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INTRODUCTION

In recent years, individuals with high incomes have turned with increasing frequency to tax shelter investments as means of maximizing after-tax income. Apartment complexes, convalescent hospitals, motion pictures, shopping centers, cattle feeding operations, oil and gas ventures and many other investment opportunities have been widely touted as potential tax shelters.[1] Congressional efforts to limit the tax savings resulting from such investments have also proliferated.[2]

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1. *See, e.g.,* Durham, *Farm and Farming: Gentlemen Farmers, New Hobby Loss Rules; Holding Period; etc.,* N.Y.U. 29TH INST. ON FED. TAX. 1527 (1971); Georges, *Timber as a Tax Shelter: What are the Benefits and are there Drawbacks,* 36 J. TAX. 364 (1972); Shelburne, *Tax Shelters via Limited Partnerships in the Oil and Gas Area,* 36 J. TAX. 246 (1972); *Tax Shelter for the Individual: A Panel Discussion,* N.Y.U. 28TH INST. ON FED. TAX. 1009 (1970); Zarrow, *Tax Shelters and the Public—New Uses for Limited Partnerships and Joint Ventures,* U. S. CAL. TAX INST. 277 (1970).

2. Numerous provisions aimed directly or indirectly at tax shelters are found in the Tax Reform Acts of 1969 and 1976. They reflect at least three approaches to the problem. Some of the provisions directly modify tax accounting and other rules of the law which allow the distortions which tax shelters exploit. The 1976 Act, for example, added §189 to the Code to require that interest and real property taxes paid or accrued during the construction phase of a building or other real property improvement be capitalized in large part and amortized over a period of years. See note 7 *infra.* Section 167(j) was added to the Code in 1969 to limit uses of accelerated methods of depreciation with respect to real estate. Other provisions are designed to remedy the distortions by imposing overall limitations on deductions of various types. For example, §465 of the Code, which was added in 1976, limits loss deductions from certain motion picture, farming, leasing and oil and gas investments to the amounts a taxpayer has placed at risk in such a venture. The 1969 Act added and the 1976 Act strengthened §163(d) of the Code which places dollar limits on deductions for interest on borrowings obtained or continued to purchase or carry investments. The minimum tax imposed by §56 of the Code, added in 1969 and amended in 1976, reflects a third approach. It is a separate tax, imposed in addition to the general income tax, which is intended to insure that persons availing themselves of various tax minimizing devices do not wholly escape the burden of taxes.

While public attention has been focused on the marketing of tax shelter investments and the legislative attempts to curb them, the Internal Revenue Service has carried on a quieter crusade to restrict the usefulness of the form of organization most often used to package tax shelter investments — the limited partnership. Tax shelter projects are frequently organized as limited partnerships because the tax laws generally allow partners to deduct their distributive shares of partnership losses, while state laws governing limited partnerships ordinarily insulate limited partners from liability for partnership debts. To be useful as a tax shelter vehicle, a limited partnership must be recognized as a partnership for tax purposes. In recent years the Service has steadily narrowed the class of cases in which it will rule that an organization formed as a limited partnership will be treated as a partnership for tax purposes rather than as an association taxable as a corporation.[3] After almost 25 years of inactivity, the government recently litigated two cases in which it contended that certain limited partnerships should be classified as associations.[4] Although the significance of the rulings policy of the Service is unclear and the two litigated cases have been decided against the government, the association issue remains a matter of concern to tax shelter promoters attracted by the advantages of the limited partnership form.

This article discusses the evolving standards applied to distinguish limited partnerships from corporations for tax purposes. It also looks at a few other arrows drawn from the Service's quiver that have recently been aimed at tax shelters organized as limited partnerships.

A Survey of the Issues

The tax shelter label can aptly be applied to any investment that causes an investor's taxable income to differ from an economically realistic measure of his current income. Income is sheltered from tax, for example, when economic income is excluded from gross income. The statutory exclusion of interest on state and local bonds[5] is the most widely used shelter of this form. A tax shelter can also be based on provisions of the law allowing deductions that do not represent costs actually incurred. Percentage depletion,[6] to the extent allowed in amounts exceeding the cost of depleted assets, is the most notorious example of such a shelter device.

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3. Rev. Proc. 74-17, 1974-1 Cum. Bull. 438; Rev. Proc. 72-13, 1972-1 Cum. Bull. 735.

4. Phillip G. Larson, 66 T.C. No. 21 (Apr. 27, 1976); Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975). The last preceding case in which the issue was litigated was Western Construction Co., 14 T.C. 453 (1950), *aff'd*, 191 F.2d 401 (9th Cir. 1951).

5. Int. Rev. Code of 1954, §103.

6. The deduction for depletion was initially allowed to permit the costs of mineral deposits as offsets against receipts from the sale of minerals extracted. In theory, depletion is a mechanism for spreading the costs of long lived assets over the periods during which they contribute to the production of income. Present law, however, allows extractors of most minerals to claim as depletion deductions fixed percentages of gross income from extraction operations. *Id.* §§611, 613. The amounts so allowed in a given period often vary widely from any reasonable estimate of the cost of minerals extracted during the period. The amounts allowed as percentage depletion over several years may exceed a taxpayer's total cost for the mineral deposits he owns. Such excesses are deductions without

To be a valuable tax planning tool, however, an investment need not yield economic income permanently exempted from tax. A delay in the imposition of a tax operates much like an interest free loan from the taxing authority. An income tax may be deferred by delaying the time of reporting gross income or by accelerating the time deductions are allowed. Many tax shelters operate principally as deferral devices. For example, when current deductions are allowed for interest paid on loans obtained to finance the construction of a building,[7] for depreciation on a building in amounts exceeding the economic costs of current usage of the building,[8] or for grain

cost and create obvious shelter opportunities. The form of percentage depletion best known to the public, that allowed in the oil and gas industry, was greatly restricted, however, by the addition of §613A to the Code in 1975. Major producers of oil are now generally limited to depletion deductions based on cost. Percentage depletion has been retained in a limited form for independent producers and the retention leaves oil and gas as a popular tax shelter investment. That popularity may be somewhat changed by the "at risk" limitation of §465 of the Code, added in 1976, which applies to oil and gas investments.

7. The costs of acquiring or constructing an asset having a useful life extending substantially beyond the taxable year may not be deducted as incurred because they do not represent expenses of producing income presently recognized. TREAS. REG. §1.263(a)-2(a). If the asset acquired or constructed is an exhausting asset, however, such costs may be deducted as depreciation over the periods the asset is used in business or for the production of income. INT. REV. CODE OF 1954, §167. In a realistic sense the costs of financing the construction of a building are as much a part of the total cost of the completed structure as are the costs of the bricks and mortar. They are costs incurred for the production of income over the period the taxpayer owns and uses the building and are not intended to generate income currently. Real property taxes for periods during which a building is constructed can similarly be viewed as capital in nature rather than as current expenses. Prior to 1976, however, all interest and real property taxes were deductible when paid or accrued. *Id.* §§163, 164. Construction period interest and taxes provided extensively used shelter opportunities to real estate investors.

The Tax Reform Act of 1976 added §189 to the Code to require interest and taxes paid or accrued during the construction of real property improvements to be amortized ratably over a period of years which will eventually be ten years. *Id.* §189(b). The provision stops short, however, of recognizing such interest and taxes as indistinguishable parts of the cost of a completed structure. The ten-year amortization period is much shorter than the useful lives of most real property improvements. Interest and taxes will still be allowed, therefore, over shorter periods than are applied in determining depreciation rates for other capital costs. The first installment of the amortization of interest and taxes is deductible in the year paid or accrued, in contrast to depreciation deductions for other costs which commence only when a structure is available for service. *Id.* §189(c)(1). The second installment of the amortization deduction is delayed, however, to the year in which the property is ready to be placed in service. *Id.* Also, the amortization rules will be phased in over an extended period. The amortization period is initially four years and will be ten years for all types of property only in taxable years beginning after 1987. *Id.* §189(6). Residential real property is not subject to the rules until 1978 and certain low income housing investments are relieved of the limitations until 1982. *Id.*

8. The deduction for depreciation is a mechanism which spreads the cost of a long lived asset over the period of its use in business or for the production of income. Conceptually, the mechanism should be structured solely to serve the goal of matching related items of income and deductions. Section 167(b) of the Code allows accelerated methods of depreciation, however, which have been permitted, in part, as a means of stimulating capital investment. *See* S. REP. No. 1622, 83rd Cong., 2d Sess. 26 (1954). Accelerated depreciation of real estate has been limited, INT. REV. CODE OF 1954, §167(j), but is still a

to be fed to cattle held for sale in future periods,[9] the deductions allowed presently are expenses of producing income to be recognized later. As a result, an investment may generate losses for tax purposes even though it is economically profitable. Such losses may generally be taken as deductions against unrelated income of the investor.[10] The benefit is usually transitory since the acceleration of deductions in earlier years will dry the well and cause taxable income to exceed economic income in later years. Nevertheless, the deferral opportunity is a valuable one. Also, the day of reckoning can be further delayed by a second tax shelter investment made when the first plays out and may be avoided in whole or in part by the investor's death.[11]

An investment device may also effect tax savings by indirectly converting ordinary income into capital gains. The use of borrowed money to carry investments in capital assets illustrates this technique. Interest on the loans is generally deductible as paid,[12] but gains arising from the capital investments are gross income only when the investments are sold.[13] In addition to the deferral opportunity the device presents, the interest deductions, which are allowed against unrelated ordinary income of the investor, are recouped through gains realized by the sale of investments, which are taxed at the

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powerful incentive to real estate investment. To the extent an accelerated depreciation method allows an investor to deduct in one year an increment of cost which generates income in a later year, a shelter opportunity exists.

9. Manufacturers and other producers of property are generally required to use inventory methods of accounting which cause the costs of producing an item to be allowed as an offset against receipts only in the year the item is sold. TREAS. REG. §§1.471-1, 1.61-3(a). Farmers generally are not subject to such requirements and may use a cash method of accounting under which costs of production are deducted when incurred. *Id.* §1.61-4(a). Costs presently incurred to produce future income are thereby allowed as current deductions. A tax shelter investor in a farming venture may usually determine his income and loss from the venture as a farmer. However, corporations and partnerships with corporations as partners must use an accrual method of accounting. INT. REV. CODE OF 1954, §447.

10. If the investment is of a type subject to the at risk limitation of §465 of the Code, however, losses exceeding the investor's capital contribution and personal liability on debt may not be deducted against other income. Also, costs incurred in an activity not carried on for profit may be deducted only to the extent of gross income generated by the activity. INT. REV. CODE OF 1954, §183(b). Losses created by artificial acceleration of deductions do not, however demonstrate a lack of profit motive. *Cf. Id.* §183(c).

11. Although an investor's death ends his existence as a taxpayer, his estate or beneficiaries may later pay the price for his tax shelter investments. The basis rules for property passing from a decedent may significantly lower that price, however. Generally, a decedent's successors take the decedent's basis for his property if he dies after December 31, 1976. *Id.* §1023(a)(1). However, there are many exceptions to the new carryover basis rule. If property was held on December 31, 1976, for example, its basis is increased at his death by any appreciation in the value of the property prior to that date. *Id.* §1023(h). If an acceleration of deductions prior to a decedent's death is reflected by a lowering of his basis for property, any step-up in basis occurring at his death may convert the deferral into a forgiveness.

12. *Id.* §163(a). If interest is prepaid for any period beyond the taxable year of payment, however, it must be capitalized and deducted only as the interest obligation accrues. *Id.* §461(g).

13. *Id.* §1001(a).

preferential capital gains rates.[14] Investments in depreciable real estate can effect another type of conversion of ordinary income into capital gain. Depreciation deductions are allowed against ordinary income.[15] When depreciable real property is sold, any gain realized represents at least in part a recoupment of depreciation deductions previously taken. Such deductions are only partially recaptured as ordinary income,[16] and any remaining gain is usually taxed as capital gain.[17]

The utility of many tax shelter investments is greatly enhanced by the use of borrowed money. For example, if an investor acquires a building and pays the purchase price of $10x wholly from his own funds, the depreciation deduction allowed him each year will be a small fraction of his investment. If the investor combines his funds with borrowed moneys of $90x, however, aggregate depreciation allowed with respect to the building he acquires for $100x may quickly exceed the investor's equity in the building. In general, when costs incurred are allowed as deductions, the deductions, as a percentage of the equity of an investor, are increased as the portion of the costs paid from borrowed moneys is increased. Many economically profitable tax shelter investments yield annual losses for tax purposes of fifty percent or more of the equity placed at risk by the investors. Therefore, a tax shelter investor can often recoup his equity in three or four years solely through the tax savings flowing from the deduction of losses generated by his investment. The leverage principle just discussed is at the heart of that phenomenon.

The nature of most tax shelter investors and investments requires aggregations of investors and professional management. A typical tax shelter investor, although among the most affluent group of the population, does not have the capital necessary to acquire sole ownership of the real estate developments, cattle feeding operations, movie productions and other activities and properties most often sold as tax shelter investments. And, most of the professional persons and corporate executives who form the largest group of tax shelter investors have little interest in becoming real estate managers, farmers or movie producers. As a consequence, a tax shelter venture is often

14. *Id.* §§1201, 1202.

15. *Id.* §167.

16. Section 1250 of the Code generally provides that gain recognized on the sale of real property is ordinary income to the extent that accelerated depreciation deductions have been taken in amounts exceeding the deductions allowable by a straight line method of depreciation. *Id.* §1250(a), (b). The amount so recaptured is reduced, however, for certain classes of real estate held for substantial periods of time. *Id.* §1250(a)(1)(B), (a)(2)(B), (a)(3)(B).

17. If the property sold was used in the taxpayer's trade or business and was held for more than six months, any gain or loss recognized (apart from that characterized by §1250) will be subject to the rule of §1231. The latter provision requires an aggregation of gains and losses subject to its terms. If the transactions occurring during the taxable year, in the aggregate, yield a gain, then all gains and losses are deemed long term capital gains and losses. Otherwise they all are ordinary. When a gain or loss recognized in the sale of real estate is not subject to §1231, it will, to the extent not governed by §1250, be capital unless the property was held for sale to customers in the ordinary course of business. *Id.*

comprised of a group of persons who have combined as investors in a project managed by others.

The choice of the form in which the investor group is to be organized is a crucial decision. If the shelter from tax arises from deductions allowed against unrelated income, it is essential that the deductions be allowable to the investors on their individual returns. If the investment is heavily leveraged, it is usually deemed equally important that the investors not be personally liable on debt incurred. The tax rules applicable to general partnerships provide that partnership losses are treated as losses of the partners individually,[18] but a partner of a general partnership is personally liable for all debts of the partnership.[19] Use of the corporate form of organization insulates investors from liability for business debts,[20] but deductions arising from corporate expenditures are generally not allowed to shareholders.[21] The limited partnership has been found to be the form of organization most generally suitable for tax shelter investments. If deemed a limited partnership for tax purposes, such an entity is subject to the tax rules generally applied to partnerships and partnership losses are allowed as deductions to the partners. If properly organized and managed as a limited partnership under state law, the limited partners are not liable on partnership obligations.[22]

A limited partnership must have a general partner and that partner has unlimited liability for partnership debts.[23] An individual who becomes a general partner of a heavily leveraged limited partnership therefore assumes

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18. *Id.* §702(a).

19. UNIFORM PARTNERSHIP ACT [hereinafter cited as UPA] §15. The UPA has been adopted in 49 states and territories and the District of Columbia and statutes corresponding to the Uniform Limited Partnership Act [hereinafter cited as ULPA] are in force in 51 jurisdictions. Throughout this article discussions of state laws governing partnerships will generally be limited to the UPA and the ULPA.

20. *See, e.g.*, FLA. STAT. §607.074 (1975).

