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Housing Partnerships: Shelters from Taxes and Shelters for People

Leon Gabinet and Ronald J. Coffey

Why should an investor put his money in low and moderate income housing when he can realize a greater net profit return from other investments?

I. INTRODUCTION

The foregoing query frames the basic issue which is the subject of this article. Those whose wealth is sought for the construction and rehabilitation of low and moderate income housing answer plaintively: Net income yield from such projects is simply not sufficient. Nor are the complaints about inadequate yield heard only from exploiters. Indeed, the more beneficent the landlord, the less likely his chances of eking out a reasonable net return. High costs of construction materials and labor, frequent tenant turnover, and other expenses peculiar to the operation of inner-city housing conspire to shrivel the margin available to the conscientious landlord. Small wonder, then, that many socially sensitive investors shrink from the prospect of substantial financial commitment to such troubled rental property. Arguments that investors should be satisfied with “social return” in lieu of monetary yield have not yet carried the day, although some foundations have instituted the practice of investing a portion of principal in “program related” projects, knowing full well that they will suffer a reduction of income. It is conceivable that the constant stream of solicitations for gifts to social programs will, in time, make industry and others more favorably disposed toward in-

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1 See Note, Government Programs to Encourage Private Investment in Low-Income Housing, 81 HARV. L. REV. 1295-96 (1968).

2 See FORD FOUNDATION, NEW OPTIONS IN THE PHILANTHROPIC PROCESS (1968).
vestment, albeit risky, as an alternative to continuous giving. No such shift in thinking on any significant scale appears to be imminent, however, and the day when investing in low and moderate income housing might become popular as a sort of sublimated gift-giving seems fairly remote.³

Faced with the inevitable low-yield phenomenon, concerned professionals and legislators have sought to devise techniques for enticing capital into the fundamentally unattractive field of low and moderate income housing. Except for those schemes aimed primarily at reducing construction costs through radically new design and production techniques, the contrivances for stimulating private investment have amounted to nothing more than subsidies, direct or indirect. One indirect method of increasing yield on rental real estate through government participation is the accelerated depreciation "tax shelter," a practice not at all unfamiliar to tax counsel. It is not the purpose of this article to assess the relative merits of subsidy variants. While the writers tend to agree with those who see significant dangers in using the tax structure as an incentive for social action,⁴ a realistic approach demands recognition of the fact that many potential investors find the tax saving approach more palatable than straightforward grants by government.⁵

Assuming, arguendo, that tax incentives represent appropriate devices for fostering socially desirable behavior, the question arises whether tax shelters, particularly those based on accelerated depreciation, are suited to the attainment of standardized housing. To be sure, the tax shelter approach is an "on the shelf" item which is familiar to many because of its more than insubstantial use in untroubled areas of real estate investment.⁶ Moreover, the legisla-

³ Indeed, it is not unusual to hear donors advance the argument that a deductible contribution is superior to a marginal investment because, upon the making of a gift, an amount equal to tax reduction is maintained in cash flow where it can quickly earn back the net cost of the donation.

⁴ See Note, supra note 1, at 1309-18. For a criticism by former Assistant Secretary of the Treasury Stanley S. Surrey of accelerated methods of depreciation on the basis of loss of government revenues and promotion of slum conditions, see Wall Street J., Oct. 29, 1968, at 7, col. 3 (Midwest ed.).

⁵ Demaree, What Business Wants from President Nixon, FORTUNE, Feb., 1969, at 87. Perhaps this attitude is a function of the fact that many men of wealth have so consistently deprecated direct government grants in other contexts that they are now wedded to an unalterable antagonism toward all kinds of open and straightforward government participation.

⁶ The real estate depreciation shelter has been devoted to the attainment of specific social goals by the Mutual Real Estate Investment Trust, whose primary aim is to purchase rental property for the purpose of establishing integrated communities of apartment dwellers. Prospectus, Mutual Real Estate Investment Trust, March 4, 1968, at 3.
tive history of the Housing and Urban Development Act of 1968,\(^7\) *mirabile dictu*, contains a Congressional exhortation to utilize tax shelters for the production of low and moderate income housing.\(^8\)

On the other hand, it has been forcefully argued that accelerated depreciation allowances actually hasten deterioration, because repairs tend to lengthen useful lives (thereby diminishing yearly deductions) and because fast write-offs encourage rotation of property as soon as depreciation no longer adequately shelters income.\(^9\) Considering the legitimate and substantial points which can be marshalled against the utilization of tax shelters in connection with low and moderate income housing, one might legitimately question the wisdom of Congress' taking the contrary tack of encouraging the use of depreciation write-offs as a stimulus to investment. The answer may lie in the protections and controls contained in federal housing legislation which Congress created as the ancillary means of maximizing the benefits of what is basically a tax incentive device.\(^10\)

It has also been suggested that the Commissioner's arsenal of anti-tax-avoidance weapons might be deployed against tax shelter investments because they are generally accompanied by a fairly intense purpose to finesse taxes.\(^11\) However, where the tax shelter is a con-


\(^10\) National Housing Act sections 221(d)(3), 12 U.S.C.A. § 1715l(d)(3) (1969), and 236(j)(3), 12 U.S.C.A § 1715z-1(j)(3) (1969), provide for 90 percent mortgage insurance for certain limited distribution entities (limited dividend mortgagors or sponsors) engaged in rehabilitation and operation of rental properties. Financing at 3 percent interest is available after final endorsement of a mortgage by the Federal Housing Administration (FHA). National Housing Act § 221(d) (4), 12 U.S.C.A. § 1715l(d)(4) (1969); 24 C.F.R. § 221.518(b) (1969). Section 236(c) of the National Housing Act, 12 U.S.C.A. § 1715z-1(c) (1969), provides for subsidies payable to the mortgagee of a limited distribution mortgagor in an amount not exceeding the difference between the debt service required under market interest financing and the debt service under 1 percent interest financing. Rent supplement payments are available to tenants of 221(d) (3) and 236(j)(3) projects conducted by limited distribution mortgagors. 24 C.F.R. § 5.15 (1969). Finally, section 236(j)(3) makes it possible for nonprofit housing sponsors or cooperatives to obtain 100 percent loans at 1 percent interest for the purpose of purchasing property at fair market value (subject to certain limitations) from limited distribution mortgagors. It will later appear how these opportunities serve to enhance the tax shelter potential of rental real estate operations. See text accompanying notes 85-124 infra. At the same time, federal mortgage insurance programs are supervised by the FHA which can specify standards of construction, rehabilitation, and operation to be met by profit-making sponsors seeking federally-backed financing. Moreover, the technique of selling real estate to a "take out" nonprofit sponsor or cooperative may halt the turnover syndrome, which some have claimed is exacerbated by depreciation tax shelters.

