Real Estate Syndication and the Effects of the Tax Reform Act of 1969

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REAL ESTATE SYNDICATION AND THE EFFECTS OF THE TAX REFORM ACT OF 1969

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I. INTRODUCTION ............................................................. 197
II. REAL ESTATE SYNDICATION ............................................... 197
   A. Sale to Limited Partnership ........................................... 197
   B. Net Lease .................................................................. 201
   C. Basis of Partner's Interest ............................................. 204
   D. Depreciation and Amortization Deductions ......................... 206
   E. Recapture of Depreciation and Investment Credit ................ 210
   F. Termination of Investment Credit ..................................... 211
   G. Interest, Prepaid Interest, and Deferral of Prepaid Receipts ...... 211
   H. Limited Partnership Agreement ....................................... 215
   I. Securities Law .......................................................... 219

I. INTRODUCTION

A typical real estate syndication may raise legal problems involving: (1) a limited partnership's purchase or acquisition of depreciable real property; (2) a leaseback by the seller from the buyer; (3) a net lease; (4) deductions for depreciation and interest expenses; (5) a limited partnership agreement; (6) appropriate disclosure to the limited partners summarizing all material aspects of the investment; or, (7) state and federal securities laws. The principal features of such a real estate syndication and the most pertinent tax considerations are discussed herein. Special consideration will be given to the effects of the Tax Reform Act of 1969.¹

II. REAL ESTATE SYNDICATION

A. Sale to Limited Partnership

Depreciable real property may be sold to a limited partnership. Any mortgage may be paid off, refinanced, assumed, or the property may be taken subject to the mortgage. A second purchase money mortgage may be placed upon the property by the seller or other lender, thereby becom-

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ing the liability of the limited partnership. A primary consideration is facilitating the sale. This means that a conclusive disposition of the seller's interest must be made in order for the seller to be assured of receiving capital treatment of any gain realized from the sale. Each of the limited partners must also be entitled to an allocable share of the depreciation and other deductions. There should be no large strings or large retained interests attached to the disposition. The purchase price should be fixed. It should not be left open-ended. Inroads can be made on the requirement that the price should be absolutely fixed; however, it would appear inadvisable to let the ultimate payout vary more than ten-percent from the original price. The Internal Revenue Service (hereinafter referred to as the Service) objects to any sale price variation in installment sales, for example, because it desires certainty in the computation of "total contract price." Other instances may be found wherein additional payments may be allowed. Examples include reorganization exchanges where there is difficulty in determining the value of one or both corporations, and situations wherein the future earnings may vary considerably, thus justifying some flexibility in the ultimate payments. A maximum payment should be stated in such cases. The disposition or transfer should not be a transaction which is in substance a mere arrangement to siphon off the profits from the assets of a going operation at capital gains rates, nor should it allow a reacquisition of the property at any time deemed desirable. The economic benefits should change and equitable ownership should change hands. The sale should be bona fide, at arm's length, and devoid of any tacit understanding to collapse the deal or artificially trigger a default. The sale price should not appear to be excessive. The price should be realistic, and within a reasonable range, in light of the earnings history of the seller and the adjusted net worth of the seller's assets. The price may be justified on the basis that the investment is made in a going concern with a proven earnings record. There should be a shift of title and risk in the sense, at least, that the operation is in the hands of a new company owned by third persons, even though it might be managed by one of the sellers under a contract. There should be a permanent shift of ownership of assets. There should be no understanding that the assets are to revert, except for default in payment of the purchase price. If necessary, a management contract or guarantee by the seller of the buyer's performance may be utilized to secure payment of the purchase price. The seller, however, should not share in the future income of the buyer. The mere fact that security holders may in the future have to resume proprietorship does not nullify the fact that they originally sold their interests. A sale, in this context, is a transfer of property for a fixed price in money or its equivalent. A transfer which does not meet the above

2. INT. REV. CODE OF 1954, § 453 [hereinafter cited as the Code].

criteria may be characterized as a franchise or a license and may result in "non capital" treatment of the transaction.\(^4\)

Capital gains treatment is intended to apply to situations which typically involve the realization of appreciation in value accrued over a substantial period of time but recognized in a single year and, thus, to ameliorate the hardship of taxation of the entire gain in one year. This increase in value may be realized as capital gain on either a cash sale or on a deferred payment plan which would involve taking an installment note and a mortgage as security. Further, if the down payment is less than thirty-percent of the sales price, the gain itself can be reported on the installment basis.\(^6\) Future earnings are normally the source from which the purchase price is expected to be paid. A financially responsible buyer is not required nor is there a need for a substantial down payment. Moreover, in the event that no interest or too little interest is specified, a part of the purchase price will be treated as "unstated interest."\(^7\) Finally, in addition to the installment income rule\(^7\) and the "unstated interest" rule\(^8\) net capital gain advantages may be reduced by the depreciation recapture rules.\(^9\) Under these rules certain depreciable real property may be held and sold without depreciation recapture, or with reduced recapture in some instances.\(^10\) For an exhaustive analysis by the Supreme Court of the United States with regard to sales and the above discussion, see Commissioner v. Clay B. Brown.\(^11\)

In many instances, such as the typical real estate syndication, depreciable real property is sold and acquired by investors rather than dealers, so that any gains involved in the sales are capital gains. This is so even though many developers are in the business of building and selling, because the underlying real property ownership may be held for investment purposes by investors who have provided the equity capital and intend to hold the property for investment purposes. If the primary purpose for which property is held is investment, rather than sale to custom-

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4. See, Code § 1253.
5. Code § 453, as amended by § 412 of the Act, includes a registered, coupon, or readily marketable bond or other evidence of indebtedness issued by a corporation or other governmental body, or an obligation payable on demand, in the year-of-sale payments subject to the thirty percent rule with regard to reporting of income under the installment sales election provision of Code § 453. This section would be most likely to affect debt-financed corporate acquisition.
7. See, note 5 supra and accompanying text.
8. See, note 6 supra and accompanying text.
10. Id.
11. 380 U.S. 563 (1965), aff'd 325 F.2d 313 (9th Cir. 1964), aff'd, 37 T.C. 461 (1961); see also Rev. Rul. 66-153, 1966-1 CUM. BULL. 187, providing that Clay Brown does not extend to a sale and leaseback where the sale price is excessive. In cases of this type, the Service will continue to resist capital gain treatment by the taxpayer when the Service believes the transaction is in substance an attempt to convert future business profits to capital gains. Code §§ 512, 514, as amended by § 121 of the Act, et seq., known as the "Clay Brown" provision, provide extensive revision of the results in a typical Clay Brown situation involving debt-financed property and an exempt organization.
ers in the ordinary course of business, capital gains result from its sale. “Primary” means “of first importance” or “principal,” not a “substan-
tial” purpose as argued by the government in William Malat v. Riddell.12

Bargain sale transactions between brother-sister corporations that result in significant shifting of income may be attacked.13 A sale to a part-
nership, where the seller owns less than fifty-percent of the capital of the partnership, by an individual or corporation, all of which stock is owned by an individual or corporation, would seem to cause no problem. The sale should not have tax avoidance as one of its principal purposes.14 The transfer of property by an individual to a corporation which is over eighty-percent owned by that individual will result in ordinary income.15

12. 383 U.S. 569 (1966), vacating and remanding 347 F.2d 23 (9th Cir. 1965); see also Simmons & O’Hara, Three New Tests Appear for Obtaining Capital Gains on Real Estate Sales, 28 J. Taxation 218 (1968). See also the Code §§ 341, 751 relating to collapsible corporations (formed with a view to sale) and partnerships (sale of unrealized receivables and appreciated inventory) which can convert capital gain into ordinary income in certain instances.

13. Code § 482 provides:
In any case of two or more organizations, trades, or businesses (whether or not in-
corporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deduc-
tions, credits, or allowances between or among such organizations, trades, or busi-
nesses, if he determines that such distribution, apportionment, or allocation is neces-
sary in order to prevent evasion of taxes or clearly to reflect the income of any of
such organizations, trades, or businesses.

14. Code § 269 provides:
If . . . any person . . . acquires . . . directly or indirectly, control of a corpora-
tion, or . . . any corporation acquires . . . directly or indirectly, property of
another corporation, not controlled, directly or indirectly, immediately before such
acquisition, by such acquiring corporation or its stockholders, the basis of which
property, in the hands of the acquiring corporation, is determined by reference to
the basis in the hands of the transferor corporation, and the principal purpose
for which such acquisition was made is evasion or avoidance of Federal income
tax by securing the benefit of a deduction, credit, or other allowance which such
person or corporation would not otherwise enjoy, then the Secretary . . . may dis-
allow such . . . control means the ownership of stock possessing at least 50 per-
cent of the total combined voting power . . . or value of . . . stock. . . .