21. Subchapter S of the Code provides a limited exception to the proposition stated in text. If a small business corporation as defined in §1371 makes an election satisfying §1372(a), its undistributed taxable income and net operating losses are reported on the returns of its shareholders. INT. REV. CODE OF 1954, §§1373, 1374. The subchapter S rules contain certain limitations, however, which restrict their usefulness in many tax shelter contexts. A corporation with more than ten shareholders, for example, is not a small business corporation and hence may not make a valid election under subchapter S. *Id.* §1371(a)(1). (The permissible number of shareholders is increased to 15 after a corporation has been subject to subchapter S for five years. *Id.* §13272(e)). The election of a small business corporation to be subject to the subchapter S rules is terminated when more than twenty percent of its gross receipts in any year are derived from rents and other passive sources. *Id.* §1372(e)(5). A shareholder of a subchapter S corporation may not deduct his share of net operating losses to the extent it exceeds the basis of the shares and notes of the corporation he holds. *Id.* §1374(c)(2). An organization may be a partnership for tax purposes regardless of the number of its partners or the sources of its income. And, although a partner may not deduct partnership losses in amounts exceeding the basis of his partnership interest, *id.* §704(d), liabilities of a partnership increase the bases of the partners' interests, making it less likely that any partner will run out of basis. *Id.* §752(a).

22. ULPA §7.

23. ULPA §9(1); UPA §15.

a heavy burden. The burden is often avoided, however, by using a corporation as general partner.[24] When a minimally capitalized corporation acts as sole general partner of a limited partnership, partnership creditors are effectively limited to recourse solely against partnership assets. Even when a corporate general partner has a substantial net worth, liability for partnership debts is restricted.

A limited partnership serves its purpose as a tax shelter medium only if it is treated as a partnership for tax purposes. If it is classified as a corporation, the loss deductions which are the motive for the investment are not available to the partners. From the beginning, the income tax statutes have defined the word "corporation" to include "associations."[25] In *Morrissey v. Commissioner*[26] the Supreme Court established that the word "association" includes any organization, however labeled by state law, that resembles a corporation more than any other type of entity recognized by the tax law. An organization formed as a limited partnership may be an association.[27]

In their exposition of the corporate resemblance test of the *Morrissey* case, the present regulations identify the following characteristics that distinguish corporations from other forms of organization: (1) associates; (2) an objective to carry on business and divide any resulting gains; (3) continuity of life; (4) centralization of management; (5) limited liability; and (6) free transferability of equity interests.[28] Partnerships and corporations share two of the enumerated characteristics, associates and an objective to carry on business and divide the gains. These are not helpful, therefore, in distinguishing partnerships from corporations, and the regulations require that they be ignored when the issue is whether an entity is a partnership or an association.[29] An entity is deemed an association under the tests of the regulations if it possesses more than one half of the corporate characteristics taken into account.[30] An entity organized as a partnership under state law will be an

24. A corporation may be a partner, general or limited, under the laws of most states. The UPA defines a partnership as "an association of two or more persons," UPA §6(1), and includes corporations within its definition of "person." UPA §2. The UPA applies to limited partnerships except where the ULPA is inconsistent with it, UPA §6(2), and the latter is silent on this issue. The only impediment to a corporation being a partner is the doctrine, which may still be the law in a few states, that a corporation acts ultra vires by undertaking to be a partner. *See* J. CRANE & A. BROMBERG, THE LAW OF PARTNERSHIPS 52-55 (1968).

25. INT. REV. CODE OF 1954, §7701(a)(3). The history of the statute is traced in Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 609-23 (1965). The word "partnership" is also defined in the statute. INT. REV. CODE OF 1954, §§761(a), 7701(a)(2). That definition, however, serves principally to distinguish partnerships from mere joint ownership of property and other groups which are not organized as joint undertakings for profit. *See* TREAS. REG. §1.761-1(a). A tax shelter venture organized under state law as a limited partnership can be assumed to be a partnership for tax purposes unless it is deemed an association.

26. 296 U.S. 344, 1936-1 U.S.T.C. ¶9020 (1935).

27. Giant Auto Parts, Ltd., 13 T.C. 307 (1949).

28. TREAS. REG. §301.7701-2(a)(1).

29. *Id.* §301.7701-2(a)(2).

30. *Id.* §301.7701-2(a)(3).

association for tax purposes, therefore, if it has three or four of the following characteristics: continuity of life, centralization of management, limited liability and free transferability of interests. The seeming precision of the regulation tests is weakened, however, by a statement that in some cases factors other than those enumerated may be relevant.[31]

The regulations contain several references to the application of the corporate resemblance test to limited partnerships. The rules for limited partnerships are derived in large part from the opinion of the Board of Tax Appeals in *Glensder Textile Co.*,[32] a case which arose in a context far removed from the present usage of limited partnerships in tax shelter investments. The limited partnership there involved, a successor to an earlier general partnership, was engaged in a mercantile business which was profitable in all years at issue. The business was organized as a limited partnership under a statute closely resembling the Uniform Limited Partnership Act to allow the owners to make gifts of equity interests without admitting the donees to the management group. The court held it to be a partnership for tax purposes. Although the court recognized that some limited partnerships may properly be classified as associations,[33] the tests applied in the opinion would characterize most of them as partnerships.

Following that lead, the regulations indicate that a limited partnership formed under a statute following the pattern of the Uniform Limited Partnership Act will be deemed an association only in unusual circumstances. Read literally, the regulations provide that two of the four relevant characteristics, continuity of life and limited liability, may never be possessed by a limited partnership.[34] Since an entity is an association only if it has more corporate attributes than it lacks, the regulations can be construed to say that a limited partnership is an association only when factors other than the four principal characteristics are present in sufficient force to turn the scales.

Rulings recognizing limited partnerships as partnerships were issued rather freely prior to 1969, and the experience of practitioners in dealing with the Service seemed generally to confirm that limited partnerships would almost always be deemed partnerships for tax purposes. During 1969 or 1970, however, the Service began applying previously unmentioned criteria in passing upon ruling requests.[35] The criteria were not then stated in any published pronouncement and became known to practitioners only through direct dealings with the Service and by word of mouth. Knowledge so acquired was unreliable because the attitudes of the Service seemed to be in a state of flux.

The first public announcement of the change in climate was *Revenue Procedure 72-13*.[36] It states several conditions, each of which must be satisfied before the Service will rule favorably on the status of a limited

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31. *Id.* §301.7701-2(a)(1).
32. 46 B.T.A. 176 (1942), *acquiesced in*, 1942-1 CUM. BULL. 8.
33. 46 B.T.A. at 183.
34. See text accompanying notes 72-73 and 116-129 *infra*.
35. *See Points to Remember*, 24 TAX LAWYER 666 (1971).
36. 1972-1 CUM. BULL. 735.

partnership with a corporation as its only general partner. The conditions imposed bear no obvious relationship to the criteria stated in the regulations. No ruling will issue, for example, if limited partners own more than 20 percent of the stock of the corporate general partner.[37] Also, the net worth of the corporate general partner is required to satisfy a rigid numerical standard.[38] Furthermore, the Procedure stopped short of clearing the waters the Service had muddied by its change in position. It only provides rules to be applied in passing upon ruling requests and does not state the standards applied in auditing partnerships that do not satisfy the new rules. Applying only when a corporation is the *sole* general partner of a limited partnership, the Procedure provides no guidance for cases involving partnerships with two or more corporate general partners, with individuals and corporations as general partners, or with only individuals as general partners.

Soon after the issuance of *Revenue Procedure 72-13* it became apparent to practitioners that compliance with the criteria stated there and in the regulations was not always sufficient to insure a favorable response to a ruling request.[39] *Revenue Procedure 74-17*[40] confirmed that the earlier procedure had not exhausted the Service's creativity. The new procedure does no more than describe cases in which the Service will and will not rule. It does not purport to be an embroidery on the definition of association. Rather, it is premised on a policy that the Service will not rule on the effect of a transaction which has as "its principal purpose the reduction of federal taxes."[41] Pursuant to that policy the Procedure states that a ruling ordinarily will not issue as to the status of a limited partnership when the general partners, whether individual or corporate, do not have at least a one percent interest in each item of partnership income, gain, deduction or loss.[42] It also provides that the Service ordinarily will not rule if the partnerships' distributive shares of partnership loss will exceed their equity contributions during the first two years of the operation of a limited partnership.[43]

More recently, the Tax Court in *Phillip G. Larson*[44] and the Court of Claims in *Zuckman v. United States*[45] classified the limited partnerships before the courts in those cases as partnerships, not associations, for tax purposes. The partnerships, which were organized as tax shelter media, each failed

37. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

38. *Id.* The procedure also imposes two other conditions of less general application. A ruling will not issue if securities of the corporate general partner are offered as part of a package including limited partnership interests. And the Service will rule only when local statutes governing limited partnerships are complied with. *Id.*

39. Kanter, *Real Estate Tax Shelters, Everything You Wanted to Know but Did not Know What to Ask,* 51 TAXES 770, 780 (1973).

40. 1974-1 CUM. BULL. 438.

41. Rev. Proc. 74-17, 1974-1 CUM. BULL. 438.

42. *Id.*

43. *Id.* The procedure also imposes a third condition of less general application which precludes the issuance of a ruling when a person making a nonrecourse loan to a limited partnership acquires an equity interest in the partnership as part of the loan transaction. *Id.*

44. 66 T.C. No. 21 (Apr. 27, 1976).

45. 524 F.2d 729, 75-2 U.S.T.C. ¶9778 (Ct. Cl. 1975).

to meet the rulings criteria stated in *Revenue Procedures 72-13 and 74-17.* The court did not cite the procedures, but held the regulations, so long as they remain in force, to be binding on the government. The regulations were held to require partnership classification in the cases at hand. The Tax Court opinion repeatedly emphasized, however, that the authority which empowered the Treasury to promulgate the present regulations included power to amend them.[46] The opinion also stated that given regulations allowing more flexibility in their application, the court would have found the limited partnerships before it to have been associations.[47] It is evident that the issues have not been put to rest.

THE REGULATIONS

The regulations describe four characteristics deemed relevant to the distinction between corporations and partnerships: continuity of life, centralization of management, limited liability, and free transferability of interests.[48] In the absence of special circumstances making other factors relevant, an entity organized as a partnership will be treated as a partnership for tax purposes and will not be deemed an association unless it possesses more than two of the characteristics.[49]

Continuity of Life

The legal existence of a corporation is not affected by the death, bankruptcy, or other change in the status of any shareholder or by an attempt of a shareholder to withdraw from the corporation.[50] As the Tax Court stated in *Phillip G. Larson,* "a corporate shareholder's investment is locked in unless liquidation is voted or he can find a purchaser to buy him out."[51] A corporation, in sum, has continuity of life. A general partnership, on the other hand, is dissolved by the death or bankruptcy of a partner or by a partner's unilateral decision that it be dissolved.[52] Because dissolution of a partnership entitles each partner to have the business wound up and his interest liquidated,[53] "a partner can always opt out of continued participation

46. The court quotes a passage from Morrisey v. Commissioner, 296 U.S. 344, 354-55, 1936-1 U.S.T.C. ¶9020, at 9244 (1935) that stated that the generality of the statutory definition leaves much to be filled in by administrative construction and concluded: "Nor can this authority be deemed to be so restricted that the regulations, once issued, could not later be clarified so as to meet administrative exigencies or conform to judicial decision." 66 T.C. No. 21 n.8 (Apr. 27, 1976). At a later point the court referred to the quoted language as outlining "respondent's future possibilities." *Id.* at n.24.

47. 66 T.C. No. 21 (Apr. 27, 1976).

48. TREAS. REG. §301.7701-2(a)(1), (2).

49. *Id.* §301.7701-2(a)(3).

50. *See, e.g.,* FLA. STAT. §607.011(1)(a) (1975).

51. 66 T.C. No. 21 (Apr. 27, 1976).

52. UPA §31. A partner of a general partnership has the power to cause dissolution of the partnership by his unilateral act even though he has agreed to remain a partner for a fixed term and his withdrawal breaches his agreement and renders him liable in damages. *Id.* §31(2).

53. UPA §38. The Act distinguishes between dissolution and termination. Dissolution

in and exposure to the risks of the enterprise."[54] Partnerships generally do not have continuity of life.[55]

A limited partnership occupies intermediate ground in this respect. The death, bankruptcy or purported withdrawal of a limited partner does not dissolve a limited partnership,[56] but the retirement, death, insanity or bankruptcy of a general partner does.[57] The regulations state that the possibility of a limited partnership being dissolved by a change in a general partner's status causes the partnership to lack the characteristic of continuity of life.

Because corporate existence may be either perpetual or limited in duration,[59] an agreement that a partnership will continue for a fixed term neither negates nor creates continuity of life.[60] A partner's undertaking to refrain from all acts that would cause dissolution is also apparently irrelevant under the regulations. Such an undertaking cannot be specifically enforced in many instances. A general partner's retirement causes dissolution of a limited

of a partnership ends the mutual agency except for the purpose of completing transactions in progress and winding up partnership affairs. UPA §33. A dissolved partnership remains in existence, however, until terminated by the winding up of its affairs. *Id.* §30.

54. 66 T.C. No. 21 (Apr. 27, 1976).

55. TREAS. REG. §301.7701-2(b)(1). The regulations look solely to the possibilities of partnership dissolution in reaching this conclusion and the word termination is not used. See note 53 *supra*. Termination is not an inevitable consequence of dissolution. When a partner causes a dissolution in contravention of the partnership agreement, for example, the other partners are entitled to continue the partnership business in the same name and thereby avoid termination. UPA §38(2)(b). However, because only dissolution is relevant under regulations, the power of a partner to cause dissolution by his withdrawal causes general partnerships to lack continuity of life.

56. J. CRANE & A. BROMBERG, *supra* note 24, at 517-19. The ULPA unfortunately leaves these matters to implication. Sections 19 and 21 provide rules governing the assignment of a limited partner's interest and the death of a limited partner, respectively, and do not suggest that either occurrence effects a dissolution. Section 20 provides that the retirement, death or insanity of a general partner causes dissolution, but there is no provision stating or implying that any act or change in status of a limited partner has that effect.

57. Section 20 of the ULPA states that the death, retirement or insanity of a general partner dissolves a limited partnership. The Court, in construing a California statute that contains the provisions of the UPA and ULPA relevant to the issue, held that the bankruptcy of a general partner also dissolves a limited partnership. Phillip G. Larson, 66 T.C. No. 21 (Apr. 27, 1976). Crane and Bromberg apparently agree. CRANE AND BROMBERG, *supra*, note 24 at 518. The UPA, the Tax Court noted, provides for dissolution on the bankruptcy of any partner and states that it applies to limited partnerships "except insofar as the statutes relating to such partnerships are inconsistent." UPA §§31(5), 6(2). Since the ULPA does not specify the effect of bankruptcy of a general partner, the Tax Court thought the UPA provision should apply. 66 T.C. at . The statutes do not compel that conclusion. Section 20 of the ULPA states that a limited partnership is dissolved by the retirement, death or insanity of a general partner and it could be read to imply that no other event affecting a general partner should have that effect. However, all of the reasons for dissolution on the bankruptcy of a partner of general partnership apply to the bankruptcy of a general partner of a limited partnership, since the rights and obligations of general partners are closely parallel in general and limited partnerships. ULPA §9. Bankruptcy of a general partner of a limited partnership should therefore be viewed as an event causing dissolution.

58. TREAS. REG. §301.7701-2(b)(1).

59. *See, e.g.*, FLA. STAT. §607.011(1)(a) (1975).

60. TREAS. REG. §301.7701-2(b)(3).

partnership, for example, even though it is a breach of his obligations under the partnership agreement.[61] It is a partner's power to effect a dissolution, not his right to do so, that causes a partnership to lack the continuity required by the regulations.[62]

Continuity is not created, furthermore, by provisions of a limited partnership agreement granting to the remaining partners or general partners a right to continue the partnership after the retirement, death or insanity of a general partner.[63] In *Glensder Textile Co.* the Board of Tax Appeals characterized such provisions as creating only a "contingent continuity of existence,"[64] and, like the author of the regulations, distinguished them from the certainty of continuity provided by corporate law.

