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A LARSON-ZUCKMAN CHECKLIST FOR PARTNERSHIP TAX CLASSIFICATION OF ULPA REAL ESTATE SHELTERS

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I. INTRODUCTION

Real estate developments necessarily require large amounts of capital, and are usually dependent on financing from sources other than the venture group assembled to construct and operate a proposed project. Theoretically, such ventures may be undertaken in many forms, corporate and otherwise, and the available financing vehicles may include debt instruments, equity shares and innumerable combinations thereof. In reality, however, business and legal considerations often dictate organization and operation of such ventures within more narrowly defined limits.

Traditionally, leveraged limited partnerships with sole corporate general partners have provided a preferred balance of those factors which are essential to the successful financing and operation of real estate ventures. They perform the dual functions of providing adequate yield, which is enhanced by tax-free cash distributions and shelter of outside income sources of the participants, and of providing optimum leverage. Partnership status preserves the pass-through of non-cash deduction items, such as depreciation, for the individual partners' use in reducing the taxable component of cash distributions and to shelter income from other sources. Properly incurred partnership debt increases the partners' basis and provides leverage. Under the Uniform Limited Partnership Act (ULPA),[1] the limited partners' risk is confined to their investment shares, unless they take an active part in operating the enterprise.[2] Formation of a sole corporate general partner insulates the organizers' independent assets from exposure to liability, and electing taxation of the sole corporate general partner under subchapter 5 of the Internal

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1. All states except Alabama, Kentucky, Louisiana and Wyoming have adopted the equivalent of the Uniform Limited Partnership Act. *See, e.g.*, VA. CODE ANN. §§ 50-44 to -73 (Repl. Vol. 1974).

2. UNIFORM LIMITED PARTNERSHIP ACT § 7, 6 UNIFORM LAWS ANN. 582 (1969); VA. CODE ANN. § 50-50 (Repl. Vol. 1974).

Revenue Code[3] preserves the pass-through of non-cash deductibles into the hands of the organizing venturers.

A threshold problem in the formation of a leveraged ULPA limited partnership with a sole corporate general partner is obtaining assurance that it will be taxed as a partnership rather than as a corporation. The importance of a correct determination can hardly be overstated. Among other consequences, corporate status may deprive the participants of the tax shelter originating in the pass-through of depreciation and may subject income to taxation at two levels rather than one.

For many years, the possibility that corporate tax status might be asserted against real estate limited partnerships was regarded as remote. Recently, however, as part of its more restrictive policy toward tax shelters in general, the Internal Revenue Service (IRS) has increasingly attempted to treat ULPA limited partnerships with sole corporate general partners as corporations for federal income tax purposes. Two significant recent cases have emerged from the Internal Revenue Service's efforts. In *Phillip G. Larson*[4] and *Zuckman v. United States*,[5] the Tax Court and the Court of Claims respectively interpreted Treasury Regulations as precluding association classification of ULPA limited partnerships with sole corporate general partners. These decisions invite an examination of the classification criteria under which such determinations are made and permit tentative conclusions regarding the effect of commonly used partnership provisions upon the tax classification of real estate shelters.

II. The Classification Regulations

The process of classifying an enterprise as a partnership involves two types of determinations. The first determination is whether the enterprise is a "partnership" as distinguished from an essentially individualistic relationship such as co-ownership,[6] expense sharing,[7]

3. INT. REV. CODE OF 1954 §§ 1371-79.

4. 66 T.C. 159 (1976); [1976 Transfer Binder] *Tax Ct. Rep.* (CCH) ¶ 33,793.

5. 524 F.2d 729 (Ct. Cl. 1975).

6. Treas. Reg. § 1.761-1(a)(1976), requiring rendition of services in addition to co-ownership; Treas. Reg. § 301.7701-3 (1960).

7. *See* note 6 *supra*.

pooling,[8] employer-employee,[9] creditor-debtor,[10] seller-purchaser,[11] lessor-lessee[12] or the like. The second determination is whether the enterprise is a partnership or an "association" taxable as a corporation. Because the IRS has recently used the latter of these two determinations as a primary weapon against real estate tax shelters, the question of partnership versus corporate status has become the more significant issue and is the issue which will be addressed in this article.

The Internal Revenue Code twice defines a partnership to include "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a . . . trust, estate or a corporation . . . ."[13] The regulations[14] recite that this definition is broader than the common law concept of partnership, and that it may include groups not commonly called partnerships. The Code defines the term "corporation" to include "associations, joint-stock companies, and insurance companies."[15]

The skeletal statutory definition of partnership has been amply augmented by the courts. The United States Supreme Court early

8. Luckey v. Commissioner, 334 F.2d 719 (9th Cir. 1964); Estate of Philip Landau, 21 T.C. 727 (1954), *aff'd*, 219 F.2d 278 (3d Cir. 1955); Rev. Rul. 54-68, 1954-1 C.B. 151.

9. *See* Estate of Craig Smith v. Commissioner, 313 F.2d 724 (8th Cir. 1963); Beck Chem. Equip. Corp., 27 T.C. 840 (1957), *acq.* 1957-2 C.B. 3; Isadore Louis Rosenberg, 15 T.C. 1 (1950); Rev. Rul. 75-43, 1975-1 C.B. 383.

10. Claire Giannini Hoffman, 2 T.C. 1160 (1943), *acq.* 1944 C.B. 13, *aff'd on other grounds sub nom.*, Giannini v. Commissioner, 148 F.2d 285 (9th Cir.), *cert. denied*, 326 U.S. 730 (1945).

11. Paul J. Kelly, 29 T.C.M. (CCH) ¶ 1090 (1970); Rupe v. United States, 1968-1 USTC ¶ 9179 (D.C. Neb. 1968); Edith W. Abrams, 20 T.C.M. (CCH) ¶ 1501 (1961).

12. University Hill Foundation, 51 T.C. 548 (1969), *rev'd*, 446 F.2d 701 (9th Cir. 1971), *cert. denied*, 405 U.S. 965 (1972); Haley v. Commissioner, 203 F.2d 815 (5th Cir. 1953), *acq.* 1952-1 C.B. 2.