comitant of investment in low and moderate income housing, it would seem that taxpayers could fend off Revenue Service attack by raising the tough shield of overwhelming social purpose and virtue. After all, the legislative history of the Housing and Urban Development Act of 1968 does expressly encourage the partnership form of business as a vehicle for augmenting general accounting net income with tax shelter return. Moreover, Title IX of the same Act authorizes the establishment of the so-called National Housing Partnership, whose structure is so clearly meant to facilitate tax sheltering that Congressional blessing on such devices cannot be denied.

II. THE TAX SHELTER IN THE PRODUCTION OF LOW AND MODERATE INCOME HOUSING

A. Depreciation Tax Shelters Generally.

The basic tax incentive in rental real estate investment is the possibility of achieving a so-called "tax shelter" for high bracket taxpayers whereby tax depreciation deductions are used to offset high bracket income. Such a state of affairs can best be achieved by a proper combination of high tax depreciation deductions in relation to a low rate of amortization of a large mortgage. This optimum combination is possible where investment basis is attributable to post 1953 new construction or where the investor acquires depreciable property after 1953 and is the first user. In such circumstances, fast depreciation methods, such as double declining balance or sum of the years digits, may be used. The availability of accelerated tax depreciation makes it possible for the investor to offset the rental income

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13 "The partnership arrangement makes it possible to assure an adequate return to investors. Under existing Internal Revenue Service regulations and rulings, partnership losses for tax purposes flow to the individual partners. In the case of new housing units financed on a 10 percent equity — 90 percent debt basis, the annual accelerated depreciation of the building cost results in substantial book losses during the initial 10 years after the project is built. Assuming the member of the partnership is in relatively high income tax bracket, his share of depreciation losses, plus cash income from project operations would provide an after-tax return on his investment which would compare favorably with the return which most industrial firms realize on their equity capital." S. Rep. No. 1123, supra note 8, at 85.
15 See discussion accompanying notes 109-16 infra.
16 See, e.g., Asch, Tax Considerations in Real Estate Syndications, 3 VILL. L. REV. 469 (1958); Boughner, How the Tax-wise Investor Buys Real Estate Today, 9 J. TAXATION 30 (1958); Graves, Depreciation for Tax Purposes, 34 TAXES 59, 60 (1956).
17 INT. REV. CODE OF 1954, §§ 167(b), 167(c), [hereinafter cited as CODE].
from the property with a portion of the depreciation deduction and to use the operating loss produced by the remaining depreciation to offset his income from other sources.

The attractiveness of the shelter is increased by the fact that the basis for depreciation includes not only the investor's own cash outlay, but the mortgage indebtedness as well. Since a real estate investment is rarely accomplished without mortgage financing, it is readily apparent that the investor is securing the additional advantage of depreciation deductions based on a total sum which may be far in excess of his own cash investment. Consequently, while income is being offset generously on the tax side by rapid tax depreciation write-offs, rental revenue may be producing tax free book net income because a lower rate of depreciation is being used for general accounting purposes.

A simple example will illustrate the advantages of using accelerated depreciation. Suppose T constructs an apartment building for $40,000, $30,000 of which was borrowed. Based on a useful life of forty years for the building and using straight line depreciation (2.5 percent or $1,000), T's taxable income and pretax book net income from the building (after straight line depreciation) amount to $800. Amortization of loan principal is $500. Assuming that taxable income from the building is taxed at a 50 percent bracket rate, the following analysis results:

<table>
<thead>
<tr>
<th>Tax</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income after straight line depreciation</td>
<td>800</td>
</tr>
<tr>
<td>Tax @ 50%</td>
<td>400</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>After-Tax Income Yield</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Book net income after straight line depreciation</td>
<td>800</td>
</tr>
<tr>
<td>Less: taxes</td>
<td>400</td>
</tr>
<tr>
<td>After-tax income yield</td>
<td>400</td>
</tr>
<tr>
<td>Percentage of equity investment</td>
<td>4%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fund Flow</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Book net income</td>
<td>800</td>
</tr>
<tr>
<td>Add back: book depreciation</td>
<td>1000</td>
</tr>
<tr>
<td></td>
<td>1800</td>
</tr>
<tr>
<td>Less: amortization</td>
<td>500</td>
</tr>
<tr>
<td>Fund flow</td>
<td>1300</td>
</tr>
</tbody>
</table>

Two points should be noted at this juncture. First, although book net income is $800, fund flow is $1300 because book depreciation ex-

18 Crane v. Commissioner, 331 U.S. 1 (1947).
ceeds amortization. Thus, $1300 could be distributed: $800 net income and $500 amounting to return of capital for general accounting purposes. Since tax depreciation exceeds amortization by $500, that amount of distributable fund flow is sheltered from taxation, but the $800 of book net income is not so sheltered.