See also Code § 1551 which provides:
If . . . any corporation transfers, directly or indirectly . . . all or part of its
property (other than money) to a transferee corporation, or . . . five or fewer
individuals who are in control of a corporation transfer, directly or indirectly . . .
property (other than money) to a transferee corporation, and the transferee cor-
poration was created for the purpose of acquiring such property or was not actively
engaged in business at the time of such acquisition, and if after such transfer the
transferor or transferees are in control of such transferee corporation . . . the
Secretary . . . may . . . disallow the surtax exemption . . . unless . . . not a
major purpose of such transfer.

Thus, when an individual or corporation sells to a partnership, §§ 269 and 1551 are not
applicable. However, see Gregory v. Helvering, 293 U.S. 465 (1935), which held that
substance prevails over form. Therefore, a sale or purchase must not be merely a device
for minimizing tax liability with no other logical business or investment purpose and for
concealing its real character which is solely for tax avoidance.

15. Code § 1239 provides:
In the case of a sale or exchange, directly or indirectly, of property . . . between
a husband and wife; or between an individual and a corporation more than 80
percent in value of the outstanding stock of which is owned by such individual,
his spouse, and his minor children and minor grandchildren; any gain recognized
to the transferor from the sale or exchange of such property shall be considered
Losses and expenses may be disallowed on certain sales between related parties. The attribution rules should be examined in sales between related parties. It should be noted that a taxpayer has been unsuccessful in attempting to sell real estate by reserving to the seller a portion of the real estate's future income in such a way that part of the purchase price is paid with dollars not taxed to the purchaser.

Since owners of real property held for investment or held for use in trade or business (but not that held for sale to customers in the ordinary course of business) have the privilege of deferring the potential gain to be realized upon a disposition of the property by exchanging it for another parcel of real property "of a like kind," the acquirer may find his acquisition made easier if he is willing to purchase other real property, desired by the party owning the property he seeks to acquire, and exchanging it for the property he seeks to acquire.

B. Net Lease

A leaseback to the seller or lease of the property to another tenant or operator may be executed by the limited partnership acquiring the depre-

16. Code § 267 provides:

No deduction shall be allowed—... in respect of losses from sales or exchanges of property . . . directly or indirectly, between persons specified [related taxpayers]. ... Members of a family . . . an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual . . . two corporations more than 50 percent in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if one of such . . . was a personal holding company. ... 17. Code § 318 provides:

An individual shall be considered as owning the stock owned, directly or indirectly, by or for—his spouse, . . . his children, grandchildren, and parents.

Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.

If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

18. Olin Bryant v. Comm'r, 399 F.2d 800 (5th Cir. 1968), aff'd 46 T.C. 84 (1966), held that the ABC transaction was inapplicable to real estate sales; cf. Code § 636 added by § 503 of the Act, which changes the traditional "ABC" transaction and provides:

A production payment retained on the sale of a mineral property shall be treated . . . as if it were a purchase money mortgage loan and shall not qualify as an economic interest in the mineral property.

Therefore, the borrower in a production payment transaction must hereafter satisfy his loan out of after-tax dollars, rather than tax-free dollars, in the same manner as a borrower of funds in any industry, for example, an apartment building purchaser paying off his mortgage. H.R. REP. No. 91-413, 91st Cong., 1st Sess. (1969) (Ways and Means Committee).

19. Code § 1031. For detailed basic information with regard to the sales agreement, tax considerations, determination of title, the conveyance, the closing, leaseholds, and financing, see FLORIDA BAR CONTINUING LEGAL EDUCATION, I FLORIDA REAL PROPERTY PRACTICE (1965).
ciable real property. The leaseback or lease may be on a net lease basis providing for a yearly rental income. Investment property may be purchased with a built-in tenant, namely the seller. An owner of property may sell it, converting its value into cash, lease it back from the purchaser, and yet be in a position to enjoy the continued use of it. Because the lease is normally executed contemporaneously with the sales agreement, the buyer will know exactly what the rate of return on his investment will be.

The factor of deductibility of rent becomes increasingly important as the owner exhausts his allowance for depreciation on the property. By transferring the property to a new owner, a new basis for depreciation is created on the books of the purchaser. Thus, some of the benefit of the new allowance for depreciation may, in effect, inure to the benefit of the seller in the form of a lesser rental. The seller may take back a purchase money second mortgage from the limited partnership buyer. The rent paid is deductible by the lessee-tenant and is income to the lessor-owner. To the extent that the net lease rental income to the lessor-owner-investors can be matched by deductions, principally for depreciation and interest, the investors' net income or cash flow becomes, in effect, tax-free.

The tenant-lessee should not acquire anything of value other than the use of the property, nor should he build up any equity in the property owned by the investors as a result of the rental payments. If this procedure is followed the payments should constitute rent and the sale and leaseback are in fact such, and, thus, the deductions remain in the hands of the intended parties. A significant test of a true sale and leaseback is the relationship between the anticipated value of the property at the end of the period of any option to purchase and the amount the buyer has to pay at that time to reacquire. The rent must be ordinary and necessary, not an obligation created solely for the purpose of permitting a division of the taxpayer's income tax, and the lease must not merely be a device for minimizing tax liability with no legitimate business purpose, thereby being disregarded for tax purposes.20

A sale, leaseback, and option to repurchase could constitute a sale and simultaneous resale to the original seller for tax purposes, if the total of the rental payments and any option price payable in addition thereto approximate the price at which the property could have been acquired by purchase at the time of entering into the agreement plus interest or carrying charges.21 Thus, the likelihood of repurchase at other than

20. Van Zandt v. Comm'r, 341 F.2d 440 (5th Cir. 1965); Roth v. Comm'r, 321 F.2d 607 (9th Cir. 1963); Armstrong Co., Inc. v. Comm'r, 188 F.2d 531 (5th Cir. 1951); Chace v. United States, 303 F. Supp. 513 (M. D. Fla. 1969), aff'd, 422 F.2d 292 (5th Cir. 1970); George S. Lansing, 30 P-H Tax Ct. Mem. ¶ 61,268 (1961).

21. See Rev. Rul. 55-540, 1955-2 CUM. BULL. 39, which provides the guides used by the Service in determining the treatment of leases of equipment used in the trade or business of the lessee; Rev. Rul. 60-122, 1960-1 CUM. BULL. 56, which provides that a lease usually involves the use of equipment for substantially less than its useful life, with no provision for renewal; and Treas. Reg. § 1.1031(a)-1(c) which provides that if a lease is
current fair market value at the time of repurchase may tie in with other factors and may convert what might be considered a sale into something else for tax purposes. The transaction might be found to be a mere lease, a loan or financing transaction, a scheme solely for tax avoidance, a sham, a transaction without purposive activity involved except for tax consequences, or the like. Therefore, several of these problems may be eliminated by giving the original seller the right of first refusal at a price geared to fair market value at the time of any future repurchase; not including lease renewal options or including renewal options at fair market value; or having the lease substantially less than the life of the various properties, and having an "arm's length" reasonable rent.  

Other factors that have been considered with regard to establishing the validity of a sale and leaseback for tax purposes are: (1) the offset of the payment against the purchase price, as well as the payments exceeding rental value; (2) the overall test of the relationship of rent, life expectancy and purchase price; (3) the option price and market value and their relationship at the time exercised; (4) a reversionary interest to the lessor at the end of its use; (5) responsibility for maintenance; (6) any indication of interest; (7) the relationship of the parties; (8) how the rentals are determined (for example, when the rentals are based on hourly and weekly rates of production, the taxpayer has a better position for supporting a lease); (9) industry custom; and, (10) the nature of the business.  

If the seller were ultimately held to be the owner, because the leaseback were deemed a resale, the lessor may be allowed to claim the benefits of the installment election.  

Interest should be charged on a sale where proceeds are deferred under an installment election, especially in the case of a leaseback, because imputed interest added to the down payment or deducted from the net proceeds received by the seller might break the election. Advance deposits may be held to be advance rentals, which can also break the installment election. Advance deposits may be distinguished from advance rentals if they are repayable, not applicable against future rent, segregated and not subject to general use by the lessor, and interest is paid on such deposits. Since the lease costs are amortizable and deductible pro rata over the life of the lease, the unamortized portion of such costs has been held for a period over 30 years, the Service holds that a like-kind exchange occurs of one property interest for another, any loss will not be recognized and the basis will merely carry over.

22. See Warren Brekke, 40 T.C. 789 (1963), vacated and remanded by 9th Cir. pursuant to stipulation, P-H Tax Ct. Mem. ¶ 66,208 (1966) (excessive rent not rent because seller retained equity interest); Royal Farms Dairy Co., 40 T.C. 172 (1963) (excessive rent above fair rate not deductible because not paid for use of property); see also Rev. Rul. 66-153, note 11 supra.  