13. INT. REV. CODE OF 1954, § 7701(a)(2). A nearly identical definition appears in INT. REV. CODE OF 1954, § 761(a), which permits members of certain unincorporated associations to elect exclusion from partnership status. The current, liberalized tax definition of a partnership originated in the Revenue Act of 1932, the legislative history of which demonstrates the congressional purpose to classify as a "partnership" any profit or loss sharing enterprise requiring capital or services, which is not in the corporate or trust form. Questions regarding the scope of the code definition, as compared with local law definitions, however, are more apparent than real under modern statutes. While section 6(1) of the Uniform Partnership Act adopts definitions and criteria similar to those of the code, the code definition prevails for federal income tax purposes. Treas. Reg. § 301.7701-1(c) (1965).

14. Treas. Reg. §§ 301.7701-3 (1960); 1.761-1(a) (1976).

15. INT. REV. CODE OF 1954, § 7701(a)(3).

recognized association and sharing of the consequences of the enterprise as primary partnership attributes, and classified the finding as a question of fact to be determined by an objectively applied test.[16]

In a subsequent decision, however, the Court phrased the test of partnership classification in terms of whether, on the facts, the parties *intended* to associate for a business purpose.[17] Although no requirement of subjective "intent" is evidenced by the language of the statute,[18] this requirement has been so consistently recognized that it is now firmly established.[19]

The factors which distinguish partnerships from corporations for tax purposes are set forth in the "association" regulations.[20] These regulations were originally designed to complement the statutory definition of "associations" and to prevent corporate tax classification of unincorporated professional associations. They are popularly called the "Kintner" regulations because they constitute the IRS's reaction to a case of that name.[21] The IRS does not normally make its determinations of partnership status of real estate shelters under

16. Commissioner v. Tower, 327 U.S. 280, 286 (1946):

> A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business *and* when there is community of interest in the profits and losses.

17. Commissioner v. Culbertson, 337 U.S. 733 (1949).

18. INT. REV. CODE OF 1954, § 7701(a)(3).

19. *See, e.g.,* Adams v. United States, 328 F. Supp. 228 (D. Neb. 1971); Ray S. Robinson, 44 T.C. 20 (1965), *acq.* 1970-2 C.B. XXI; Hubert M. Luna, 42 T.C. 1067 (1964); Lucia Chase Ewing, 20 T.C. 216 (1953), *aff'd on other grounds,* 213 F.2d 438 (2d Cir. 1954); Hubert F. Baughn, 28 T.C.M. (CCH) ¶ 1447 (1969).

In the foregoing cases, the courts have held that the requisite intent may be found from the following objective factors:

> (1) Joint contribution of capital or services for the purpose of carrying on a trade or business and joint ownership of the capital contributions and earnings of the enterprise;
> (2) Sharing of profits and losses;
> (3) Mutual control of the business;
> (4) The parties' agreement and their conduct pursuant thereto;
> (5) Representations of partnership status to others;
> (6) Separate books of account for the enterprise; and
> (7) Holding title to the business property and conducting the business in a partnership name.

20. Treas. Reg. § 301.7701-2 (1965). The regulations are based on Morrissey v. Commissioner, 296 U.S. 344 (1935), with modifications originating primarily in subsequent cases.

21. United States v. Kintner, 216 F.2d 418 (9th Cir. 1954).

the "partnership" regulations (which assume noncorporate status). Rather, the determination is made by a negative application of the "Kintner" regulations. These regulations list six major characteristics ordinarily found in corporations, and state that an unincorporated organization will be classified as an association if it has more corporate characteristics than non-corporate characteristics.[22]

In determining the preponderance of characteristics, those common to both types of organizations are ignored.[23] The regulations conclude that corporate or partnership status will be determined on the basis of four factors—continuity of life, centralization of management, liability for corporate debts being limited to corporate property, and free transferability of interests.

An organization lacks continuity of life if it will dissolve upon the "death, insanity, bankruptcy, retirement, resignation, or expulsion of any member . . . ." The regulations provide that an organization does not have continuity of life if its existence after the withdrawal of a member depends on an agreement by the remaining members to continue in business.[24] Even where the agreement provides for continuation of the business in the event of the death or withdrawal

22. Treas. Reg. § 301.7701-2(a)(3)(1965). The six "major corporate characteristics" of Regulation § 301.7701-2(a) are:

(1) Associates;
(2) An objective to carry on business and divide the gains therefrom;
(3) Continuity of life;
(4) Centralization of management;
(5) Liability for corporate debts limited to corporate property; and
(6) Free transferability of interests.

The Regulations caution that the foregoing list is not exclusive, and that other factors may be taken into account in a particular case. Treas. Reg. § 301-7701-2 (1965) does not specify what "other factors" might be relevant in a given case. Morrissey v. Commissioner, 296 U.S. 344 (1935), however, recognized that where other partnership and corporate characteristics are equal, factors such as by-laws, minute books and the use of a corporate seal might be relevant to corporate status. *See also* Rev. Proc. 72-13, 1972-1 C.B. 735; Rev. Proc. 74-17, 1974-1 C.B. 438. Query, whether in a case where other characteristics are equal, the *absence* of such factors might be relevant to partnership status. *See* Phillip G. Larson, 66 T.C. 159 (1976), where in his concurring opinion, Judge Dawson eloquently points out the dangers of using "other factors," which introduce a further element of subjectivity among otherwise objective criteria.

23. Treas. Reg. § 301.7701-2(a)(3)(1965). "Associates" and "an objective to carry on business and divide the gains therefrom" fall within this category, being recognized as partnership attributes as early as Commissioner v. Tower, 327 U.S. 280 (1946) and Commissioner v. Culbertson, 337 U.S. 733 (1949).