If $T$ were to employ double declining balance (twice straight line percentage) depreciation for tax purposes, the analysis of his apartment rental operation would be as follows:

\[\begin{align*}
\text{Tax} & \\
\text{Taxable income after straight line depreciation} & \quad 800 \\
\text{Less: additional depreciation deduction under 200\% declining balance} & \quad 1000 \\
\text{Tax} & \quad \text{---} \\
\text{Taxable income (net tax loss) after 200\% declining balance} & \quad (200) \\
\text{Net tax loss from apartment taken against other income} & \\
of T @ 50\%; tax saving & \quad 100 \\
\text{Percent of equity investment} & \quad 1\% \\
\text{After-Tax Income Yield} & \\
\text{Pretax net after straight line depreciation} & \quad 800 \\
\text{Less: taxes} & \quad 0 \\
\text{Percentage of equity investment} & \quad 8\% \\
\text{Fund Flow} & \\
\text{Book net income} & \quad 800 \\
\text{Add back: book depreciation} & \quad 1000 \\
\text{Less: amortization} & \quad 500 \\
\text{Fund flow} & \quad 1300
\end{align*}\]

By switching to accelerated depreciation, $T$ has increased the effective yield on his equity investment to 9 percent, comprised of 8 percent tax-free book net income and a 1 percent tax shelter saving on income from other sources. Tax depreciation was increased to exceed amortization by $1500, thus creating a shelter for $1300 of distributable fund flow (including $800 book net income) as well as $200 of $T$'s other income.\(^{19}\)

\(^{19}\) All this is frequently explained by the generalization that a tax shelter is created when tax depreciation exceeds amortization. Such a proposition should be handled with care, however. The shelter notion involves a mixture of fund flow and net income concepts. The starting point of the analysis is book net income, that is, net income after book depreciation. Fund flow is computed by adding to net income the non-cash deduction of book depreciation and by subtracting debt principal amortization.
The shelter is also rendered more attractive by the further possibility of toying with the useful lives of assets and with allocation of cost between depreciable structures and nondepreciable land. The investor is usually very pessimistic about useful life — a view which encourages him to depreciate the asset more quickly and thus accentuate the shelter possibilities which inhere in depreciation. The same effect is procured by adopting a more cheerful view as to the relation of the value of depreciable structures to nondepreciable land. Both attitudes will result in “overdepreciating” the property which lowers his after-tax investment and maximizes his profit potential.

It would be unfair to paint so cheerful a picture of the tax shelter possibilities of a rental real estate investment without noting some disquieting elements on the scene. First, if the actual rate of wear and tear equals or exceeds available depreciation deductions, then the cash flow resulting from the deduction is completely illusory. In those circumstances, the deduction merely replaces the asset. Second, there is an inescapable correlation between the rate of depreciation and mortgage amortization. If accelerated depreciation is used, then in later years, when the depreciation deductions are significantly reduced, the rate of mortgage amortization will begin to outstrip the effects of depreciation deductions. At this point, of course, the investment begins to lose its appeal as a shelter and the investor will

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20 Treas. Reg. § 1.167(a)-5 (1960) requires allocation of purchase price between depreciable and nondepreciable property, since depreciation basis may not exceed that portion of a lump sum purchase price which represents the value of the depreciable property.
generally sell the property. If sold for an amount in excess of the tax basis, there will be a capital gains tax to pay if the property was held for investment, and there is also the possibility of depreciation recapture under section 1250\textsuperscript{21} of the Internal Revenue Code. Moreover, since the property is no longer new, a prospective buyer will not be entitled to accelerated depreciation and marketing problems may develop.\textsuperscript{22}

In general, however, the foregoing illustrates that an investor who is able to combine the necessary ingredients of accelerated depreciation and a relatively low rate of mortgage amortization can, indeed, achieve distributable but nontaxable net income from his investment as well as a tax shelter for other income. At the very least, he will be able to shelter the income from the investment itself and thus achieve the object of securing more spendable cash. It is small wonder, therefore, that the terms "tax shelter" and "tax sheltered investment" have found their way into common parlance among the investing public.

B. Possible Business Forms for Utilizing the Tax Shelter.

The foregoing discussion of real estate tax shelters has been framed in terms of an individual investor acting alone and on his own behalf. The growth of large real estate developments, however, both residential and commercial, coupled with the financial, legal and other intricacies of large projects, has led to a concomitant search for proper legal entities wherein a number of investors may join to pool their resources and jointly reap the profits. Some developers and investors find the corporation well suited to their needs. Others have turned to trusts, partnerships, limited partnerships, syndicates of one sort or another, and, more recently, to formal Real Estate Investment Trusts (REIT) governed by specific Code provisions.\textsuperscript{23}

In recent years, the use of the corporate form has been limited to the construction segment of the real estate business, where limited liability and the continuing active nature of the enterprise render this form useful. It is not particularly useful to the investment segment of the business because, by the interposition of an independent tax-paying entity, the pass-through of depreciation deductions to the

\textsuperscript{21} Code §§ 1231, 1250. See discussion accompanying notes 108 and 121-24 infra.

\textsuperscript{22} Code § 167(c). See note 108 infra.

\textsuperscript{23} See Kelley, Real Estate Investment Trusts After Seven Years, 23 Bus. Law. 1001 (1968).
individual investor cannot be accomplished.\textsuperscript{24} The corporation can, of course, make use of accelerated depreciation to reduce its own taxable income and earnings and profits, so as to render distributions to shareholders nontaxable to the extent of basis in the shares.\textsuperscript{25} However, to the extent that the corporation’s depreciation deductions exceed its income and cannot be used by way of a carryover loss deduction, they are wasted. Even if a net operating loss generated by excess tax depreciation could be used to reduce the corporation’s taxable income in another year, the loss could not be used to reduce earnings and profits of such other year.\textsuperscript{28} Furthermore, the \textit{Code} specifically provides that distributions to shareholders will receive dividend treatment notwithstanding a deficit of earnings and profits from prior years if there are current earnings and profits.\textsuperscript{27} Thus, excess tax depreciation from one year may not be available to render distributions of another year nontaxable to shareholders.

