103. Foster v. United States, 221 F. Supp. 291, 295 (S.D.N.Y. 1963), *aff'd on other grounds,* 329 F.2d 717 (2d Cir. 1964).

104. Rev. Rul. 56-675, 1956-2 CUM. BULL. 459. *See also* F. A. Falconer, 40 T.C. 1011 (1963); Rev. Rul. 66-95, 1966-1 CUM. BULL. 169.

ever, created a net operating loss to the partnership, so that the taxpayer received as income the guaranteed payment, against which he could offset his one-third share in the operating loss.

There do not, then, seem to be any tax problems incident to a management contract executed between a corporate general partner and the limited partnership. Similarly, there are no rules of partnership law that would affect the transaction. Although the Indiana Partnership Act does preclude partners from receiving remuneration for acting in the partnership business,[105] that rule applies only if no agreement to the contrary is made between the partners.[106] Such a management contract, therefore, appears to be a permissible means of allocating the cash flow to those investors seeking current income.[107]

b. Allocation of Profits and Losses

Having concluded that the income objectives of the shareholders of the corporate general partner may be effectuated primarily by the management contract, the next issue is the allocation of partnership profits and losses. Since little difficulty is encountered with respect to the allocation of profits, which may be allocated by partnership agreement without regard to the tax avoidance rule,[108] the discussion will relate primarily to losses. These are of particular importance in real estate investment partnerships because it is the nature of such investment vehicles to generate, at least in their early years, net operating losses—chiefly as a consequence of accelerated depreciation and other "expensible" charges, such as management contracts with general partners.

Inasmuch as the shareholders of the corporate general partner will receive the bulk of their current income, which was their presumed investment objective, from the management contract and the corporation's share in such profits as may exist, the first question is whether all losses of the partnership may be entirely allocated to the limited partners, which will be a necessary element in establishing their tax shelter objective. As already noted, the allocation of profit and loss as such need not

105. IND. CODE § 23-4-1-18(f) (1971), IND. ANN. STAT. § 50-418(f) (1964).

106. IND. CODE § 23-4-1-18 (1971), IND. ANN. STAT. § 50-418 (1964).

107. *See generally* Alexander, *supra* note 25, at 217.

It is to be noted that in its revised proposed statement of policy, the Midwest Securities Commissioner Association has proposed limitations on the payment of management fees to limited partners. *Statement of Policy Regarding Real Estate Limited Partnership,* BLUE SKY L. REP. No. 458 (Dec. 4, 1972) [hereinafter cited as *Statement of Policy*]. Although the impact of this proposal is unclear in both scope and meaning, it may be evidence of a feeling that limitations should be placed on management fees. In that event, of course, another scheme would have to be adopted if it were crucial to avoid the policy proposed by the Midwest Securities Commissioners Association.

108. *See* note 98 *supra.*

meet the tax avoidance rule of § 704(b)(2), and so long as the partnership agreement directs all losses to be shared among the limited partners there should be no problem in making that allocation.[109]

The ability to make the loss allocation among the limited partners, however, is only the first problem, since there is also a limit on the deductibility of such losses. Section 704(d) provides that a partner's distributive share of partnership losses shall be an allowable deduction only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the year in which the loss occurred.[110] The initial basis of a partner's interest is acquired by the contribution of money or property, in an amount equal to the money contributed or the adjusted basis of the property.[111] The partner's basis is then increased by the amount of his share in the liabilities of the partnership and his individual liability.[112] In the case of a limited partnership, these rules are modified only slightly. A limited partner's share of partnership liabilities cannot normally exceed the difference between his actual contribution and that which he is obligated to make under the partnership agreement.[113] Where, however, none of the partners have personal liability on partnership liabilities—as in the case of a real estate mortgage acquired by the partnership as a whole—the limited partners may share such liability in the same proportion that they share in profits.[114] The sharing in accordance with the profit ratio is significant since in all other situations partnerships' liabilities are shared pursuant to loss ratios.[115]

Thus, it is clear that it will be highly desirable for limited partners in a partnership engaged in real estate investment to be able to add mortgage indebtedness to their adjusted basis. This may not, however, be an

109. This would be especially clear if the limited partners made all capital contributions, with the general partner contributing some other factor in return for its share in partnership profits. The allocation would then have the substantial economic effect of returning to the limited partners a portion of their capital contribution, *i.e.*, a return in terms of tax shelter savings, as well as a business purpose, *i.e.*, inducing persons to join the limited partnership.

110. INT. REV. CODE of 1954, § 704(d).

111. *Id.* § 722. The adjusted basis is computed pursuant to § 705 of the Code.

112. INT. REV. CODE of 1954, § 752(a).

113. Treas. Reg. § 1.752-1(e) (1956).

114. *Id. See also* Curtis W. Kingbay, 46 T.C. 147 (1966); Fine, *Real Property and the Internal Revenue Code: A Potpourri of Tax Problems Involving Lessors, Lessees, and Others*, 51 CHI. B. REV. 359, 365-66 (1970). It has been argued that Treas. Reg. § 1.752-1(e) is erroneous to the extent that it precludes a limited partner from including in his basis from the outset indebtedness for which the general partner is liable. Epstein, *The Application of the Crane Doctrine to Limited Partnerships*, 45 S. CAL. L. REV. 100, 129-30 (1972) [hereinafter cited as Epstein]. This argument is based upon analogy to the cases allowing contingent obligations to be included in basis calculation. *Id.* at 107-14.