24. Treas. Reg. § 301.7701-2(b)(1)(1965), *citing* Glensder Textile Co., 46 B.T.A. 176 (1942), *acq.* 1942-1 C.B. 8.

of a partner, the regulations provide that an enterprise only has continuity of life if under local law, death or withdrawal does not cause a dissolution notwithstanding the agreement.[25] The regulations state categorically that a general or limited partnership subject to a statute corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act lacks the corporate attribute of continuity of life.[26]

The courts have not taken the same view of the effect of dissolution under local law as that expressed by the regulations. In *United States v. Kintner,*[27] a group of doctors dissolved their partnership, formed under the Montana version of the Uniform Partnership Act, and executed "Articles of Association." The articles provided that the organization would continue upon the death of the last survivor, and that death or retirement of a member would not result in dissolution. Montana law prohibited corporate medical practice. Despite a finding that the organization was probably a partnership under Montana law, with the result that any member had the power to dissolve it, the Ninth Circuit held that the medical clinic had continuity of life and was classifiable as a corporation for federal income tax purposes. On similar facts, other cases have taken a similar view.[28]

The regulations provide that centralized management exists if any person or persons have "continuing and exclusive authority" to make business decisions for the organization without ratification by its members.[29] Such authority is usually indicated by the powers granted to the management group. There is no centralized management if the management group can perform only ministerial acts as agent for the participants. Centralized management implies management in a representative capacity. This attribute has been found lacking where the managers acted in their own capacity as partners, and where they could not be removed by the limited partners.[30] As in the case of continuity of life, the regulations take a favorable view

25. Treas. Reg. § 301.7701-2(b)(2) and (3) (1965).
26. Treas. Reg. § 301.7701-2(b)(3) (1965).
27. 216 F.2d. 418 (9th Cir. 1954).
28. *See, e.g.*, Foreman v. United States, 232 F. Supp. 134 (S.D. Fla. 1964); Galt v. United States, 175 F. Supp. 360 (N.D. Tex. 1959).
29. Treas. Reg. § 301.7701-2(c) (1965).
30. Glensder Textile Co., 46 B.T.A. 176 (1942), *acq.* 1942-1 C.B. 8.

of the centralized management requirement, especially as it applies to entities created under ULPA. On the basis of the position that an organization lacks centralized management if any member who is not a member of the management group can bind the organization as far as outsiders are concerned,[31] the regulations state that a Uniform Partnership Act general partnership "cannot achieve effective centralization of management" even on the basis of an agreement among the partners.[32] A slightly more restrictive conclusion is reached respecting limited partnerships under the ULPA. The regulations state that while a limited partnership generally does not have centralized management, this attribute may exist if the limited partners own "substantially all" the interests in the partnership.[33]

The "substantially all" concept is not peculiar to the issue of centralized management. The regulations provide that the corporate attribute of free transferability exists when members who own "substantially all" the interests can transfer all their membership rights to non-members without the consent of other members and without effecting dissolution under local law.[34] A right to transfer to non-members only after the interests are offered to members is a modified form of free transferability. In this situation, however, the regulations provide that the characteristic of free transferability will be accorded less weight than in the case of an unrestricted exercise.[35] Absence of a provision regarding transfer is not conclusive if transfers have been, or could have been, made.[36] This attribute has also been recognized where transfer could be accomplished indirectly, such as through the withdrawal and entry of members.[37]

31. Section 9 of the UPA permits a partner to bind the partnership in such a situation when dealing with a person who does not know of any prohibiting provision in the partnership agreement.

32. Treas. Reg. § 301.7701-2(c)(4)(1965).

33. Treas. Reg. § 301.7701-2(c)(4)(1965), following Glensder Textile Co.,. 46 B.T.A. 176 (1942), *acq.* 1942-1 C.B. 8.

34. Treas. Reg. § 301.7701-2(e)(1965).

35. Treas. Reg. § 301.7701-2(e)(2) (1965); *see* Frank B. Killiam, Trustee, 11 T.C.M. (P-H) 79 (1942).

36. Del Mar Addition v. Commissioner, 113 F.2d 410 (5th Cir. 1940); Hoersting Family Trust, 14 T.C.M. (P-H) 885 (1945).

37. Schroeder Employees Thrift Club, 36 B.T.A. 645 (1937); Investment Trust of Mutual Investment Co., 27 B.T.A. 1322 (1933), *aff'd,* 71 F.2d 1009 (2d Cir. 1934).

The regulations[38] provide that an organization possesses the corporate attribute of limited liability if, under local law, no member is personally liable for organization debts in excess of organization assets. The regulations recognize that limited liability does not exist in the case of a general partnership formed under the ULPA or its equivalent.[39] A general partner in a limited partnership subject to a state statute corresponding to the ULPA bears unlimited liability unless:

> (1) it does not have substantial assets other than its partnership interest, which can be reached by the organization's creditors, *and*
> (2) it is merely a "dummy" acting as an agent of the limited partners.[40]

The "Kintner" regulations pose definite hazards to the tax classification of real estate limited partnerships formed under the ULPA or its equivalent. Under applicable provisions these partnerships will lack continuity of life. They lack centralized management unless substantially all the partnership interests are owned by the limited partners. Limited liability requires the existence of a general partner without substantial assets (other than his partnership interest) that can be reached by creditors, and it further depends on whether the general partner is merely a "dummy" acting as agent of the limited partners. Free transferability of interest exists when the owners of substantially all the interests can transfer them without the consent of the remaining partners. Given these circumstances, many situations exist in which advance rulings on partnership status are desirable.

III. ADVANCE RULING REQUIREMENTS

Although tax shelters in real estate have been utilized with more or less frequency since the 1960's, they have only attracted significant audit attention from the national office in the last several

38. Treas. Reg. § 301.7701-2(d)(1965).
39. Treas. Reg. § 301.7701-2(d)(1)(1965).
40. Treas. Reg. § 301.7701-2(d)(2)(1974); *cf.* Glensder Textile Co., 46 B.T.A. 176 (1942), *acq.* 1942-1 C.B. 8, wherein the court phrased a similar test of limited liability in a ULPA limited partnership in the disjunctive rather than in the conjunctive.

years.[41] Because proper tax classification of such enterprises is a practical necessity, the IRS's leverage in requiring compliance with its criteria is substantial.[42]

The IRS has established the following prerequisites to an advance ruling on the partnership classification of a limited partnership with a sole corporate general partner:

> (1) The limited partners may not own, directly or indirectly, individually or in aggregate, more than 20 percent of the stock of the corporate general partner or its affiliates, either individually or by attribution.[43]
> (2) If the corporate general partner has an interest in only one limited partnership and the total contributions to that partnership are less than $2,500,000, the net worth of the corporate general partner at all times will be at least 15 percent of such total contributions or $250,000, whichever is the lesser. If total contributions to the partnership are $2,500,000 or more, the net worth of the corporate general partner, at all times must be at least 10 percent of such total contributions. In computing net worth, the corporation's interest in the limited partnership, certain receivables and payables are excluded.[44]
> (3) The purchase of a limited partnership interest must not entail either a mandatory or discretionary purchase, or option to purchase, of any type of security of the corporate general partner or its affiliates.[45]

The organization and operation of the limited partnership must be in accordance with the applicable state statute relating to limited partnerships.[46] Additionally, if the corporate general partner has

41. In 1972, the IRS promulgated criteria for advance rulings on limited partnerships with sole corporate general partners. Rev. Proc. 72-13, 1972-1 C.B. 735. In November 1973, Commissioner Alexander publicly announced the IRS's intention to increase audit and advance ruling activity relating to tax shelters. 749 CCH ¶ 6257 (Nov. 11, 1973). Further requirements for tax classification of real estate shelters as partnerships were announced in 1974, Rev. Proc. 74-18, 1974-1 C.B. 439, and 1975, Rev. Proc. 75-16, 1975-1 C.B. 676.

42. The IRS takes the position that these criteria are procedural rather than substantive. *See, e.g.,* Rev. Proc. 74-17, 1974-1 C.B. 438. Failure or inability to satisfy these rules, however, may be a material fact which should be disclosed to potential investors under whatever disclosure documents might be required, and the risk remains that the Service will use the criteria substantively in the event of an audit.

43. Rev. Proc. 72-13 § 2.01, 1972-1 C.B. 735.

44. *Id.* § 2.02.

45. *Id.* § 2.05.

46. *Id.* § 2.06.

interests in more than one limited partnership, the net worth requirements are applied separately and cumulatively to each limited partnership.[47] For purposes of computing the net worth of the corporate general partner, the current fair market value of the corporate assets must be used.[48]

The IRS has established three additional guidelines which must be met before it will consider ruling that a limited partnership constitutes a partnership for federal income tax purposes.[49] These criteria, which apply to all limited partnerships, not just those with sole corporate general partners, are as follows:

> (1) At all times, the aggregate percentage interest of all general partners, as general partners, in each material item of partnership income, gain, loss, deduction or credit must be at least 1 percent.[50]
> (2) The aggregate amounts to be deducted by the partners as their distributive shares of partnership losses for the first two years of operation must not exceed the amount of equity capital invested in the partnership.[51]
> (3) A creditor who makes a nonrecourse loan to the partnership cannot have or acquire, at any time as a result of making the loan, any direct or indirect interest in the profits, capital or property of the partnership (excluding a security interest in partnership property).[52]

The IRS has promulgated a checklist of documents and other information to be submitted with a ruling request concerning the tax classification of an enterprise as a partnership.[53] Generally, the required documents include the partnership agreement, the partnership certificate, the registration statement or its substitute, and a copy of the promotional material relating to the enterprise. Additional required information includes disclosures respecting state partnership law, the net worth of all general partners, a description of creditors' interests and benefits, disclosures of capital contributions, an explanation of the participation of each partner in profits

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47. *Id.* § 2.03.
48. *Id.* § 2.04.
49. Rev. Proc. 74-17, 1974-1 C.B. 438.
50. *Id.* § 3.01.
51. *Id.* § 3.02.
52. *Id.* § 3.03.
53. Rev. Proc. 75-16, 1975-1 C.B. 676.

and losses, and disclosures relating to negative capital accounts and partnership distributions.

Many unresolved questions are raised by the criteria established by the IRS.[54] The disclosure requirements compound the question whether to seek a formal advance ruling on partnership classification.[55] The courts, however, have not taken as narrow a view of partnership classification as has the IRS.

IV. The Larson and Zuckman Decisions

As part of its stepped up activity against real estate shelters, the Internal Revenue Service early began scrutinizing ULPA limited partnerships with sole corporate general partners for compliance with the "Kintner" regulations. Among the objects of its analysis were three more or less conventional limited partnerships with sole corporate general partners.[56] In each case, the IRS took the position that the enterprise more closely resembled a corporation than a partnership. In each instance, the taxpayer litigated the issue and prevailed. *Larson*[57] involved two California syndications, Mai-Kai and Somis, whose sole corporate general partner, GHL, was formed primarily to organize and manage the two ventures. Upon the formation of Mai-Kai, GHL, as general partner, contributed the right to acquire the partnership real property. GHL was not required to make any further capital contributions to Mai-Kai, and its initial capital contribution was carried at zero on the partnership's books. Purchase of apartments was accomplished with partnership capital and a nonrecourse loan secured by a deed of trust on the apartments.

For its contribution, GHL obtained a 20% interest in cash flow and profits which was subordinated until the limited partners re-

54. Although a detailed analysis of Rev. Proc. 72-13, 1972-1 C.B. 735, and Rev. Proc. 74-17, 1974-1 C.B. 438, is beyond the scope of this article, see BNA Tax Management Portfolios 2d, Partnerships—Statutory Outline and Definition, 28-37 (1975), for a discussion of some of the problems presented.

55. Among counsel's concerns in disclosing the information requested by Rev. Proc. 75-16, 1975-1 C.B. 676, is the possibility that the IRS will use personal net worth and other data on the partners in connection with separate audit activities.

56. These partnerships were formed pursuant to Cal. Corp. Code §§ 15501 et seq. (West Supp. 1976) and Mo. Ann. Stat. §§ 359.010 et seq. (Vernon 1976).

57. 66 T.C. 159 (1976); *see* note 4 *supra*, and accompanying text.

covered their initial investment. Losses were allocated among all partners according to their capital contributions. The Mai-Kai agreement prohibited assignment of partnership interest without the consent of the general partner, whose consent could not be unreasonably withheld. In order to transfer his capital interest at less than fair market value, a limited partner was required to offer it first to the other limited partners under a procedure specified in the agreement. Bankruptcy of GHL would dissolve the partnership. Somis was set up in a manner similar to Mai-Kai. No limited partner in either Somis or Mai-Kai was a stockholder in GHL, except one 23% owner of GHL, who held less than a 2% interest in Somis.