An unpublished Technical Advice Memorandum issued by the Service in 1972 held that a partnership agreement allowing limited partners to replace a retiring general partner by less than a unanimous vote gives continuity of life if the partnership cannot be terminated at the will of a general partner.[65] The holding is not easily reconciled with the rules stated in the regulations. Although a provision for electing a new general partner by majority vote reduces the possibility of premature termination of a partnership, the focus of the regulations is on dissolution, not termination.[66] Under the California statute applied in the Memorandum the bankruptcy of a general partner probably dissolves a limited partnership even though a procedure for replacing the bankrupt partner may avoid termination.[67] Termination also could result from bankruptcy of a general partner, notwithstanding the election procedure, if no candidates were proposed as replacements for the general partner or if none received the needed majority vote. The Uni-

61. Section 20 of the ULPA states that a general partner's retirement causes dissolution, but does not define the word retirement. Although the UPA does not use the word retirement, it provides that a partnership is dissolved "by the express will of any partner at any time," even though that consequence is "in contravention of the agreement between the partners." UPA §31(2). Since the UPA applies to limited partnerships except when inconsistent with the ULPA, UPA §6(2), there seems little doubt that a general partner's retirement in contravention of his agreement to continue for a fixed term would be deemed to dissolve a limited partnership. Zuckman v. United States, 524 F.2d 729, 737, 1975-2 U.S.T.C. ¶9778, at 88,435 (Ct. Cl. 1975).

62. In describing the effect of an agreement that a partnership continue for a fixed term, the regulations state: "Nevertheless, if, notwithstanding such agreement, any member has the power under local law to dissolve the organization, the organization lacks continuity of life." TREAS. REG. §301.7701-2(b)(3). The partnership involved in Zuckman v. United States, 524 F.2d 729, 1975-2 U.S.T.C. ¶9778 (Ct. Cl. 1975), was a party to a loan guarantee agreement prohibiting acts which would dissolve the partnership. Although the relevant provisions of the agreement were incorporated in the partnership agreement, the court found the general partner had power to cause dissolution in violation of the agreement and held the partnership lacked continuity of life. *Id.* at 737, 1975-2 U.S.T.C. at 88,435.

63. TREAS. REG. §301.7701-2(b)(1).

64. 46 B.T.A. 176, 185 (1942), *acquiesced in*, 1942-1 CUM. BULL. 8.

65. The Memorandum is reproduced in BIERMAN, LIMITED PARTNERSHIPS 91-97 (1974).

66. See note 55 *supra*. The distinction between dissolution and termination is discussed in note 53 *supra*.

67. Phillip G. Larson, 66 T.C. No. 21 (Apr. 27, 1976) so construed the statute. See note 57 *supra*.

form Limited Partnership Act, unlike the California statute applied in the Memorandum, gives general partners the power to cause dissolutions in all cases by their unilateral acts,[68] and the author of the Memorandum conceded its holding would not apply to partnerships organized under unmodified enactments of the uniform act. Furthermore, *Phillip G. Larson*, a case governed by the California statute involved in the Memorandum, held that continuity of life was not created by a partnership agreement entitling limited partners, by a majority of 51 percent in interest, to elect a successor general partner.[69]

The Service may also contend that continuity of life exists when the remaining general partners of a limited partnership are required by agreement to continue the partnership after the withdrawal of any of them. Even though such an agreement may prevent dissolution as long as any general partner remains,[70] the partnership will dissolve on the death, retirement, insanity, or bankruptcy of the last general partner.[71] Under the regulations, that possibility negates continuity of life.

There appear to be no means under the Uniform Limited Partnership Act by which continuity in the life of a limited partnership can be created with the same certainty as is provided by the law of corporations. Arrangements can be made that so reduce the possibility of dissolution that a practical equivalent of corporate continuity exists. The regulations, however, appear to demand more. They state, without qualification, that "a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act [lacks] continuity of life."[72] The Tax Court has found that the emphasis in the regulations on the legal concept of dissolution rather than the practical possibility of termination of the business virtually requires that conclusion.[73]

The rules of the regulations relating to continuity of life do not refer specifically to limited partnerships with corporations as their general partners. A corporation presumably cannot experience two of the events which cause dissolution of a limited partnership: death and insanity. However, a corporate general partner may cause dissolution by its retirement, even though the retirement breaches its obligations under the partnership agreement, or by its bankruptcy.[74] Under the rules of the regulations, the issue of continuity appears to be unaffected by whether general partners are individual or corporate.

Centralized Management

The regulations state: "An organization has centralized management if

68. See note 61 *supra*.
69. 66 T.C. at .
70. Section 20 of the ULPA provides that the retirement, death or insanity of a general partner will not cause dissolution of a limited partnership if "the business is continued by the remaining general partners under a right to do so stated in the certificate."
71. ULPA §20. Dissolution would also result if the remaining general partners refused to abide by their agreement to continue the business after the death, retirement or insanity of any of them.
72. TREAS. REG. §301.7701-2(b)(3).
73. Phillip G. Larson, 66 T.C. No. 21 (Apr. 27, 1976).
74. See notes 57 and 61 *supra*.

any person (or group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed."[75] The board of directors of a corporation is vested with the exclusive power to manage its business.[76] No shareholder, acting as such, can represent it or bind it by contract. A corporation has centralized management. Each partner of a general partnership, in contrast, is an agent of the partnership with at least apparent authority to carry on its business in the usual way.[77] Although partners may agree among themselves to restrict their mutual agency, the restriction does not bind persons without knowledge of it. A general partnership therefore lacks centralized management.[78]

The power to manage the business of a limited partnership is vested solely in its general partners.[79] Limited partnerships have centralized management in a sense, but generally not in the sense intended by the regulations. The directors of a corporation act as elected representatives of the shareholders. A director usually need not be a shareholder[80] and even if he is his authority is independent of his status as a shareholder. A general partner of a limited partnership, on the other hand, is not a mere representative. He is authorized to act for the partnership only because he is a partner and acts, at least in part, on his own behalf as part owner of the business. The Board of Tax Appeals concluded in *Glensder Textile Co.* that centralized management exists only when management functions are centralized in persons who, like corporate directors, act as representatives of the owners and that the sort of centralization that occurs in the operation of most limited partnerships is not analogous to corporate centralization.[81] The regulations reflect that conclusion by providing that a limited partnership formed under the Uniform Limited Partnership Act generally does not have centralized management.[82]

A general partner acts as an agent of the partnership.[83] Like all agents, he must faithfully represent his principal[84] and cannot act solely to serve his

75. TREAS. REG. §301.7701-2(c)(1).

76. *See, e.g.*, FLA. STAT. §607.111(1) (1975).

77. UPA §9.

78. TREAS. REG. §301.7701-2(c)(4).

79. ULPA §§9, 10. A limited partner who "takes part in the control of the business" is liable for partnership debts to the same extent as a general partner. *Id.* §7.

80. *See, e.g.*, FLA. STAT. §607.111(2) (1975).

81. Glensder Textile Co., 46 B.T.A. 176, 185 (1942), *acquiesced in*, 1942-1 CUM. BULL. 8.

82. TREAS. REG. §301.7701-2(c)(4). Prior to the adoption of the cited regulation, the Treasury proposed a regulation stating that all limited partnerships had centralization of management. *See* Rustigan, *Effect of Regulation Definitions on Real Estate Syndications*, N.Y.U. 19TH INST. ON FED. TAX. 1065, 1071 (1961). Although the final regulation does not explain the basis for the rule it adopts, the change evidently derived from an acceptance of the rationale of *Glensder Textile Co.* that centralization of management in the corporate sense exists only when managers act primarily as representatives.

83. Section 9 of the ULPA provides a general partner has the rights, powers and liabilities of a partner in a general partnership. The UPA states a "partner is an agent of the partnership for the purpose of its buiness." UPA §9(1).

84. RESTATEMENT (SECOND) OF AGENCY §13 (1957).

own interests. The regulations are apparently premised on a belief that the representative capacity of a general partner is usually subordinate. The opposite is obviously true, however, when a general partner's interest in a partnership is insubstantial. The regulations therefore provide that a limited partnership will be regarded as having centralized management if "substantially all the interests in the partnership are owned by the limited partners."[85] This test leaves many questions unanswered. It is not stated, for example, when the test is applied. Presumably the existence or lack of centralized management is not determined for all time when a limited partnership is formed. If substantially all interests are owned by limited partners at any time, centralized management will probably be deemed present for the period that situation persists.[86] Also, the meaning of the phrase "substantially all" is explained only by examples indicating that more than 90 percent is "substantially all."[87] The Service will apparently rule there is no centralization of management, however, when limited partners own no more than 80 percent of all interests.[88]

The phrase "all the interests in the partnership" is also less than precise. Partners may share profits and losses in proportions different from their proportionate interests in partnership capital. General partners often receive guaranteed payments, computed independently of partnership profits, as compensation for their services. Profit and loss sharing arrangements and capital accounts may change from year to year. How do such variables affect the measurement of the substantiality of limited partner's interests?

Examples given in the regulations imply that only capital interests are relevant.[89] The Service will apparently rule that limited partners do not own substantially all interests, however, when general partners have at least

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85. TREAS. REG. §301.7701-2(c)(4).

86. In Phillip G. Larson, 66 T.C. No. 21 (Apr. 27, 1976), the court indicated that the relative values of the interests in the years at issue should be the controlling factor.

87. Centralization is found in two examples in the regulations in which limited partners furnished capital of $5 million out of total capitalizations of $5,300,000 and $5,150,000, respectively. TREAS. REG. §301.7701-3(b)(2), Exs. (1), (2).

88. *See Points to Remember*, 24 TAX LAWYER 605, 606 (1971); Kanter, *supra* note 38, at 777. In applying the regulation rules relating to free transferability of interests, which also turn in part on whether substantially all interests are held by limited partners, the court in Zuckman v. United States, 524 F.2d 729, 742, 1975-2 U.S.T.C. ¶9778, at 88,439 n.14 (Ct. Cl. 1975) cited with approval Burnet v. Bank of Italy, 46 F.2d 629, 630 (9th Cir. 1931), *cert. denied*, 283 U.S. 846 (1931), which defined the phrase "substantially all" in another context as "all except a negligible minority interest." The court also found persuasive the use of 90% as a rule of thumb in applying the phrase "substantially all the properties" in §368(a)(1)(C). Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232. The rule of thumb is applied there for ruling purposes only, however, and is not intended as a substantive rule defining the lower limits of "substantially all." On the facts before it, the *Zuckman* court held that limited partner ownership of 61% of all interests did not create centralization of management.

89. The only examples illustrating the application of the regulation rules to limited partnerships describe the capital contributions of the partners but make no reference to the agreements for sharing profits and losses. TREAS. REG. §301.7701-3(b)(2), Exs. (1), (2). The author of the examples may have intended, however, that it be assumed that profits and losses were divided in proportion to capital contributions.

a 20 percent interest in either capital or profits.[90] A general partner's entitlement to management fees or other compensation for its services has not been regarded as part of its partnership interest.[91]

Phillip G. Larson[92] was a case in which interests changed over time. The two partnerships before the court were created under agreements allocating all profits and all proceeds of the sale of partnership assets to the limited partners until such allocations equalled their investments. Thereafter, profits and sale proceeds were to be allocated 80 percent to the limited partners and 20 percent to the general partner.[93] In essence, the general partner had a 20 percent interest in the profits and capital of each partnership, subject to the limited partners' rights to recover their investments first.[94] The court found the taxpayer had not shown the likelihood that any substantial allocations would ever be made to the general partner and thus held they had failed to sustain their burden of proving that substantially all of the interests were not held by limited partners. The interests of the general partner were also minimized, the court held, by the power granted to the limited partners in each agreement to remove the general partner. Although the court did not clearly state the standard it would apply when such evidentiary problems were overcome, it suggested that the values of the interests in the years at issue would be the determining factor.

Further complexities arise in applying the test of the regulation when a person has an interest in a partnership as both a general and a limited partner.[95] Assume, for example, that an individual acting as sole general partner of a limited partnership has a 30 percent interest as general partner and a five percent interest as limited partner. The limited partners, in their capacities as such, own only 70 percent of all interests, but viewing their ownership in all capacities they own 100 percent of all interests. The former percentage should probably be the one relevant to the centralization issue. The general partner's ownership of a limited partnership interest increases the extent to which he acts on his own behalf and hence reduces his representative role. In fact, the general partner in the example acts in a representative capacity with respect to only 65 percent of the partnership interests and that should perhaps be the percentage deemed relevant.

When there is a corporate general partner and limited partners are shareholders of the corporation, the interests of limited partners could be

90. *See Points to Remember*, 24 TAX LAWYER 605, 606 (1971); Kanter, *supra* note 39, at 777.

91. Technical Advice Memorandum of September 25, 1972, reproduced in BIERMAN, LIMITED PARTNERSHIPS 91, 96 (1974); Zarrow, *Tax Shelters and the Public—New Uses for Limited Partnerships and Joint Ventures*, U. SO. CAL. TAX INST. 277 (1970).

92. 66 T.C. No. 21 (Apr. 27, 1976).

93. Losses were allocated solely to limited partners at all times.

94. Another common factual variant raising the same problem is an arrangement which allocates profits and losses to limited partners only for a stated period of time, after which profits and losses are shared by all partners.

95. Section 12(1) of the ULPA states: "A person may be a general partner and a limited partner in the same partnership at the same time." The status of a person occupying such a dual role is described in §12(2) of the Act.

calculated by taking into account their indirect interests in the partnership as shareholders of the corporation. In *Zuckman v. United States*,[96] for example, a limited partner holding a 47 percent interest in a partnership was indirect owner of all shares of the corporate general partner which held a 51 percent interest. The government asserted that the general partnership interest should be attributed to the limited partner and that all interests should therefore be deemed held by limited partners. The court held that no attribution rules were implicit in the regulations, but further stated that, assuming the attribution could be made as suggested by the government, the ownership of 98 percent of all interests by one person was by itself sufficient to warrant a finding of no centralization. In view of the fact that a corporation wholly owned by one person is a corporation for tax purposes, the latter holding is of doubtful validity. The facts in *Zuckman* do show a practical equivalent of centralized management in the sense that the board of directors of the corporate general partner acted as representatives of a person owning 98 percent of all interests in the partnership. The representation so created is much closer to corporate centralization than that occurring when an independent general partner has no substantial interest in a limited partnership. However, the regulations, by focusing the issue solely on the extent of limited partner interests, preclude a finding of centralization based on such a practical equivalence.

The position of the government in *Zuckman* can be sustained under the regulations, therefore, only by reading rules of attribution into them. Historically, attributions between related parties, when intended, have not been left to implication.[97] Furthermore, attribution concepts, if accepted in principle in this area, quickly lead to a quagmire. Assume, for example, a child is a limited partner of a partnership in which his parent is a general partner. It has earlier been suggested that an individual general partner's ownership of a limited partnership interest does not create corporate resemblance. Thus, any attribution from child to parent or vice versa in the example assumed would likely lead to improper results if deemed relevant to the association issue. If related party attributions are to be made in some instances, but not in others, the courts may reasonably look to the regulations for guidance before embarking on the first step.

Free Transferability of Interests

Unless bound by an agreement providing otherwise, a shareholder of a corporation can freely dispose of his shares and any transferee succeeds to all his rights. A corporation thus possesses the characteristic of free transferability of interests. A transferee of an interest in a partnership, on the other hand, does not become a partner unless the other partners

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96. 545 F.2d 729 (Ct. Cl. 1975).

97. INT. REV. CODE OF 1954, §§267(c), 318, 341(e)(8), 544, and 958 each set forth rules for attributing ownership of corporate stock to related persons. The service has adopted the attribution rules of §318 in determining the status of limited partnerships for rulings purposes. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

consent.[98] In the absence of that consent, the transferee takes the interest of his transferor in the profits and capital of the venture, but is excluded from all rights to participate in management and may require an accounting for partnership transactions only upon dissolution.[99] An organization has the characteristic of free transferability only if each member may, without the consent of the others, "confer upon his substitute all the attributes of his interest in the organization."[100] Unless consent to substitute transferees as partners is given by the partnership agreement, a partnership does not possess the characteristic of free transferability of interests.

