[COMMITTEE PRINT]

TAX SHELTERS:
USE OF LIMITED PARTNERSHIPS, ETC.

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

SEPTEMBER 13, 1975

U.S. GOVERNMENT PRINTING OFFICE
58-147 WASHINGTON : 1975 JCS-29-75

CONTENTS

GENERAL

The form of entity most commonly chosen to maximize tax benefits in a tax shelter investment has been the limited partnership, which, upon meeting certain requirements, is subject to both the general partnership provisions and certain provisions of the income tax regulations having particular application to limited partnerships. A limited partner is, in effect, a passive investor who is not personally liable for any more than his equity contribution to the partnership (plus his agreed future contributions), even though he may benefit by certain partnership provisions allowing him to deduct losses in excess of that contribution.

Under the partnership provisions of the Internal Revenue Code (secs. 701–771), a partnership is generally treated as an entity for accounting purposes and treated as a conduit for taxpaying purposes. It is an entity for purposes of calculating taxable income and many particular items of income, deduction, and credit (sec. 703). It is also an entity for purposes of reporting information to the Internal Revenue Service (sec. 6031).

A partnership is a conduit for purposes of income tax liability and payment. Each partner takes into income his own "distributive share" of the partnership's taxable income and the separately allocable items of income, deduction, and credit (sec. 702(a)). The liability for income tax payment is that of the partner, and not of the partnership (sec. 701).

On the profit side, this means that income is taxed at only one level—the partner's level (as distinguished from the corporation, where income is taxed at the corporate level and dividends are taxed at the shareholder level [1]). Also, this means that the partner is taxed on the partnership profits even though none of those profits may be distributed to the partner.

On the other side, this means that partnership losses, deductions, and credits pass through to the partner and can be used to offset other income, thereby reducing the income tax liability of the partner. The amount of losses which a partner may deduct under these provisions for a particular year is not to exceed the amount of the adjusted basis of his partnership interest (sec. 704 (d)), which, at the inception of the partnership, equals the sum of his capital contribution to the partnership plus his share, if any, of partnership liabilities. With respect to limited partnerships, the Treasury Regulations (§ 1.752–1(e)) provide that a limited partner's share of the partnership's liabilities includes a pro rata share (the same proportion in which he shares profits) of all liabiilties with respect to which there is no personal liability ("nonrecourse liability"). (See Nonrecourse

[1] Electing small business corporations (subchapter S corporations) are taxed in a manner roughly similar to partnerships; a number of the relevant elements of this treatment are discussed below.

Loans, under IRS Rulings Policy, below, for an explanation of the impact of this provision of the Treasury Regulations.)

Subject to the restriction that its purpose is not to avoid or evade tax, a limited or general partnership agreement may provide for the manner in which the partnership's items of income, gain, loss, deduction, or credit will be allocated among the partners (sec. 704).

OTHER FORMS OF BUSINESS

The limited partnership is generally preferred over the general partnership for tax shelter arrangements because the limited partners, who are passive investors, have limited liability for the debts of or claims against the partnership.

Corporations

The corporate form of doing business generally does not lend itself to tax shelter investments by individuals since the corporation is a taxpaying entity and, therefore, the tax incidents of its operation remain at the corporate level and do not pass through to its shareholders. The one exception to this treatment is for electing small business corporations ("subchapter S corporations"). To a great extent, the tax incidents of a subchapter S corporation's operations pass through to its shareholders. However, there are certain tax limitations applicable to the subchapter S corporation which are not imposed upon a limited partnership under the partnership provisions.