Zuckman v. United States[58] presented facts similar to those involved in the *Larson* case. In *Zuckman,* the parties formed a Missouri limited partnership called Towne House, to acquire land, and construct and operate an apartment project. The sole corporate general partner, Forest Park, was a wholly-owned subsidiary of another corporation which was wholly owned by Kanter, one of the Towne House limited partners. Forest Park was capitalized at only five hundred dollars, had no substantial assets other than its interest as general partner in Towne House, and was engaged in no other activities. Kanter held a 21% limited partnership interest in Towne House, and held a continuing proxy to vote all the stock of its general partner, Forest Park.

Forest Park owned a 61% interest in the Towne House venture. The venture was initially financed with a non-recourse FHA loan, but subsequent refinancing resulted in an assumption of part of the partnership's liability by Forest Park's parent corporation. The financing documents included an agreement prohibiting dissolution of the partnership without FHA consent.

For the taxable years in question, all three partnerships generated losses which were passed through and deducted by the limited partners on their individual returns. The IRS disallowed these deductions on the theory that Mai-Kai, Somis and Towne House more closely resembled corporations, and assessed deficiencies. The Mai-Kai and Somis taxpayers contested their deficiencies in the Tax Court, while the Towne House taxpayers paid the tax and sought a

58. 524 F.2d 729 (Ct. Cl. 1975); *see* note 5 *supra,* and accompanying text.

refund in the Court of Claims. Both courts treated the "Kintner" regulations as controlling, and held for the taxpayers, finding that the enterprises were partnerships within the definition of the regulations. In so doing the Tax Court withdrew an earlier *Larson* opinion[59] holding otherwise, which, during its brief tenure, had created much concern over the partnership classification of limited real estate ventures with sole corporate general partners.

Both courts found the corporate characteristic of continuity of life lacking in the partnerships under consideration. The Tax Court found centralized management in *Larson,* but the Court of Claims found it absent in *Zuckman.* Neither court found limited liability, and only the Tax Court found corporate free transferability of interests. The *Larson* and *Zuckman* decisions indicate that, under the existing "Kintner" regulations, there remains relatively little risk of corporate classification for conventional ULPA limited partnerships with sole corporate general partners, although the risk is probably greater in the Tax Court than in the Court of Claims.

Both *Larson* and *Zuckman* recognize that the characteristics of "associates" and "profitable objective"[60] apply to both enterprises, and both opinions, for reasons of predictability, apply the remaining four characteristics of corporate resemblance on a mechanical, equal-weight basis. The Tax Court, however, indicated that if it could weigh each factor according to the degree of corporate similarity it provides, it would be "inclined to find" that the involved entities were taxable as corporations.

Through application of the "Kintner" regulations to concrete provisions of the ULPA and the agreements promulgated thereunder, *Larson* and *Zuckman* provide valuable insight into the present status of the classification problem. The important conclusions are summarized in the checklist appended hereto. A more detailed analysis of these conclusions follows.

A. *Continuity of Life*

In *Larson* and *Zuckman* both the Tax Court and the Court of Claims found the corporate characteristic of continuity of life lack-

59. 65 T.C. No. 10 (Nov. 14, 1975).
60. *See* note 22 *supra.*

ing.[61] The regulations specifically provide that there is no continuity of life in the case of ULPA limited partnerships.[62] The gravamen of the inquiry involves the effect of bankruptcy or other disability of the general partner upon the partnership. Under the regulations, if bankruptcy of any partner causes dissolution of the enterprise, the venture avoids the corporate characteristic of continuity of life.[63] Thus, since under the California version of ULPA a partnership is dissolved upon the bankruptcy of a partner, the *Larson* court held that Mai-Kai and Somis lacked the corporate characteristic of continuity of life.[64]

Initially, *Larson's* lesson respecting bankruptcy of the general partner appears clear. If under the applicable version of the ULPA, bankruptcy causes dissolution of the partnership, the enterprise lacks the corporate characteristic of continuity of life. *Zuckman* adopts the same view.[65] For planning purposes, however, several distinctions and refinements must be made. First, in order to promote partnership status, the general partner's bankruptcy (or other disability) should actually cause dissolution of the partnership, and not merely confer on the remaining partners the right of dissolution. *Zuckman* held irrelevant the fact that the general partner, by financing agreement or otherwise, relinquishes its *right* to dissolution as opposed to its *power* of dissolution.[66] Secondly, the reservation, in the remaining partners, of a right to replace a disabled general partner or to continue the enterprise in the event of dissolution, constitutes only a "contingent continuity of existence" which is insufficient to meet the corporate standard. Third, if attempts by

61. *See* notes 4 & 5 *supra*.
62. Treas. Reg. § 301.7701-2(b)(3)(1965).
63. Treas. Reg. § 301.7701-2(b)(1)(1965).
64. We hold that the partnerships involved herein do not satisfy the "continuity of life" test as set forth in respondent's regulations. We recognize that our application of respondent's existing regulations to the event of bankruptcy results in a situation where it is unlikely that a limited partnership will ever satisfy the "continuity of life" requirement of those regulations. But the fact that the regulations are so clearly keyed to "dissolution" (a term encompasssing the legal relationships between the partners) rather than the "termination of the business" (a phrase capable of more pragmatic interpretation encompassing the life of the business enterprise) leaves us with no viable alternative.

66 T.C. 175 (footnotes omitted).

65. 524 F.2d at 737.
66. *Id.*

the partners to contract against dissolution in the event of the general partner's bankruptcy are invalid under local law, such attempts do not affect the partnership's tax status. In this regard *Larson* and *Zuckman* require verification that the applicable version of ULPA causes dissolution of the partnership in the event of bankruptcy or other disability of the general partner, and they provide that this fact alone destroys the corporate characteristic of continuity of life.[67] However, the cases further hold that provisions such as the relinquishment of a general partner's right to voluntarily file for bankruptcy, or a reservation of the right in other partners to continue the enterprise upon such dissolution, do not impair this aspect of partnership status.[68]

B. *Centralization of Management*

Larson and *Zuckman* provide an unusual opportunity for analysis of the corporate characteristic of centralized management because, applying the same principles to similar facts, the Tax Court found this characteristic present,[69] and the Court of Claims found it lacking.[70] These different results are explainable on the basis of factual differences relating to the partnerships' agreements and activities. Both cases recognize that centralized management, of the type characteristic of corporations, is management in a *representative* capacity, and that it is lacking in ULPA limited partnerships unless "substantially all" the interests in the partnership are owned by the limited partners. Both cases apply the "substantially all" test to determine the existence of centralized management under the stated facts.