Because of the problems inherent in the use of corporations, real estate investors, banded together in syndicates, have generally sought some other business form as their investment vehicle. By avoiding the corporate form, they manage to secure the pass-through of depreciation which, as we have seen, is the key to the real estate investment. However, by the same token, they give up limited liability, centralized management, continuity of life, and easy transferability of interests in the enterprise, all of which are inherent in the corporate form. Thus, the story of real estate syndication is basically a search for an investment vehicle which combines these nontax corporate advantages with the tax advantages of a noncorporate business entity.\textsuperscript{28} The alternatives are fairly limited and the choice is generally narrowed to the following: a common law trust, a limited partnership, and (more recently) a REIT.

In choosing an investment vehicle which has noncorporate tax attributes and nontax advantages of a corporation, the real estate


\textsuperscript{25} CODE §§ 301 (c), 316 (a). \textit{But see} Tax Reform Act of 1969, § 452, H.R. 13270, 91st Cong., 1st Sess. 270-71 (1969) (only straight line depreciation can be used to calculate earnings and profits).

\textsuperscript{26} Treas. Reg. § 1.312-6(d) (1960).

\textsuperscript{27} CODE § 316(a) (2). Of course, an earnings and profits deficit can be set off against undistributed earnings and profits of a later year.

vestment syndicate often finds itself confronted with the provisions of section 7701(a)(3) of the Code. In general, this section provides that the term "corporation" includes a number of business forms such as "associations, joint stock companies, and insurance companies." For tax purposes, therefore, an association is treated as a corporation. Unfortunately, the term "association" is not defined either in the Code or the Regulations. However, the Regulations do set forth certain definite criteria for determining whether a particular business entity is a corporation or something else. The four critical standards are: (1) continuity of life; (2) centralization of management; (3) limitation of liability; and (4) free transferability of interests. If the unincorporated association has more of these corporate characteristics than noncorporate ones, it is classed as a corporation for income tax purposes. Thus, the choice of a noncorporate form which nevertheless is weighted with corporate characteristics may defeat the tax expectations of the entity and its individual constituents. How, then, do the various alternatives open to real estate investors fit into the association picture?

1. The "Traditional," "Ordinary," or "Normal" Trust.—Single tier taxation plus depreciation deduction pass-through can be implemented through the traditional (as contrasted with a business) trust form. To the unwary, the traditional trust presents itself as a rather attractive vehicle for achieving tax depreciation pass-through as well as near-corporate business attributes. The beneficiaries of a traditional trust are normally not held personally liable for trust obligations; beneficial interests can be made freely transferable; the trust survives the continuous succession of its beneficial interest-holders; and the trustee enjoys full power of management.

However, it must be realized that the private investment sponsor of low and moderate income housing will be engaged in a rather continuous process of acquisition, operation, and disposal of real property. These very activities, together with broad trustee discretion, appear to have been proscribed by the Supreme Court's holding that significant real estate operations under the control of a discretionary trustee will subject a trust to corporate taxation as an association.

30 Id.
31 Treas. Reg. § 1.167(h)-1(b) (1964).
The High Court’s decision with respect to trusts possessing all major corporate characteristics could probably be supported by current Treasury Regulations, where the approach is to attach corporate tax treatment to a business form which has too many corporate traits, in any combination.

There is also the possibility that, under state law, the insulation from personal liability enjoyed by the beneficiaries of a normal or traditional trust might be judicially withdrawn where the cestuis have supervisory control over the trustees. Of course, if by dint of state law the beneficiaries of a trust are not protected from personal liability, it could be urged that the trust should be taxed as a partnership. While such a retrenchment might result in the desired tax treatment, it would be an unsatisfactory solution to the investors’ need for limited liability. It is also conceivable that a trust would continue to be treated as an association for tax purposes, notwithstanding the unlimited personal liability of its beneficiaries. This most unhappy situation could follow from the tabulation-of-attributes analysis contained in the Regulations, because the trust might still possess three of the four major corporate characteristics. To steer clear of this eventuality, another corporate attribute, such as free transferability, might be deleted from the trust structure. But if resort must be had to such contortions in order to obtain partnership-type noncorporate tax treatment for a trust, it seems hardly worth the candle to cast the enterprise in the trust form to begin with.

The general analysis announced in the regulations presents a rather mechanically arithmetic scheme of determining whether an ostensibly unincorporated business form will receive corporate tax treatment. See Treas. Reg. § 301.7701-2 (1965). Generally speaking, noncorporate treatment is promised if an unincorporated organization has fewer than three of the following characteristics: continuity of life (organizational identity not altered under local law by death, incapacity, insolvency, withdrawal, or expulsion of a member); centralization of management (decisional authority vested in a group made up of fewer than all members); limited liability (members not personally liable for the debts of the organization); and free transferability of interest (each member empowered to sell all the rights and privileges of his interest without consent of other members). Id.

Code § 7701(a)(3); Treas. Reg. § 301.7701-4(b) (1960).


As a theoretical matter, it would be difficult to obtain normal trust-type noncorporate tax treatment where the trust involves active conduct of real estate operations. The most appealing case for such treatment would involve an arrangement with all the typical characteristics of a passive investment inter vivos or testamentary trust. The beneficiaries' freedom from personal liability and lack of power to direct trust activities would distinguish the trust from a partnership. Absence of free transferability of interests, limitation of the life of the trust by reference to designated beneficiaries, and lack of beneficiaries' control over the activities of the trustee would probably avoid corporate tax treatment. The result: trust-type noncorporate taxation — at least under the Regulations. But the Supreme Court's test does not seem to be so rigidly mathematical. Broad trustee discretion and the operation of business assets may have been the most critical factors for the Court. In any event, to bolster the chances for normal trust taxation, it would be necessary to circumscribe the trustee's powers so as to emphasize the traditional function of conserving assets. Such an approach is hardly possible in a tax shelter context where investment turnover is clearly contemplated. On balance, therefore, it appears that the trust, because of dangerously uncertain tax treatment and the possibility of unlimited personal liability for the beneficiaries, is not the optimum organizational vehicle for low and moderate income housing construction, rehabilitation, operation, and sale.