Since limited partners are always excluded from management, the failure of a transferee to become a substituted partner is less significant when the subject of a transfer is a limited partnership interest than when a general partnership interest is transferred. However, a transferee of a limited partnership interest who does not become a substituted partner has no right to an accounting or to information concerning partnership transactions.[101] The absence of such rights perhaps justifies the position of the regulations that a limited partnership interest, like a general partnership interest, is freely transferable only if the holder has the power to substitute another as partner without the consent of his fellow partners.[102]

The regulations provide that free transferability of limited partnership interests is negated by conditioning the right of substitution upon the consent of general partners only.[103] Limited partners need not have any say in the matter. Although the regulations refer only to a case in which the unanimous consent of all general partners is required, the same result would presumably follow when a mere majority of the general partners can authorize a substitution.

The Tax Court held in *Phillip G. Larson*[104] that limited partnership interests in the partnerships at issue were freely transferable notwithstanding a requirement of general partner consent to substitutions because the

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98. UPA §27; ULPA §19.

99. *Id.*

100. TREAS. REG. §301.7701-2(e)(1).

101. ULPA §19(3).

102. Some limited partnerships are structured to have only one limited partner who sells fractional shares of his interest in profits, losses and capital to other investors. Since the investors are not admitted as substituted limited partners, it is hoped that the partnerships will lack free transferability even though there are no restrictions on the transfer of the fractional shares. Zarrow, *supra* note 91, at 283. Although not denying that the device precludes free transferability, the Service has thrown a damper over it by refusing to rule on whether an assignee who is not a substituted partner will be treated as a partner for income tax purposes. See *Points to Remember*, 28 TAX LAWYER 625-26 (1975). Evans v. Commissioner, 447 F.2d 547, 1971-2 U.S.T.C. ¶9597 (7th Cir. 1971) held, however, that an assignee of a partnership interest (which was a corporation wholly owned by the assignor) became a partner for tax purposes even though it was not admitted as a substituted partner. The consequence of not recognizing an assignee as a partner would be that profits and losses would be allocated to the assignor for tax purposes even though he has no economic interest in them. The absurdity of such a result speaks strongly against any rule leading to it.

103. TREAS. REG. §301.7701-3(b)(2), Ex. (1).

104. 66 T.C. No. 21 (Apr. 27, 1976).

partnership agreements provided the general partner could not unreasonably withhold its consent. Because a limited partner is a passive investor without any voice in management, the welfare of a limited partnership will rarely be affected by the identity of its limited partners and there will seldom be a reasonable ground for withholding consent to a substitution. The Tax Court thus found that a consent requirement does not impose a meaningful restriction on transfer if consent may not be unreasonably withheld. *Zuckman v. United States*[105] held that a requirement of general partner consent did not deny free transferability to a limited partnership interest held by a person who controlled the general partner: "[T]he existence of a mere formal or nominal condition will not prevent such member's interest from being freely transferable within the meaning of the regulations."[106] The holdings in *Larson* and *Zuckman*, although quite logical in themselves, tend to undermine the rule stated in the regulations. When a partnership agreement does not provide standards to be applied by a general partner in granting or denying his consent to a substitution, for example, it is unlikely that a court would construe the agreement to permit a general partner to withhold his consent unreasonably.[107] If a provision requiring that consent not be withheld unreasonably merely states what the law would imply in its absence, the presence of the provision should not affect any tax result. A "formal or nominal condition" seems to be enough to deny free transferability under the regulations.

If a partnership agreement entitles each partner to substitute another in his place, but only after he has offered his interest to the other partners at its fair market value, "a modified form of free transferability of interests exists."[108] The rule, unfortunately, raises more questions than it answers.

It is not clear, for example, how a modified form of transferability affects the ultimate conclusion on association status differently than an unmodified form of that characteristic. The regulations state that "the presence of this modified corporate characteristic will be accorded less significance than if such characteristic were present in an unmodified form."[109] However, the basic test of the regulations is that an entity is an association if it possesses more of the relevant corporate characteristics than it lacks.[110] In distinguishing between partnerships and corporations, four characteristics are relevant. A modified characteristic plus an unmodified characteristic or two unmodified characteristics will not be enough. But, two unmodified characteristics plus

105. 524 F.2d 729, 1975-2 U.S.T.C. ¶9778 (Ct. Cl. 1975).

106. *Id.* at 743.

107. A general partner would probably be deemed to act as a partner, and not individually, in granting or denying his consent. As a partner, a general partner acts as an agent of the partnership and like all agents must act as a fiduciary in carrying out his duties. A fiduciary must act reasonably in doing his work.

108. TREAS. REG. §301.7701-2(e)(2). In Phillip G. Larson, 66 T.C. No. 21 (Apr. 27, 1976), the Tax Court held that free transferability is present in unmodified form when a right of first refusal is the only restraint on transfer and is exercisable only when a partner proposes to dispose of his interest for less than fair market value.

109. TREAS. REG. §301.7701-2(e)(2).

110. *Id.* §301.7701-2(a)(3).

a modified one will apparently mandate association status just as three unmodified characteristics will. If that is so, there is seemingly no difference in weight between a modified and an unmodified characteristic. If a modified characteristic, when added to two unmodified characteristics, is not enough to bring association status, then the presence of a modified characteristic is irrelevant.

In referring only to a right of first refusal granted to other partners to purchase at fair market value, the regulations leave uncertainty as to the consequence of other restrictions which are similar in effect. Will a modified form of free transferability exist, for example, if the only restriction on the power of substitution is that a partner desiring to sell must first allow the partnership to retire his interest for an amount equal to its fair market value? A retirement of a partner's interest may entail tax consequences to him different from those arising from a sale of his interest to another partner.[111] However, a right of first refusal imposes essentially the same limitation on transferability whether it is granted to the partnership or to the other partners. The two types of restrictions should not have differing effects upon the association issue.

The regulations refer only to a right of first refusal exercisable at a purchase price equal to fair market value. Must the agreement use the phrase "fair market value" or will the rule apply when the option price is determined by a formula stated in the agreement? The effect of a formula price should probably depend on whether the formula is reasonably calculated to yield a price equal to fair market value. If the price is book value of the interest to be sold, for example, it will often be less than fair market value. The prerequisite that an interest be offered at a depressed price will restrict transferability quite significantly, since the making of a transfer may result in a forfeiture. Unless the nature of partnership assets is such that book value is a reasonable measure of market value, provisions for a right of first refusal to purchase at book value should therefore be deemed to negate free transferability of interests. A formula price based upon partnership earnings or the fair market value of partnership assets may represent a realistic measure of fair market value, and a right to purchase at a price so determined should be viewed as a right to purchase at fair market value.

What effect will be given to an agreement granting the remaining partners or the partnership an option to purchase or retire a partner's interest when he dies? Perhaps such an option should be viewed as not affecting the transferability issue since it can only force a transfer and can never block one. The option may make a sale by a living partner more difficult, particularly if the option price may not equal fair market value, because prospective purchasers may be unwilling to buy the interest subject to the option. Even viewed from that perspective, however, the option may be seen as only depressing the value of the interest and as not limiting the right of substitution, since the act of transfer would never cause a forfeiture. Such an option, in sum, should not be relied upon as negating free transferability.

111. INT. REV. CODE OF 1954 §§736, 741.

The regulations state an organization possesses the characteristic of free transferability of interests only if the power of substitution is granted to "each of its members or those members owning substantially all of the interests in the organization."[112] A limited partnership agreement allowing limited partners to substitute freely, but denying the right of substitution to general partners, will not have the characteristic unless the limited partnership interests constitute substantially all of the interests in the partnership. Because a grant of the right of substitution to general partners allows management responsibilities to be passed from hand to hand without the consent of limited partners, few partnership agreements grant that right to general partners.

Limited Liability

The regulations provide that an entity possesses the corporate characteristic of limited liability if it is governed by local laws that relieve all its members of personal liability for debts of the organization.[113] Limited partners are usually not personally liable for claims against the partnership,[114] but general partners enjoy no limitation of liability.[115] Since the regulations state that the corporate characteristic of limited liability is present only when no member of an organization has personal liability for its debts, limited partnerships organized under statutes patterned after the Uniform Limited Partnership Act generally do not have the characteristic.[116]

A general partner is not deemed personally liable for partnership debts, however, "when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when he is merely a 'dummy' acting as the agent of the limited partners."[117] The test and much of the language used to express it are taken from the opinion of the Board of Tax Appeals in *Glensder Textile Co.*[118] The regulations, however, give it a role of less importance than that contemplated by the court. The opinion in *Glensder Textile Co.* states that "there would be something approaching the corporate form of stockholders and directors"[119] whenever all general partners are dummies without substantial assets, which suggests that such circumstances might alone be justification for classifying a limited partnership as an association. The regulations, in contrast, make the test relevant only to the issue of limited liability.

The reference in the regulations to "substantial assets" might, under the circumstances, suggest a relative test. A general partner having assets valued

112. TREAS. REG. §301.7701-2(e)(1).
113. *Id.* §301.7701-2(d)(1).
114. A limited partner's insulation from personal liability is lost only if he "takes part in the control of the business." ULPA §7.
115. ULPA §9(1); UPA §15.
116. TREAS. REG. §301.7701-2(d)(1).
117. *Id.* §301.7701-2(d)(2).
118. 46 B.T.A. 176, 183 (1942), *acquiesced in*, 1942-1 CUM. BULL. 8. The opinion speaks of a hypothetical limited partnership whose "general partners were not men with substantial assets risked in the business, but were mere dummies without real means acting as agents of the limited partners, whose investments made possible the business." 46 B.T.A. at 183.
119. *Id.*

at $10,000, for example, could be regarded as having substantial assets if total liabilities of his partnership are $50,000 or $100,000, but not if they are $5 million or $10 million. However, the regulations indicate the test is an absolute one. They state:

> [I]f the organization is engaged in financial transactions which involve large sums of money, and if the general partners have substantial assets (other than their interests in the partnership), there exists personal liability although the assets of such general partners would be insufficient to satisfy any substantial portion of the obligations of the organization.[120]

Since a meaningful ability to respond to partnership obligations is not required, there is no basis for defining "substantial assets" by reference to the magnitude of the liabilities of a partnership.[121] Without that reference, however, it is very difficult to quantify the meaning of the phrase. The regulations simply leave the issue to baseless speculation.

The "substantial assets" test is applied, of course, by looking to a general partner's assets, not his net worth. A general partner who is hopelessly insolvent may have substantial assets. However, the issue as stated by the regulations is whether a general partner has "substantial assets . . . which could be reached by a creditor of the organization. . . ."[122] Assets encumbered by liens securing individual liabilities of a general partner are therefore taken into account only to the extent of the partner's equity in them.[123]

120. TREAS. REG. §301.7701-2(d)(2).

121. One author has noted, however, that the Service, in audit examinations of his clients, has measured the substantiality of the assets of general partners by computing ratios comparing general partner assets with limited partnership liabilities. Sexton, *The Shrinking Tax Shelter Umbrella*, 52 TAXES 715, 726-27 (1974). Such an approach could perhaps be reconciled with the regulations if the ratio required to show "substantial assets" was quite small. For example, assets valued at 10 or 15% of partnership liabilities might be seen as "insufficient to satisfy any substantial portion of the obligations of the organization." TREAS. REG. §301.7701-2(d)(2). When partnership liabilities are not large, however, a ratio test of 10 or 15% could characterize assets worth only a few hundreds of dollars as substantial.

When measuring substantiality using ratios of general partner assets to partnership liabilities, the Service will apparently treat as liabilities so-called nonrecourse debt on which no partner, general or limited, has personal liability. Such debts are always secured by partnership assets, and a partnership must pay them when due to retain the benefits of its assets. The Service therefore does not regard the lack of personal liability as a sufficient ground for ignoring them. See Sexton, *supra*, at 726-27. A nonrecourse debt, however, is in no sense a charge against the assets of general partners. The relationship between general partner assets and nonrecourse debt is quite clearly relevant to nothing. The presence of nonrecourse debt creates a form of limited liability. However, the regulations, by their focus on the assets and roles of general partners, exclude from consideration any limitation on liability which does not derive from the status of general partners personally.

122. TREAS. REG. §301.7701-2(d)(2).

123. If a general partner grants a security interest in his individual assets to secure partnership liabilities, however, the encumbrance should be ignored for this purpose since the full value of the assets, except to the extent burdened by prior encumbrances, may be "reached by a creditor of the organization." *Id.*

Furthermore, a general partner's interest in the partnership is excluded in determining the substantiality of his assets.[124]

The test for determining whether a general partner is personally liable is phrased in the conjunctive. A general partner without substantial assets lacks personal liability only if it is also shown that "he is merely a 'dummy' acting as agent of the limited partners."[125] The word "dummy" is not defined, but it probably adds little to the meaning of the quoted phrase. Presumably the intelligence of the general partner is not an issue. The dictionary definition of "dummy" evidently intended is "one . . . that although seeming to act for himself is in reality acting for another. . . ."[126] A dummy is an agent acting for an undisclosed principal.

A casual reading of the regulations leaves the impression that a limited partnership has the characteristic of limited liability if all its general partners are dummies with no substantial assets. However, the regulations further state: "when the limited partners act as the principals of such general partner, personal liability will exist with respect to such limited partners."[127] The rule derives from state law, not the tax statutes. The Uniform Limited Partnership Act denies the privilege of limited liability to a limited partner who "takes part in the control of the business."[128] Although the issue has not been ruled on under the Act, it seems reasonable to conclude, as the writer of the regulations apparently did, that a limited partner who designates an agent to act as general partner is participating in the control of the business through the agent and thus loses his insulation from personal

124. *Id.* The regulations do not define the phrase "interest in the partnership." Presumably it refers only to interests held as a partner and does not include the value of a general partner's claims as a creditor of his partnership.

125. *Id.* The government argued in Phillip G. Larson, 66 T.C. No. 21 (Apr. 27, 1976), that the test should be read disjunctively. The plain meaning of the words used in the regulations is to the contrary and the court dismissed the government's contention.

Prior to the adoption of the present regulations, the Treasury proposed regulations making the issue of a general partner's personal liability turn only on the extent of his assets. The reference to dummies was added to the final regulations in response to taxpayer protests that *Glensder Textile Co.* had established that a general partner should never be found to lack personal liability unless he acts "as the agent for the persons who supplied the capital." Rustigan, *Effect of Regulation Definitions on Real Estate Syndicates,* N.Y.U. 19TH INST. ON FED. TAX. 1065, 1073-74 (1961).

The Tax Court indicated in *Phillip G. Larson,* that the Treasury may have been overly generous in yielding to such complaints. The court quoted from the sentence in *Glensder Textile Co.* stating that corporate resemblance would exist "if, for instance, the general partners were not men with substantial assets, but were mere dummies. . . ." 66 T.C. at . Glensder Textile Co., *quoting,* 46 B.T.A. 176, 183 (1942), *acquiesced in,* 1942-1 CUM. BULL. 8. This sentence, the *Larson* court believed, made a general partner's status as a dummy a consequence of his lack of substantial assets, not an independent criterion. The regulations, by substituting "and" for "but," changed the import of the sentence, according to the court, and gave the word "dummy" a meaning not related to the quantity of assets held by general partners. The history of the regulations, as well as the language used, fully supports that conclusion.

126. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE UNABRIDGED 701 (1959).

127. TREAS. REG. §301.7701-2(d)(2).

128. ULPA §7.

liability; or, perhaps the statement in the regulations is based on the liability of a principal for obligations incurred by his agent while acting within the scope of the agency.[129]

The effect of the rule, wherever its base may lie, is seemingly to preclude a limited partnership from possessing the corporate characteristic of limited liability. When all general partners act as agents of limited partners, as they apparently must to be deemed lacking in personal liability under the regulations, the limited partners are principals and have personal liability. In any limited partnership, therefore, either general partners or limited partners are deemed personally liable for partnership debts. The corporate characteristic of limited liability exists, according to the regulations, only when no member of an organization has personal liability. The inevitable conclusion, which the Court of Claims reached in *Zuckman v. United States*,[130] is that a limited partnership may not have the corporate characteristic of limited liability.