25. CODE § 483.  

not deductible in full in the year of sale, but deductible from gain as part of the cost of the investment in the real estate. If the lessor-partnership pledges the lease as security for borrowings to finance the acquisition of the property leased, the Service may contend that the lessor has received rental income in advance if a sufficient property interest in future rentals is transferred to the creditor. Thus, every loan agreement should be carefully drafted to assure that the lease rentals are really pledged and not sold, transferred, or assigned as consideration for the advance. Finally, the net lease payments can be guaranteed to the limited partners by the tenant-lessee, and the tenant’s second mortgage pledged as security for such guarantee.

C. Basis of Partner’s Interest

Income and deductions of a partnership are allocable to the partners as provided in the partnership agreement. If the agreement makes no specific provision for sharing such items, they shall be determined in accordance with the provisions for the division of profits or losses. It would seem to follow that all of the depreciation may be allocated to the limited partners providing the equity capital. This view would be strengthened if the general partner provided no part of the partnership capital. The investors would then suffer the “economic loss” due to depreciation. The Regulations suggest that such allocations are permissible. If the tests in the Regulations are met, special allocations are respected and may offer a basis for sound tax planning. The principal purpose of the allocation must not be the avoidance or evasion of Federal income tax.

A related problem arises in connection with those cases in which the syndicator (or any other partner) contributes property to the partnership which has a basis lower than its value. In the absence of a special provision in the partnership agreement, depreciation with respect to the property, or gain on its sale, is allocated to the partners in accordance with the general profit and loss ratio. To avoid the possibility of the syndicator or another partner acquiring a “borrowed” basis and deriving a tax benefit at the expense of his investor partners, the agreement may

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27. Post v. Comm’r, 109 F.2d 135 (2d Cir. 1940); but see S & L Bldg. Corp., 19 B.T.A. 795 (1930), which permitted unamortized fees, commissions, and expenses in obtaining a loan to be deducted in full when the property was sold and the mortgage assumed. It can be argued that lease costs represent expenditures for the cost of renting and operating the property rather than capital expenditures for the cost of any asset.


31. Cf. Rabinowitz, Realty Syndication: An Income Tax Primer for Investor and Promoter, 29 J. TAXATION 95 (1968). United States v. Cocke, 399 F.2d 433 (5th Cir. 1968), rev’d, 263 F. Supp. 762 (S.D. Tex. 1966) (carried party denied expenses and depreciation; tax emoluments and breaks not granted to economic observer, but to risktaker); Rev. Rul. 68-139, 1968-1 CUM. BULL. 311 (limited partners may be allocated by the agreement all intangible costs in accordance with their portion of the contributions to the respective items of cost).

32. Cook § 704(b)(2).
provide special allocation of depreciation deductions to the partners con-
tributing cash, and allocation to the syndicator of the portion of the gain
attributable to the zero or other low basis property contributed by him.\textsuperscript{33} The partnership agreement may be modified retroactively for this pur-
pose after the close of the partnership taxable year, provided the modifi-
cation is made, verbally or in writing, prior to the due date (not includ-
ing any extension of time) for filing of the partnership return.\textsuperscript{34} If tax
inequities occur, they may be rectified during the preparation of the part-
nership's first tax return.

The basis for a partner's interest in a partnership is his original basis,
\textit{plus} his share of partnership liabilities. Each partner's basis is increased
annually by his share of partnership income. Basis is reduced annually by
any distributions received from the partnership and the partner's share of
partnership losses. A partner is not permitted to deduct his share of the
partnership's losses in an amount greater than the basis of his interest in
the partnership at the end of the partnership year in which the loss oc-
curred. A partner's share of partnership liabilities shall be determined in
accordance with his ratio for sharing losses under the partnership agree-
ment. In the case of a limited partnership, a limited partner's share of
partnership liabilities shall not exceed the difference between the actual
contribution credited to him by the partnership and the total contribution
which he is obligated to make under the limited partnership agreement.
However, where none of the partners have any personal liability with re-
spect to a partnership liability, as in the case of a mortgage on real estate
acquired by the partnership without the assumption by the partnership
or any of the partners of any liability on the mortgage, then all partners,
including limited partners, shall be considered as sharing such liability
under section 752(c) in the same proportion as they share the profits.
This may be illustrated by the following example:

G is a general partner and L is a limited partner in a part-
nership GL. Each makes equal contributions of $20,000 cash to
the partnership upon its formation. Under the terms of the part-
nership agreement, they are to share profits equally but L's li-
abilities are limited to the extent of his contribution. Subse-
duently, the partnership pays $10,000 for real property which is
subject to a mortgage of $5,000. Neither the partnership nor
any of the partners assume any liability on the mortgage. The
basis of such property to the partnership is $15,000. The basis
of G and L for their partnership interests is increased by $2,500
each, since each partner's share of the partnership liability (the
$5,000 mortgage) has increased by that amount. However, if
the partnership had assumed the mortgage so that G had be-
come personally liable thereunder, G's basis for his interest

\textsuperscript{33} \textit{Code} §§ 704(c), 734, 743, and 754.

\textsuperscript{34} \textit{Code} § 761(c).
would have been increased by $5,000 and L's basis would remain unchanged.\(^{85}\)

Therefore, the syndicate-investor's basis is increased by his share of the partnership's mortgage liabilities, and he may deduct losses in excess of his cash investment.

Since a partner's basis includes his share of partnership liabilities, any reduction of those liabilities is treated as a distribution to him which reduces the basis of each partner's interest in the partnership by that amount.\(^{86}\) Conversely, any refinancing of the partnership's mortgage which increases the outstanding principal balance would increase his basis to the extent of his share thereof, thus permitting the tax-free distribution to the partners of the proceeds of the mortgage refinancing. Even after the early years of maximum depreciation write-offs, cash flow can thus keep pace with taxable income, if the mortgage can be refinanced at such time as the mortgage amortization payments begin to exceed the annual depreciation deductions.

There were no substantial changes made to Code Section 701 et seq. involving partnerships by the Tax Reform Act of 1969.

D. Depreciation and Amortization Deductions

Depreciation and interest are the most significant deductions available to the investors over the life of the property. Depreciation and interest may be accelerated in the earlier years in some instances. Higher deductions in the earlier years are more advantageous because they create a higher cash flow. Accelerated depreciation and interest deductions in excess of basis may thus bring about a desirable cash flow and return to the limited partners on their investments in their capital equities—if the technicalities and guidelines noted herein are observed—and these deductions will not be inadvertently shifted to unintended receivers.

The present fair market value of the property at the time of the sale should be substantiated by an appraisal. An independent businessman in the business of buying and selling such properties may also substantiate the fair market value by recording what a willing buyer and seller would establish as its price and his reasons therefor.

The law permits a deduction of a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business, or of property held for the production of income.\(^{37}\) The new Act applies the brakes to accelerated depreciation for real estate constructed after July 24, 1969, with the following general exceptions: (1) the 200 percent declining balance or the sum of the years digits method may be used for

\(^{35}\) Treas. Reg. § 1.752-1(e).

\(^{36}\) Treas. Reg. § 1.752-1(b). For the effect of a discharge of indebtedness on the basis of partnership property, see Code §§ 108 and 1017. For further information on partnership transactions in property mortgaged in excess of basis, see P. Anderson, Tax Factors in Real Estate Operations 204, et seq. (1960).

\(^{37}\) Code § 167.
new residential rental property; (2) 150 percent declining balance for other new real estate; (3) 125 percent declining balance for used residential rental property with a useful life of twenty years or more at the time of acquisition; (4) if the Commissioner permits otherwise, used residential rental property with a useful life of less than twenty years may be depreciated at a rate accelerated from that of straight line; and, (5) capital expenditures made for the rehabilitation of old properties (such as slum or substandard housing) rented to persons of low or moderate income may be amortized under the straight line method using a five year useful life and no salvage.\textsuperscript{38} Accelerated depreciation on realty and amortization of rehabilitation expenditures are tax preference items on which an additional ten percent may be levied (on the total of such items in excess of $30,000).\textsuperscript{39} Used property is that which is converted to business or income producing property, or whose first use did not begin with the taxpayer. In order to qualify as residential rental property, at least eighty percent of the gross rental income from the building must be rental income from dwelling units. A dwelling unit is defined as a house or an apartment used to provide living accommodations in a building or structure, but not including a hotel or motel unit or other establishment in which more than half of the units are used on a transient basis. The quick write-off also does not apply to rehabilitation of motels, hotels, or other establishments where more than one-half of the units are rented on a transient basis. Finally, the rehabilitation expenditure must meet two requirements to be eligible for rapid depreciation: (1) it must not exceed 15,000 dollars per dwelling unit in the building, and (2) it must exceed 3,000 dollars per unit over a period of two consecutive years.