In *Larson,* the general partner, GHL, obtained a 20% interest in cash flow and profits, which was subordinated until the limited partners recovered their initial investment. The petitioners had failed to show, furthermore, that GHL's capital interests had any present value during the years in issue. Given the limited partners' power to remove GHL as general partner, the Tax Court reasoned that GHL's right to participate in future growth and profits was

67. Larson, 66 T.C. at 176; Zuckman, 524 F.2d at 735.
68. Larson, 66 T.C. at 176; Zuckman, 524 F.2d at 736.
69. 66 T.C. at 176-79.
70. 524 F.2d at 739.

wholly contingent on satisfactory performance of its management role. The court concluded, therefore, that GHL's interest was "not at all analogous to the independent proprietary interest of a typical general partner,"[71] and held that Mai-Kai and Somis possessed the corporate characteristic of centralized management.[72]

The *Larson* holding is perhaps best explained as an example of evidentiary failure, coupled with an unusually contingent method of compensating a general partner. Under a more vigorous analysis, however, the Tax Court's holding raises a number of questions regarding more or less standard provisions which appear in ULPA limited partnership agreements. First, the court does not specify how much weight it will accord the fact that the general partner's income interest is subordinated, or its conclusion that the general partner's capital interest has no proven present value. How would the court classify an agreement providing only for subordination of income, or providing only for a contingent capital interest? Hopefully, the Tax Court would not hold, as a matter of law, that a provision subordinating a general partner's interest in profits until the limited partners recover their initial investment creates centralized management. Such provisions are commonplace in limited partnership agreements. Since the court specifically distinguished GHL's interest from the independent proprietary interest of a typical general partner,[73] it is unlikely that mere subordination, without more, would result in a finding of centralized management.

Second, if GHL's capital interest is so uncertain that it does not merit consideration as a "meaningful proprietary interest,"[74] what capital interest would merit such consideration? Two related aspects of a general partner's capital interest are relevant. The first is its defeasible nature, and the second is its lack of proven present value. In *Larson,* the Tax Court first appears to say that the mere power in the limited partners to remove the general partner deprives the general partner of a "meaningful proprietary interest" as a matter of law.[75] The court bolsters this conclusion with its finding that

71. 66 T.C. at 178.
72. *Id.* at 179.
73. *Id.* at 178.
74. *Id.* at 177.
75. *Id.*

such removal is not required.[76] Given such a finding on the issue of removal of the general partner, it would become very difficult, if not impossible, to satisfy the court on the issue of centralized management. Such a holding would diminish to insignificance the petitioner's failure to prove present value, which the court assigned as an alternative reason for its finding of centralized management.[77]

It is important to recognize, however, that the court does not ascribe corporate, centralized management to all limited partnerships in which the limited partners have the power to remove the general partners from their management role. Rather, the court indicates that centralized management exists if the general partner's present capital interest can be defeased by such a removal.[78] *Larson's* lesson, as it applies to the capital interests of general partners, is that these interests must be specifically, initially, and indefeasibly vested under the agreement, and not conditioned on satisfactory future management performance or the power to remove the general partner. Presumably, a right of removal involving a market value buy-out of the expelled general partner's capital interest would not violate this requirement.

An interesting aspect of *Larson* is that, although the issue of centralized management turned entirely on the concept of ownership of "substantially all" the partnership interests by the limited partners, the court made no effort to quantify "substantially all." In *Zuckman,* however, the court discussed the "substantially all" requirement in the context of free transferability of interests. The court held that 61% of the partnership's interests would not constitute "substantially all," but suggested that 90% would suffice.[79] It is believed that an accurate analogy may be drawn to the centralized management issue, and that therefore a general partner's retention of an indefeasible 39% interest in the partnership would effectively prevent a finding of the corporate characteristic of centralized management. A retention of between 10 and 39% is subject to question, while retention of less than 10% is probably insufficient.

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76. *Id.* at 178-79.
77. *See* 66 T.C. at 177-78.
78. *Id.* at 178.
79. 524 F.2d at 742 n.14.

C. *Limited Liability*

The regulations provide that an organization has the corporate characteristic of limited liability if, under local law, no member is personally liable for debts of, or claims against the organization.[80] Since in the case of limited partnerships, such liability ordinarily exists with respect to the general partner, the corporate characteristic of limited liability is lacking. Many limited partnerships, however, attempt to circumvent the general partner's liability by incorporating a thinly capitalized sole corporate general partner whose assets are insufficient to meet foreseeable debts and claims, but which, in theory at least, is fully liable for them. The anticipated result is an enterprise with the tax advantages of a limited partnership, but with limited liability approaching that found in the pure corporate business form. The regulations attempt to limit such abuses of the partnership form by establishing a two-pronged test of the general partner's limited liability:

> In the case of an organization formed as a limited partnership, personal liability does not exist, for purposes of this paragraph, with respect to a general partner when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when he is merely a "dummy" acting as the agent of the limited partners.[81]

Although the regulations attribute this dual concept to *Glensder Textile Co.*,[82] the *Glensder* court phrased a single test of substantial assets as follows:

> If, for instance, the general partners were not men with substantial assets risked in the business, *but* were mere dummies without real means acting as the agents of the limited partners . . . there would be something approaching the corporate form of stockholders and directors.[83]

A comparison of the language of *Glensder* with that of the regula-

80. Treas. Regs. § 301.7701-2(d)(1).
81. Treas. Regs. § 301.7701-2(d)(2).
82. 46 B.T.A. 176 (1942), *acq.* 1942-1 C.B. 8.
83. *Id.* at 183.