115. WILLIS, *supra* note 49, § 17.05. *See generally* Alexander, *supra* note 25, at 204-06.

easy task and will certainly require advance planning.[116] This first step is to note again that the regulations provide that a limited partner's share of liabilities shall not exceed the difference between his actual contribution and the contribution that he is obligated to make under the partnership agreement. Thus, before a limited partner can claim any share in liabilities, he must be bound by the partnership agreement to contribute additional capital—and an "agreement," for this purpose, means a specific agreement to contribute to the partnership, not an agreement to indemnify the general partner in the event of loss.[117] However, such an agreement may not be particularly attractive to a limited partner, who presumably chose that status to find limited liability, because circumstances may arise where he would be forced to make the contribution, and the agreement will then be an enforceable debt to the partnership.[118]

If the limited partner will not agree to a sufficient increase in his contribution obligation, then the partnership must be able to obtain nonrecourse financing—that is, there must be no personal liability on the indebtedness. The easiest way of accomplishing that result, of course, would be to simply have neither the general nor limited partners, nor the partnership itself, assume liability on the mortgage. This might be accomplished by several means. The property could, first of all, be purchased by the partnership, with the mortgage being secured by the property itself and not by any personal assumption of liability by a partner,

116. The danger in not planning ahead is illustrated by the result in Curtis W. Kingbay, 46 T.C. 147 (1966). There the limited partners were specifically said not to be liable for any additional contribution, and all indebtedness was taken in the name of the corporate general partner. Trying to find a means which would allow them to deduct losses of the partnership, the limited partners sought to argue that the corporate general partner was a dummy, and that loans to the partnership were contributions to capital, though they had been evidenced by notes payable. The Tax Court rejected both arguments, requiring the limited partners to live with the form in which they had cast their partnership. It should be noted that there was no argument by the Commissioner on the associational question in *Kingbay*, *see* notes 60-81 *supra* & text accompanying, although it was unquestionably present. *See* WILLIS, *supra* note 49, § 17.05.

117. *See* Rev. Rul. 69-223, 1969-1 CUM. BULL. 184.

118. IND. CODE § 23-4-2-17(1)(b) (1971), IND. ANN. STAT. § 50-137(1)(b) (1964).

119. Treas. Reg. § 1.752-1(e) (1956). Perhaps the best example of such a procedure, though not involving a limited partnership situation, can be found in David F. Bolger, 59 T.C. No. 75 (1973). In *Bolger*, a corporation was used to obtain full nonrecourse financing for the purchase of real property. After financing was obtained, the property was deeded to the corporation's shareholders. The shareholders were allowed to claim depreciation deductions on the property and to use the mortgage indebtedness incurred by the corporation in obtaining financing to increase their basis for deduction purposes even though they had not assumed personal liability on the mortgages. *See* note 29 *supra*. The benefits of the scheme approved by the Tax Court in *Bolger* could be obtained in the limited partnership context, without sacrificing the benefits of the limited partnership form, by having a corporation distribute its property to the limited partnership rather than to the corporation's shareholders.

general or limited.[119] Alternatively, the property could be placed in a land trust with the partnership as a beneficiary, and the trustee executing the mortgage and loan agreement,[120] or the property could be purchased, and the indebtedness assumed, by the general partner, who would then convey the property to the partnership subject to the indebtedness, which would not be assumed by the partnership.[121] The difficulty with these approaches is that lenders may require personal liability, and in that event there may be no way for the partners to share in the liabilities, though suggestions have been made to cover even this situation.[122] If the limited partners cannot use a share of the liabilities to increase their basis, they can at least take solace in the fact that operating losses disallowed under § 704(d) may, to a limited extent, indefinitely carried forward.[123]

For the limited partners to share in partnership liabilities for the purpose of increasing their adjusted basis to facilitate operating loss deductions, then, there must be an obligation for them to contribute additional capital in at least their share of the liabilities, or there must be no personal liability on the partnership liability.[124]

To make this analysis complete, attention must also be given to the effects on the limited partner of disposition of the mortgage-encumbered property. In *Crane v. Commissioner*,[125] the Supreme Court held that upon disposition of mortgage-encumbered property, the "amount realized" would be the amount of cash received plus the amount of the mortgage, although neither the seller nor the buyer had ever personally assumed the mortgage.[126] Thus, if a limited partner is able to share in partnership liabilities to increase his adjusted basis, he will, on disposition of the property by the partnership, be taxable on his share of the mortgage.[127] This

120. Bluhm, *Tax Considerations in Financing Real Estate Transactions*, 47 TAXES 844, 847-48 (1969) [hereinafter cited as Bluhm].

121. *See* WILLIS, *supra* note 49, § 17.05. However, this approach appears to be precluded by the regulations, which say that a limited partner may have a share of the liabilities only "where none of the partners have any personal liability. . . ." Treas. Reg. § 1.752-1(e) (1956).

Other methods in addition to those considered in the text are considered in Shapiro, *Tax Planning for Equity Financing by Real Estate Developers*, 50 TAXES 530, 532 (1972).