The partnership may also take a 2,000 dollar bonus depreciation write-off in the year of purchase, which results from the 20 percent first-year depreciation bonus allowed on tangible personal property (with a remaining useful life of at least six years); but only to the extent of 10,000 dollars.\textsuperscript{40} Depreciation starts when the partnership assumes the burden of ownership and takes possession.\textsuperscript{41} Depreciation in the year of a sale at a gain is deductible.\textsuperscript{42}

The Service publishes guidelines for depreciable assets used by business in general, and for items such as land improvements, furniture, fixtures and equipment, and buildings.\textsuperscript{43} These guidelines use the term “building” as inclusive of the structural shell of the building, all integral parts thereof, and the normal service equipment such as heating, plumbing, air conditioning, fire-prevention equipment, elevators, and escalators. The term excludes special-purpose structures which are an integral part

\textsuperscript{38} Code §§ 167, 1250, as amended by § 521 of the Act.
\textsuperscript{39} Code §§ 56-58, added by § 301 of the Act.
\textsuperscript{40} Code § 179.
of the production process and which, under normal practice, are replaced contemporaneously with the equipment which they house, support or serve. Nonindustrial and general-purpose industrial buildings, such as warehouses, storage facilities, general factory buildings and commercial buildings, are not special-purpose structures in this context. Finally, special-purpose structures shall be classified with the equipment which they house, support or serve, and their depreciable lives determined by reference to the appropriate guidelines for the particular industries. It would follow that buildings to serve specialized purposes and equipment, likely to become out-of-date as trends change, would have expected lives less than that set forth in the guidelines. An example would be fast food franchise buildings and equipment when viewed prospectively. The Service notes that the depreciable lives of buildings and additions which are neither special-purpose structures nor included in the types of buildings listed shall be determined according to the facts and circumstances of each case.44 For example, gasoline service stations (including buildings) are given a life of sixteen years, and farm buildings are given a twenty-five year life.

The Service also sets forth guidelines for nonmanufacturing activities, excluding transportation, communications, and public utilities, but inclusive of all depreciable property not covered by another guideline class.45 Examples include recreation and amusement establishments such as bowling alleys, cafes, and motels.

The purpose of the allowance is to permit taxpayers to recover through annual deductions the cost (or other basis) of the property over its useful economic life. The determination of the useful economic life of an asset is a matter of judgment and estimate; for this reason, it is a policy of the Internal Revenue Service generally not to disturb depreciation deductions. Therefore, adjustments in the depreciation deduction should not be proposed unless there is a clear and convincing need for a change.46 These guidelines apply to broad classes of assets rather than to individual assets.47 Since the prescribed guideline lives are expressed in terms of years, the procedures set forth herein cannot be applied to assets depreciated under the unit-of-production, machine-hour, or similar methods of depreciation. If any asset in a guideline class is depreciated under one of these alternate methods, the procedures expressed in the guidelines are inapplicable.48 Whether depreciation claimed by the taxpayer with respect to that guideline class is reasonable will continue to be determined under two former Service positions.49 It is noted that the guideline lives issued by the Service will not be regarded as evidence of the

45. Rev. Proc. 62-21, supra note 43, group II.
47. Id.
48. Id.
appropriate useful lives to be used where taxpayers do not follow retirement and replacement practices consistent with those lives during the years under examination. Where a class life used is shorter than the guideline life and has not been previously justified, a significant factor in determining whether the class life is justified for the taxable year under examination on the basis of all the facts and circumstances is the fact that the life used by the taxpayer in computing his depreciation deduction is the same as the life used in computing the depreciation shown on the taxpayer's books of account and financial statements. Substantial weight should also be given to any other objective factors which indicate that the taxpayer intends to follow a more rapid retirement and replacement practice than is reflected in the guideline life and to whether the taxpayer has previously followed retirement and replacement practices consistent with lives previously used. Other situations in which the class life used by a taxpayer may be justified by the facts include those situations: (1) where there is an abnormally intensive use of assets; (2) where some of the assets were not new when acquired; (3) where there is an extraordinary obsolescence which affects the particular taxpayer; and (4) where the class contains a disproportionate amount of relatively short-lived assets.

The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. Thus, hindsight evidence should not be considered in determining the useful life of the taxpayer's real property. Some of the other relevant factors considered by the courts include actual physical decay of the building, obsolescence in the building because of changes in office building design, local economic factors affecting useful life, competition, building's comparative status, additions and improvements which may have to be made, taxpayer's policy as to repairs, renewals, and replacements, uncertainty of use (e.g., as a shopping center), experience with similar use in the area, frequency that new tenants require substantial modernization before moving (e.g., complete rewiring, replacement of ceilings and store fronts, removal of walls), likelihood of lease renewal, economic changes, wear and tear from natural causes, developments within the business, conditions peculiar to the taxpayer's business, and the period over which the asset may be expected to be useful to the taxpayer in his particular business.

51. Id.
52. Id.
53. Treas. Reg. § 1.167(b)-0-(a); Western Terminal Co. v. United States, 412 F.2d 826 (D. Wash. 1969), on remand from 9th Cir. (Five-year useful commercial life for storage facility for depreciation purposes allowed, though physical life was twenty years); see also Johnson v. Comm'r, 302 F.2d 86 (4th Cir. 1962), cert. denied, 371 U.S. 904; Burnett v. Niagara Falls Brewing Co., 282 U.S. 648, 655 (1931); Moise v. Burnet, 52 F.2d 1071, 1073-74 (9th Cir. 1931).
54. See Herbert Shainberg, 33 T.C. 241 (1959) (partnership segregated shopping center buildings and equipment into component grouping method).
A facility may be depreciated on either a composite basis or a component basis. If a composite basis is adopted, the building, improvements and equipment are assigned a thirty year useful life. If, on the other hand, the facility is to be depreciated on a component basis, the facility may be broken down into its components. The building may be assigned a thirty-three year useful life; the appliances assigned an eight year useful life; and, the land improvements assigned a twenty year useful life. A typical group of component accounts might include: (1) building (33 1/3 years); (2) cabinets (10 years); (3) appliances and special equipment (8 years); (4) painting (3 years, on the straight line method); (5) floor covering (8 years); (6) parking lot (10 years); (7) other land improvements (20 years); (8) roofs (12 years); and, (9) windows (12 years).\(^5\)

In establishing values for new construction, the costs should be separated into three categories. The first category, costs allocable to depreciable property, may include the following: building, land improvements, builder’s general overhead, architect’s fee, general requirements, bond premium, builder’s profit, sponsor’s profit, insurance, title and recording costs, F.H.A. examination and inspection, and legal costs. The second category, costs deducted when paid, may include the following: taxes, and fees of the Federal National Mortgage Association or the Government National Mortgage Association. The third category, costs deducted over the period of benefit or coverage, and the period over which they may be deducted include the following: F.H.A mortgage insurance premium (0.5 per cent per year is deductible over the twelve month period covered), financing fee (deductible over the construction period if paid for that period), and interest under the accrual method.

The advantages of selecting the depreciation method best suited to the particular enterprise’s goals cannot be gainsaid. The previous discussion should provide a basis for establishing such a method.

E. Recapture of Depreciation and Investment Credit

The excess of post-1969 realty depreciation over straight line depreciation will be 100 percent recaptured on dispositions after 1969, except for the phase-out of recapture allowed for residential rental housing and rehabilitation expenditures. To provide incentive for the continued building and restoration of residential properties, the new Act sets forth a more beneficial recapture rule for post-1969 depreciation on residential rental property and rehabilitation expenditures. The post-1969 depreciation is fully recaptured if the property is held for 100 months (eight years, four months) or less. For each month the property is held over 100 months, the recapture percentage decreases by one percent. Thus, there would be no recapture of post-1969 depreciation after sixteen years, eight

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\(^5\) REV. RUL. 70-383, 1970 INT. REV. BULL. No. 30, at 8. This ruling permits use of guideline lives when the taxpayer has used the component depreciation method.
months. The holding period for determining the recapture percentage for rehabilitation expenditures begins with the date the improvement is placed in service. There are also special rules for a qualified low-income housing project which limit recapture upon the disposition, and eliminate tax upon sale if the proceeds are reinvested.

Section 1250-1(c)(6) of the Internal Revenue Code provides that recaptured depreciation must be reported as ordinary income before any capital gains may be reported from an installment sale of real estate. The first challenge to these rules involved recapture of depreciation on a sale of business equipment. The District Court held that Section 1.1245-6(d) which gives recaptured depreciation a similar priority on an installment sale, is valid.

In general, under the investment credit recapture rules, if an asset is disposed of, the owner (or lessee if the credit was passed over to him) must recompute the investment credit based on the actual life.

F. Termination of Investment Credit

The investment credit is repealed by the new Act for property acquired after, or whose construction or reconstruction was begun after, April 18, 1969. There are a number of exceptions for property with respect to which binding commitments or substantial plans were made on or before that date. However, even these exceptions will cease to apply after 1975. Unused credits may generally be carried back three years and forward seven years, except that in certain situations a ten year carryover is allowed.