As previously noted, under the partnership tax regulations, a person's adjusted basis in his limited partnership interest not only includes his cash investment but also a pro rata share of any nonrecourse liability of the partnership. By contrast, a shareholder's adjusted basis in his stock in a subchapter S corporation includes his investment in the stock and any loan he has made to the corporation, but, most significantly, does not include any portion of the corporation's liability (sec. 1374(c)(2)). In both cases, that of the subchapter S corporation shareholder and the limited partner, it is the adjusted basis in the stock or the partnership interest; as the case may be, which serves as the upper limit on the amount of loss that may be deducted by the shareholder or the partner in a given year. Thus, in comparison to the limited partner, the subchapter S corporation shareholder is severely limited in terms of the amount of losses, and therefore tax shelter, available.[2]

Other limitations which apply only to subchapter S corporations are: (1) a subchapter S corporation may not have more than ten

[2] As a theoretical matter, essentially the same tax shelter result regarding nonrecourse loans as is now available under Treasury Regulations § 1.752–1(e) could be achieved in both the subchapter S area and in the limited partnership area without the use of those special regulations. This result can be achieved by the investor borrowing on the security of his subchapter S stock or limited partnership interest, with the loan being on a nonrecourse basis. The amount thus borrowed could then be used by the subchapter S shareholder or limited partner as his capital investment in the subchapter S corporation or partnership. The net effect would be that the nonrecourse loan would increase the basis of the subchapter S stock or limited partnership interest. with essentially the same result as under the special limited partnership regulations. Although in fact this device has been used in the subchapter S area and may have been used in limited partnerships. as a practical matter is apt to be less attractive to the lender in most cases because the strength of the security of the stock or partnership interest normally would be less than the strength of the security of a first mortgage on a specific property. If, in the case of a subchapter S corporation. the lender obtains a guarantee from the corporation and that guarantee is secured by assets of the corporation. the Internal Revenue Service might well be successful in characterizing the transaction as a borrowing by the corporation rather than by the shareholder; as a result, the borrowing would produce no increase in the shareholder's basis.

shareholders; (2) trusts may not be shareholders of a subchapter S corporation; (3) a subchapter S corporation may not have more than one class of stock; (4) no more than 20 percent of a subchapter S corporation's gross receipts may be derived from passive investment income, which includes, among other things, certain types of rental income; and (5) no provision may be made for special allocation of losses and other items to the shareholders, these items being allocated strictly in proportion to stock ownership.

Agency

Certain tax shelter investments are susceptible to organization as an agency relationship (created in many cases pursuant to a management contract or a services contract), where the promoter or operator, as the case may be, serves as the agent for each investor. This format is feasible where the investment is sufficiently large to warrant separate income and expense determinations. The agency arrangement has been used most often in cattle tax shelter investments and in oil and gas tax shelter investments.

The main advantage of the agency arrangement, in comparison to the limited partnership, is the flexibility it provides in terms of custom-tailoring the arrangement to the requirements of the particular investor. Thus, for instance, in a cattle tax shelter investment, investors may be given the opportunity to choose, depending on their tax situations, programs with differing deferral periods, differing amounts or types of "stop-loss" guarantees,[3] varying mixes of feeding and breeding cattle, and (within limitations) differing timing of deductible expenses. Moreover, certain requirements which must be met by a corporation serving as the sole general partner of a limited partnership need not be met by an agent.

One drawback of the agency relationship may be the potential liability to which the investor is subject. In practice, though, such potential liability generally can be minimized by the use of nonrecourse financing and comprehensive insurance (carried by either the investor or the agent). However, some risks may be uninsurable. In practice, at least in cattle-feeding operations, such risks may well be nonexistent (or negligible). Nonetheless, a limited partnership provides additional protection against liability, since limited partners are not personally liable for any of the debts of, or claims against, the limited partnership.

Another drawback of the agency relationship is that it generally requires much more substantial investments in any given project than does a limited partnership. Thus, an investor utilizing agency relationships cannot diversify his investments to the same extent as one who invests in limited partnerships.