Several lines of argument may be advanced in opposition to the categorical position of the Court of Claims. The government argued in *Zuckman* that limited partners become personally liable for partnership debts only when they are held out to third parties as being so liable.[131] When general partners are dummies without substantial assets, but limited partners are not held out as general partners, the government contended, no partner has personal liability. The argument is difficult to square with the Uniform Limited Partnership Act which makes no reference to public representations in its rule imposing personal liability upon limited partners participating in the control of a limited partnership.[132] The argument also ignores the rules of agency law making undisclosed principals liable for obligations incurred by their agents while acting within the scope of the agency.[133] The court rejected the argument.

Judge Simpson, in his dissent in *Phillip G. Larson*,[134] attempted to avoid the dilemma by refining the meaning of the word "dummy." The regulations take the word from the opinion of the Board of Tax Appeals in *Glensder*

129. RESTATEMENT (SECOND) OF AGENCY §140 (1957).

130. 524 F.2d 729, 741-42 (Ct. Cl. 1975).

131. The argument, as summarized by the court, was that a limited partner is personally liable when it is shown that he participated in control and "in addition, that his words or actions have actually and reasonably led third parties to believe that he was generally liable, and to act on that belief." *Id.* at 740. The government argued that a limited partner of the partnership before the court, who was alleged to have exerted management control, did not have personal liability, because he "at all times was held out as only a limited partner." *Id.*

132. ULPA §7. A limited partner who holds himself out as a person responsible for partnership debts may be estopped from denying his liability, even though he does not participate in management. E. LATTY & G. FRAMPTON, BASIC BUSINESS ASSOCIATIONS, 596-97 (1963). Section 7 of the ULPA has not, however, been construed to be premised on estoppel. Walker, *Partnership: Can Rights Required to be Given Limited Partners Under the New Tax Shelter Regulations be Reconciled with Section 7 of the Uniform Partnership Act*, 26 OKLA. L. REV. 289, 293 (1973).

133. RESTATEMENT (SECOND) OF AGENCY §186 (1957).

134. 66 T.C. No. 21 (Apr. 27, 1976).

Textile Co.[135] The *Glensder* court, according to Judge Simpson, did not intend the word to refer only to strawmen or agents in a common law sense, but meant to include any arrangement allowing limited partners the sort of control over general partners that shareholders of a corporation have over directors.[136] A significant characteristic of the relationship between shareholders and directors is the power of shareholders to vote directors out. Judge Simpson would therefore have found the general partner of the partnerships before the court to be a dummy because the limited partners in each case had the power to remove it. The general partner was admitted by all to be without substantial assets, and the power of the limited partners to remove the general partner was not seen as making limited partners personally liable. Judge Simpson would therefore have held no partner was personally liable for the debts of the partnerships at issue. The argument is not readily reconciled with the language of either the regulations or the *Glensder* opinion which both follow the reference to dummies with the phrase "acting as agents of the limited partners."[137] There is no indication in either source that the word "agents" is used in a figurative sense. Furthermore, a power of limited partners to indirectly control a general partner does not affect, legally or practically, the extent of the general partner's responsibility for partnership debts. When a general partner is a common law agent for limited partners, he has a right to be indemnified against liabilities incurred for the benefit of his principals.[138] A relationship between general and limited partners that has some of the characteristics of an agency, but which does not create that right, does not bear upon whether the general partner has personal liability and should not be considered in defining the word dummy.

The regulations contain an enigmatic reference to corporations acting as general partners which may be read to say that a corporate general partner can lack personal liability even though it is not a dummy. The regulations state: "[I]f a corporation is a general partner, personal liability exists with respect to such general partner when the corporation has substantial assets which could be reached by creditors of the limited partnership."[139] The sentence curiously omits any mention of the dummy criterion. The other sentences of the paragraph use the unqualified phrase "general partner" in

135. 46 B.T.A. 176, 183 (1942), *acquiesced in*, 1942-1 CUM. BULL. 8.

136. The Service may define the word "dummy" even more broadly than Judge Simpson. One author has reported that the Service, in auditing certain of his clients, has treated general partners as dummies when they have no capital at risk in their partnerships, receive compensation for their services in amounts determined independently of partnership income, and do not share in partnership profits and losses. Sexton, *supra*, note 121 at 726-27. The financial participation of such a general partner is similar to a typical financial arrangement between agent and principal. It does not, however, make the general partner a common law agent of any limited partner or allow limited partners to control the actions of the general partner. It has no apparent relevance to the issue of a general partner's personal liability and thus should not be considered in applying the word "dummy" in the regulation provision dealing with personal liability. See text accompanying note 138 *infra*.

137. In the Regulations the word "agent" is singular.

138. RESTATEMENT (SECOND) OF AGENCY §438(2)(a) (1957).

139. TREAS. REG. §301.7701-2(d)(2).

stating the dual test for determining whether a general partner has limited liability and give no indication that the rules are different for individual and corporate general partners. However, the isolated reference to corporate general partners implies that they may be deemed lacking in personal liability even when they are not dummies.[140] Furthermore, corporate general partners can reasonably be distinguished from individuals acting in that role. An individual general partner who is not an agent and hence has no right to be indemnified against his undertakings as general partner, can escape the burden of partnership debts only by declaring bankruptcy. Even though he presently has no substantial assets, partnership obligations can be satisfied from his future earnings and assets. The personal liability devolving upon an individual general partner is rarely a trifling matter. A corporate general partner with no substantial assets, on the other hand, can simply be abandoned by its shareholders if the partnership business turns sour and partnership creditors will then have no recourse against any substantial assets or earnings, present or future, outside the partnership. When a corporate general partner has no substantial assets, in sum, its legal liability for partnership debts is not a meaningful burden. Therefore, the Treasury could reasonably ignore the legal liability in such a case and base a finding of limited liability solely upon a corporate general partner's lack of substantial assets. The regulations arguably so provide.[141]

Other Factors

The regulations provide that factors other than the four characteristics primarily stressed may be of importance in some cases in distinguishing partnerships from associations.[142] They do not describe any such factors, however, and the reference was probably intended only to allow flexibility in resolving cases not anticipated by the authors of the regulations. *Morrissey v. Commissioner*[143] established that corporate resemblance is the touchstone of the association concept. A factor not mentioned in the regulations is relevant to the issue, therefore, only if it tends to show or negate corporate resemblance. To be relevant over and above the four primary characteristics, furthermore, a factor should not be related to any of the primary characteristics. For example, Judge Simpson, dissenting in *Phillip G. Larson,*[144] pointed to pro-

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140. Admittedly, the implication is not a strong one. The statement made, that a corporate general partner with substantial assets is deemed to have personal liability, is fully consistent with the dual test expressed in the remainder of the regulation. However, if the "substantial assets" and "dummy" tests both apply to corporate general partners, the rules applied to corporate and individual general partners are identical and the reference to corporate general partner partners is wholly redundant.

141. The argument made here is inconsistent with Zuckman v. United States, 524 F.2d (Ct. Cl. 1975) and Phillip G. Larson, 66 T.C. No. 21 (Apr. 27, 1976), both of which held corporate general partners without substantial assets to have personal liability because they were not dummies. The argument was not advanced by the government in either case, however.

142. TREAS. REG. §301.7701-2(a)(1).

143. 296 U.S. 344 1936-1 U.S.T.C. ¶9020 (1936).

144. 66 T.C. No. 21 (Apr. 27, 1976).

visions allowing limited partners to remove a general partner as a salient additional factor. Judge Dawson, concurring in the same case,[145] disagreed, saying that the only relevance of the removal power was in resolving the issue of centralization of management.[146] As the regulations are presently structured, the latter is the better view. If the power were taken to create a separate corporate attribute, factors bearing on centralization would create two characteristics and the mechanical rules of the regulations would be unfairly biased toward association status.[147]

REVENUE PROCEDURE 72-13

Revenue Procedure 72-13[148] was issued in 1972 to provide guidance to taxpayers seeking advance rulings regarding the tax status of limited partnerships whose only general partners are corporations. Four conditions are stated. They relate to limited partner ownership of the stock of the general partner,[149] the net worth of the general partner,[150] sales of limited partnership interests in conjunction with securities of the general partner,[151] and compliance with state laws governing limited partnerships.[152] A limited partnership having a corporation as its sole general partner will be ruled a partnership for tax purposes only if all of the conditions are satisfied.

Limited Partner Ownership of Stock of General Partner

Revenue Procedure 72-13 states that a ruling on the status of a limited partnership whose only general partner is a corporation will not issue unless "[t]he limited partners will not own, directly or indirectly, individually or

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145. *Id.*

146. A power of limited partners to remove a general partner resembles the power of shareholders to vote directors out. The power of shareholders to elect and remove directors is part of the battery of rules making directors representatives of shareholders and giving corporations the representative form of centralization described in the regulations.

147. An organization is deemed an association only when it possesses more than one-half of the relevant corporate characteristics. TREAS. REG. §301.7701-2(a)(3). Any fraction is, of course, increased by adding one to both its numerator and denominator. A partnership possessing two of the four primary characteristics will be classed as an association, for example, if it is found to also possess a fifth relevant characteristic.

Judge Dawson's concurring opinion in Phillip G. Larson, 66 T.C. No. 21, (Apr. 27, 1976), points to another problem in adding "other factors" to the mechanical procedure prescribed by the regulations. If the presence of some "other factor" is to be taken into account in determining whether an organization has more than one-half of the relevant corporate characteristics, it would seem that the absence of the factor should also be weighed in the formula. If that is so, it cannot be said that any organization has more than one-half of the relevant characteristics until all possible "other factors" are identified and counted. Since the reference to "other factors" is intended as a device to catch unanticipated cases, they are, by definition, not capable of being catalogued.

148. 1972-1 CUM. BULL. 735.

149. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

150. *Id.*

151. *Id.*

152. *Id.*

in the aggregate, more than 20 percent of the stock of the corporate general partner."[153]

The regulations contain no suggestion that limited partner ownership of stock of a general partner may be relevant to the association issue. The imposition of a single requirement which must be met, furthermore, seems to conflict with the general rule of the regulations that an entity is classified as an association only if it possesses more of the relevant corporate characteristics than it lacks.[154] The ownership condition is apparently deemed justified by the statement in the regulations that factors other than those described there "may be found in some cases which may be significant in classifying an organization."[155] Other factors should be relevant, however, only if they bear upon the touchstone of the association concept, corporate resemblance.[156] Can a limited partnership reasonably be seen as resembling a corporation more than a partnership merely because its limited partners own stock of its corporate general partner? A plausible argument can be made that limited partner ownership of stock of a sole corporate general partner can in some situations give a limited partnership practical equivalents of three of the four corporate characteristics given primary emphasis in the regulations: continuity of life, centralized management, and limited liability.

Continuity of life is deemed to exist, for example, "if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization."[157] When the sole general partner of a limited partnership is a corporation, the entity can usually be prematurely dissolved only by the retirement or bankruptcy of the general partner.[158] If a corporate general partner is controlled by limited partners, they will determine, directly or through the directors they elect, whether and when the general partner retires. A decision that the general partner should retire and thereby cause dissolution of the partnership therefore resembles the decision of shareholders that a corporation should be dissolved. The possibility of dissolution by the bankruptcy of a general partner does not fit as readily within the corporate model. However, when limited partners control a corporate general partner, their elected representatives determine the course of action which may lead the corporation to bankruptcy. A limited partnership must be declared a bankrupt when its sole general partner enters bankruptcy.[159] The bankruptcy of a sole corporate general partner controlled by limited partners therefore bears a certain resemblance in its effect on entity continuity to the bankruptcy of a venture conducted wholly in corporate

153. *Id.* This rule also forbids limited partner ownership of more than 20 percent of the stock of any corporation in an affiliated group (as defined in Int. Rev. Code of 1954, §1504(a)) that includes the corporate general partner. The stock ownership of any limited partner is determined by applying the attribution rules of INT. REV. CODE OF 1954, §318.

154. TREAS. REG. §301.7701-2(a)(3).

155. *Id.* §301.7701-(2)(1).

156. See text accompanying notes 142-147 *supra*.

157. TREAS. REG. §301.7701-2(b)(1).

158. See text accompanying notes 57, 61 and 74 *supra*.

159. 11 U.S.C. §23(i) (1970).

form. A limited partnership whose only general partner is a corporation controlled by limited partners can thus be seen as possessing a practical equivalent of continuity of life.

Limited partner control of a corporate general partner can also be viewed as creating centralization of management. A limited partnership is managed by its general partners.[160] When a corporation is the only general partner of a limited partnership, its board of directors, which has the power to manage all corporate business,[161] is ultimately responsible for its actions as general partner. If the limited partners can elect a majority of the directors of the general partner, the business of the partnership is managed by representatives of the limited partners and centralization of management in the representative sense intended by the regulations exists.[162]

When the ownership of limited partnership interests parallels ownership of the stock of a sole general partner, a practical equivalent of limited liability also exists. When the same persons hold all limited partnership interests and all shares of the corporate general partner in the same proportions, for example, the partnership and corporation can realistically be seen as a single venture owned by a group of persons none of whom is personally liable for its obligations. The fact that corporate assets can be looked to for satisfaction of partnership debts is, in such a case, little different from the exposure of one division of a corporate enterprise to liabilities arising in the conduct of other divisions. When the ownership of limited partnership interests and shares of a general partner overlap but complete identity is lacking, the corporate analogy is less clear, but a practical equivalent of limited liability may still exist.

A substantial overlap in the ownership of limited partnership interests and shares of a sole corporate general partner, when sufficient to give limited partners practical control of the general partner, can therefore create equivalents of three of the four relevant corporate characteristics. Of course, limited partner ownership of 20 percent of the stock of a corporate general partner, the guidepost established by *Revenue Procedure 72-13*, is not enough to constitute practical control in all cases. The Procedure, however, is intended only to specify cases in which the Service will not rule. The 20 percent rule is evidently only a rule of thumb imposed to weed out cases presenting issues of fact not appropriate for resolution in advance rulings.

The arguments advanced above, although drawn from certain of the rules of the regulations, are not consistent with the regulations as a whole. For example, the regulations state without qualification that "a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act [lacks] continuity of life."[163] The Act allows corporations to act as general partners of limited partnerships[164] and does not forbid limited partners from owning stock of such a general partner. The regulations state

160. ULPA §9; UPA §9(1).
161. *See, e.g.*, FLA. STAT. §607.111(1) (1975).
162. See text accompanying notes 79-82 *supra*.
163. TREAS. REG. §301.7701-2(b)(3).
164. See note 24 *supra*.

with equal clarity that a general partner with substantial assets will be deemed personally liable for partnership debts.[165] The ownership test of *Revenue Procedure 72-13* makes no reference to the quantity of assets held by a corporate general partner. Although the regulations are less categorical in describing the centralized management characteristic,[166] they do plainly state that possession of one of the relevant characteristics will not make an entity an association.[167] Any rule based solely on ownership of stock of a general partner can be reconciled with the regulations only by pointing to their unexplained reference to "other factors."[168] Because limited partner ownership of such stock relates to three of the primary characteristics, but in ways generally excluded from consideration by the regulations, the appropriateness of an ownership test based on "other factors" is doubtful.[169]

The ownership condition of *Revenue Procedure 72-13* may also be criticized for its lack of precision. When it refers, for example, to limited partner ownership of "more than 20 percent of the stock of the corporate general partner,"[170] is it intended that stock be taken into account whether it is common or preferred, voting or nonvoting? The Procedure suggests that all shareholdings are considered. However, if limited partner shareholdings are relevant only when they insure limited partner control of the corporate general partner, the test should turn only on ownership of voting shares.