The real estate investment trust, an admitted association and a distinct business form for federal tax purposes, receives special treatment under the Code and is dealt with in later material.

2. Limited Partnership.

a. Corporate or Partnership Tax Treatment? — The limited partnership is undoubtedly the most popular form of entity in real estate syndication. It enjoys this popularity because of two salient features. First, it allows a distinction between limited and general partners. The former are basically investors who do not participate in the management of the enterprise. Unlike the general partners, they are not liable individually for partnership obligations, and this

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39 See Cleveland Trust Co. v. Commissioner, 115 F.2d 481 (6th Cir. 1940) (no trustee power to buy, sell, or deal in operational real estate). Cf. Lewis & Co. v. Commissioner, 301 U.S. 385 (1937).
40 CODE §§ 856-58. See discussion accompanying notes 75-84 infra.
41 UNIFORM LIMITED PARTNERSHIP ACT § 1 [hereinafter cited as U.L.P.A.].
limitation of liability continues as long as the limited partner does not participate in the central management of the partnership business. Second, the limited partnership has a built-in mechanism for centralization of management, since management power must necessarily inhere in the general partner or partners. Clearly, this is an ideal situation for real estate syndication, since it permits the promoters of the enterprise to assume managerial responsibility as general partners. As a corollary, however, the promoters as general partners must assume unlimited liability for partnership obligations as in an ordinary partnership. The limited partnership does, therefore, combine the tax advantage of a noncorporate form with the nontax corporate characteristics of limited liability and centralization of management. Its popularity as a real estate investment vehicle is therefore quite understandable and is well earned.

The possibility that the limited partnership may be classified as an "association" and therefore taxed as a corporation is an ever present danger. However, careful draftsmanship of the partnership agreement permits the general and limited partners to run the maze created by the applicable Regulations and thus to achieve the tax reward. An examination of the Regulations and the manner in which they apply the four basic standards to the limited partnership will be helpful in pointing the way.

(i) Continuity of Life.— Under the Uniform Limited Partnership Act, the retirement, death, or insanity of a general partner will dissolve the partnership unless the remaining general partners (if any) continue the operation of the partnership business pursuant to authority granted in the certificate or by agreement of all the partners. It is entirely possible that where a limited partnership certificate provides for automatic continuation of the partnership by the remaining general partners, without the requirement of consent or agreement of the remaining partners, the partnership may be regarded as having continuity of life. On the other hand, if the certificate does not provide for automatic continuation of the business and makes continuation contingent upon consent of the remaining partners, it would appear that this element of uncertainty is sufficient to negate the existence of continuity. Unfortunately, the Regulations are not entirely clear on this point. One Regulation on the sub-

42 Id. § 7.
43 See Bernstein, Limited Partnerships — Their Use in Real Estate Syndications, 46 Taxes 549 (1968).
44 Treas. Reg. § 301.7701-2(a) (1965).
ject provides that if the consequence of death, insanity, or retirement of a general partner is dissolution unless the remaining general partners or all remaining partners agree to continue the partnership, then continuity of life does not exist. On the basis of this Regulation, it appears that a certificate provision for automatic continuation does in fact create continuity. However, a subsequent Regulation concludes: "Accordingly . . . a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act [lacks] continuity of life." On the basis of the latter provision, it appears that a limited partnership organized under the Uniform Act does not have continuity of life. However, since the prior provision casts some doubt as to the existence of continuity where the certificate of limited partnership automatically provides for continuation, the best course to follow in drafting the certificate is simply to provide the necessary element of uncertainty, that is, to make the continuation contingent upon the agreement of all the remaining general partners.

This will insure absence of the continuity of life attribute.

In the limited partnership which utilizes a corporation as a general partner, the problem is somewhat more complicated. Here, of course, durability of the general partner is not subject to the vagaries of death or insanity. However, a corporate general partner can withdraw from the partnership. It may be dissolved by action of the stockholders or dissolved involuntarily for nonpayment of licenses or for other reasons. The conclusion seems warranted, therefore, that a limited partnership using a corporate general partner should take the same precautions to avoid the continuity of life attribute as the one which uses an individual or individuals.

(ii) Centralized Management.—A limited partnership admittedly has the centralized management which is characteristic of a corporation. However, the Treasury Regulations provide that "limited partnerships subject to a statute corresponding to the Uniform Limited Partnership Act, generally do not have centralized management, but centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners."

While the Regulation does not elucidate on just what sort of interest must be held by the general partners to avoid "substantially all"
interests being held by the limited ones, it seems clear that the regulation is aimed at preventing a total separation of ownership and management. That is, as long as management (the general partners) has some significant portion of the proprietary interest, the Commissioner is willing to respect the partnership status of the limited partnership. In the vast majority of real estate limited partnerships, the general partners do have significant interests. They usually constitute the promotional group and they have generally committed their own funds to the initial costs of securing options, making downpayments on contracts, arranging financing, etc.\(^5\)

(iii) **Limited Liability.**—The Regulations are similarly kind to limited partnerships as regards the corporate characteristic of limited liability. In general, the regulations reflect the Commissioner's readiness to overlook this essentially corporate attribute where the general partners have personal liability, that is, where they have substantial assets (outside the partnership) available for satisfaction of partnership obligations or where they are not mere "dummies" acting as agents of the limited partners.\(^5\) Thus, even though a general partner does not have substantial assets other than its interest in the partnership, the general partner will be deemed to be personally liable if he is not an agent for the limited partners.\(^5\) In the normal syndicate, the general partners will have no difficulty in satisfying this regulation, though again, there may be some question as to just what constitutes "substantial assets" over and above the general partnership interest.