QUALIFICATION FOR PARTNERSHIP TAX STATUS

The Treasury Regulations (§§ 301.7701-2 and 301.7701-3) provide that, in order to qualify for the partnership tax treatment de-

[3] The Internal Revenue Service has ruled (Rev. Rul. 75-43, 1975-6 I.R.B. 24) that, for Federal tax purposes, no partnership was created where (1) an individual entered into an agreement with a corporation pursuant to which the individual committed funds to a cattle feeding operation and the corporation fed, cared for, and marketed the cattle supplied by the individual (or purchased for his account), and (2) there was a separate agreement between the parties which provided that the corporation would guarantee to the individual a return of 90 percent of his original commitment to the cattle feeding operation, in exchange for the corporation receiving 10 percent of the profits from the operation.

scribed above, a limited partnership must be lacking in at least two of the following four characteristics peculiar to corporations: (1) centralization of management, (2) continuity of life, (3) free transferability of interest, and (4) limited liability. If the limited partnership is not lacking in at least two of these corporate characteristics (or, put another way, if at least three of the four corporate characteristics are present), it will be subject to tax treatment as a corporation, one consequence of which is to preclude the passthrough of the tax shelter losses to the investors. Thus, it is of crucial importance for tax shelter purposes that the limited partnership have fewer than three of the four corporate characteristics so that its partners can deduct its tax shelter losses.

Centralization of Management

In the context of a limited partnership, centralization of management exists if substantially all of the interests in the partnership are owned by the limited partners. While the Internal Revenue Service disavows any mechanical test for advance ruling purposes, the staff understands that if the general partners in the aggregate have a 20-percent or greater interest in the partnership capital obtained through capital contributions, the corporate characteristic of centralization of management will be treated as being absent. In most limited partnerships, the general partner does not have a 20-percent interest in capital, and for planning purposes, this characteristic generally is considered to be present.

Continuity of Life

The regulations provide three distinct situations by which a limited partnership would be lacking in the corporate characteristic of continuity of life:

1. if the bankruptcy, dissolution, retirement, resignation, death, insanity, or expulsion of a general partner causes a dissolution of the partnership (even though the partnership would not be dissolved if the remaining general partners or all remaining partners agree to continue the partnership);
2. if a general partner has the power at any time to dissolve the partnership; or
3. if the partnership is formed pursuant to a State statute corresponding to the Uniform Limited Partnership Act.[4]

Free Transferability of Interest

Most limited partnerships encounter little difficulty in negating the characteristic of free transferability of interest. This characteristic relates exclusively to the ability of a limited partner to make another person a substitute limited partner. Thus, notwithstanding a limited partner's right to assign profits and losses, free transferability can be negated simply by providing that no assignee of a limited partner may become a substitute limited partner without the prior consent of the general partners. In the tax shelter area, general partners normally consent to such substitutions.

[4] In 1973 and again in 1974 California amended a section of its version of the Uniform Limited Partnership Act to conform with the corresponding section of the Uniform Limited Partnership Act. Seemingly, the sole purpose of these conforming amendments was to facilitate California limited partnerships negating the corporate characteristic of continuity of life. See Rev. Rul. 74-320, 1974-2 C.B. 404, and Announcement 75-23, 1975-11 C.B. 87, ruling that those amendments resulted in the negation of the characteristic of continuity of life.

Limited Liability.

In the context of a limited partnership, the characteristic of limited liability is not present if the general partner has substantial assets (other than the interest in the partnership) which can be reached by a creditor or if the general partner is not a "dummy" acting as agent of the limited partners.

IRS RULINGS POLICY

Limited Liability—Net Worth Test

In connection with the characteristic of limited liability, the Service has set forth certain net worth requirements which must be met by a corporation serving as the sole general partner of a limited partnership before the Service will consider issuing an advance ruling classifying the limited partnership as a partnership for Federal tax purposes (Rev. Proc. 72–13, 1972–1 C.B. 735). The Service requires a net worth, based on a current fair market value test, equal to the sum of 10 percent or 15 percent of the capital raised in the partnership, the percentage depending upon the amount of capital raised:

1. if the capital raised is less than $1,666,667, the net worth of the corporate general partner must be at least 15 percent of the capital;
2. if the capital raised is between $1,666,667 and $2,500,000, the net worth of the corporate general partner must be at least $250,000; and
3. if the capital raised exceeds $2,500,000, the net worth of the corporate general partner must be at least 10 percent of the capital.