G. Interest, Prepaid Interest, and Deferral of Prepaid Receipts

A deduction is allowed for all interest paid or accrued within the taxable year on indebtedness. But, for taxable years ending after 1969, excess investment interest is considered a tax preference and thus subject to the new minimum tax of ten percent on items in excess of 30,000 dollars. Furthermore, investment interest only comes under the minimum tax provisions until 1972, when the new rule limiting the deduction of investment interest becomes applicable. Interest deductions attributable to investments by noncorporate taxpayers are limited, in general, for taxable years beginning after 1971 to the sum of all the following: (1) 25,000 dollars, (2) net investment income, (3) excess of net long-term capital gain over net short-term capital loss (note that this converts

59. Code § 47.
60. Code § 49, added by § 703 of the Act.
61. Code § 163(a).
63. Code § 163(d)(1), added by § 221 of the Act.
capital gain into ordinary income), and (4) fifty percent of the investment interest in excess of the sum of (1), (2) and (3). Any disallowed investment interest deduction can be carried over to subsequent years. The investment interest limitation affects only substantial investors. For example, at an eight percent interest rate, the investor has to borrow 312,500 dollars in order to have interest expense of 25,000 dollars. The new Act provides a number of other special rules and exceptions in applying the limitation on investment interest. For example, each partner is required to take into account his separate distributive share of the partnership's investment interest; interest on construction loans for property used in a trade or business is not investment interest; and, property subject to a net lease receives special treatment. 64

Generally, despite the above new limitations, interest on the first and second mortgages is deductible in full, except in extremely large syndications; net lease rental payments from the tenant to the limited partnership will normally be sufficient to pay the mortgage payments; and the depreciation and interest deductions will shelter from tax a substantial portion or all of the rental income.

A second mortgage may be most helpful in bringing about the acquisition, and it may also increase the interest deductions, especially if no principal payments are required and only interest is paid. 65 Where a borrower and a lender designate, in a bona fide and arm's length agreement, that loan installment payments by the borrower on a loan, made at a discount, shall be applied first to loan principal, a lender, who employs the cash receipts and disbursements method of accounting, is not required to report any portion of such payments as interest income until after the amount he actually advanced to the borrower has been recovered. Conversely, no interest-paid deduction will be allowed the borrower, on the cash receipts and disbursements method of accounting, until after the amount he actually received has been repaid. 66 It would seem to follow that the parties may specify that only interest is to be paid on the note until it matures.

A loan origination fee, known as points, to obtain an FHA or VA mortgage is a service charge—not interest. 67 However, a loan processing fee (points) paid by a mortgagor-borrower as compensation to a lender solely for the use or forebearance of money is considered to be interest. 68 The portion of a loan charge that can be established as paid by the borrower for the use, forebearance, or detention of money is deductible

64. Id.
65. See CCH, Rewrite Bulletin, § 8232 (March 12, 1969), noting that a buyer paid 10,000 dollars down, and deducted depreciation and interest on a ninety-nine year purchase money mortgage providing for no principal payments in the note.
66. Rev. Rul. 63-57, 1963-1 Cum. Bull. 103; but see Code § 483 with respect to imputed interest if a deferred payment sale contract specifies either no interest or an unrealistically low rate of interest.
as interest. One-half of one percent premium charge (points) by a savings association for the privilege of being granted a loan is considered deductible interest. However, a membership subscription payment during a construction period is not deductible as interest or real estate taxes, if paid for land acquisition costs, construction costs which exceed mortgage proceeds, working capital, cost of leasing, or operating and maintaining sales area.

Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Thus, personal liability on the mortgage is not necessary, but there must be true ownership by the buyer after a conclusive disposition and sale for tax purposes. As Tillie Goldstein v. Commissioner held:

Sec. 163 . . . does not permit a deduction for interest paid or accrued in loan arrangements, like those now before us, that cannot with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences . . . [T]here is no requirement that deductible interest serve a business purpose, that it be ordinary and necessary, or even that it be reasonable . . . On the other hand, and notwithstanding Section 163's broad scope, this provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction . . .

Therefore, interest is not deductible if the funds are borrowed in a transaction with purposeless activity, as, for example, a transaction resulting in an economic loss except for the interest deduction.

On November 26, 1968, the Service announced that it was revoking its position followed since 1945 which had held that where a taxpayer keeps books of account and files returns on the cash receipts and disbursements method of accounting, interest paid in advance for a period of five years is deductible for the year in which paid, but where the accrual method of accounting is used in reporting income, interest is deductible for the year in which the liability to pay accrues irrespective of when payment is actually made. The Service now concludes that the deduction of prepaid interest in the year of payment by a taxpayer employing the cash receipts and disbursements method of accounting may not result in a clear reflection of income for the taxable year of payment. The Service reasons:

72. Treas. Reg. § 1.163-1(b).
73. 364 F.2d 734, 739 (2d Cir. 1966).
A deduction for interest paid in advance on each indebtedness for a period not in excess of 12 months of the taxable year immediately following the taxable year in which the prepayment is made will be considered on a case by case basis to determine whether a material distortion of income has resulted. Some of the factors to be considered in determining whether the deduction of prepaid interest gives rise to a material distortion of income include but are not limited to the amount of income in the taxable year of payment, the income of previous taxable years, the amount of prepaid interest, the time of payment, the reason for prepayment, and the existence of a varying rate of interest over the term of the loan. If interest is prepaid for a period extending more than 12 months beyond the end of the current taxable year, the deduction of such prepaid interest in the taxable year of payment will be considered as materially distorting income. Where a material distortion of income has been found to result from the deduction of prepaid interest, the Service will require the taxpayer to change his method of accounting with respect to such prepaid interest in order to allocate it over the taxable years involved.\(^7\)

Advance payments and other prepaid income for both cash and accrual basis taxpayers are generally income in the year received, provided no restriction has been placed upon their use, even though the advances are returnable upon the happening of some specified condition. This is the same treatment as that usually accorded the receipt of income by a cash basis taxpayer under the "claim of right" doctrine. Such is the case with rentals, royalties or bonuses paid upon the execution of a lease, and prepaid advertising charges.\(^7\) Since the Service position provides that advance payments must be included in income for the year of receipt regardless of the period covered or the method of accounting employed

\(^7\)Rev. Rul. 68-643, 1968-2 CUM. BULL. 76, revoking I.T. 3740, 1945 CUM. BULL. 109; H.R. Rep. No. 91-413, 91st Cong., 1st Sess. (1969) (Ways and Means Committee) (to accompany H.R. 13270) stated that Rev. Rul. 68-643 was "in accord with your committee's concept of the law;" Baton Coal Co., 19 B.T.A. 169 (1930), aff'd, 51 F.2d 469 (3d Cir. 1931), cert. denied, 284 U.S. 674 (1931), noted that prepaid rent is not deductible because it was not "ordinary and necessary;" but see Fackler v. Comm'r, 39 B.T.A. 395 (1939) (two years' prepayment of interest), and Court Holding Co. v. Comm'r, 2 T.C. 531 (1943), which permitted the deduction of prepaid interest in both cases; Pauley v. United States, 63-1 U.S. Tax Cas. 9280 (S.D. Cal. 1963), which allowed the deduction of prepaid intangible drilling expenses even though the services were rendered in the following year; and, Kaster, Prepaid Interest Purchase Method Still Useful Despite IRS Attack, 30 J. TAXATION 16 (1969), wherein it is stated that Rev. Rul. 68-643 does not put an end to all prepaid interest transactions. (Such real estate acquisitions utilizing prepaid interest involve a buyer's promissory note representing most of the purchase price in excess of existing mortgages and the buyer's prepayment at the closing of several years' interest on that purchase money note).

by the taxpayer, this would seem to provide the taxpayer with a stronger case for the deductibility of prepaid interest, especially where, for example, there is included a provision for a rebate of unearned interest and the buyer and seller have adverse tax positions. Finally, it is noted that interest does not have to be ordinary and necessary to be deductible as in the case of prepaid rent. It would follow that interest can be at a different rate from one year to the next.

The use of escrow devices to delay receipt of income is a possible solution for deferring prepaid receipts. The government, however, seems opposed to allowing the use of escrows in this manner. In *Angelus Funeral Home v. Commissioner*, a sufficiently restrictive trust arrangement, wherein the taxpayer had no right to use receipts paid in by its pre-need applicants, was validated as an income deferral device. (A second trust in that case was found to allow too much taxpayer control to preclude current receipt). Thus, a trust device can be used to defer receipt of income only if the taxpayer cannot effectively use the funds. Such a device, however, might well aid the taxpayer seeking only to allow his buyer an early deduction, yet will delay receipt.