The same Regulation deals with the interesting question of whether a corporation may act as a general partner in a limited partnership. The treatment of a corporate general partner parallels the treatment provided for noncorporate general partners; that is, if the corporation has substantial assets other than the partnership interest,

\(^{50}\) See Aronsohn, *supra* note 28, at 647-48. Treasury Regulation section 301.7701-3(b)(2), Examples (1) and (2), establishes what appears to be a ratio test for determining when the limited partners own "substantially all of the interests" in the partnership. The examples postulate two situations: one where the limited partners have contributed $5,000,000 as compared to an aggregate contribution of $300,000 by the general partners, and another in which the limited partners have contributed $5,000,000 as compared to the general partners' $150,000. In both examples, while the general partners' contributions are "substantial" in an absolute sense, they are not "substantial" in the relative sense. In each example, therefore, the Regulation concludes that the limited partners own "substantially all of the interests" in the partnership and that, in each example, there is centralization of management because of such ownership. The Regulation does not indicate what sort of ratio of ownership will prevent this result.


\(^{52}\) Treas. Reg. § 301.7701-2(d)(2).
then it is considered to be personally liable for partnership obligations, notwithstanding the fact that such personal liability is limited to corporate assets.\textsuperscript{53} Presumably, the requirement that such a corporate general partner shall not be a "dummy acting as the agent of the limited partners"\textsuperscript{54} also applies. This latter provision, however, raises some difficult questions. For example, what is the effect of this Regulation on the status of the corporate general partner where the limited partners are also shareholders in the corporation? Clearly, a corporation whose stock is wholly owned by all the limited partners cannot escape treatment as a "dummy." But what of the corporation whose stock is somewhat more widely held and only some fraction of whose stock is held by the limited partners, or all of whose stock is owned by several (but not all) of them? Will informal rules of ownership attribution be developed in such cases? What percentage of stock ownership will render the corporation a dummy and an agent? What if the partners own securities of such a corporation other than voting common stock? These questions are not answered in the Regulations nor do they appear to have been litigated. If a corporation is to be used as a general partner, and if there is some common ownership of stock and limited partnership interest, these issues will have to be given serious consideration.

If they are found to be agents or dummies, the general partners would not possess unlimited personal liability, unless they had substantial assets besides their interests in the partnership. But even where the general partners are not deemed to have personal liability because they lack non-partnership assets \textit{and} are agents for the limited partners, the corporate attribute of limited liability will generally not attach to the limited partnership because the limited partners, by virtue of their control over the partnership affairs, will be personally liable for obligations of the partnership as a matter of state law.\textsuperscript{55} It can be rather safely concluded, therefore, that a limited partnership will not receive a limited liability tag except in the unusual case where the general partners have no substantial non-partnership assets \textit{and} are agents of the limited partners \textit{and} where the limited partners do not, by virtue of state law, lose their limited liability because of their intrusions into management.

\textit{(iv) Free Transferability of Interests.}— Treasury Regulation section 301.7701-2(e)(1) provides that an organization will be

\textsuperscript{53} Id.
\textsuperscript{54} Id.
\textsuperscript{55} Id.; U.L.P.A. § 7.
deemed to possess the corporate characteristic of free transability of interests if each of its members, or those owning substantially all of the interests in the organization, may, without the consent of other members, substitute for themselves a person who is a nonmember. In a limited partnership, where substantially all of the interests in the partnership will be held by the limited partners, this presents no real problem. First, the Uniform Limited Partnership Act provides that substitution of an assignee as a limited partner can take place only when authorized by the partnership certificate or with the consent of all of the members of the partnership. Thus, in a partnership organized under the Act, free transferability of interests, as defined in the Regulation, does not exist. Second, even if the partnership is not organized under the Act, this corporate characteristic can be avoided by compliance with the Regulation, that is, by incorporating into the agreement a restrictive provision which requires the consent of the other members of the partnership. Treasury Regulation section 301.7701-3(b)(2), states that a restriction requiring the consent of all the general partners to the substitution of a limited partner will be sufficient to prevent the existence of free transferability. In an example preceding the regulatory comment, 30 limited partners contributed $5,000,000 while three general partners contributed $100,000 each, and an assignee could not be substituted as a limited partner except with the consent of the general partners. It seems, therefore, that inclusion of such a restrictive provision is all that is necessary to defeat the free transferability of interests. Such a provision would probably be advisable even where the Uniform Limited Partnership Act governs the organization of the partnership, simply out of an abundance of caution.

b. Partnership Tax Treatment.— The essential feature of partnership taxation is that the entity can pass through to its members its own tax attributes, that is, items of income and deduction. In addition, it can pass on to its partners the same character which an item of income or deduction would have had in its own hands (the capital gain or ordinary income character of items of receipt, and the capital or ordinary character of an item of expense or loss). The ordinary common law trust and the REIT are, however, taxpaying entities in their own right and their function as a conduit of tax attributes is circumscribed by a complex system of rules.

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56 U.L.P.A. § 19(4).
57 CODE § 702(b).
58 Id. §§ 641-83, 691-92, 856-58.
A limited partnership is, however, if taxed as a partnership, a true conduit of tax attributes. While a partnership is required to file a tax return wherein it reports its taxable income as though it were, indeed, a separate taxpaying entity, that return is essentially an information return only. Partnership tax attributes, such as items of income and deduction, are taxed only to the individual partners according to their respective shares in profits and losses or according to special allocations made in the partnership agreement. The partnership does not pay a tax on its net income.

This scheme of partnership taxation has had a profound effect upon the choice of business form for the real estate investor. The pass-through of partnership income and deductions makes it possible for a group of investors to use the partnership form as a vehicle for syndication of the real estate investment and thereby to realize all of the above described tax shelter benefits in their respective individual capacities. The effects of the tax shelter are first reflected in the partnership's information return and then passed through proportionally to the partners. Partnership taxation, therefore, has been one of the chief factors in the immense popularity of the partnership as a vehicle for real estate syndication.