122. For example, it has been suggested that more than one mortgage might be executed, and that personal liability be omitted from at least one. Bluhm, *supra* note 120, at 848.

123. Treas. Reg. § 1.704-1(d)(1) (1956); *see also* WILLIS, *supra* note 49, § 18.02; Bluhm, *supra* note 120, at 848-49; Tigner, *supra* note 99, at 266-67.

124. It should also be observed that if the limited partners do increase their basis by their share of partnership liabilities, they will also be able to claim a proportionate amount of the allowable depreciation on the properties. *See* Crane v. Commissioner, 331 U.S. 1, 11-12 (1947); WILLIS, *supra* note 49, § 18.04.

125. 331 U.S. 1 (1947).

126. *Id.* at 12-14.

127. *See* WILLIS, *supra* note 49, § 18.04. *See generally* Epstein, *supra* note 114.

is not, however, necessarily an unattractive feature. First, the net effect of the transactions will be that the taxpaying limited partners will have achieved the tax shelter benefit, since the amount of gain which will be taxed at capital gain rates will equal the excess of their prior deductions for depreciation, interest, and operating losses over their capital investments. Second, the time for taxation will have been long postponed, and when it occurs it will be at capital gains rates, subject, of course, to whatever § 1245 or § 1250 recapture is required. Third, if he dies, the limited partner's basis will be "stepped-up" in the hands of his heirs or devisees.[128] Finally, if the taxpayer exchanges his property in a like-kind exchange,[129] he may postpone most tax even further.[130]

In light of this discussion, therefore, it seems clear that the investment objectives of the common investment group may be accomplished by a profit and loss allocation among the partners, both general and limited, together with a management contract between the corporate general partner and the limited partnership.

Use of a Corporation as the General Partner

In the allocation scheme assumed hypothetically, it has been proposed that the general partner in the limited partnership be a corporation. The employment of a corporate general partner is, in fact, the best means of fully reaping the benefits of a limited partnership.[131] By so doing, the investors will obtain virtually complete limitation of liability, they will avoid any state usury law restrictions, and concern over the death of participants will be ameliorated. Use of a corporate general partner does, however, raise two troublesome questions: first, whether a corporation has the power to enter a partnership; and second, if it does become the general partner, whether the limited partnership would then be classified as a corporation for tax purposes.

(1) The Power to Enter a Partnership

As a general rule, a corporation may not enter into a partnership, unless the power to do so is expressly conferred, for in so doing it would lose its identity, and the direction of at least part of its affairs would be placed in hands other than those contemplated by its charter.[132] Although

128. INT. REV. CODE of 1954, § 1014.

129. *Id.* § 1031.

130. All of the advantages are discussed in WILLIS, *supra* note 49, § 18.04; Epstein, *supra* note 114, at 102-03.

131. *See* Aronsohn, *supra* note 1, at 589-90; Comment, *The Limited Partnership with a Corporate General Partner—Federal Taxation-Partnership or Association,* 24 Sw. L.J. 285 (1970).

132. *See* 6 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2520 (perm. ed. 1968); Annot., 60 A.L.R.2d 917, 920-21 (1958).

this rule was at one time followed in Indiana,[133] it is no longer the prevailing view. Thus, the Attorney General has said that so long as its articles of incorporation expressly provide the power to enter a partnership, a corporation may lawfully do so.[134] This result could also be reached through the express language of the Indiana versions of the Uniform Partnership Act (UPA) and the Uniform Limited Partnership Act (ULPA), inasmuch as the ULPA defines a limited partnership as one formed by two or more "persons"[135] and the UPA defines "persons" to include corporations.[136] Moreover, the UPA applies to the ULPA, except when its provisions are inconsistent with those of the ULPA.[137] With regard to the first question, then, it may be safely concluded that a corporation may be a general partner in a limited partnership in Indiana.[138]

(2) Avoiding Entity Taxation as a Corporation

Presumably because the use of a corporation as the general partner in a limited partnership is so beneficial, the IRS has recently adopted an "associational" ruling posture that is far more stringent than that formally set forth in its regulations. This posture was promulgated in Rev. Proc. 72-13,[139] in which the IRS said that in order to obtain a favorable ruling as to the qualification for partnership status of a limited partnership which has as its only general partner a corporation, the following tests must be met: (1) the limited partners must not own, directly or indirectly, individually or in the aggregate, more than twenty per cent of the stock of the corporate general partner, or any of its affiliates; (2) if the corporation has an interest in only one limited partnership and its contribution thereto is less than 2,500,000 dollars, it must have a net worth at all times of at least 15 per cent of the contribution or 250,000 dollars, whichever is lesser, and if the contribution exceeds 2,500,000 dollars, it must have a net worth of at least ten per cent of that figure; (3) if the corpora-

133. Traders Loan & Investment Co. v. Butcher, 74 Ind. App. 548, 129 N.E. 257 (1920) (held that a corporation was estopped to deny its partnership status); Brenig v. Sparrow, 39 Ind. App. 455, 80 N.E. 37 (1907).