In calculating net worth, the corporation's interest in the limited partnership and receivables to and from the limited partnership are excluded.

Rules also are provided for cases where the corporate general partner has interests in more than one limited partnership.

Common Ownership of Corporate General Partner

In addition to its net worth requirements, the Service has established (Rev. Proc. 72–13, *supra*) certain other restrictions with regard to the percentage of stock ownership that the limited partners may have in a sole corporate general partner. Thus, an advance ruling will not be issued if the limited partners directly or indirectly own more than 20 percent of the stock of the corporate general partner or its affiliates. Moreover, the Service will not issue an advance ruling if the purchase of a limited partnership interest by a limited partner would entail either a mandatory or discretionary purchase or option to purchase any type of security of the corporate general partner or its affiliates. Seemingly, the purpose of these restrictions is to prevent a substantial identity of interest in the corporate general partner and the limited partnership.[5]

[5] The most extreme case of this situation would be where the corporation is wholly owned by all the limited partners in proportion to their partnership interests. A persuasive argument could be made here that, in substance, the shareholders of the corporation were conducting corporate business through a limited partnership while having essentially the same rights and obligations had the business been operated directly by the corporation. The Service apparently believes that the danger of substantial identity of interest is too great to be acceptable whenever the limited partners' ownership of stock in the corporate general partner is greater than 20 percent.

Principal Purpose of Avoidance of Federal Taxes

In Rev. Proc. 74–17, 1974–1 C.B. 438, the Service set forth its position that it will not issue an advance ruling that a limited partnership is a partnership under the tax laws where factual questions are raised as to whether the principal purpose of the limited partnership's formation is the reduction of Federal taxes. The following operating rules ordinarily must be complied with in order for the Service to be willing to issue an advance ruling that a limited partnership is a partnership under the Internal Revenue Code:

(1) At all times during the existence of the partnership, the general partners, taken together, must have at least a one-percent interest in each material item of partnership income, gain, loss, deduction, or credit.

(2) For the first two years of operation of the limited partnership, the partners may not claim aggregate deductions which exceed the amount of equity capital invested in the limited partnership. This requirement generally precludes the use of nonrecourse liability included in the partners' adjusted bases to absorb losses incurred during the first two years of operation.

(3) Any creditor who has made a nonrecourse loan to the limited partnership must not have or acquire at any time, as a result of that loan, any direct or indirect interest, other than as a secured creditor, in the profits, capital or property of the partnership.

Syndication and Organization Fees

Until recently, it has been the common practice for limited partnerships to deduct the payments made to the general partner for the services he rendered in connection with the syndication and organization of the limited partnership. In recently issued Rev. Rul. 75–214 (1975–23 I.R.B. 9), the Service ruled that such payments to general partners for services rendered in organizing and syndicating a partnership constitute capital expenditures which are not currently deductible.[6]

Nonrecourse Loans

Commonly, the equity contributions of limited partners do not adequately capitalize the operations of a limited partnership. The additional capital frequently is obtained by borrowing, using partnership property as security, without the limited partnership or its partners incurring any personal liability with respect to that borrowing. The loans obtained by the limited partnership provide "leverage"—in this context, that means that the nonrecourse loans make it possible for a partner to deduct tax losses in excess of his equity contribution to the partnership.

A limited partner may deduct from his personal income all the deductible items of the partnership which are allocated to him under the partnership agreement, but not more than the amount of his basis for his interest in the partnership, which is reduced by the amount of the deductions as they are taken.

