Securities Law Series

1984 Tax Sheltered Investments Handbook

by Robert J. Haft
and Peter M. Fass

Clark Boardman Company, Ltd.

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Preface

The Economic Recovery Tax Act of 1981 changed—and complicated—the rules for tax sheltered investments . . . and the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, with its stiff penalties for "abusive" shelters and underpayments—penalties which unequivocally extend to investors' attorneys as well as investors—sharply increased the risks of less than highly meticulous structuring and handling of such investments.

Because the 1981 Act created new liberalized depreciation rules for real estate and equipment, it is necessary that professionals counseling high-income clients fully understand the available methods of sheltering income in the top brackets, and the possibilities of converting such ordinary deductions into capital gains. Because the 1982 Act exposes taxpayers and their advisors to potential penalties for substantial underpayment and promoting "abusive tax shelter" investments, the definition of tax shelter and what constitutes "substantial authority" is relevant to every tax shelter investor and tax advisor. The compliance, enforcement, and penalty provisions and the IRS's implementing rules and procedures present many difficult and potentially costly decisions for tax shelter investors and their advisors. The 1984 HANDBOOK reviews both Acts as they affect tax sheltered investments.

Up-to-date, authoritative information is provided on all aspects of the field. Covered in depth are the "trouble spots"—Regulation D and its coordination with the state Blue Sky laws; current IRS litigating positions and attacks on abusive shelters; relevant TEFRA provisions; new Blue Sky provisions affecting compensation and structuring of tax sheltered investments; and tax shelter opinions. Also included are an entirely new chapter on Subchapter S corporations and extensive new material on real estate shelters.

Consistent with other publications in the tax field, the HANDBOOK, prepared in late 1983, is dated 1984 and contains the pertinent material that will govern tax shelter operations during

calendar year 1984. This HANDBOOK replaces the *1983 Tax Sheltered Investments Handbook.*

TAX SHELTERED INVESTMENTS HANDBOOK has been designed and separately bound so that it may be conveniently carried in a briefcase or circulated among attorneys and accountants in an office. Litigators will find it a handy means of verifying points in the courtroom. New handbooks will be issued annually to present the latest trends and techniques.

The Publisher

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Tax Sheltered Investments

CHAPTER 1

Selected Problems in the Creation, Operation, and Dissolution of the Limited Partnership

PETER M. FASS

§ 1.01 General

[1] A key step in the development of any tax sheltered investment is the choice of appropriate legal structure or organization form to be used by the participants in owning the investment. Such an organization should have the operating and market advantages of a corporation, yet enable the participants to enjoy the same tax benefits available to an individual investor—primarily the ability to pass through paper tax losses created by depreciation to reduce his other taxable income.

[a] Tax shelter syndications are usually in the form of limited partnerships, principally because the income and expenses of the enterprise "pass through" to the investors for tax purposes, allowing them to claim allocable deductions on their personal income tax returns. Corporations and business trusts, on the other hand, because they are separate tax-paying entities, do not offer this benefit. The property could be held directly by the investor or in a general partnership, but under these arrangements the investor's liability (i.e., for contract claims, personal injury) would not be limited to his investment. A second reason for structuring the syndication as a limited partnership, therefore, is that it permits the investor to limit his economic risk to his investment in the activity. Properly constituted, a limited partnership does not subject a passive investor to the debts and liabilities of the enterprise.

[2] The limited partnership comes closest to combining the benefits of corporate organization with individual tax treatment. The limited partner's liability is limited to his investment in the partnership while the general partner of a limited partnership has unlimited exposure. The partnership has substantial continuity since the death or bankruptcy of a limited partner, the assignment of his interest, or his withdrawal does not terminate the partnership. While in theory the death, bankruptcy or resignation of the general partner may terminate the partnership, most partnership agreements provide a ready means for re-forming the partnership upon agreement of the limited partners to do so. The partnership management is centralized in the hands of the general partner. Unlike the corporate form, however, there is no true accountability of management to investors since, unlike corporate directors, the general partner does not come up for reelection. And even though in some states the limited partners are permitted by the partnership law to remove and replace the general partner, essentially the limited partner's role is passive.