134. Op. Att'y Gen. Ind. 225, 228 (1951).

135. Ind. Code § 23-4-2-1 (1971), Ind. Ann. Stat. § 50-121 (1964) (adopting Uniform Limited Partnership Act § 1).

136. Ind. Code § 23-4-1-2 (1971), Ind. Ann. Stat. § 50-402 (1964) (adopting Uniform Partnership Act § 2).

137. Ind. Code § 23-4-1-6(2) (1971), Ind. Ann. Stat. § 50-406(2) (1964) (adopting Uniform Partnership Act § 6).

138. *See generally* Rowley, *The Corporate Partner,* 14 Minn. L. Rev. 769 (1930); Stein, *supra* note 7, at 436; Comment, *Landing the Gentry: Real Estate Investment as a Means of Executive Compensation,* 18 U.C.L.A. L. Rev. 962, 987-88 (1971) [hereinafter cited as Comment]. It may also be a limited partner. Note, *Power of a Corporation to Enter Into a Limited Partnership,* 35 Texas L. Rev. 265 (1956).

139. Rev. Proc. 72-13, 1972 Int. Rev. Bull. No. 2, at 26.

tion has an interest in more than one limited partnership, the net worth requirements in (2) must be met for each such partnership, and it must have a net worth at least as great as the sum of the amounts required by (2) for each separate partnership; (4) the purchase of a limited partnership interest must not entail a mandatory or discretionary purchase of any security in the corporate general partner or any of its affiliates; and (5) the organization of the limited partnership must be in accord with its applicable state laws.[140]

Although the effect of this posture is to inhibit the use of a corporation as the limited partner,[141] it does not prevent its employment. It simply requires a more careful structuring of the organizational framework.[142] The posture does, in fact, facilitate organizational planning and will help to insure that the partnership will not be classified as an association for tax purposes.[143] By complying with the requisites for a favorable ruling, the planner can be certain of avoiding the limited liability characteristic, since the regulations provide that where a corporation is the general partner it will have personal liability if it has substantial assets beyond its partnership interest,[144] and compliance with the net worth requirement will certainly give the corporation substantial assets. It will also preclude any assertion that the corporation is a sham. In addition, by providing the corporate general partner with substantial assets, it will also be possible to insure that the limited partners do not own substantially all the interests in the partnership, thereby avoiding the centralization of management characteristic as well.[145] It should be kept in mind, however, that Rev. Proc. 72-13 specifically provides that in calculating the net worth requirement, the corporate general partner's interest in the partnership will be excluded.[146]

Compliance with the Securities Laws

The use of a limited partnership will also involve securities regula-

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140. *Id. See generally* Weiler, *Limited Partnerships with Corporate General Partners: Beyond Rev. Rul. 72-13,* 36 J. TAX. 306 (1972).

Provisions similar to those in Rev. Rul. 72-13 are contained in *Statement of Policy, supra* note 107.

141. In an article discussing the use of a limited partnership engaged in real estate investment as a means of executive compensation, the author suggests that the safest course is to forego the use of a corporate general partner altogether in favor of an individual. Comment, *supra* note 138, at 990.

142. *See* Stein, *supra* note 72, at 446-49.

143. The factors considered by the IRS in making the "associational" determination are considered at notes 60-81 *supra* & text accompanying.

144. Treas. Reg. § 301.7701-2(d)(2) (1960).

145. *Id.* § 301.7701-2(c)(4).

146. Rev. Proc. 72-13, 1972 INT. REV. BULL. No. 2, at 26.

tion considerations, at both the state and federal levels.[147]

(1) At the Federal Level

The basic question with regard to securities regulation, at least at the preliminary planning stage, is whether the security being considered must be registered.[148] The Securities Act of 1933 (the 1933 Act)[149] provides that it shall be unlawful for any person to make use of any means of interstate commerce to sell or deliver a security unless a registration statement is in effect, or the security or transaction involved is subject to one of the various exemptions provided.[150]

The first issue to be addressed, therefore, is whether a limited partnership interest is a "security," which is defined in § 2(1) of the 1933 Act as follows:

> the term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract . . . or, in general, any interest or instrument commonly known as a 'security,' . . . .[151]

Although at one time, there may have been some question, it is now undisputed that a limited partnership interest is a "security" for federal securities regulation purposes.[152] This result has been reached by finding that an interest in a limited partnership is an investment contract, which was defined by the Supreme Court in *SEC v. J. W. Howey Co.*[153] to include any "contract, transaction or scheme whereby a person invests his

147. If a corporate general partner is used, there will also be securities regulation problems incident to the issuance of its stock, but since those problems are essentially the same as those discussed in the text, they need not be further pursued.

148. *See generally* Rifkind & Borton, *SEC Registration of Real Estate Interests: An Overview*, 27 Bus. Law. 649 (1972). In some real estate investment projects, there may also be a need to comply with the Interstate Land Sales Act, 15 U.S.C. §§ 1701-20 (1970). *See generally* Wharton, *Application of Federal and State Security Regulations to Real Estate Transactions*, 12 S. Texas L.J. 237, 238-39 (1971).

149. 15 U.S.C. §§ 77a-77mm (1970).

150. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1970).