---

[6] In a recent case involving a related situation, the United States Tax Court disallowed the deductions for certain payments made to a general partner. *Jackson E. Cagle, Jr.*, 63 T.C. 86 (1974), on appeal to C.A. 5 (payment for services rendered for conducting a feasibility study of a proposed office-showroom facility obtaining financing, and developing a building for the partnership).

In general, at the inception of the partnership, a limited partner's basis for his interest equals the sum of his capital contribution plus his share, if any, of partnership liabilities. A general partner's liability for his share of the partnership's liabilities is theoretically unlimited and so a general partner's basis in his partnership interest is increased by partnership liabilities in accordance with his ratio for sharing losses under the partnership agreement. Under the Treasury's income tax regulations (§ 1.752–1(e)), a limited partner's share of partnership liabilities is not to exceed the amount that that limited partner may be called upon to contribute under the partnership agreement. However, the regulations then go on to provide that "where none of the partners have any personal liability with respect to 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." [7] Through the use of this device, a limited partner may obtain a substantial increase in his basis, and, thus, in the amount of losses he may deduct.

[7] This rule has been justified as an adaptation to the limited partnership situation of a principle set forth by the United States Supreme Court in *Crane* v. *Commissioner*, 331 U.S. 1 (1947).

For example, if a limited partner pays $10,000 for a 5 percent interest in the capital and profits and losses of a limited partnership which obtains a nonrecourse loan of $500,000, the limited partner's basis in his interest would be $35,000 ($10,000 plus 5% of $500,000). Thus, as a result of "leveraging", the limited partner may be able to deduct an amount far exceeding that of his actual investment.

Where a lender requires that the general partner be personally liable on a loan (such as a construction loan), some limited partnerships have attempted to create basis for each of the limited partners by providing for contingent contributions; i.e., the limited partners are obligated to make certain additional contributions if they are called for by the general partner. The rights to call for the additional contributions commonly would expire upon the obtaining of nonrecourse financing and, in some cases, there may well have been no intention to call for such additional contributions. The intended effect of this arrangement is to provide the same increase in the limited partners' bases for their partnership interests (hence, the same increase in the ceiling for tax shelter deductions) as would have been the case if the general partner had not been made personally liable on the loan.

It should be noted that while the nonrecourse loan rule may permit an investor to take deductions exceeding his initial investment, this rule can also result in the subsequent recognition by the investor of substantial amounts of both ordinary and capital gain income where either the partnership sells or otherwise disposes of the partnership property that secures the nonrecourse loan or a limited partner sells or otherwise disposes of his partnership interest.

In general, in computing the gains derived upon these sales or dispositions, the outstanding principal amount of the nonrecourse loan (which usually is at or near its original amount) must be added to the amount received, and will thus increase the amount of gain to be recognized. Because the partnership property or the partner's partnership interest may at that time have a very low basis (because of such previously claimed accelerated deductions as depreciation), the recognizable gain may be sizeable in amount. Under the partnership tax law (sec. 751) there may be a recapture of certain accelerated deductions and, consequently, there may be recognition of ordinary income.

Sometimes the gain recognized in these situations is referred to as "phantom gain" due to the fact that the sale or disposition generates little or no cash (such as in a mortgage foreclosure, which is treated as taxable disposition of the property), but does result in a gain with respect to which substantial tax liability is created. In other words, in such a case, the taxpayer is required to repay part or all of his interest-free loan from the Government (the earlier savings from the tax shelter), which to a great extent was generated by nonrecourse borrowings.

In 1972, the Service issued two rulings involving nonrecourse loans. While both rulings dealt with and have particular application to limited partnerships engaged in oil and gas exploration, they are susceptible to a much broader application. In Rev. Rul. 72-135, 1972-1 C.B. 200, the Service ruled that a nonrecourse loan from the general partner to a limited partner, or from the general partner to the partnership, would constitute a contribution to the capital of the partnership by the general partner, and not a loan, thereby precluding an increase in the basis of the limited partner's partnership interest with respect to any portion of such a loan. In Rev. Rul. 72-350, 1972-2 C.B. 394, the Service ruled that a nonrecourse loan by a nonpartner to the limited partnership, which was secured by highly speculative and relatively low value property of the partnership, and which was convertible into a 25 percent interest in the partnership's profits, did not constitute a bona fide debt, but was, in reality, equity capital placed at the risk of the partnership's business. This, too, would preclude the loan from causing increases in the bases of the limited partner's interests.