Whenever two or more classes of stock are taken into account there will be obvious difficulties in determining whether the shares held by limited partners constitute more than 20 percent of the outstanding stock. If only voting shares are considered, the test should be whether the limited partners hold shares representing more than 20 percent of the voting power of all shareholders. If nonvoting shares are also taken into account, the test can be applied reasonably only by reference to the value of the shares outstanding. But the Service will not ordinarily rule on issues turning principally on the value of property.[171] When common and preferred stock is outstanding, furthermore, the relative values of the two types of shares fluctuate constantly and the Service would usually be reluctant to issue an advance ruling when the relevant facts are ever changing. The difficulties encountered in applying an ownership test for rulings purposes to nonvoting stock furnish additional support for the conclusion that only voting stock should be counted.

The Procedure addresses only the case in which a corporation is the *sole* general partner of a limited partnership. Will the stock ownership condition

165. TREAS. REG. §301.7701-2(d)(2).

166. The regulations state that "limited partnerships subject to a statute corresponding to the Uniform Limited Partnership Act *generally* do not have centralized management" except when substantially all interests are held by limited partners. *Id.* §301.7701-2(c)(4) (emphasis added). The word "generally" allows some flexibility in the application of the quoted language, but no factor other than the substantiality of general partnership interests is identified in the regulations as being relevant to the issue.

167. *Id.* §301.7701-2(a)(3).

168. *Id.* §301.7701-2(a)(1).

169. See text accompanying notes 144-147 *supra*.

170. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

171. Rev. Proc. 72-9, 1972-1 CUM. BULL. 721.

also be applied when a limited partnership has two or more corporate general partners? The policy underlying the condition, whatever it might be, probably precludes a favorable ruling when limited partners own more than 20 percent of the stock of each general partner. A favorable ruling could be issued consistently with the Procedure, however, when limited partners own more than 20 percent of the shares of one corporate general partner, but less than 20 percent of another. If any corporate general partner is not controlled by limited partners, persons independent of the limited partners can cause dissolution of the partnership by deciding that the general partner should retire. Limited partner control of another corporate general partner would not, in such a case, create a practical equivalent of continuity of life. Since all general partners are agents with at least apparent authority to carry on partnership business in the usual way,[172] control of one corporate general partner by limited partners does not create an equivalent of centralization of management if another corporate general partner is not so controlled. The appearance of limited liability is also weakened when any corporate general partner is owned independently of the limited partners.

Correspondingly, neither the 20 percent condition nor any analogue to it should apply when an individual serves as general partner, either alone or with a corporate general partner. Superficially, it may seem that an individual general partner who is an agent of limited partners resembles a corporate general partner controlled by limited partners. However, an individual general partner's status as an agent of limited partners will not prevent his death from causing dissolution of the partnership contrary to the wishes of his principals.[173] And the regulations properly point out that such an agency reduces liability limitations by making limited partners personally liable.[174] The only corporate characteristic created by the agency is a form of centralized management[175] and it should not be sufficient, standing alone, to preclude issuance of a ruling on the association issue. Also, the 20 percent rule should not apply when an individual serves as general partner along with a corporation controlled by limited partners. The presence of an individual general partner effectively dispels the equivalence of continuity of life, centralization of management, and limited liability which otherwise could be created by limited partnership ownership of stock of the general partner.

The Service has also not spoken on the role of the policies underlying the 20 percent condition in the government's position in audits and litigated cases. If the policy relates largely to limited partner control of corporate general partners, as is here suggested, the 20 percent figure cannot reasonably be advanced as an unyielding benchmark. Ownership of significantly less than

172. ULPA §9; UPA §9(1).

173. ULPA §20. An organization which may be dissolved by the death of any of its members lacks the corporate characteristic of continuity of life. TREAS. REG. §301.7701-2(b)(1).

174. TREAS. REG. §301.7701-2(d)(2). See text accompanying notes 127-129 *supra*.

175. Although the regulations state that a limited partnership generally has centralized management only when substantially all interests in it are held by limited partners, TREAS. REG. §301.7701-2(c)(4), an agency relationship between limited and general partners creates a representative form of management so close to the corporate model that it could hardly be ignored even though not mentioned in the regulations.

50 percent of the voting shares of a corporation usually carries practical control only when the holders of the shares in question are closely associated and the remaining shares are dispersed. The issue of control must, in sum, be resolved case by case.

The breadth of limited partner ownership of a general partner's stock should also be relevant. Corporate resemblance is most striking when the stock and the limited partnership interests are held by the same persons in the same proportions.[176] In *Phillip G. Larson*,[177] at the other pole, a limited partner having less than a two percent interest in one of the partnerships there involved also owned more than 20 percent of the stock of its general partner. There was no other cross ownership. In such a case, most limited partners have no voice in the general partner's management of the partnership and a decision of the general partner to retire, for example, cannot reasonably be said to be a decision of the limited partners. Analogies to the corporate characteristics of continuity of life and centralization of management are also quite weak. The cross ownership of stock and limited partnership interests should be given little weight in such situations. The government did not raise the issue in *Larson*.

Net Worth of the Corporate General Partner

A limited partnership having a corporation as its sole general partner will be ruled a partnership for tax purposes only if the net worth of the general partner will at all times equal or exceed a floor prescribed by the following rules: If the total of all contributions to a limited partnership is less than $2.5 million, the net worth of its corporate general partner must be at least $250,000 or 15 percent of the contributions, whichever is less. When partnership contributions are $2.5 million or more in the aggregate, the net worth floor is 10 percent of the contributions.[178] If a corporation serves as general partner of more than one limited partnership, a floor is separately computed for each limited partnership and the net worth of the corporation must not be less than the sum of the amounts so determined.[179] The net worth of a general partner is computed using the fair market value of its assets,[180] but its interest in all limited partnerships of which it is general partner and all accounts and notes receivable from such partnerships are not counted as assets for this purpose.[181] Liabilities owing to the partnerships are also excluded from consideration.[182]

176. Zuckman v. United States, 524 F.2d 729, 1975-2 U.S.T.C. ¶9778 (1975), almost fits the factual model described in text. The corporate general partner there was indirectly owned by a person who held about 96 percent of all the limited partnership interests. The government did not contend in *Zuckman*, however, that limited partner ownership of the corporate general partner was, by itself, sufficient to categorize the limited partnership as an association.

177. 66 T.C. No. 21 (Apr. 27, 1976).

178. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

179. *Id.*

180. *Id.*

181. *Id.*

182. *Id.*

The net worth tests of the Procedure could be viewed as a statement of the rulings position of the Service in applying the regulation provisions relating to limited liability.[183] It has previously been suggested that the regulations can be read to say that a corporate general partner lacks personal liability when it has no substantial assets.[184] However, limited liability is only one of four factors stressed by the regulations in distinguishing between partnerships and corporations[185] and the regulations state that an entity is to be deemed an association only if it has more corporate characteristics than it lacks.[186] The net worth tests of the Procedure must always be satisfied even though a partnership has no other corporate attributes. Furthermore, the regulation rules relating to limited liability look to the extent of a general partner's assets, not its net worth.[187] The net worth tests, in sum, are not easily reconciled with the regulations.

The tests can be justified, however, by viewing the issues somewhat more broadly than they are in the regulations. If a corporate general partner's only asset is its interest in a limited partnership, for example, the shares of the general partner represent no more than indirect interests in the partnership. When such a partner has assets apart from its partnership interest, but its independent net worth is insignificant in comparison to the value of that interest, the shares are primarily indirect interests in the partnership. Whenever the ownership of shares in a sole corporate general partner is principally an indirect investment in a limited partnership, the shares and the limited partnership interests are essentially two classes of ownership interests in the partnership business and resemble voting and nonvoting shares of a corporation. That resemblance gives the limited partnership practical equivalents of at least three of the four corporate characteristics described in the regulations as most important.

For example, the possibility of dissolution by reason of the retirement or bankruptcy of the general partner[188] does not negate continuity of life in such a case. A decision that the general partner should retire will be made by the shareholders of the general partner or the directors of the corporation as their representatives. Because the shares are principally indirect interests in the partnership, any such decision resembles a shareholder vote for corporate dissolution. If the general partner has few activities apart from the partnership its bankruptcy will usually result only from bankruptcy of the partnership. Even if the partnership remains solvent, the general partner's bankruptcy will result in the partnership being declared a bankrupt.[189] A dissolution resulting from the bankruptcy of such a general partner is not

183. TREAS. REG. §301.7701-2(d)(2).

184. See text accompanying notes 139-141 *supra*.

185. TREAS. REG. §301.7701-2(a)(2).

186. *Id.* §301.7701-2(d)(2).

187. *Id.*

188. Generally, premature dissolution will result only from the bankruptcy or retirement of a general partner when a limited partnership has a corporation as its only general partner. See text accompanying notes 57, 61 and 74 *supra*.

189. 11 U.S.C. §23(1) (1970).

materially different in practical effect from the bankruptcy of a venture conducted wholly in corporate form.

Centralization of management in the representative sense intended by the regulations[190] also exists, because the board of directors of the general partner manage the business of the partnership as representatives of shareholders whose beneficial interests are primarily interests in the partnership. Also, when limited partners and shareholders of the general partners are viewed as joint owners of a consolidated enterprise comprised principally of the partnership business, it becomes evident that none of the ultimate owners is personally liable for business debts and that a practical equivalent of limited liability exists. Furthermore, there is no reason to regard transferability of the general partnership interest as being relevant when the corporation acting as general partner is little more than a conduit for its shareholders to invest in the partnership. If the limited partnership interests and the shares of the general partner are freely transferable, the partnership should be deemed to possess the corporate characteristic of free transferability of interests. In sum, a corporate general partner's lack of substantial net worth apart from its partnership interest creates practical equivalents of three and sometimes of all four relevant characteristics.

Some of the mechanics of the net worth tests of the Procedure are not so easy to rationalize, however. Why should the net worth of the general partner be compared to the aggregate of the contributions of the partners?[191] The analysis suggested here, if it is the rationale underlying the tests, would be better served by basing the net worth tests on the relative values of the general partnership interest and the remaining net assets of the general partner. The Procedure probably adopts the only comparison which can be applied without resolving factual questions of the sort not appropriately determined in advance rulings proceedings.[192] However, a test which is readily applied but is not relevant to the underlying policies is not a good test. Furthermore, there is no apparent reason for requiring a corporate general partner's net worth to be a larger percentage of partnership contributions when the contributions are less than $2.5 million than when they exceed that amount.[193] The tests should either be proportional or absolute. As presently stated, the tests discriminate arbitrarily against smaller ventures.

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190. See text accompanying notes 79-82 *supra.*

191. The Procedure requires that the independent net worth of a general partner be either 15 or 10% of partnership contributions. See text accompanying note 178 *supra.*

192. The tests applied, which depend in part on the fair market value of the assets of a general partner other than its partnership interest, raise obvious factual questions which are apparently avoided by conditioning rulings issued upon the accuracy of value representations accompanying rulings requests. *See* Rev. Proc. 75-16, 1975-1 CUM. BULL. 676. However, there are few items of property of more speculative value than a general partnership of interest in a typical tax shelter limited partnership. The Service might reasonably have concluded that a ruling conditioned on the accuracy of a representation as to the value of a general partnership interest would be the equivalent of no rulings at all.

193. General partner net worth is generally required to be 15% of partner contributions when they total less than $2.5 million, but only 10% when they exceed that mark. See text accompanying note 178 *supra.*

There are a few construction problems which may arise in applying the net worth tests. The tests, for example, compare the net worth of a general partner to "the total contributions to [the] partnership."[194] The word "contributions" presumably refers only to consideration given by partners for their partnership interests; amounts loaned by partners to a partnership will probably be ignored. If services or property other than cash is contributed to a partnership, the value of the contribution when made should be its measure. Although the basis of property contributed to a partnership carries over from contributing partner to partnership,[195] it is not relevant to any conceivable policy underlying the net worth tests, and an application of the tests using the basis of contributed property would therefore be arbitrary. Since the tests are minimums to be met by taxpayers, the Service should have no objection to an exclusion of the value of contributed property or services. However, contributed property may be worth either more or less than its basis and the Service may not acquiesce in a substitution of basis for value in documents supporting a ruling request.[196] Except for interests in and claims against limited partnerships, all assets of a general partner are taken into account in computing its net worth. In many instances, the net worth of a general partner required by the Procedure is created by shareholder contributions of their own notes to the corporation.[197] Since the notes are not payable to or receivable from a limited partnership, the Procedure clearly allows them to be included in determining a general partner's net worth.[198] It must be remembered, however, that net worth is computed using the fair market value of corporate assets.[199] When a note is worth less than its face amount because the obligor's ability to pay is doubtful or because interest is provided at less than the prevailing rate, only the value, not the face amount, will be taken into account.

The Procedure requires that the net worth tests be satisfied "at all times."[200] The tests are, of course, conditions to be satisfied before a request for an advance ruling will be considered, but the Procedure does not indicate the mechanism for enforcing the tests after a ruling has been issued.[201] It also fails to state the frequency with which a corporation must prepare financial statements to demonstrate that its net worth equals or exceeds the prescribed minimum "at all times."

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194. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

195. INT. REV. CODE OF 1954, §723.

196. Revenue Procedure 75-16, 1975-1 CUM. BULL. 676, requires that a statement of the amount of all capital contributions accompany a ruling request, but gives no guidance as to the means of measuring the amounts.

197. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

198. Livsey, *Limited Partnerships with a Sole Corporate General Partner: The Impact of* Larson *and* Zuckman, 54 TAXES 132 (1976); Kanter, *supra* note 39, at 780.

199. *Id.*

200. *Id.*

201. Revenue Procedure 75-16, 1975-1 CUM. BULL. 676, requires that a request for a ruling on the status of a limited partnership be accompanied with "a representation of the net worth of the general partner(s)." The representation required apparently need relate only to present net worth. *Cf.* note 202 *infra.*

The Procedure does not disclose the rulings standards applied to cases not involving corporations as sole general partners. An individual general partner's lack of independent net worth should not be enough, standing alone, to justify denial of a ruling.[202] The net worth of an individual general partner has no bearing upon the issues of continuity of life, centralization of management, or transferability of interests, even if the strictures of the regulations are relaxed. Although an individual general partner's minimal net worth could, contrary to the present regulations, be deemed a sufficient ground for finding limited liability, it is doubtful that limited liability alone may be a basis for finding association status even under the broadest application of the corporate resemblance concept. For the same reasons, a ruling should issue without regard to the net worth of a corporate general partner if the partnership also has an individual as general partner.[203]

When two or more corporations serve as general partners of a limited partnership, a favorable ruling on the tax status of the partnership should be issued if any of the general partners satisfies the net worth tests of the Procedure. The presence of a corporate general partner not meeting the tests, when another does, gives no appearance of corporateness. In fact, the Service should apply the net worth tests by aggregating the assets and liabilities of all corporate general partners, since the division of the requisite net worth between several corporate entities does not increase corporate resemblance.[204]

Package Investments

A taxpayer seeking an advanced ruling on the status of a limited partnership whose only general partner is a corporation must also satisfy the following rule: "The purchase of a limited partnership interest by a limited partner [must] not entail either a mandatory or discretionary purchase or option to purchase any type of security of the corporate general partner or its affiliates."[205]

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202. The Service has, at least in some instances, refused to issue rulings on the status of limited partnerships with individual general partners unless the ruling requests are accompanied by representations that the general partners have and will continue to have net worths in substantial amounts. McDONALD, MAKING THE DEAL AND CREATING THE PARTNERSHIP IN THE LIMITED PARTNERSHIP AS AN INVESTMENT VEHICLE 40 (1970). It is not clear whether the representation is required to support only a ruling as to limited liability or whether the Service has a net worth standard for individual general partners which must always be met, even when no other corporate attributes are present.

203. It has been reported that the Service will apply the proposition stated in the text, but only when the individual general partner or partners have "substantial means" and are not "judgment proof." *Points to Remember*, 25 TAX LAWYER 180 (1971). See note 202 *supra*.

204. The tests were so applied prior to the issuance of the Procedure. *Points to Remember*, 25 TAX LAWYER 130 (1971). There is no indication of a subsequent change in attitude.

205. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735. The word "affiliates" is not defined in this context. However the 20% test as to stock ownership refers to "any affiliate as defined in section 1504(a) of the Internal Revenue Code of 1954." *Id.* Presumably the same meaning is intended here.