151. Securities Act of 1933 § 2, 15 U.S.C. § 77b(1) (1970).

152. SEC Securities Act Release No. 4877 (Aug. 8, 1967). *See also* Pawgan v. Silverstein, 265 F. Supp. 898 (S.D.N.Y. 1967); SEC Securities Act Release No. 5347 (Jan. 4, 1973) (condominium unit offerings as securities). Prior to the issuance of Release No. 4877, it had only been thought that a limited partnership interest *may* be a "security" for purposes of federal regulation. *See* 1 L. Loss, Securities Regulation 503 (2d ed. 1961) [hereinafter cited as Loss]. It should be noted that a result similar to that decreed in Release No. 4877 has been reached under the Securities Act of 1934, where Rule 3a11-1 defines "equity securities" to include limited partnership interests. 17 C.F.R. § 240.3a11-1 (1971); 4 Loss, *supra* at 2549.

153. 328 U.S. 293 (1946).

money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. . . ."[154] This conclusion is undoubtedly correct, since a limited partner will contribute his capital to a venture in which he will have no active management participation in hopes of sharing in the profits to be made by the efforts of others.[155]

Although the limited partnership interest may be a "security" within the § 2(1) definition, there are at least two exemptions available which will in most cases eliminate the need for registration. The first is provided by § 4(2) of the 1933 Act, which exempts "transactions by an issuer not involving any public offering"[156]—that is, a private offering. Whether a particular offering is "private" is a question of fact and requires analysis of all the surrounding circumstances, including the relation of the offerees and the issuer and the nature of the offering.[157] In *SEC v. Ralston Purina Co.*,[158] the Supreme Court made it plain that the exemption was to be interpreted in light of the statutory purpose to provide all investors with full disclosure of all information. Accordingly, the Court adopted a test which looks at the sophistication of the offerees and their access to corporate information to determine "whether the particular class of persons affected *need* the protection of the Act."[159] Thus, if all the offerees of a particular issue have sufficient business sophistication and information to "fend for themselves," they will be "non-Ralstonians"—that is, informed investors who do not need the protection of the Act—and the private offering exemption should be available. The number of offerees may also be important. The SEC long followed a "rule of thumb"

154. *Id.* at 298.

155. Where this element is not present, however, the limited partnership interest may not be considered a "security." Thus, in Romney v. Richard Prows, Inc., 289 F. Supp. 313 (D. Utah 1968), it was held that the interest of one who had become a joint venturer in an organization whose success would hinge to an important degree upon his services was not a "security."

156. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970). In considering means of avoiding federal securities regulation requirements, it may be well to keep in mind what is known as the "Regulation A" rules. Section 3(b) of the Securities Act of 1933, 15 U.S.C. § 77c(b) (1970), authorizes the SEC to promulgate exemptions for issues of securities which do not exceed 500,000 dollars. *See* SEC Securities Act Release No. 5125 (Jan. 7, 1971). Pursuant to this authority, the SEC has adopted what is known as Regulation A, which provides a simplified form of registration, rather than an exemption from registration as such. *See* Glavin & Purcell, *Securities Offerings and Regulation A—Requirements and Risks,* 13 BUS. LAW. 303, 304 (1958). Though it may save some filing costs because of the shortened registration form, Regulation A is relatively unattractive simply because of the stringent rules applied to its use by the SEC. *See* 17 C.F.R. §§ 230.251-230.263 (1972). Its attractiveness is also diminished by the fact that the private offering and intrastate exemptions will ordinarliy be available to small real estate investment projects. *See generally* Loss, *supra* note 152, at 609-35.

157. SEC Securities Act Release No. 4552 (Nov. 6, 1962).

158. 346 U.S. 119 (1953).

159. *Id.* at 125.

that an offering to no more than 25 would be a private offering,[160] and although it is said that this rule is no longer followed,[161] the fact that it has not been repudiated by the SEC indicates that it should be viewed as a practical ceiling on the permissible number of offerees. The presence of a private offering must, finally, include an analysis of whether, in fact, the securities offered will "come to rest" in the hands of "non-Ralstonians," or whether the purchasers are merely conduits for a wider distribution.[162]

Since the ordinary real estate investment group will be small, this exemption would seem to be generally available. Because it has been suggested that the private offering exemption "should be handled gingerly,"[163] it will, however, be prudent in all cases to provide the participants with all the information available to the group, as well as their advisers and planners, so that all members will be "non-Ralstonians" who do not require the protection of the securities laws.[164] With proper planning and dissemination, therefore, the private offering exemption can be achieved.[165]

The second exemption provides that securities which are both offered and sold exclusively to residents of the state in which the issuer is both incorporated and doing business need not be registered.[166] This exemption is applied literally, so that any sale to a nonresident will preclude its application; there is no de minimis rule.[167] The exemptive benefits

160. SEC Securities Act Release No. 285 (Jan. 24, 1935). *See also* Orrick, *Some Observations on the Administration of the Securities Laws,* 42 MINN. L. REV. 25, 33 (1957).

161. *See* D. HERWITZ, BUSINESS PLANNING 211-12 (1966).

162. SEC v. Los Angeles Trust Deed & Mortgage Exchange, 186 F. Supp. 830 (S.D. Cal.), *aff'd,* 285 F.2d 162 (9th Cir. 1960). *See also* SEC Securities Act Release No. 4434 (Dec. 6, 1961).

163. Berger, *Real Estate Syndication: Property, Promotion, and the Need for Protection,* 69 YALE L.J. 725, 770 (1960) [hereinafter cited as Berger].