While these rulings have reduced the use of leverage in oil and gas limited partnerships, the practice has continued for the most part, and there is no assurance that the Service's position will ultimately be sustained by the courts.

PARTNERSHIP ALLOCATIONS

Special Allocations

Under the partnership provisions, a limited (or a general) partnership agreement may allocate "any item of income, gain, loss, deduction, or credit among the partners in a manner that is disproportionate to the capital contributions of such partners (sec. 704(a), (b)(1)). These are sometimes referred to as "special allocations" and, with respect to any taxable year, may be made by amendment to the partnership agreement at any time up to the initial due date of the partnership tax return for that year (sec. 761(c)).

Special allocations of profits, losses, income items, and deductions may be used to combine tax-oriented and nontax-oriented investors in a single partnership. Typically, the tax benefits and large portions of the capital appreciation on resale are given to the high-income investor, while greater security and first return of cashflow are given to the nontax-oriented investor.

A special allocation will not be recognized if its principal purpose is to avoid or evade a Federal tax (sec. 704(b)(2)). In determining whether a special allocation has been made principally for the avoidance of income tax, the regulations focus upon whether the special allocation has "substantial economic effect," that is, whether the allocation may actually affect the dollar amount of the partner's share of the total partnership income or loss independently of tax consequences (Regs. § 1.704-1(b)(2)). The regulations also inquire as to whether there was a business purpose for this special allocation, whether related items from the same source are subject to the same allocation, whether the allocation ignored normal business factors and was made after the amount of the specially allocated item could reasonably be estimated, the duration of the allocation, and the overall tax consequences of the allocation.

A primary case dealing with this issue, *Stanley C. Orrisch*, 55 T.C. 395 (1970), affirmed C.A. 9, disallowed a deduction of 100 percent of the depreciation by one of the partners in a two-man partnership. The allocation in this case was found to have been made for the principal purpose of evading or avoiding income tax, the parties failing to demonstrate any economic effect of the allocation. The court indicated that the taxpayer had not shown that he had borne the risk of economic depreciation of the property in question.

In the case of *Leon A. Harris*, 61 T.C. 770 (1974), the United States Tax Court sustained the special allocation to a partner of a loss sustained upon the sale of an interest in a shopping center, where the entire sales proceeds were distributed to that partner and his capital account was charged with the entire loss on the sale.

More recently, the Service announced (Rev. Proc. 74-22, 1974-2 C.B. 476) that it would not issue advance rulings as to whether the principal purpose of a special allocation is the avoidance or evasion of Federal income tax.

Retroactive Allocations

Investments in tax shelter limited partnerships are commonly made toward the end of the taxable year. It is also common for the limited partnership to have been formed earlier in the year on a skeletal basis with one general partner and a so-called "dummy" limited partner. In many cases the limited partnership incurs substantial deductible expenses prior to the year-end entry of the limited partner-investors.

In these tax shelter limited partnerships, the limited partnership usually allocates a full share of the partnership losses for the entire year to those limited partners joining at the close of the taxable year. These are referred to as "retroactive allocations." For example, in the case of a limited partnership owning an apartment house which has been under construction for a substantial part of the year, where construction interest and certain deductible taxes have been paid during that time, such deductions might be retroactively allocated to investors entering the partnership on, say, December 28th of that year.