The combination of accelerated depreciation and financial leverage has certain other tax ramifications which are of interest to investors using the partnership entity. We have noted that the excess of depreciation over amortization may give rise to a tax shelter. An additional ramification is the effect of distributions on a partner's basis in his partnership interest. Suppose, for example, that a rental real estate syndicate has a cash flow of $50,000 from the property before depreciation but after the payment of mortgage amortization in any one year. Suppose further that the depreciation deduction will be $40,000, leaving taxable income of $10,000 for the year. If the organization decides to distribute not only its taxable income, but all available cash ($50,000), $40,000 of the distribution is obviously a return of capital in the year of distribution. If we assume that there are five equal participants each of whom contributed $50,000 in cash (to be used for the downpayment on the property) and that the organization then executed a note and purchase money mortgage of $750,000, what effect does the distribution have on the partners' basis and how is the distribution taxed?

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69 Id. §§ 701-04.

60 See, e.g., Casey, supra note 29; Levy, Real Estate Partnerships, N.Y.U. 16TH INST. ON FED. TAX. 183 (1958).
If the participants had used a corporation as a vehicle for the syndicate the results would be as follows: Each shareholder would have a basis of $50,000 in his stock. The corporation will pay a tax on the taxable income, which will decrease the amount available for distribution by, let us say, 50 percent or $5,000. The corporation's earnings and profits for the year would be roughly $5,000 ($10,000 less federal taxes). Consequently, out of the $9,000 which each shareholder would receive (1/5 of the total cash distribution of $45,000), $1,000 would be considered a dividend paid out of earnings and profits for the year.\(^6\) The balance would be a distribution over and above earnings and profits and therefore could not be treated as an ordinary dividend. Instead, it would be applied against the shareholder's basis until that basis is exhausted, and any amount distributed after the exhaustion of basis would be treated as capital gain.\(^6\) In our example, each shareholder's basis would be reduced to $42,000 and each would have received a taxable dividend of $1,000.

In a partnership, the situation is considerably altered because of a number of statutory provisions peculiar to partnerships. First, a partner's basis in his partnership interest is, in general, increased annually by his distributive share of partnership taxable income for the year\(^6\) and is decreased by any cash distributions and the partner's share of losses.\(^6\) Furthermore, a partner's basis in his partnership interest includes his proportionate share of partnership liabilities.\(^6\) Thus, in the hypothetical example, each partner's basis in his partnership interest will consist initially of his cash contribution ($50,000) and his 1/5 share of the mortgage indebtedness ($150,000), or a total basis of $200,000. To this basis, there will be added (in the year of distribution) the $2,000 of partnership taxable income allocable to each partner, and there will be subtracted from basis a total of $10,000, consisting of $2,000 of taxable net income and $8,000 of depreciation fund flow. The result, obviously, will be taxable ordinary income of $2,000 and a net reduction in basis of $8,000, so that each partner will now have a basis of $192,000 in his partnership interest.

This example further illustrates the advantages inherent in the

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61 Code § 316.
62 This treatment is set forth in Code § 301(c).
63 Id. § 705(a)(1).
64 Id. §§ 705(a) (2), 733.
65 Id. §§ 722, 752(a).
partnership entity. Obviously, a basis provision which provides that a partner's share of partnership liabilities may be added to his basis in the partnership is of critical importance in a real estate venture relying heavily on mortgage financing. If a corporation had been used in the above example, distributions at times when there were no earnings and profits would be tax-free to the shareholders only until the $50,000 basis had been exhausted, whereas, if a partnership had been used, each partner would be able to receive tax free distributions to the extent of $200,000.66

It should be noted that the foregoing discussion of the effect of the mortgage liability on a partner's basis applies to the usual situation of partners in a general partnership. To gain the same treatment for all of the partners, general and limited, in a limited partnership, further refinements are necessary. Limited partners are not, after all, liable for the obligations of the partnership, whereas general partners are. It seems logical, therefore, that in a general partnership a partner's pro rata share of a partnership liability should be treated as a contribution of money to the partnership, regardless of whether the obligation has been personally assumed or is merely an obligation of the entity.67 The limited partner's situation, however, is that he is not liable for partnership obligations except to the extent of his actual or required contribution to the partnership.68 It is only the general partners who are liable without limitation for the obligations of the limited partnership. In recognition of this fact, the Regulations provide that, in the case of a limited partnership, "a limited partner's share of partnership liabilities shall not exceed the difference between the actual contribution credited to him by the partnership and the contribution which he is obligated to make under the limited partnership agreement."69 Presumably, the purpose of this limitation is to avoid crediting a limited partner with additional basis in respect of a partnership debt for which the general partner may be held liable in full. Thus it is only where the limited partner's actual contribution exceeds his subscription (the amount

66 Moreover, if the partnership has a net operating loss, a partner may take a share of such loss to the extent of the adjusted basis in his partnership interest. CODE § 704(d). Adjusted basis is then reduced by the partner's share of losses. Thus, even where there are no cash distributions to the partners, it is extremely important that a partner start with as high a basis as possible so that he can continue to take advantage of tax loss pass-throughs.
67 CODE § 752(a).
69 Treas. Reg. § 1.752-1(e) (1956).
he is obligated to pay) or where he has not yet fully paid the subscription that he is permitted to add to his basis. This follows logically, since he could be held liable for the full amount of his subscription when it has not been fully paid, and this fact should be reflected by allowing him to add to his basis a share of partnership liabilities. The Regulation, however, then goes on to make a special exception to this basis rule where none of the partners in a limited partnership have any liability with respect to a partnership obligation, specifically mentioning, by way of example, a mortgage on real estate of the partnership acquired without assumption of liability by the partnership or by the partners.70 In these circumstances, all of the partners, "including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits."71 Thus, where a limited partnership acquires property subject to a mortgage, with no personal liability attaching to any partner, the liability (query, whether the encumbrance should be called a liability under these circumstances) is allocated pro rata among all the partners and the benefits connected with the addition of the mortgage liability to basis are the same as for the general partnership. Presumably, the rationale is that where no partner is personally liable on the mortgage, a foreclosure will affect both the general and limited partners of a limited partnership in precisely the same way as it would affect the partners of a general partnership. The loss would be suffered pro rata; hence, the same treatment is prescribed and addition of the indebtedness to basis is permitted.72