Sums received by a principal from his exclusive sales agent as a security deposit to insure the agent’s performance under the terms of a contract are not includible in the gross income of the principal where he is under an obligation to repay such amounts upon the performance of the terms of the contract. The sales agent may not deduct these payments made during the period of the contract. However, the security deposit or the appropriate part thereof will be includible in the gross income of the principal in any year in which the agent defaults on the contract and the sums are, as a consequence, appropriated by the principal to cover such default. When such default occurs, the sales agent may deduct such sums.

H. Limited Partnership Agreement

The buyer or acquirer of the property will be a limited partnership in many instances. It can also be a regular partnership. Besides giving the tax deductions to the individuals, the limited partnership has the additional advantage of limiting the liability of the limited partners to the amount of their investments. An election under Subchapter S for a corporation to be taxed as a partnership is not available in most instances to corporations holding substantial amounts of real estate, because a “tax-option” corporation may not have over twenty percent of its gross income from real estate.

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78. 47 T.C. 391 (1967).
income from rents. A corporation is usually less desirable than a partnership because a corporation must pay the corporate tax, and it cannot pass deductions through to individuals. Though a real estate investment trust pays no corporate tax, it also cannot pass the deductions through to the individual investors. Furthermore, a corporation holding rental property in many instances may become liable for the personal holding company penalty tax, unless over fifty percent of its adjusted ordinary gross income is from rents. Even then, it is difficult to prevent rental income from becoming personal holding company income subject to the penalty tax, because of the manner in which adjusted ordinary gross income is determined wherein rental income must be reduced by deductions for depreciation and amortization, property taxes, interest, and rents paid which are attributable to such income.

A detailed limited partnership agreement is worthwhile. The state statutes and federal tax regulations with regard to limited partnerships must be followed closely. The federal tax regulations give two examples that may be followed for real estate syndications, one with thirty limited partners and the other with 900 limited partners. The business of the limited partnership will be acquiring, owning, leasing, operating and refinancing leasehold or fee interests in real property for investment purposes. The limited partnership agreement should cover all material aspects of the limited partners' rights and other matters discussed herein, including the election with regard to basis computations, management agreements, leases, guarantees, liability, depreciation, sales proceeds, and mortgage refinancing distributions. If the guidelines as set forth herein are followed, the limited partners will be entitled to their allocable shares of the depreciation and interest deductions in accordance with their capital accounts; in no event will any limited partner be liable for any debts, liabilities, or obligations of the partnership in excess of his capital contribution; the limited partners, as investors, will have capital gain upon any subsequent sale of their partnership interest; they may have no personal liability on the mortgages, and yet have all of the depreciation; and, they may have the mortgage refinancing distributions tax-free. It

82. Code §§ 541-543.
83. See Fla. Stat. §§ 620.01-.32 (1943) (Part I, Uniform Limited Partnership Law). Note that (1) a corporation may be a partner pursuant to §§ 620.011, 620.01; (2) per § 620.07, a limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business or violates § 620.05 (relating to misuse of the limited partners name); (3) a person may be a general and a limited partner in the same partnership at the same time pursuant to § 620.12; (4) such interest is personal property pursuant to § 620.18; and, (5) the contributions of a limited partner may be cash or other property, but not services pursuant to § 620.04. See Fla. Stat. §§ 689-717 (1969) (Real and Personal Property) for further information on conveyances of land, conveyances by corporations, mortgages, Condominium Act, marketable record title, and liens; and Fla. Stat. §§ 725-27 (1969) (statute of Frauds, Fraudulent Conveyances and General Assignments).
84. Treas. Reg. § 301.7701-3(b) (1960).
would be customary for them to receive a percentage, e.g., fifty percent of such distributions and the syndicator fifty percent, along with a percentage, e.g., fifty percent of the "resale rights," or one-half of the capital appreciation or profit upon any subsequent sale. These rights may be bargained for between the investors and syndicator.

The general partner or general partners may be an individual, corporation, an individual and a corporation, a subsidiary corporation, a subsidiary corporation of the parent corporation selling the real property to the limited partnership, or some other possible combination. If the general partner is a corporation, and if certain conditions are met, it may make a Sub-S election to be taxed as a partnership. A corporation as general partner may receive its compensation through a management contract and thus avoid the problems of having over twenty percent of its gross income from rents, and characterization as a personal holding company if less than fifty percent of its income is from rents. Particularly when a corporation is a general partner, it must be viable, engaged in a valid business or commercial purpose, and not a mere recipient of income actually earned by others, or a mere skeleton or dummy used to split income with no other reason for its existence than to achieve tax savings. An adequate capital contribution from the corporate general partner to the limited partnership, the elimination of any of the limited partners as shareholders of the corporate general partner, and the elimination of any officer or director of the corporate general partner, as a limited partner, regardless of whether he owns any stock in such corporation, is believed to be sufficient to dispel problems in this area. The tax status of a partnership otherwise valid should not be affected by the fact that a corporation is a general or limited partner.

It is clear from a close examination of the regulations, section 301. 7701-2 and 3, that a limited partnership with a corporation as the general partner will be taxed as a partnership if the partnership complies with the following criteria:

1. Provide that the death, insanity, bankruptcy, retire-

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85. McGuire v. United States, 23 Am. Fed. Tax R.2d 69-800 (S.D.N.Y. 1969). The court considered corporate records, stock certificates, manner of operation, suppliers dealings with corporation rather than individuals, use of place of business, corporate compensation, stockholders, officers, activities of officers and stockholders, and Code § 482 (reallocation of income to actual earner of income); see also Hobet, The Corporate Entity: When Will It Be Recognized For Federal Tax Purposes?, 26 J. Taxation 74 (1967); Noonan v. Comm'r, 52 T.C. 641, (1969); but see John L. Denning & Co., Inc., 180 F.2d 288 (10th Cir. 1950), rev'g, 17 P-H Tax Ct. Mem. ¶ 48,277 (1948), on the ground that the undisputed facts showed that the partnership which the Tax Court had held to be a sham served an independent business purpose.

ment, resignation, or expulsion of any member will cause a dissolution of the partnership, so that continuity of partnership life does not exist. Terminability at will of any member also eliminates continuity of life. Regulations, section 301.7701-2(b)(1).

(2) Have the corporate general partner own a substantial interest (e.g., over 20%) in the partnership and contribute as much capital as possible to the partnership. This is designed to avoid centralized management, which ordinarily does not exist if the limited partners do not own substantially all the interests in the partnership. Regulations, section 301.7701-2(c)(4).

(3) The corporate general partner must be viable, and not a mere dummy acting as agent of the limited partners. Limited liability is thus avoided. Regulations, section 301.7701-2(d)(2). (A large capitalization and substantial assets in this corporate general partner are not essential to avoid limited liability under the Regulations.)

(4) Prohibit the assignment of members’ rights to participate in management of limited partnership, thereby avoiding the free transferability of interests. Regulations, section 301.7701-2(e)(1). (Rights to share in profits may be assigned without the consent of other members. The right of first refusal creates a modified form of free transferability).

Therefore, even if paragraph 2 above cannot be complied with because not feasible, compliance with paragraphs 1, 3, and 4 will conclusively prevent the limited partnership from being taxed as a corporation, since the limited partnership has more noncorporate characteristics (3) than corporate characteristics (1, possibly). Regulations, section 301.7701-2(a)(3).

The general partner may be the syndicator and may be related to the seller or buyers in some manner or he may be independent. The general partner may also hold his interest as an investment, so that a sale will give rise to capital gains. Where the syndicator does not acquire his interest at a time prior to the investors’ acquisition of their interests, an interest in the profits received in a tax-free exchange may still result in capital gains upon a later sale without bringing about imputed compensation at the formation. Further interests such as the resale or refinancing rights also result in capital gains when realized, unless specifically intended as compensation. If the syndicator receives an interest in the partnership

87. If the parties are related, or controlled directly or indirectly, Code §§ 267, 269, 318, 446, 482, 483, 1239, and 1551 should be checked to ascertain whether they apply.
89. See United States v. Frazell, 335 F.2d 487 (5th Cir. 1964), which discusses and recognizes a "springing executory interest," Ayrton Metal Co., Inc. v. Comm’r, 299 F.2d 741 (2d Cir. 1962) (disposition of unaccrued, unearned, and uncertain future net profits interest in a partnership resulted in capital gains); cf. Burnet v. Logan, 283 U.S. 404 (1931) (uncertain profits interest deferred until received).
capital without making a capital contribution, purchasing it, or receiving it in a tax-free exchange, the resulting compensation may be taxable as ordinary income. The syndicator may assure capital gain on the sale of his interest by forming the limited partnership and contributing capital for his interest, purchasing his capital interest, or acquiring his profits interest (none of which are received or intended as compensation), and then acquiring the property, since the value of the initial interest cannot be said to exceed the price paid therefor, and any consequent accretion in wealth through unrealized capital appreciation is taxed only upon sale. This parallels the traditional method of increasing share values without tax, but eliminates an immediate cash gain. The lack of capital interest of the syndicator strengthens the position of the limited partners if they desire to take all of the depreciation. The general partner may control the lease, which should be an arm's length transaction. The efforts of the syndicator may be essential to the formation of the syndicate. He may act as promoter, underwriter and manager, and has organizational expenses, temporary financing costs, legal and accounting costs, selling costs, and profit. There are numerous methods of compensating the syndicate organizer such as the following: (1) direct underwriting fees; (2) sale of the syndicated property to the syndicate at a profit to the syndicator; (3) participation in the syndicate on the same basis as investors at nominal or reduced investment; (4) participation in syndicate profits on a basis subordinate to the investors; (5) transfer of assets to the syndicate in exchange for an interest therein; and, (6) indirect compensations, if syndicators are real estate brokers, managers, lawyers, or accountants.