There has been much debate about whether a retroactive allocation of loss is permissible under the Internal Revenue Code. Different commentators have given different technical interpretations of the partnership provisions of the Code, some to support and some to reject retroactive allocations.[6]

Three cases dealing directly or indirectly with this issue provide some support for retroactive allocations. *Smith v. Commissioner*, 331 F.2d 298 (C.A. 7, 1964) (retroactive allocation allowed for lack of finding of purpose to avoid tax); *Jean V. Kresser*, 54 T.C. 1621 (1970) (retroactive allocation disallowed for failure to modify the partnership agreement, but the court indicated that if the agreement had been so modified, the allocation would have been sustained, notwithstanding its recognition of avoidance of tax as a principal purpose); and *Norman A. Rodman*, 32 T.C.M. 1307 (1973) (retroactive allocation of profits, as argued by the Government, sustained).

PARTNERSHIP ADDITIONAL FIRST-YEAR DEPRECIATION

An owner of tangible personal property is eligible to elect, for the first year the property is depreciated, a deduction for additional first-year depreciation of 20 percent of the cost of the property (sec. 179). The cost of the property on which this "bonus" depreciation is calculated is not to exceed $10,000 ($20,000 for an individual who files a joint return). The maximum bonus depreciation deduction is thus limited to $2,000 ($4,000 for an individual filing a joint return). Bonus depreciation is available only for property that has a useful life of six years or more.

Where the owner is a partnership, the election for bonus depreciation is made by the partnership. However, the dollar limitation described above is applied to the individual partners rather than to the partnership entity. For example, each one of 40 individual investors who contributed $5,000 to an equipment leasing limited partnership, which purchased a $1 million executive aircraft on a leveraged basis, would be entitled to $4,000 of bonus depreciation if he filed a joint return. In this case, additional first-year depreciation would provide total deductions to the partners of $160,000.

A corporation, however, is allowed to deduct only $2,000 in additional first-year depreciation. Thus, in the case of the purchase of an aircraft, as described above, a corporation would be limited to $2,000 in additional first-year depreciation, whereas the partnership would pass through to the partners total first-year additional depreciation of $160,000.

The additional first-year depreciation reduces the depreciable basis of the equipment. However, the partnership is still entitled to claim (and the partners to deduct) accelerated depreciation on the reduced basis in the property both for the first year and for the later years of the property's useful life.

---

[6] Read in conjunction with each other, sections 704(a) and 761(c) would seem to support retroactive allocations. Some would interpret section 704(b)(2), which prohibits an allocation having tax avoidance as its principal purpose, as being inapplicable to allocations of net profit and loss, as opposed to an allocation of a particular item of income or loss. Others arrive at the opposite interpretation of this provision. Yet another partnership provision, section 706(c)(2)(B), is proffered by many as the provision which would restrict a partner's losses to those incurred in that part of the year during which that person was a partner. Here again, there are contrary interpretations by other tax experts.

PROBLEM

It is argued that because the limited partnership is the form of business most suited to tax shelters, the tax provisions should be modified so as to restrict its use in this regard. Others argue that it is the tax shelter deduction provisions, not the limited partnership provisions, which require modification.

Criticism has been directed at the provision of the income tax regulations (§ 1.752-1(e)), which allows a limited partner to increase the basis in his investment, and therefore the amount of losses that he may deduct, by a portion of nonrecourse indebtedness. Under this regulation, the investors are able to use borrowed funds with respect to which they have no personal liability to generate deductions in amounts larger than what they have at risk in the limited partnership. On the other hand, it has been argued that this provision of the income tax regulations applying to limited partners is no more than an adaption of the principle of a Supreme Court case [9] where nonrecourse indebtedness, regardless of the form of business involved, is added to the owner's basis of the property.

It is argued that the syndication and organization fees paid by tax-sheltered limited partnerships are more in the nature of capital expenditures and should not be deducted. This position has been sustained recently in the courts and in an IRS ruling.