164. *See* SEC Securities Act Release No. 4877 (Aug. 8, 1967); H. ROTHSCHILD & D. BERMAN, HOW TO INVEST AND PROTECT YOUR PROFITS IN REAL ESTATE SYNDICATES 11 (1964).

165. Loss, *supra* note 152, at 504-05.

166. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970). *See generally* McCauley, *Intrastate Securities Transactions Under the Federal Securities Laws,* 107 U. PA. L. REV. 937 (1959).

167. SEC Securities Act Release No. 4434 (Dec. 6, 1961). *See also* Stadia Oil & Uranium Co. v. Wheelis, 251 F.2d 269, 275 (10th Cir. 1957).

The requirements for compliance with the intrastate exemption of § 3(a)(11) have also been the subject of Proposed Rule 147, the purpose of which is to provide objective standards for the guidance of those who seek the exemption's benefits. *See* SEC Securities Act Release No. 5349 (Jan. 8, 1973), which also sets forth the purpose of the exemption:

> Section 3(a)(11) was intended to allow issuers with localized operations to sell securities as part of a plan of local financing. Congress apparently believed that a company whose operations are restricted to one area should be able to raise money from investors in the immediate vicinity without having to register

will also be denied if it is found that the sale to a resident was made with a view toward resale to a nonresident in the near future.[168] Thus, the issuers are, to some extent, at the mercy of their purchasers, since the buyers may destroy the exemption by making the original purchase as a nominee or trustee for a nonresident, or with a view to resale to a nonresident.[169]

With these consideratons in mind, the intrastate exemption will definitely be available to a limited partnership engaged in real estate investment only if (1) all investor-purchasers are residents of Indiana, (2) they acquire their interest in their own behalf, with no view to resale or other distribution to nonresidents, and (3) the entire investment enterprise is carried out in Indiana, thus making it subject to the cognizance of Indiana securities regulation.[170] Although the limited partnership interests are covered by the intrastate exemption, it should be kept in mind that if the person offering the interests—for example, the general partner who is also acting as a real estate investment promoter—does so on a relatively regular basis on behalf of different partnerships, he may be required to register as a broker-dealer under the rules of the Securities Exchange Act of 1934 (the 1934 Act).[171]

Although it will not guarantee the availability of the intrastate exemption, it may be prudent to include a statement in the limited partnership agreement that all partners are residents of Indiana and that they are not acting in an agency capacity for any nonresident. It may also be wise to restrict the transferability of the interests, place restrictive legends on all brochures, and obtain "investment letters" from all investors, which should include the legend that all ownership and transfer rights are restricted solely to Indiana residents.[172] The planner should not have undue difficulty in tailoring these provisions to the needs and objectives of the parties, and in view of their additional, though, of course, not complete, protection against inadvertent violation of the federal securities laws,

the securities with a federal agency. In theory, the investors would be protected both by their proximity to the issuer and by state regulation.

168. *See* SEC v. Hillsborough Investment Corp., 173 F. Supp. 86 (D.N.H. 1958), where the court said that it was a "devious and futile" attempt to invoke the § 3(a)(11) exemption where the transfer was planned and carried out within a thirty-day period. *Id.* at 88-89.

169. Greenwood, *Syndication of Undeveloped Real Estate and Securities Law Implications*, 9 HOUSTON L. REV. 53, 66 (1971) [hereinafter cited as Greenwood].

170. Berger, *supra* note 163, at 769. The Indiana securities regulation scheme is considered at notes 177-90 *infra* & text accompanying.

171. 15 U.S.C. §§ 78a-78jj (1970). *See* Boetel & Co., [1971-72 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,343 (SEC 1971); *see also* SEC Securities Act Release No. 4877 (Aug. 8, 1967).

172. *See* Greenwood, *supra* note 169, at 66.

their use should be given serious consideration.[173]

It should also be kept in mind that although registration may or may not be required, the anti-fraud and civil liability provisions of both the 1933[174] and 1934 Acts[175] will continue to apply if the facilities of interstate commerce are utilized.[176]

(2) At the State Level

Although there may be no need to register the securities at the federal level, there is still the question of whether state registration is necessary. Under the Indiana Securities Law,[177] it is unlawful for any person to offer or sell a security unless it is either registered or the security or transaction is exempted.[178] Registration, where necessary, may be accomplished either by coordination with registration under the federal 1933 Act[179] or by specific Indiana qualification.[180]

The first question, again, is to ask whether a limited partnership interest will be a statutory "security." The definition of a "security" in

173. There is also good reason, aside from the intrastate exemption rationale, for including such provisions. Courts have often relied upon the presence or absence of the partnership right of *delectus personam*—the right of members to consent to the substitution of a new member—in determining whether a "security" was present. *See, e.g.,* Solomont v. Polk Development Co., 245 Cal. App. 2d 488, 54 Cal. Rptr. 22 (1968); Rivlin v. Levine, 195 Cal. App. 2d 13, 15 Cal. Rptr. 587 (1961). This approach is reasonable because an interest in a corporation is ordinarily fully transferable and should be a security, whereas an interest in a bona fide limited partnership is transferable only with unanimous member consent or certificate provision, and arguably should not be a security. Therefore, to avoid any inference that the limited partnership interest is transferable, the certificate should provide that no assignee may become a substituted limited partner without the unanimous consent—the *delectus personam*—of all members of the partnership. Although such a provision will not be conclusive on the "security" question, "it should certainly be persuasive." Loss, *supra* note 152, at 505.