I. Securities Law

Appropriate information should be submitted to all of the limited partners containing a full and fair summary of all material aspects of the investment. The Florida and Federal laws seek to protect the investing public from the fraudulent sale of worthless securities by requiring the registration of securities (with certain exceptions) before sale to the pub-

90. Treas. Reg. § 1.721-1(b) (1).
91. See H. ROTHCHILD & D. BERMAN, HOW TO INVEST AND PROTECT YOUR PROFITS IN REAL ESTATE SYNDICATES 11 (1964) (list of material facts respecting the investment to be included in prospectus or brochure and disclosed to all investors), at 145 (checklist for investor to rate investment), at 148 (list of items of basic information required to be included in a syndicate brochure under New York law), at 152 (regulations issued under the N.Y. Real Estate Syndicate Act setting forth items to be contained in a public offering prospectus, advertising rules, prefiling procedure, annual reports, provisions in the case of limited partnership syndications with the general business law, requirements relating to sources of distributions); 15 U.S.C. § 77 (aa) (1933), Schedule A (information required in registration statement); SEC Securities Act Release No. 4877 (Oct. 12, 1967) (real estate syndications); SEC Securities Act Release No. 4885 (Oct. 28, 1967) (a comprehensive study of the effectiveness of present disclosure requirements instituted by the SEC)—the study "Disclosure to Investors, a Re-Appraisal of Federal Administrative Policies under the 1933 and 1934 Acts," was released in 1969.
lic. The acts are implemented by civil remedies and criminal sanctions for violations of their provisions. Federal securities laws require full and fair disclosure of all material facts to the prospective purchaser and do not pass on the merits of the proposed issue. The Florida laws require disclosure and also permit the commission to refuse to register any proposed offering unless the sale be “fair, just, and equitable” to the new investor. Even “exceptions” to the registration requirements of Florida and Federal laws may carry civil or criminal liabilities for fraudulent acts. It must be determined from all the facts in each case whether there is a security, a sale, a non-exempt transaction, and the jurisdiction and applicability of the appropriate laws.

“Blue sky laws” have been adopted in most of the states. The Federal Securities Act of 193392 is similar to, but not identical with, most state laws in scope or operation. Other Federal enactments on the subject are the Securities Exchange Act of 1934,93 the Trust Indenture Act of 1939,94 the Investment Company Act of 1940,95 and the Investment Advisers Act of 1940.96 The Federal enactments impose certain conditions, limitations, and restrictions upon the right to the use of the mails or the instrumentalities of interstate commerce in connection with transactions involving securities. Various types of transactions are made unlawful by the provisions of the Securities Exchange Act,97 and the same transactions may constitute a violation of both the Securities Exchange Act of 1934 and the Federal Securities Act of 1933. Some of the acts require that notice of an intention to offer securities for sale be given to a designated public official or authority, and prohibit or otherwise regulate the payment of compensation for organizing corporations, procuring subscriptions for their capital stock, or selling corporate securities.98 Most of the states’ acts provide that the actual issuance of the certificate of approval shall precede the right to do business.99 Allowance is usually made for the filing of a statement or otherwise furnishing information with respect to the securities.100 Further, with respect to securities required to be registered under the Federal Securities Act of 1933, it is provided that such registration shall not be permitted to become effective unless the securities are

92. 15 U.S.C. §§ 77(a) et seq. (1933) (registration of initial distribution of securities offered through mail or by interstate commerce).
93. 15 U.S.C. §§ 78(v) et seq. (1934) (regulation of transactions upon securities exchanges and over-the-counter markets).
95. 15 U.S.C. §§ 80(a)-(1) et seq. (1940) (protection of investors in investment companies against the managing of those companies in the interests of persons other than the investors).
96. 15 U.S.C. §§ 80(b)-(1) et seq. (1940).
100. 15 U.S.C. §§ 77(f)(a) (1933) (registration), 77(g) and 77(aa) (schedule of information required in registration); Annot., 87 A.L.R. 43 (1933).
issued under an indenture conforming to the requirements of the Federal
Trust Indenture Act, and unless the person designated as trustee is eligi-
ble under its provisions. The Federal Securities Act of 1933 declares
that it shall be unlawful to carry or cause to be carried through the mails
or in interstate commerce any security registered under the Act, for the
purpose of sale or for delivery after sale, unless accompanied or pro-
ceeded by a prospectus meeting certain requirements.

Provision is frequently made for the registration of persons engaged
in the sale or marketing of securities as brokers, dealers, salesmen, agents,
etc., as a condition precedent to the right to engage in such business.
The Federal Securities Exchange Act provides for the registration, with
the Securities and Exchange Commission, of brokers and dealers in over-
the-counter brokers' and dealers' associations. Some statutes stipulate
that all sellers of certain types of securities must obtain a license, which is
granted only after due examination of the nature of the security to be dealt
in and the character of the applicant. The applicant may be required to
furnish certain information to the licensing authority for such purpose.
Congressional inaction leaves the state free to impose such an indirect or
incidental burden upon interstate commerce as may result from a statute
forbidding dealers from disposing or offering to dispose of corporate or
quasi-corporate securities "within the state" without first having obtained
a license from a specified state official.

The Federal Trust Indenture Act of 1939 is designed to protect
investors in securities by requiring trust indentures under which securi-
ties are issued to conform to certain specific statutory requirements, so as
to assure the investors the services of a trustee properly qualified to rep-
resent their interests. The Trust Indenture Act applies to indentures cov-
ering securities registered under the Federal Securities Act of 1933, as
well as those covering some securities exempt from the Securities Act.

The use of the mails or the instrumentalities of interstate commerce
in connection with fraudulent transactions in securities or in order to ef-
fect a sale thereof by certain improper practices is made unlawful by the

As a general rule, so-called "blue sky laws" do not have any extra-
territorial operation or effect. State legislation regulating the issuance
and sale of securities, insofar as it concerns matters within the jurisdic-

104. 15 U.S.C. §§ 78(o) and 78(o)(3) (1934).
109. Mayer v. Rankin, 91 Utah 193, 63 P.2d 611 (1936). But see State v. Swain,
147 Ore. 207, 51 P.2d 745 (1934), reh. denied, 32 P.2d 773 (1934), where sale and contract
were in one state and delivery of stock was in another state.
tion of the federal government, is usually superseded and rendered inoperative by federal legislation on the same subject. The term "security", as used in securities acts, is frequently defined in the act itself. The phrase "investment contracts" includes agreements whereby the purchasers look entirely to the efforts of other persons to make their investment a profitable one. It has been held without exception that documents evidencing a share or interest in a trust, syndicate, or other unincorporated entity, which are sold or intended for sale to the public (as distinguished from documents issued to the organizers or original participants) constitute "securities" within the meaning of various "blue sky laws."

Certain classes of securities are usually excepted from the operation of the provisions, or particular provisions, of the various acts. The Securities and Exchange Commission may, by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to those exempted. This power to exclude certain securities is limited to areas where the Commission finds that the enforce-

111. SEC v. W.J. Howey Co., 328 U.S. 293 (1946) which originated in Florida, is referred to as the landmark case in this area of securities regulation by Sowards, Florida Securities Regulation, 1966, 20 U. MIAMI L. REV. 546, 560 (1966). It has been held that the Texas Securities Act by including in its definition of "security" any preorganization certificate or receipt or note or other evidence of indebtedness, extends to a memorandum containing a proposal with respect to the acquisition of stock to be issued by a corporation pursuant to the plan, as well as to letters acknowledging receipt of money in acceptance of the proposal. Brown v. Cole, 155 Tex. 624, 291 S.W.2d 704 (1956). Under the Texas statute defining the term "securities", inter alia, as "any instrument representing any interest in or under an oil, gas or mining lease, fee or title," it has been held that an oil or gas lease constituted a security subject to the provisions of the regulatory act. Annot., 163 A.L.R. 1050 (1946). So also, under the circumstances involved, documents assigning mineral leases have been held to be "securities" within the meaning of the Federal and California statutes. Annot., 163 A.L.R. 1050 (1946). Compare Howey supra with Polikoff v. Levy, 55 Ill. App. 2d 229, 204 N.E.2d 807 (1965), cert. denied, 382 U.S. 903 (1965), wherein unit interests in a joint business venture to build and operate a motel were held not to constitute "securities" within the meaning of section 2(1) of the Securities Act of 1933 and section 2 of the Illinois Act, on the ground that all members of the group had equal rights of management and control of the enterprise, and because the protection of the full disclosure offered by registration is not needed as it is in cases involving a nonparticipating investor. Contra, Pawgan v. Silverstein, 265 F. Supp. 898 (S.D.N.Y. 1967). See also In re Los Angeles Land & Inv., Ltd., 282 F. Supp. 448 (D. Hawaii 1968). On franchises as securities, see Coleman, A Franchise Agreement: Not a 'Security' Under the Securities Act of 1933, 22 BUS. LAW. 493 (1967).