One of the more significant problems arising under the partnership tax provisions concerns the allocation by a limited partnership to a new partner of deductions that were incurred or paid prior to the time of his entrance into the partnership. The partnership provisions of the Internal Revenue Code are unclear as to whether these allocations can be made. The consequence of allowing these allocations, essentially, is that new limited partners, who ordinarily invest in the partnership towards the close of the taxable year, deduct expenses which were incurred or paid prior to their entry into the partnership.

Some argue that these retroactive allocations are proper because the funds invested by the new limited partners serve to reimburse the original partners for their expenditures (or other deductible items) and that, as an economic matter, the new partners have incurred the costs for which they are taking deductions. However, this argument may lose its persuasiveness when the new investor in a limited partnership situation is compared to that of an investor who directly purchases property which had previously generated tax losses during the taxable year. It is clear that in the latter case the investor would not be entitled to any deductions for the losses incurred prior to his ownership of the property, notwithstanding the fact that he may, in effect, be reimbursing the seller of the property for losses already incurred.

If the committee concludes that such retroactive allocations should not be allowed, one approach might be to apportion the allocable items of gain, loss, etc., in accordance with the portion of the year that the new investor was a partner in the partnership. In order to take account of those circumstances where major items of gain, loss, etc., in fact occur in a particular part of the year, it may be appropriate to permit the allocation of such items to those who were partners during that

[9] *Crane v. Commissioner*, 331 U.S. 1 (1947).

part of the year, if the partnership can demonstrate that those items of gain, loss, etc., in fact occurred during that limited part of the year.

Some maintain that many of the large syndicated limited partnerships which closely resemble corporations should be treated as corporations for tax purposes. In response it is noted that an entity that qualifies for partnership tax treatment under the income tax regulations is lacking in at least two of the four characteristics peculiar to corporations. Such an entity, it is maintained, should not be subject to corporate tax treatment. However, as has been noted above, it is frequently possible to simulate the absence of the corporate characteristic of transferability of interests merely by providing that the general partner has the power to reject a transferee of a limited partnership interest when, as a practical matter, it is understood that the general partner would not exercise that right.

Also, it is argued that allowing an individual partner in a partnership first year depreciation situation to have the full $2,000 deduction (or $4,000, in the case of a married partner filing a joint return) inflates the amount of "bonus depreciation" which should be allowable in the year the property is placed in service. Consequently, it is argued, the dollar limitation should be applied at the partnership level in addition to the limitation at the partner level.

ALTERNATIVE APPROACHES

If the committee believes that certain partnership tax provisions facilitate tax shelter deductions in a manner that is undesirable, these provisions could be revised.

On the other hand, if the committee believes that there is nothing wrong with the partnership tax provisions as they apply to limited partnerships, but that the problem lies instead with the tax shelter deductions passing through such partnerships to the investors, then the alternative approaches discussed in previous pamphlets may be considered, i.e., direct revision of the provisions providing tax benefits and deductions, the LAL proposal, or broadening of the application of the minimum tax.

The following is a summary of the committee's decisions with respect to limited partnerships in its 1974 tax reform bill, Mr. Ullman's proposals, and alternative proposals by other committee members.

Partnership Syndication Fees

A. 1974 Committee bill

In last year's bill, partnership syndication fees were required to be capitalized.

B. Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

Nonrecourse Loans

Mr. Corman

He proposes to overrule the nonrecourse loan Treasury Regulation (§ 1.752–1(e)) by providing that a limited partner's share of partnership liabilities cannot exceed the difference between his actual contribution credited to him by the partnership and the total contributions he is obligated to make under the partnership agreement.

Retroactive Allocations

Mr. Stark and Mrs. Keys

They propose to require that partnership losses be allocated pro rata to partners over the number of days of the partnership year during which the partner was a member of the partnership.

Qualification for Partnership Tax Treatment

Mr. Corman

The proposal would provide that if a registration statement filed with the Securities and Exchange Commission offers units of participation or other units in a partnership, the partnership is to be treated as a corporation for years ending after the date of the filing of the registration statement.

O