In addition to their importance for purposes of complying with federal laws, restrictive provisions are a means of complying with the small offering exemption in the Indiana Securities Law, IND. CODE § 23-2-1-2(b)(10) (1971), IND. ANN. STAT. § 25-855(b)(10) (1970), which requires that purchasers buy securities for investment purposes only. *See* note 187 *infra* & text accompanying.

174. Securities Act of 1933 §§ 12(2), 17(a), 15 U.S.C. §§ 77*l*(2), 77q(a) (1970).

175. Securities Act of 1934 § 10b, 15 U.S.C. § 78j(b) (1970).

176. *See* Pawgan v. Silverstein, 265 F. Supp. 898 (S.D.N.Y. 1967); Loss, *supra* note 152, at 710.

177. IND. CODE § 23-2-1-1 *et seq.* (1971), IND. ANN. STAT. § 25-854 *et seq.* (1970). *See generally* Masmas, *Securities Issuance and Regulation: The New Indiana Securities Law,* 38 IND. L.J. 38 (1962).

178. IND. CODE § 23-2-1-3 (1971), IND. ANN. STAT. § 25-856 (1970).

179. IND. CODE § 23-2-1-4 (1971), IND. ANN. STAT. § 25-858 (1970). "Coordination" simply refers to the procedure whereby an expedited process can be utilized to register the security in Indiana if the same offering has been the subject of a registration statement under the federal 1933 Act.

180. IND. CODE § 23-2-1-5 (1971), IND. ANN. STAT. § 25-859 (1970). Both the "coordination" and "qualification" procedures are discussed in Note, *Securities Registration Requirements in Indiana,* 3 IND. LEGAL F. 270, 272-74 (1969) [hereinafter cited as Note].

the Indiana statute[181] is very similar to that in § 2(1) of the 1933 Act,[182] and although there is no Indiana ruling specifically including limited partnership interests in that definition, the inclusive result reached at the federal level,[183] and by many other states,[184] would certainly indicate that Indiana courts might reach a similar result if the question were brought before them,[185] though there is room for meritorious argument to the contrary.[186]

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181. IND. CODE § 23-2-1-1(k) (1971), IND. ANN. STAT. § 25-854(k) (1970), which adopts the definition from the UNIFORM SECURITIES ACT § 401(1). *See generally* L. Loss & E. COWETT, BLUE SKY LAW 350-51 (1958) [hereinafter cited as BLUE SKY LAW].

182. *See* note 151 *supra* & text accompanying.

183. *See* notes 151-54 *supra* & text accompanying.

184. *See, e.g.,* People v. Hoshor, 92 Cal. App. 2d 250, 206 P.2d 882 (1949); People v. Woodson, 78 Cal. App. 2d 132, 177 P.2d 586 (1947); Curtis v. Johnson, 92 Ill. App. 2d 141, 234 N.E.2d 566 (1968); State v. Simons, 238 P.2d 247 (Ore. 1951). *See also* Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act,* 33 CALIF. L. REV. 343, 363-67 (1945) [hereinafter cited as Dahlquist]; Miller, *supra* note 59, at 382; Smith, *Limited Partnership Interests as Securities Under the Corporate Securities Act,* 19 L.A. B. BULL. 257 (1944); Note, *Sale of Limited Partnership Interests:* Rivlin v. Levine, 14 HASTINGS L.J. 176 (1962).

185. This might be inferred from the fact that the Indiana Court of Appeals has already given an expansive definition to the term "security." In Holloway v. Thompson, 112 Ind. App. 229, 42 N.E.2d 421 (1942), the court said that the term included "any form of investment used for the purpose of financing and promoting enterprises and which is designed for investment." *Id.* at 239, 42 N.E.2d at 425.

186. One seeking to argue that a limited partnership interest is not a "security" might look to the California decisions. In Farnsworth v. Nevada-Cal Management, Ltd., 188 Cal. App. 2d 382, 10 Cal. Rptr. 531 (1961), the court held that all limited partnership interests were exempt from registration requirements. This rule was then limited in Rivlin v. Levine, 195 Cal. App. 2d 13, 15 Cal. Rptr. 587 (1961), to cover only bona fide limited partnerships. The rule has since been followed in Solomont v. Polk Development Co., 245 Cal. App. 2d 488, 54 Cal. Rptr. 22 (1966).

It should be noted, however, that these cases were decided under a California registration statute which specifically exempted general and limited partnership interests. The California Securities Act has since been amended, and the exemption is no longer available. Therefore, the probative value of the cases is questionable.

Attention might also be given to the New Jersey case of Conroy v. Schultz, 80 N.J. Super. 443, 194 A.2d 20 (1963). Although *Conroy* arose under a statute adopting the Uniform Securities Act definition of "security," New Jersey added to the definition the following sentence:

> "Security" means any . . . certificate of interest or participation in any profit-sharing agreement including but not limited to certificates of interest or participation in real or personal property. . . .