Superficially, the requirement seems supplementary to the condition proscribing limited partner ownership of more than 20 percent of the stock of a sole general partner.[206] It clearly is not, however. A package joining the purchase of limited partnership interests with rights or obligations to acquire securities of a sole corporate general partner is sufficient ground for denying a ruling, according to the Procedure, even though limited partners may never own more than 20 percent of the stock of the general partner. Also, the package rule is applied with respect to all securities of the general partner, not only its stock. In applying the 20 percent test, stock of a general partner subject to a package purchase is included in computing limited partner ownership of the general partner, independently of the package rule.[207] The package rule therefore is not a satellite of the 20 percent test and must find its conceptual justification elsewhere. Can the combining of purchases of limited partnership interests with rights or obligations to acquire securities of a sole corporate general partner be reasonably viewed as causing a limited partnership to resemble a corporation more than a partnership, even though limited partners may never own more than 20 percent of the stock of the general partner?

The package rule may be based on a belief that such a combination is evidence that a limited partnership lacks independent substance and is in reality an arm of its general partner. Assume, for example, that a corporation desires to raise additional capital to finance an extension of its activities which is likely to operate at a loss for a few years. It organizes a limited partnership to undertake the new venture and agrees to serve as its only general partner. The needed capital is raised by selling investment units comprised of one unit of limited partnership interest and one share of the general partner's stock. The limited partnership interests entitle the limited partners to share in profits and losses only and expire after a fixed number of years. It is expected that the partnership will be liquidated when the limited partnership interests expire. The scheme just suggested, if governed by tax rules recognizing the form of the transactions, would enable the new investors to share in the deduction of start up losses of the new venture, even though their investments are primarily purchases of interests in the corporation. In such a case and in any other situation in which limited partnership interests are incidental to investments in securities of a sole corporate general partner, the partnership can reasonably be ignored as lacking independent substance. The rulings policy reflected in the package rule may be intended to do just that.

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206. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

207. The ownership test is met only if "[t]he limited partners *will* not own . . . more than 20 percent of the stock of the corporate general partner. . . ." *Id.* (emphasis added). The use of the future tense includes within the rule any stock a limited partner is obligated to acquire in the future as well as stock presently owned. Furthermore, stock ownership is determined for purposes of the 20% test by applying "the attribution rules set forth in section 318 of the Code." *Id.* Section 318(a)(4) regards a person as the owner of stock he has an option to acquire. Hence, all stock which is or may be purchased under the terms of a package investment is included in applying the 20% ownership test and would be so included even if the package rule were deleted from the Procedure.

There are a few problems in the application of the package rule. It forbids, for example, the tying of purchases of limited partnership interests to present or future acquisitions of "any type of security" of a corporate general partner.[208] The word "security" is evidently intended to encompass debt obligations of a general partner as well as all types of stock.[209] Short term debt obligations may not be included, however. It seems likely that the policy underlying the package rule, whatever it might be, would justify only a prohibition of long term investments in a general partner. A requirement that a purchaser of a limited partnership interest make a short term loan to a general partner would not seem to create any corporate resemblance or cause the limited partnership to lack independent substance.[210]

The rule requires that the purchase of a limited partnership interest "not entail either a mandatory or discretionary purchase or option to purchase" a security of a general partner.[211] It therefore encompasses package offerings in which limited partners are required to purchase securities of a general partner presently or in the future, in which a general partner's securities are offered as optional additions to limited partnership investments, or in which warrants or options to acquire a general partner's securities are issued with limited partnership interests. A package investment program should not lead to the conclusion that a limited partnership lacks independent substance unless the securities of the general partner are the principal ingredient in a package and limited partnership interests are incidental. However, the Service cannot be expected to rule in advance whether one part of a package or another is its mainstay.

The policies underlying the package rule may also apply to cases other than those in which corporations are sole general partners. The presence of a second corporate general partner in which limited partners have no interest or the presence of an individual as general partner in addition to a corporation would not insure that a package purchase is not principally an investment in securities of a general partner. Since the determination of the primary ingredient of an investment package is a factual matter not appropriate for resolution in an advance ruling, the Service may apply the package rule in all cases in which a corporation is a general partner in a limited partnership.

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208. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

209. The use of the word "stock" in describing the 20% ownership test, implied that the word "security" in another part of the Procedure includes more than stock.

210. The proposition stated in text, if accepted, requires definition of what is meant by "short term." The word "securities" as appearing in §§351 and 354 of the Code is generally construed as not including obligations whose terms are five years or less. Bonds and notes with terms of more than ten years are usually deemed securities for that purpose, whereas a term of five to ten years leaves an obligation in an undefined hiatus. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶3.04 (3d ed. 1971). The definition of "securities" so developed, although lacking in complete certainty, would provide a convenient reference here.

211. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

Conformity with State Law

The final condition of *Revenue Procedure 72-13* states that a limited partnership with a corporation as sole general partner will be treated as a partnership for advance ruling purposes only if "the organization and operation of the limited partnership [is] in accordance with the applicable state statute relating to limited partnerships."[212]

The justification for the condition is unexplained. A failure to adhere to limited partnership restrictions will sometimes make an organization a general partnership under state law.[213] The Service should not be reluctant to rule a general partnership to be a partnership for tax purposes even though its partners had hoped it was a limited partnership. However, there may be instances in which nonconformance with limited partnership statutes would give a partnership features resembling corporate characteristics. Perhaps the condition stated in the Procedure means only that in passing upon ruling requests the Service will not determine the consequences under state law of deviations from statutes regulating the limited partnership form of organization.

The policy served by the condition probably is not unique to partnerships with sole corporate general partners. The condition may therefore be applied whenever a ruling as to the tax status of a limited partnership is sought.

REVENUE PROCEDURE 74-17

Revenue Procedure 74-17[214] added height to the wall to be scaled by taxpayers seeking advance rulings on the tax status of limited partnerships. Ordinarily no ruling will issue, according to the Procedure, unless the distributive shares of the general partners include at least one percent of each item of partnership income, gain, loss, deduction or credit.[215] Distributive shares of partnership loss claimed by partners as deductions in the first two years of a partnership's operation ordinarily may not exceed the capital contributions of the partners.[216] And, persons making nonrecourse loans to the partnership ordinarily may not have any interest in the partnership or its property other than as creditors.[217]

Apart from the content of the rules stated, *Revenue Procedure 74-17* reflects an approach differing in several respects from that of *Revenue Procedure 72-13*. Whereas the earlier procedure applies by its terms only when a corporation is the sole general partner of a limited partnership,[218] for example, the rules of *Revenue Procedure 74-17* apply to all limited partnerships, whether their general partners are individuals or corporations.[219] Also,

212. *Id.*
213. CRANE & BROMBERG, *supra* note 24, at 164-67.
214. 1974-1 CUM. BULL. 438.
215. Rev. Proc. 74-17, 1974-1 CUM. BULL. 438.
216. *Id.*
217. *Id.*
218. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.
219. Rev. Proc. 74-17, 1974-1 CUM. BULL. 438.

the rules of *Revenue Procedure 74-17* are not derived from the association concept. Although a failure to comply with the rules will ordinarily result in a denial of a request for a ruling that a partnership is not an association,[220] the basis of the denial will be that the failure to comply suggests the organization of the partnership "has as its principal purpose the reduction of Federal taxes."[221] The propriety of denying rulings on that broad ground is far from clear. The role of the rules is further confused by a statement that they "are not intended as substantive rules for the determination of partnership status and are not to be applied as criteria for the audit of taxpayers' returns."[222]

Presumably the Procedure was not promulgated to erect a series of hurdles to be overcome by taxpayers seeking rulings, but which have no relation to the legal principles determining tax liability. The Procedure was probably issued to delineate certain perimeters beyond which lie questions of fact not appropriate for determination in the advance rulings process. The relevant questions of fact are not described in the ruling, however, except by implication. Furthermore, a question of fact is a relevant question only if there is a rule of law making it so. The legal principles underlying the rules of *Revenue Procedure 74-17* are not stated there and have not been suggested by any prior or subsequent pronouncement of the Service. There are provisions of the Code denying certain deductions and allowances when transactions are motivated by tax avoidance purposes,[223] but none of them relates in any perceivable way to the factors identified in the Procedure. The courts have long held that the tax consequences of transactions are to be determined by their economic substances and not necessarily by the forms in which they are cast.[224] However, the Procedure does not suggest that its rules are based upon that doctrine alone. The Procedure, like *Revenue Procedure 72-13*, reminds one of a parent who says to his child: "You do it as I say and don't you dare ask why you should or what will happen to you if you don't."

Minimum Interest of General Partners

The rule of *Revenue Procedure 74-17* relating to the interests of general partners is stated as follows:

> The interests of all of the general partners, taken together, in each material item of partnership income, gain, loss, deduction or credit [must be] equal to at least one percent of each such item at all times during the existence of the partnership. In determining the

220. *Id.*
221. *Id.*
222. *Id.*
223. Section 269(a) is probably the best known example of such a provision. It denies the benefit of any deduction, credit or allowance when the shares or property of a corporation are acquired for the principal purpose of avoiding tax by obtaining that benefit. INT. REV. CODE OF 1954, §269(a). *See also* INT. REV. CODE OF 1954, §§357(b), 704(b)(2), 877(a), 954(b)(4).
224. *See, e.g.*, Gregory v. Helvering, 293 U.S. 465, 1935-1 U.S.T.C. ¶9043 (1935).

general partners' interests in such items, limited partnership interests owned by the general partners shall not be taken into account.[225]

One commentator has suggested that the rule is an outgrowth of the association concept.[226] If a general partner has no substantial interest in the profits and losses of a partnership, it is argued, he is not truly associated with the other partners in carrying on a business for joint profit and is therefore seen by the Service as not being a partner. When a limited partnership is viewed as comprised solely of its limited partners, its resemblance to a corporation is very close indeed. The explanation suggested is probably the only one available, but is somewhat less than convincing. The rule, if derived from the association concept, is not consistent with the regulations. The substantiality of the interests of general partners is put at issue by the regulations in their description of only two corporate characteristics, centralization of management[227] and free transferability of interests.[228] Since an entity with only two corporate characteristics is not an association under the regulations,[229] the insubstantiality of a general partner's interest alone will not support a finding of association status under the regulation tests. The Tax Court so held in *Phillip G. Larson.*[230]

Furthermore, if the insubstantiality of a general partner's interest is a ground for disregarding his presence as a partner, it is surprising that the Service would concede that a one percent interest is always enough to make him a partner in substance.[231] Also, a general partner is personally liable for partnership debts even though his partnership interest is insubstantial. When partnership activities create significant financial risks to the general partners, it does not seem reasonable to treat them as not being participants in the venture merely because their interests in profits and losses are not a substantial part of the total. When a general partner lacks a significant interest in profits and losses, on the other hand, the issue of whether his personal liability is of sufficient importance to make him a partner in substance is a question of fact. The rule stated in the Procedure may be justified as a statement that the question of fact is not one appropriately resolved by an advance ruling.

The Procedure will deny advance rulings, however, in many cases in which the interests of general partners are substantial. It requires that general partners have a one percent interest in each material item of income, deduction or credit. A lack of an interest in one class of items will preclude an advance ruling, even though general partners have substantial interests in

225. Rev. Proc. 74-17, 1974-1 CUM. BULL. 438, 439.

226. Livsey, *Limited Partnerships: How Far Can IRS Go in Limiting Their Use in Tax Shelters?*, 39 J. TAX 123 (1973).

227. TREAS. REG. §301.7701-2(c)(4).

228. *Id.* §301.7701-2(e)(1).

229. *Id.* §301.7701-2(a)(3).

230. Phillip G. Larson, 66 T.C. No. 21 (Apr. 27, 1976).

231. Prior to the issuance of the Procedure it was rumored that the Service insisted that general partners have a five percent interest in each item of income, deduction and credit. Kanter *supra* note 39, at 780.

most items. The Service could perhaps support the application of the rulings policy to such cases by pointing out that it cannot reasonably be expected to determine by an advance ruling whether an interest is substantial on the whole when it does not include a distributive share of some items and the importance of the excluded items cannot be predicted with certainty.[232]

It is likely that the principal targets of the rule are arrangements that divert losses to limited partners but that plainly provide substantial interests to general partners in gains and profits. A real estate tax shelter, for example, generates substantial loss deductions in the early years of the venture. The losses, which derive from interest on construction loans and accelerated depreciation, typically decline in succeeding years and the investment eventually yields taxable income if it is reasonably successful. When such a shelter is organized as a limited partnership, the loss deductions are a primary incentive for limited partners to invest. The general partners may have little independent income against which loss deductions may be taken. In such cases limited partnership agreements frequently allocate all profits and losses to limited partners for the periods losses are projected to occur and allow general partners to share in profits and losses to a significant extent during later periods when profits are anticipated. Gains from the sale of partnership assets are often shared by general and limited partners whenever they are realized. The purpose of the arrangement is to allocate losses to the partners who can best use them as deductions. Because it allocates no items of income or loss to general partners in the early years, the arrangement does not satisfy *Revenue Procedure 74-17.*

A diversion of losses away from general partners does not reduce their financial interests. If the Service's policy was only to insist that the interests of general partners be substantial, it would require that they participate meaningfully in items of income, gain and credit, the financial benefits, but would ignore the allocation of deductions and losses, the financial detriments, which are given a glamour only by the tax laws. If the rule of the Procedure is directed principally at loss sharing arrangements, it is not intended as a requirement that general partners participate meaningfully as partners.[233]

Losses are shifted to limited partners, of course, to reduce taxes. If the law frustrates the tax avoidance motive, however, it does not do so by classifying partnerships as associations. Section 704(b) of the Code provides that a partner's distributive share of income, loss or credit is to be determined

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232. Failure to satisfy the rule does not preclude the issuance of a ruling, since the Procedure describes cases in which the Service "ordinarily" will not rule. Rev. Proc. 74-17, 1974-1 CUM. BULL. 438. A ruling may therefore be issued when general partners share to the extent of at least one percent in all items excepting some which clearly will not be substantial.

233. Another common arrangement, that which excludes general partners from sharing profits and losses but provides general partners with compensation for their services determined independently of profits and losses, raises greater doubt as to the substantiality of general partners' participation as partners. If such arrangements are the principal target of the rule, however, the Service should not require an allocation of losses to general partners, since the interests of a general partner can be made substantial by causing him to share in profits only.

by an overall evaluation of the extent of his interest whenever "the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect."[234] When a loss sharing arrangement has substantial economic effect, any tax avoidance resulting from its operation is, by negative implication, authorized by section 704(b). The Service should not interfere with the operation of the statute by denying a ruling on an unrelated issue such as the classification of the partnership.[235]

Maximum Deduction of Partnership Losses

A limited partnership ordinarily will not be given advance assurance that it will be treated as a partnership for tax purposes if it fails to satisfy the following rule relating to partnership losses: "The aggregate deductions to be claimed by the partners as their distributive shares of partnership losses for the first two years of operation of the limited partnership [must] not exceed the amount of equity capital invested in the limited partnership."[236]

The rule probably derives from a belief that an excess of losses over equity contributions in the first two years of a venture's existence raises doubt as to whether it is carried on for profit. Such an excess cannot be taken as conclusive evidence of the intentions motivating a venture, of course. Substantial losses must often be incurred to bring a new endeavor into a healthy existence. And, tax shelter investments are usually structured to take advantage of tax accounting rules which provide a poor measure of the economic viability of the investments.[237] However, the Service cannot be criticized for declining to rule in advance that a profit motive exists when start-up losses, even though determined under artificial accounting rules, will quickly exceed equity invested.

It is less clear, however, that the lack of a profit motive is a valid basis for denying a ruling that an entity is a partnership for tax purposes. The Code defines a partnership as an organization which carries on "any business, financial operation, or venture" which is not encompassed by the tax defini-

234. The language quoted was added by the Tax Reform Act of 1976. At the time Revenue Procedure 74-17 was promulgated, §704(b) stated in relevant part that any agreement for sharing specific items of income, loss, deduction or credit would be ignored when the principal purpose of the agreement was "the avoidance or evasion of any tax imposed by this subtitle." INT. REV. CODE OF 1954, §704(b): When the provision applied, items covered by a tainted agreement were allocated by the general income and loss sharing arrangement of the partner. In 1974 there was no statutory provision requiring revision of a general income and loss sharing arrangement adopted for a tax avoidance purpose.