tions indicates that the *Glensder* court viewed "dummy" status as "equivalent to" not risking substantial assets in the business, while the IRS intended to establish "dummy" status as a separate criterion of limited liability, unrelated to the risk of substantial assets. In order to find the corporate characteristic of limited liability, both *Larson* and *Zuckman* require that the separate tests of insubstantial asset risk *and* "dummy" status be satisfied.[84] *Larson* suggests several factors which are consistent with "dummy" status:

> (1) total control of the general partner by the limited partners,
> (2) power, in the limited partners, to direct the business activity through the general partners,
> (3) use of the general partner as a screen to conceal the limited partners' active involvement in the conduct of the business; and,
> (4) the general partner acting as a "rubber stamp" for the actions of the limited partners.[85]

All of the foregoing factors contemplate that the general partner will act as agent for one or more limited partners who control the partnership. In making a determination of "dummy" status of the sole corporate general partner, the *Larson* court took a more liberal view of the limited partners' right to remove the general partner than it did in the context of centralized management. The court held that the power of removal only gave the limited partners a measure of control over their investment, without involving them in the control of the business.[86] The right of removal, therefore, was held not determinative of "dummy" status.

Zuckman raises an intriguing possibility respecting limited partners who take part in control of the business. Since under the ULPA, such limited partners themselves become liable as general partners, the *Zuckman* court found only two alternatives: If the sole corporate general partner is not a "dummy," it is liable for partnership debts, and corporate limited liability does not exist.[87] If the sole corporate general partner is a "dummy," however, the limited partners from whom it acts as agent are liable, and corporate limited liability still

84. Larson, 66 T.C. at 179-80; Zuckman, 524 F.2d at 741.
85. *See* 66 T.C. at 180-81.
86. *Id.*
87. 524 F.2d at 741.

does not exist.[88] The effect of this rationale is a finding that ULPA limited partnership with sole corporate general partners lack the corporate characteristic of limited liability as a matter of law. It may make no tax difference whether the sole corporate general partner or an individual limited partner bears unlimited liability, but limited partners should not take part in control of the business such that they become liable as general partners.

D. *Free Transferability of Interests*

Like centralized management, the corporate characteristic of free transferability of interests provides an unusual opportunity for analysis because, on similar facts, *Larson* found it present and *Zuckman* found it lacking.[89] The regulations provide that this fourth major corporate characteristic exists when the members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute non-members for themselves, and to confer upon their substitutes all the attributes of their interests in the organization.[90]

Larson and *Zuckman* provide only limited guidance as to what constitutes "substantially all" the partnership interests. The concept recurs in connection with centralized management, where the limited partners' ownership of "substantially all" the partnership interests is indicative of corporate status. In *Larson,* the Tax Court held, without quantifying the concept, that the limited partners owned substantially all the interests in Mai-Kai and Somis for purposes of centralized management.[91] When deciding the issue in the context of free transferability, the court treated its prior determination as dispositive, thereby suggesting that the same test would apply, regardless whether the determination is made for purposes of centralized management of free transferability.[92] In *Zuckman,* however, the Court of Claims made a limited attempt to quantify the concept, by holding that 61% interest is not substantially all, and by suggesting that a 90% interest may be.[93] Given the Tax

88. *Id.*
89. Larson, 66 T.C. at 184; Zuckman, 524 F.2d at 743.
90. Treas. Regs. § 301.7701-2(e)(1).
91. 66 T.C. at 182.
92. *Id.* at 184.
93. 524 F.2d at 742 n.14.

Court's reliance on *Zuckman* in connection with the centralized management issue, and its own treatment of centralized management as dispositive of this aspect of free transferability, a persuasive argument can be made for the acceptance of *Zuckman's* 61%—90% test by the Tax Court.

The gravamen of the concept of free transferability is in the question how much consent is required to effectuate a transfer of all the rights and liabilities associated with a member's partnership status. This issue was addressed in *Larson,* which found substantially all the interests to be freely transferable,[94] and also in *Zuckman* which held the other way.[95] In *Larson,* the applicable uniform act required consent of all members to effect a transfer of a limited partnership interest,[96] and the agreements provided that consent to a limited partner's assignment of his income interest could not be unreasonably withheld.[97] The Tax Court found that such a limited restriction was not typical of partnership agreements and held that the limited partner's income rights were freely transferable.[98] The limited partners' capital interests were similarly characterized, despite a requirement that such interests be first offered to the other limited partners before transfer to third parties. The court held that there was no effort by the parties to select their business associates, as is characteristic of the usual partnership arrangement.[99]

Larson provides few clues to the concept of free transferability. It holds that reasonable consent to a transfer of income interests is not an attempt to select business associates which characterizes the partnership form.[100] It further holds that a requirement, that a limited partner offer his capital interests to the other members before he transfers them for less than fair market value, does not destroy free transferability.[101] Both of these conclusions are understandable. The benchmark of free transferability is a partner's power to transfer his right to direct or control the enterprise to third parties with-

94. 66 T.C. at 183-84.
95. 524 F.2d at 743.
96. *See* 66 T.C. at 183.
97. *Id.* at 184.
98. *Id.*
99. *Id.*
100. *Id.*
101. *Id.*

out affording his associates an opportunity to pass on the capabilities or characteristics of his transferee. Reasonable consent to the assignment of income rights, without more, does not constitute control of the enterprise. Consent to the transfer of capital interests might impair free transferability, but on *Larson's* facts the remaining partners had only the first right to acquire those interests in the event of a transfer for less than fair market value. In sum, the court found that an assignee for fair consideration of a limited partner's interest in Somis or Mai-Kai could acquire all the rights of his assignor, without discretionary consent of any other member. This, the court reasoned, is free transferability of interests.[102]

Zuckman adopted a more mechanistic approach than the "effort to select business associates" concept of *Larson*. In *Zuckman*, the agreement required consent of the general partner before a limited partner could substitute an assignee as a contributor or as a transferee of his interest.[103] One of the limited partners controlled the general partner, and the court held that his interest was freely transferable.[104] The general partner's interest, however, could only be transferred with the consent of the limited partners, and the court found this characteristic determinative that "substantially all" the interests were not freely transferrable.[105]

Larson and *Zuckman* suggest that the corporate characteristic of free transferability may be avoided in several ways. If the general partner owns at least 39% of the partnership, a requirement of the limited partners' discretionary consent to a transfer of its interests will defeat free transferability, regardless of how freely the limited partners may transfer their shares. Conversely, a requirement of discretionary consent of the remaining limited partners before transfer of a limited partner's capital interests appears sufficient to defeat free transferability if the limited partners own at least 39%. Mere formal or procedural prerequisites will not suffice.