113. 15 U.S.C.A. § 77 (c)(a) (1933) (exempted securities). For example, § 77(c)(11) exempts Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.

ment of the Act with respect to such securities is not necessary in the public interest for the protection of investors by reason of the small amount involved or the limited character of the public offering, and further qualified by excepting cases where the aggregate amount at which the issue is offered to the public exceeds a specified sum. 114

The securities acts frequently contain fairly specific provisions with respect to the transactions intended to be included within their operation. Certain classes or forms of transactions are usually exempted or excepted. 115 The evident intent of Congress, in enacting the Securities Act of 1933, has been said to be to include all interstate transactions which are the legitimate subject of its regulation of sale of securities. Moreover, transactions which involve the use of the mails may be subject to the Act, regardless of whether or not they involve interstate commerce. 116

The Federal Securities and Exchange Act of 1934 applies to transactions in over-the-counter markets as well as those conducted on organized stock or security exchanges. 117

The term “sale” may include any agreement whereby a person transfers, or agrees to transfer, either the ownership of or an interest in a security. Preorganization subscriptions for financing a prospective corporation have been held to constitute an offer to sell, as well as an actual sale, within the “blue sky laws.”

The phrase “offered to the public” is frequently found in the statutes of the various states. It is immaterial that the sale is a private sale if the security sold is offered to the public. Under some statutes, an offering of securities may be a public offering, even though confined to stockholders of the offering company. Under a statute requiring the approval of speculative securities as a condition precedent to their sale “by advertisement,

114. 15 U.S.C. § 77(c)(b) (1933) provides that “no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $300,000.” Thus, all issues not exceeding 300,000 dollars are exempt from full registration pursuant to Commission regulation respecting exempt securities. The total amount issued by all affiliates may not exceed 300,000 dollars. United States v. McGuire, 381 F.2d 306 (2d Cir. 1967), cert. denied, 389 U.S. 1053 (1968).


116. See 15 U.S.C. § 77(q) (1933) (sale by use of interstate transportation or communication or by use of mail). § 77(q) applies also to § 77(c) exemptions (intrastate security issues and public offerings under 300,000 dollars).

circulars, or prospectus, or by any other form of public offering;" a sale of unapproved securities by private solicitation in the purchaser's store is not an offense, but a sale through newspaper advertisements, followed by personal solicitation, is within the statute. Some of the statutes provide, in varying terms, that they shall not apply to isolated or casual sales, or sales not made in the course of repeated or successive transactions of a similar nature.

The Florida securities act attempts to protect the investing public by requiring registration of securities (with certain exceptions) before such securities can be offered for sale to the public; by licensing and regulating dealers and salesmen, including investment advisors; by providing civil remedies to purchasers; and by providing disciplinary penalties, preventative measures, and in some cases criminal penalties.

When property in Florida is held by or for a limited partnership under section 620, Florida Statutes, the certificates of interest, or other evidences of partnership interest are within the purview of section 517, Florida Statutes. The solicitation of limited partners constitutes solicitation of subscriptions to participate in profit-sharing agreements or transferable beneficial interests in profits or earnings included under the definition of securities in section 517.02(1), Florida Statutes. The definition of security as found in Florida Statutes, section 517.02(1), is very broad and sweeping in that virtually every type of investment program is included. This statute includes an offer to an investor to purchase small parcels of land in Florida by warranty deed incorporated within a "performance guarantee," wherein there is involved the investment of money in a common enterprise, with profits for the first two years of the agreement to come solely from the efforts of others.

Securities, unless of an exempted class, or unless sold in an exempt transaction, must be registered with the Securities Commission before they may be sold within the state of Florida. Securities required to be registered before being sold in the state, and not entitled to registration by notification or by announcement, may be registered only by qualification. Registration by qualification requires filing in the office of the Commission certain statements, exhibits, and documents.

If any of the securities to be registered by qualification are issued for organization or promotion fees or expenses, inter alia, the statement

120. FLA. STAT. §§ 517.01 et seq. (1969), cited as the UNIFORM SALE OF SECURITIES LAW.
125. FLA. STAT. § 517.09 (1969) (registration by qualification).
containing information as to the securities to be registered must fully set forth the amount and nature thereof and the Commission may require that the securities be delivered in escrow to the Commission or other depository under an escrow agreement whereby the owners may not withdraw the securities from escrow until all other stockholders who have paid for their stock in cash have been paid dividends aggregating not less than six percent shown to the satisfaction of the Commission to have been actually earned on the investment.\(^\text{128}\)

The Florida Uniform Sale of Securities Act enumerates several classes of securities that are entitled to registration by notification.\(^\text{127}\)

Securities that have been outstanding and in the hands of the public for not less than one year as the result of prior original marketing by the issuer, or by an underwriter on behalf of an issuer, are entitled to registration by announcement, but they may be registered only by a registered dealer by his act of filing in the office of the Commission a written announcement of intention to trade in the securities.\(^\text{128}\)

No dealer or salesman may engage in business in the state as such dealer or salesman, or sell any securities, including exempt securities, except in exempt transactions, unless he has been registered as such in the office of the Commission.\(^\text{129}\)

Generally, the provisions of the Uniform Sale of Securities Law do not apply to certain classes of securities denominated as exempt securities,\(^\text{130}\) or to certain classes of transactions denominated exempt transactions.\(^\text{131}\)

The Florida Securities Commission provides for the rules and regula-

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\(^{126}\) FLA. STAT. § 517.18 (1969) (escrow agreement).

\(^{127}\) FLA. STAT. § 517.08(1) (1969) (registration by notification). Examples include securities issued by a corporation, partnership, or syndicate which has been in continuous operation not less than three years, \textit{inter alia}.

\(^{128}\) FLA. STAT. § 517.091 (1969) (registration by announcement).

\(^{129}\) FLA. STAT. § 517.12 (1969) (registration of dealers and salesmen).

\(^{130}\) FLA. STAT. § 517.05 (1969) (exempt securities). For exempted securities and transactions under federal laws, see 15 U.S.C. §§ 77(c), 77(d), 77(ddd), 78(c), 79(c), 79(f) (1964).

\(^{131}\) FLA. STAT. § 517.06 (1969) (exempt transactions). Certain transactions are exempted whether securities involved are exempt or nonexempt. Hammond v. State, 151 So.2d 872 (Fla. 2d Dist. 1963). A preorganization exemption from registration is available which permits the raising of an unlimited amount of funds, before incorporation, by means of a maximum of twenty-five preorganization subscriptions. The requirement that solicited funds be placed in escrow pending organization is mandatory when subscriptions are to be received from more than five subscribers. FLA. STAT. § 517.06(10) (1969). A private offering exemption for a Florida corporation or trust is also available with no ceiling on the amount of funds which may be obtained, if the number of sales is limited to a maximum of fifteen persons during any period of twelve consecutive months, provided that each purchaser prior to the sale has been furnished adequate information concerning the financial condition of the issuer, its operations, and the use of the proceeds, and, provided further that sales shall be made without any public solicitation, ads, and that no commission or other remuneration is to be paid or given, directly or indirectly, in connection with the sale and that sales are made solely to persons who purchase for investment purposes. FLA. STAT. § 517.06(11) (1969). \textit{See Sowards, Florida Securities Regulation, 1966, 20 U. MIAMI L. REV. 546-51 (1966).}
tions necessary for the administration and enforcement of the Florida Uniform Sale of Securities Act.\textsuperscript{182} For example, the Commission will allow to be registered only such securities as are to be sold by an issuer having assets in excess of liabilities in an amount equal to approximately twenty-five percent of the securities to be sold.\textsuperscript{183} Promotion stock issued or proposed to be issued may not exceed fifteen percent of the aggregate amount outstanding in all classes of stock, and any stock so issued must be escrowed with the Commission.\textsuperscript{184}

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