235. At the time Revenue Procedure 74-17 was issued, the scope of §704(b) was much narrower than at present. The point made in the text was, however, valid even then. To the extent the law in 1974 permitted tax avoidance by economically meaningless arrangements for sharing losses, the defect was in the restricted scope of §704(b) and was not related to the association issue. The Service acted arbitrarily in promulgating Revenue Procedure 74-17 if its purpose was to deny rulings on the association issue to taxpayers availing themselves of other provisions of law which it regarded as loopholes.

236. Rev. Proc. 74-17, 1974-1 CUM. BULL. 438, 439.

237. See text accompanying notes 6-10 *supra*.

tions of corporation, trust or estate.[238] Neither the Code nor the regulations[239] require that a partnership be carried on for profit.[240] A tax shelter package, although organized principally to generate losses deductible against other income of investors, is a "business, financial operation, or venture" if those words are given their common meanings. And the lack of a profit motive certainly does not make an organization a corporation,[241] trust or estate.

Furthermore, the law provides a tool for denying loss deductions to investors not seeking profit which seems to negate any implication that the entity definitions are intended to be used for that purpose. Section 183 of the Code provides that most expenses incurred in an activity not carried on for profit are allowed as deductions only to the extent of gross income derived from the activity.[242] Although section 183 states it applies only to individuals and subchapter S corporations,[243] the taxable income of a partnership is generally determined by the rules applicable to individuals.[244] It would be better if the Service applied section 183 in the audit of limited partnership returns and simply ignored the question of profit motivation in passing on requests for rulings as to the status of such entities.

The loss rule of *Revenue Procedure 74-17* is also lacking in clarity. The rule, like the others stated in the Procedure, "must be contained in relevant documents furnished with the request for ruling."[245] As applied to the loss rule, the quoted language apparently requires a taxpayer requesting a ruling to furnish projections of the income and deductions of the limited partnership for its first two years that show the rule will likely be satisfied.[246] The Service may also insist that a partnership receiving a ruling formally undertake to adopt the depreciation and other accounting methods used in preparing the projections.[247] A statement in a partnership agreement that losses may not exceed equity in the first two years would be meaningless. A deductible loss is an excess of deductions allowed by law over gross income.[248]

238. INT. REV. CODE OF 1954, §§761(a), 7701(a)(2).

239. TREAS. REG. §§1.761-1(a), 301.7701-3.

240. The UPA defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." UPA §6(1). The tax definitions of "partnership" quite clearly include organizations which are not partnerships under local law, however. TREAS. REG. §§1.761-1(a), 301.7701-3(a).

241. Morrissey v. Commissioner, 296 U.S. 344, 356, 1936-1 U.S.T.C. ¶9020, at 9244-45 (1935), held that the word "association" in the statutory definition of corporation "implies the entering into a joint enterprise, and . . . an enterprise for the transaction of business."

242. The rule does not apply to interest, taxes and other expenditures which are deductible even when paid as personal living expenses. INT. REV. CODE OF 1954, §183(b)(1).

243. *Id.* §183(a).

244. *Id.* §703(a). Because §641(b) requires that the taxable income of a trust or estate be computed as though it were an individual, the regulations provide that §183 applies to trusts and estates. TREAS. REG. §1.183-1(a). Although the regulations do not refer to partnerships, the same reasoning should apply to them.

245. Rev. Proc. 74-17, 1974-1 CUM. BULL. 438.

246. However, Revenue Procedure 75-16, 1975-1 CUM. BULL. 676, which lists certain items to be included with a request for a ruling on the status of a limited partnership, does not require that such projections be furnished.

247. Revenue Procedure 75-16, *id.*, does not require that such an undertaking accompany a ruling request, however.

248. INT. REV. CODE OF 1954, §§63, 703(a).

Although a loss is generally apportioned among the distributive shares of partners in accordance with the partnership agreement,[249] the amount of the loss is determined not by the agreement but by law.

The "equity capital invested in the limited partnership"[250] which may not be exceeded by losses in the first two years presumably equals the capital contributions of the partners. Amounts that partners have loaned to the partnership will not be taken into account. Distributions made by a partnership may decrease invested equity if not deemed made from profits, and profits will probably be determined for this purpose by the tax accounting rules used by the partnership. When services or property other than cash is contributed, the fair market value of the services or property when contributed should be included as "equity capital invested."[251] A partner's basis for contributed property, although it usually becomes the partnership's basis for the property,[252] would be an arbitrary measure of the extent of the partnership's capitalization. However, the Service ordinarily will not rule on issues turning on questions of valuation.[253] Therefore, the position of the Service may be that only cash contributions are taken into account in applying the loss rule.[254]

The loss rule is applied by comparing aggregate partnership losses in the relevant period to aggregate equity capital of a partnership.[255] The statutes do not require that partners share partnership profits and losses in proportion to their capital contributions.[256] Although the rule first stated in *Revenue Procedure 74-17* requires that general partners be allocated at least one percent of partnership losses,[257] it does not demand that their distributive shares of such losses be proportionate to their contributions. When more than one percent of the equity capital of a limited partnership is supplied by general partners, the profit and loss sharing agreement of the partners may therefore allocate losses to limited partners in the initial two years which exceed their equity contributions.

Furthermore, there is no indication that the loss rule will affect activities of a partnership undertaken after its second year of operation. Assume a limited partnership is formed to engage in a real estate project to be completed in stages over a period of years. It employs the straight line method of depreciation with respect to portions of the project completed during the first two years and thereby satisfies the loss rule of *Revenue Procedure 74-17*. An advance ruling will apparently issue declaring the entity to be a partnership for tax purposes, even though accelerated methods of depreciation em-

249. *Id.* §704(a). *Cf.* INT. REV. CODE OF 1954, §704(b).
250. Rev. Proc. 74-17, 1974-1 CUM. BULL. 438.
251. *Id.*
252. INT. REV. CODE OF 1954, §723.
253. Rev. Proc. 72-9, 1972-1 CUM. BULL. 719.
254. Alternatively, taxpayers submitting representations as to the value of contributed property may be issued rulings conditioned on the representations subsequently being determined to be accurate.
255. Rev. Proc. 74-17, 1974-1 CUM. BULL. 438.
256. *See, e.g.*, INT. REV. CODE OF 1954, §704.
257. Rev. Proc. 74-17, 1974-1 CUM. BULL. 438.

ployed with respect to subsequently acquired properties produce loss deductions in the third and fourth years exceeding equity capital. If later acquisitions are financed in part by the admission of new limited partners, the added partners will obtain benefits equivalent to those provided by a limited partnership organized in contravention of the loss rule.

Interests of Nonrecourse Lenders

The third rule of *Revenue Procedure 74-17* is stated as follows:

> A creditor who makes a nonrecourse loan to the limited partnership must not have or acquire at any time as a result of making the loan, any direct or indirect interest in the profits, capital, or property of the limited partnership other than as a secured creditor.[258]

A quirk in the law has made nonrecourse loans the backbone of the financing of many tax shelter ventures organized as limited partnerships. Tax shelters are typically structured to generate loss deductions exceeding the equities of the investors.[259] A partner is allowed to deduct his distributive share of partnership losses, however, only to the extent of the basis of his partnership interest.[260] An excess of losses over equity investments may not be deducted by partners, therefore, unless the bases of their interests are larger than their capital contributions. When a partnership interest is purchased for cash, the amount paid is the initial basis of the interest.[261] However, section 752(a) of the Code provides in effect that the basis of a partner's interest is increased by his share of partnership liabilities.[262] Since partners are usually personally liable for partnership debts, section 752(a) is a fitting corollary to the general principle that the basis of property includes, in addition to the down payment made to acquire it, all amounts which must be paid in the future to obtain unencumbered ownership of the property.[263] Because the rule of section 752(a) derives from the personal liabilities of partners for partnership debts and because limited partners are not so burdened,[264] the regulations under section 752(a) provide that liabilities incurred by limited partnerships usually increase the bases of general partners

258. *Id.*

259. If a tax shelter operates as a deferral device, the loss deductions, which are generally concentrated in the early years of the venture, are made up in later years when taxable income may substantially exceed cash flow. See text accompanying notes 7-11 *supra*.

260. INT. REV. CODE OF 1954, §704(d).

261. *Id.* §722. When property other than cash is contributed to a partnership in exchange for a partnership interest, the adjusted basis of the contributed property is the initial basis of the partnership interest. *Id.*

262. Section 752(a) states that "any increase in a partner's share of the liabilities of a partnership . . . shall be considered as a contribution of money by such partner to the partnership." *Id.* §752(a). A partner's basis for his interest in a partnership is the sum of the money he contributes and the adjusted basis of contributed property other than money. *Id.* §722.

263. Crane v. Commissioner, 331 U.S. 1, 47-1 U.S.T.C. ¶9217 (1947).

264. ULPA §7.

only.[265] The rationale supporting the rules breaks down when no partner, general or limited, has personal liability for certain obligations of a limited partnership. The Treasury concluded that the mandate of section 752(a) applies to such liabilities, however, and the regulations therefore provide that a partnership liability for which no partner is personally liable increases the bases of all partners, including limited partners, in proportion to their interests in profits of the partnership.[266] The Tax Reform Act of 1976 largely overruled the regulation rule and the basis of a partnership interest now is usually computed without taking nonrecourse liabilities into account.[267] There are significant exceptions to the 1976 change, however. For example, it does not apply to any partnership the principal activity of which is investing in real property (other than mineral property).[268] In cases encompassed by any exception to the new rule, limited partners may deduct partnership losses in amounts exceeding their capital contributions if, but only if, the partnerships have liabilities for which no general partner is personally liable. Partnerships have acquired such liabilities by purchasing property subject to liabilities without assuming them, or by obtaining loans directly from lenders agreeing to look solely to partnership assets for satisfaction of their claims. Such liabilities are commonly referred to as nonrecourse loans.

Prior to the appearance of *Revenue Procedure 74-17*, the Service issued two rulings relating to nonrecourse loans made by persons having present or potential equity interests in the debtor partnerships. *Revenue Ruling 72-135*[269] held that a nonrecourse loan to a limited partnership made by one of its general partners was to be treated as a capital contribution by the purported lender. *Revenue Ruling 72-350*[270] held that a nonrecourse lender who had the right to convert his claim into a profits interest was also to be treated as having made a capital investment rather than a loan. The rulings are at least arguably correct. Recourse against partners personally is a customary characteristic of partnership debt. When a purported creditor does not have that right, but does have a present or potential interest in partnership profits, his status closely resembles that of a partner.[271]

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265. More specifically, the regulations state that a limited partner's share of partnership liabilities generally may not exceed the contributions he is obligated to make in the future. TREAS. REG. §1.752-1(e). When no capital contributions are required of limited partners after their initial contributions, as is commonly the case, a limited partner's share of liabilities under this rule is zero.

266. *Id.*

267. INT. REV. CODE OF 1954, §704(d).

268. *Id.*

269. 1972-1 CUM. BULL. 200. The ruling also held that a general partner's nonrecourse loan to a limited partner of cash contributed by the limited partner to the partnership, was to be treated as a capital contribution to the partnership by the general partner, not the limited partner.

270. 1972-2 CUM. BULL. 384.

271. There are cases holding that the debt versus equity issue is to be resolved in a partnership context by applying the rules developed for determining whether purported debt of corporations is true debt or equity. *See, e.g.*, Joseph W. Hambuechen, 43 T.C. 90 (1964). Those rules turn on factors not mentioned in the rulings and would not justify the categorical position taken in the rulings. *See* B. BITTKER & J. EUSTICE, *supra* note 210, at

When a nonrecourse loan is characterized as a capital contribution, the amount of the loan is added to the basis of the purported lender for his partnership interest, and, because no partnership liability is incurred, the bases of the other partners are unaffected.[272] For a nonrecourse loan to provide a foundation supporting loss deductions by limited partners in excess of their capital contributions, in sum, the loan must be treated as debt rather than as equity. An unsuccessful attempt at that goal, however, does not affect the status of the purported debtor as a partnership. Therefore, prior rulings do not provide a justification for the nonrecourse debt test of *Revenue Procedure 74-17* since the sole consequence of a failure to satisfy that test is a denial of a request for ruling classifying an entity as a partnership.

Furthermore, the test established by the Procedure is not coterminous with the holdings of the prior rulings. The test of the Procedure only precludes the acquisition of interests by a nonrecourse lender "as a result of making [his] loan."[273] Therefore, it is less broad than *Revenue Ruling 72-135*,[274] which would characterize a purported loan as equity when it is made by a general partner independently of the transaction in which his general partnership interest was acquired. The Procedure, on the other hand, refers to "any direct or indirect interest in the profits, capital, or property of the limited partnership other than as a secured creditor."[275] It may apply to nonrecourse loans bearing interest contingent on profits even though the lender is not a partner and has no right to convert his interest into a partnership interest.

CONCLUSION

There is much to criticize in the opinions of the Tax Court and the Court of Claims in *Phillip G. Larson*[276] and *Zuckman v. United States*.[277] To cite but a few examples, a limited partnership should be deemed to have continuity of life when it is organized in a manner greatly reducing the chances of termination contrary to the will of the majority, should be deemed to have centralization of management when its sole general partner is a corporation controlled by persons owning nearly all limited partnership interests, and should be deemed to have limited liability when its corporate general partner has no substantial assets. There is also much to commend in the rules stated in *Revenue Procedure 72-13*.[278] The mechanical counting of corporate characteristics demanded by the regulations perhaps serves the need for certainty but requires that an exorbitant price be paid through its sacrifice of rationality. In some cases a single fact should be sufficient to

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¶4.03-4.06 (3d ed. 1971). However, the debt versus equity cases decided in the partnership context have not involved loans made without recourse against other partners.

272. Rev. Rul. 72-350, 1972-2 CUM. BULL. 394.
273. Rev. Proc. 74-17, 1974-1 CUM. BULL. 438.
274. 1972-1 CUM. BULL. 200.
275. Rev. Proc. 74-17, 1974-1 CUM. BULL. 438.
276. 66 T.C. No. 21 (Apr. 27, 1976).
277. 524 F.2d 729, 75-2 U.S.T.C. ¶9778 (Ct. Cl. 1975).
278. 1972-1 CUM. BULL. 735.

justify association classification. For example, a limited partnership is practically indistinguishable from a corporation when its corporate general partner either is a creature of the limited partners or has no substantial net worth apart from interests in the partnership. The results in the *Larson* and *Zuckman* cases, however, seem unavoidable under the regulations presently in force, and any litigating position based upon the policies reflected in *Revenue Procedure 72-13* is doomed to defeat so long as the current regulations exist.

There are only two meaningful choices left to the Treasury in the matter: It can amend its regulations or it can concede that all limited partnerships properly organized under the Uniform Limited Partnership Act are to be treated as partnerships for tax purposes. The former is the preferable alternative. In *Morrissey v. Commissioner* the Supreme Court said, "The inclusion of associations implies resemblance; but it is resemblance and not identity."[279] If a limited partnership can ever be an association under the current regulations, it is only when the partnership functions in a manner virtually identical to the operation of a corporation. Consideration of practical equivalence is generally foreclosed by the regulations. A limited partnership does not have continuity of life, for example, if it is properly organized under the Uniform Limited Partnership Act, and that is so under the regulations even though the possibilities for premature termination have been made remote contingencies. The regulations seem to say that no limited partnership has limited liability, even though many of them are structured to create a practical equivalent of the laws insulating shareholders from liability. Until the regulations are amended, the limited partnership will stand as a form which can be freely elected whenever the state law advantages of incorporation are desired to be combined with the tax rules applied to partnerships.

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279. 296 U.S. 344, 357, 1936-1 U.S.T.C. ¶9020, at 9245 (1935).