V. Conclusion

Larson and *Zuckman* constitute clear evidence that neither the

102. *Id.*
103. *See* 524 F.2d at 742.
104. *Id.* at 743.
105. *Id.*

Tax Court nor the Court of Claims will permit the IRS to use its "Kintner" regulations to destroy the partnership status of standard ULPA limited partnerships with sole corporate general partners. The risk remains greater under *Larson* than under *Zuckman*. *Zuckman* found all four corporate characteristics lacking in a unanimous opinion. The Tax Court opinion in *Larson* found only the bare minimum of two corporate characteristics lacking. Furthermore, the Tax Court evidenced indecision by issuing the withdrawal of an earlier contrary opinion and by the existence of five dissenting opinions. Initially, practitioners may be pleased at a majority Tax Court opinion holding in favor of partnership classification. Analysis of the *Larson* opinion, its concurring opinions and dissents, however, leaves unresolved the question whether *Larson* constitutes the Tax Court's final view of these issues, and if so, how easily the IRS might reverse this result by an invited amendment of the "Kintner" regulations. The IRS is in the process of appealing *Larson*, and the possibility of a reversal exists.

Both courts saluted the initial question of the applicability of the "Kintner" regulations but treated them as dispositive because of the parties' agreements to that effect. In each case the court admonished the IRS for using these regulations for an unintended purpose.

The salient conclusions to be drawn from *Larson* and *Zuckman* are appended to this article in the form of a checklist which counsel may find useful when drafting limited partnership agreements.

Under the *Larson* and *Zuckman* decisions, the IRS is bound to make two-way classification determinations under its "Kintner" regulations, but the circumstances will be rare in which the IRS succeeds in forcing corporate status upon ULPA limited partnership with sole corporate general partners.

Appendix

A Larson—Zuckman Checklist for Partnership Tax Classification of ULPA Limited Partnerships with Sole Corporate General Partners

I. "Corporate" characteristics two or more of which must be *lacking* in order to obtain partnership classification for federal income tax purposes:

A. Continuity of Life
B. Centralized Management
C. Limited Liability
D. Free Transferability of Interests

II. *Continuity of Life*

A. Factors evidencing a lack of continuity of life, consistent with partnership classification:

1. Bankruptcy or other disability of the general partner causes dissolution of the partnership under applicable law or the partnership agreement (it does not merely confer a *right* to dissolve).

B. Factors evidencing the existence of continuity of life, consistent with corporate classification:

1. Bankruptcy or other disability of the general partner does not dissolve the partnership; or it confers the mere *right* to dissolve the partnership under applicable law and the agreement.

C. Nondispositive factors.

1. The agreement removes the *right* to voluntary dissolution, but not the *power* of voluntary dissolution.
2. The remaining partners reserve the right to replace a disabled general partner or to continue the enterprise in the event of dissolution.
3. Attempts to contract against dissolution in the event of a partner's disability, if such attempts are invalid under local law.

III. *Centralized Management*

A. Factors evidencing a lack of centralized management, consistent with partnership classification.

1. The general partner's authority to make decisions on behalf of the partnership is not exercisable in a representative capacity on behalf of limited partners, but in an individual capacity on behalf of itself.
2. The limited partners do not own "substantially all" the interests in the partnership (limited partners own 61% or less).
   (a) Retention of a "meaningful proprietary interest" in the partnership by the general partner.
   (b) The general partner's income interest is not subordinated to that of the limited partners.
   (c) The general partner's capital interest has provable present value.
   (d) There is a reasonable expectation of future return to the general partner as a result of its partnership interest.
   (e) The general partner's right to participate in future growth and profits is vested, regardless of future satisfactory performance of its management role.
   (f) The agreement prohibits, or narrowly restricts circumstances permitting removal of the general partner.

B. Factors evidencing centralized management, consistent with corporate classification:
1. The general partner has continuing exclusive authority to make independent business decisions in a representative capacity, on behalf of the partnership.
2. "Substantially all" the interests in the partnership are owned by the limited partners (90% or more).
   (a) The general partner's income interest is subordinated to that of the limited partners.
   (b) The general partner's capital interest has little or no present value.
   (c) There is no reasonable expectation of future return to the general partner as a result of its interest in the partnership.
   (d) The general partner's right to participate in future growth and profits is contingent on satisfactory performance of its management role.
   (e) The agreement provides for removal of the general partner.

IV. *Limited Liability*

A. Factors evidencing unlimited liability consistent with partnership classification.

1. Unlimited liability of the sole corporate general partner.
2. The sole corporate general partner has substantial assets other than its partnership interest.
3. The sole corporate general partner is not a "dummy" acting as an agent for the limited partners.
4. Individual limited partners take part in control of the business such that they are liable to third parties for partnership debts under ULPA.

B. Factors evidencing limited liability consistent with corporate classification.

1. The sole corporate general partner has no substantial assets other than its partnership interest, *and* is a dummy acting as the agent of the limited partners.
2. In the preceding situation, the limited partners do not take part in control of the business such that they are liable to third parties for partnership debts under ULPA.

V. *Free Transferability of Interests*

A. Factors evidencing lack of free transferability consistent with partnership classification.

1. Less than "substantially all" the partnership interests are freely transferable (61% or less are freely transferable).
2. Significant partnership interests (39% or more) are only transferable with the discretionary consent of the remaining partners.

B. Factors evidencing free transferability consistent with corporate classification.

1. "Substantially all" the partnership interests are freely transferable (90% or more).
2. Transfer does not require discretionary consent of the remaining partners.

C. Nondispositive factors.

1. Formal or procedural, rather than substantive, restrictions on transfer of interests.
2. Requirement of first offer to other partners prior to transfer for less than fair market value.