N.J. REV. STAT. § 49:3-49(m) (1970). In *Conroy,* the defendant was engaged in the real estate syndication business, and used limited partnerships, with the defendant being the general partner, to obtain the capital for his various undertakings. Thereafter, "unit participations" in the limited partnerships were offered to the public under conditions which the court found to be rife with fraud and manipulation. In rejecting the defendant's claim that the limited partnership interests were not securities, the court relied upon New Jersey's addition to the Uniform Securities Act definition of a "security." It added, however, that it was unnecessary to determine whether the interests were those of "a genuine limited partnership," since such an organization was clearly absent. 80 N.J. Super. at 448, 194 A.2d at 25. Thus, although the statutory definition of "security" clearly included interests in profit-sharing agreements in real estate projects, it left open the question of whether a bona fide limited partnership interest could still be

Since a limited partnership interest will in all likelihood be deemed a statutory "security," the next inquiry will be whether an exemption will also be available at the state level. The most probable exemption is that which excepts transactions where offers are made to fewer than twenty Indiana persons in a twelve-month period, without commission or remuneration, and the purchasers buy for the purpose of investment only.[187] Although there is no Indiana case law construing this exemption, it would seem, on its face, to provide the necessary exemption in all cases where there are no more than twenty limited partners.[188] In addition, the exemption which excepts isolated non-issuer transactions[189] should be considered, though it would seem to be more difficult to comply with this provision than the small offering exemption. Also, as was noted in the discussion of the federal laws, the mere fact that a security may be exempted from registration does not by any means indicate that it is immune from fraud challenge.[190]

CONCLUSION

When investors approach real estate investment, they usually do so with one of two investment objectives. They may, first of all, seek to obtain a flow of current income from their investment, or, secondly, they may need to obtain the fruits of a "tax shelter" to reduce an otherwise heavy federal income tax burden. Since these objectives are not parallel, though they are not mutually exclusive, the selection of an organizational vehicle through which both are sought to be accomplished will require

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excluded from the coverage of the statute.

One may also argue that a limited partnership interest is not a security because "[t]hey do not readily lend themselves to bold and dishonest schemes whereby capital is raised to carry out a venture by indiscriminate solicitation of the public at large." Dahlquist, *supra* note 184, at 363.

Despite these arguments, the position of the SEC that all limited partnership interests are securities compels one to conclude that a much safer, and far more prudent course is to assume that such interests are securities, and then look for an exemption.

187. IND. CODE § 23-2-1-2(b)(10) (1971), IND. ANN. STAT. § 25-855(b)(10) (1970). To help insure compliance with the "investment" requirement of the small offering exemption, the restrictive provisions discussed at notes 172-73 *supra* & text accompanying, should be given consideration.

188. *See* BLUE SKY LAW, *supra* note 181, at 368-74.

189. IND. CODE § 23-2-1-2(b)(1) (1971), IND. ANN. STAT. § 25-855(b)(1) (1970). *See generally* BLUE SKY LAW, *supra* note 181, at 314-23. The availability of this exemption might be indicated by the fact that the definition of an issuer does not include certificates of interest or participation in oil, gas, or mining titles or leases, IND. CODE § 23-2-1-1(f) (1971), IND. ANN. STAT. § 25-854(f) (1970), which are interests similar to those in a limited partnership engaged in real estate investment. In addition, "non-issuer" is defined to mean "not directly or indirectly for the benefit of the issuer." IND. CODE § 23-2-1-1(g) (1971), IND. ANN. STAT. § 25-854(g) (1970).

190. *See* Note, *supra* note 180, at 271. The civil and criminal fraud provisions are contained in IND. CODE §§ 23-2-1-12, 23-2-1-18, 23-2-1-19 (1971), IND. ANN. STAT. §§ 25-866, 25-872, 25-873 (1970).

considerable care. In most circumstances involving a relatively small number of investors, the limited partnership will be the preferred form, and if its structure is properly organized, it will yield the requisite investment objectives. Such an organizational structure might include the utilization of a corporation as the general partner, a careful allocation of profit and loss among the limited partners, and a management contract executed between the general partner and the partnership. Although it is suggested that this form will successfully yield the investment objectives of most real estate investors, the structure does pose several problems from an organizational point of view. It is these problems that this article has chiefly sought to analyze.

The limited partnership is, then, a valuable means of accomplishing the relatively diverse investment objectives of those who pursue real estate investment. To meet these objectives, however, the organizer may find it necessary to manipulate its traditional structure. Since many of the investment objectives will doubtlessly be tax-oriented, any such manipulation may pose a serious hazard to successful compliance with those provisions of the Internal Revenue Code which make the limited partnership an attractive organizational form. This hazard is not, however, insurmountable, and so long as watchful attention is paid to the form required by the Code, the objectives sought may be successfully reaped. In implementing any plan to maneuver around or through the Code requirements, though, the form of the limited partnership must be carefully kept in mind to insure that the limited liability of the limited partners is not sacrificed in the effort to obtain the most favorable tax results.

In short, the limited partnership is a valuable organizational vehicle because it yields the most favorable tax consequences to the small investment group, and because its form is sufficiently flexible to allow it to meet the needs of many different kinds of investors. But in utilizing this flexibility, careful attention must be paid to the permissibility of the various nuances sought to be employed, from tax, partnership, corporate or securities points of view to guarantee that benefits from one standpoint are not sacrificed for those from another.