[3] There were no limited partnerships under common law, and each state which recognizes limited partnerships has enacted a law setting forth the detailed requirements for attaining this classification. Thus, if a passive investor in a partnership is to receive the benefit of limited liability, there must be substantial compliance with the relevant state limited partnership statute. All states (except Louisiana), including the District of Columbia and the Virgin Islands, have enacted, in one form or another, the provisions contained in the 1916 version of the Uniform Limited Partnership Act ("ULPA").

[a] The origin of limited partnerships is not found in English or American common law. Limited partnerships were first known and recognized in the Italian commercial centers of Pisa and Florence in the twelfth century, as a means for the owners of wealth, primarily the nobles and clergy, to invest their capital without being known or named. The system was carried to France at an early date and has always been there a major form of business organization. The system of limited partnership was first brought to America by the French in Louisiana and Florida. In Louisiana it has been known as "partnership in commendam." Beginning in 1822 in New York, various statutes were enacted by

different states providing for limited partnership, and patterned after the French Code.

[b] Underlying the ULPA is the theory that a willing investor should be able to put his money in a limited partnership and depend on others for investment skills without incurring any liability in the process. "The act proceeds on the assumption that no public policy requires a person who contributes to the capital of a business, acquires an interest in the profits, and some degree of control over the conduct of the business, to become bound for the obligations of the business, provided creditors have no reason to believe at the times their credits were extended that such person was bound." See ULPA, sec. 1 Comment. Further, the ULPA reflects a desire to provide reasonable protection of commercial expectations through a uniform system of regulation of limited partnerships. *Rathke v. Griffith,* 35 Wash.2d 394, 218 P2d 757 (1950).

[c] In August, 1976, The National Conference of Commissioners on Uniform State Laws at their annual meeting approved and recommended for enactment in all states a Revised Uniform Limited Partnership Act ("RULPA").

[*i*] Arizona, Arkansas, California, Colorado, Connecticut, Idaho, Iowa, Maryland, Massachusetts, Michigan, Minnesota, Montana, Nebraska, Washington, West Virginia, and Wyoming have adopted RULPA (with various modifications), and several other states are considering its adoption.

[*ii*] Since the RULPA can be reasonably expected to be adopted in an increasing number of states in the near future, its impact upon the problems discussed herein will be considered where appropriate.

§ 1.02 Checklist of Items to Be Considered Prior to Formation of the Limited Partnership

[1] Partnership name, including consideration of which partners' surnames should be included in partnership name. (See Section 5 of ULPA.) Section 5(2) provides that "a limited partner whose name appears in a partnership name contrary to the provisions of paragraph one is liable as a general partner to partnership creditors

who extend credit to the partnership *without actual knowledge that he is not a general partner.*"

Note that the limited partner has "general partner" liability unless he is relieved of that liability under a very stringent test—he must show that the partnership creditor had actual knowledge that he was not a general partner. It makes no defense that the creditor could have found out his status by inquiry or by examining the recorded certificate, or that the creditor may not have relied on the ostensible status of the individual.

[2] Principal place of business. If doing business in several states, see § 1.03 [10], below.

[3] Term of the partnership and what law will govern (see § 1.03 [10], below.)

[4] Who will be the general partner-individual or corporation (see *Rev. Proc.* 72–13, 1972–1. C.B. 735).

[5] Limited partners—How will they be selected and how many will be admitted to the partnership?

[a] Federal and State Securities Act considerations.

[b] Will transfer of limited partners' interest be allowed or restricted?

[*i*] If transfer is allowed, what procedures will be followed and standards applied for assignment and/or substitution or assignee? (See Sections 18 and 19 of the ULPA.)

[6] Termination of the partnership—determine if death, retirement, insanity, resignation, expulsion or bankruptcy of the general partner will cause dissolution of the limited partnership unless the business is continued by the remaining general partners under a right to do so stated in the certificate or with the consent of all members (see ULPA sec. 20).

[a] The Federal Bankruptcy Act was enacted and became effective on October 1, 1979. Section 365(e)(1)(A) of that Act provides that a contractual provision mandating termination or modification of an executory contract upon the insolvency of a debtor is unenforceable during the administration of the debtor's bankruptcy proceeding. Clauses requiring the withdrawal of a