The usual device employed by a limited partnership acquiring property subject to a mortgage, without the assumption of personal liability thereon by any partner, is to have the mortgage executed by

70 Id.
71 Id.
72 If this is, in fact, the reasoning which underlies the regulation, then it is not entirely sound. The Commissioner's assumption seems to be that a default in the payment of the mortgage will result inevitably in a foreclosure, both in the case of a general or limited partnership. However, in the case of a general partnership in which all of the partners have personally assumed the mortgage liability, it may well be that a default will result in an action on the mortgage note without a suit to foreclose. This would be unlikely, but certainly not unheard of. In such a situation, the position of the general partnership and its partners cannot be considered substantially similar to the position of all the partners in a limited partnership, none of whom have personally assumed the mortgage indebtedness. In the former, each is personally liable and can be sued on the note. In the latter, the only consequence of foreclosure is a pro rata loss of equity in the property. It seems, therefore, that there is a flaw in the rationale for allowing the limited and general partners of a limited partnership to include the mortgage in their respective basis as a partnership liability when none of the partners are personally liable thereon.
a nominee for the partnership who subsequently transfers the fee to
the partnership, subject to the mortgage. Generally, the nominee
is a corporation organized for this purpose. While this device is a
transparent avoidance of the limitations with respect to basis set
forth in Regulation section 1.752-1(e), there is nothing in the Regu-
lations or in the cases to indicate that the Commissioner takes issue
with it.

3. Real Estate Investment Trust.— A new approach to real es-
tate investment was formulated in 1960 by the enactment of Code
sections 856-58. These relatively recent Code provisions provide
for the establishment and taxation of an entity called a Real Estate
Investment Trust. In essence, they permit the establishment of a
common law business trust, to be managed by trustees for the benefit
of holders of beneficial interests in the trust, which, if it satisfies the
statutory provisions and regulatory requirements, will be taxed essen-
tially in the same manner as mutual fund. The owners of beneficial
interests who receive distributions of trust income will be taxed
essentially in the same manner as mutual fund shareholders in re-
spect of such distributions.

From a tax point of view, this means that a business trust having
all the desirable attributes of a corporation can be established as a
vehicle for real estate investment without suffering the full ramifi-
cations of corporate taxation. In effect, the trust will act as a conduit
whereby its distributable income will be taxed only to the beneficial
owners. Moreover, the character of the income so distributed will
be the same in the hands of the distributees as it would have been in
the hands of the trust; that is, ordinary income and capital gain dis-
tributions will retain their respective characters in the hands of
the distributees and will be taxed accordingly.

The purpose of these favorable tax provisions is to provide wide-
spread real estate investment opportunity for the moderate and small
investor, and to encourage the establishment of REITs to finance ur-


73 See Bernstein, supra note 40, at 555-56.
74 The Commissioner, in Rev. Rul. 69-223, 1969 INT. REV. BULL. NO. 18, at 12,
has ruled that a mortgage liability assumed by a limited partnership does not increase
the basis of limited partner's interest in the partnership, notwithstanding the fact that
the limited partner agreed to indemnify the general partners for payments which they
may be required to make in excess of their pro rata share of partnership liabilities.
This appears to be the only consideration which the Commissioner has given the prob-
lem.
75 Compare CODE § 857(b) with § 852(b).
76 CODE §§ 857(b) (3), 858.
77 Id. § 857(b)(3)(B).
The enactment of REIT provisions is a tacit recognition of the fact that the usual real estate syndicate, operating as a limited partnership, is not an entirely satisfactory business form for real estate investment. The tax objective of avoiding taxation as a corporation and providing a tax shelter through depreciation deductions can be achieved by the partnership only after the most painstaking care in structuring the entity. The need to provide the nontax corporate attributes of centralized management, continuing life, limited liability, and transferability of interests cannot always be reconciled with achievement of the tax objective, or at best the reconciliation is accompanied by uncertainty.

Assuming compliance with statutory and regulatory requirements, the REIT offers conduit tax treatment along with the flexibility of the desired nontax corporate attributes, including limited liability of beneficial owners. In addition, by registering the beneficial interests as securities with the Securities and Exchange Commission and under state blue sky laws, the REIT can appeal to a much larger segment of the investment market than is available to the normal syndicate. Wide participation enables the REIT to diversify its holdings so that its fate is not determined by the success or failure of a single investment.79

The statutory requirements for qualification as a REIT are set forth in detail in section 856 of the Code. For the purposes of this article, a detailed analysis of these provisions and of the regulations thereunder would serve no useful purpose. In general, however, the REIT must be organized as an unincorporated association managed by trustees, and it must have transferable shares owned by at least 100 persons.80 The other basic requirements are:

- At least 75% of the gross income of the REIT must be derived from:
  - real property rents
  - interest on obligations secured by mortgages on real property
  - gain on the sale or other disposition of real property
  - dividends or other distributions in respect of shares in other REITs
  - gain from the sale or other disposition of shares in other REITs

In addition to the foregoing requirements, the REIT must distribute to its shareholders 90 percent of its ordinary taxable income

79 For a general discussion of REITs, their purposes and objectives, see Kelley, supra note 23.
80 Code § 856(a).
81 Id. § 856(c).
for each tax year.\textsuperscript{82} Upon compliance with this requirement, each shareholder is taxed at ordinary income rates on that portion of the distribution which represents ordinary income of the REIT, and at capital gain rates upon that portion which represents a distribution of net long term capital gains. A deduction is allowed to the trust in respect of dividends paid, so that only one tax is paid at the shareholder level. A simple example will illustrate the effect of these provisions. Assume that a REIT has aggregate general accounting depreciation deductions of $150,000, tax depreciation deductions of $200,000, net income and taxable income (before depreciation) of $180,000, and mortgage amortization of $125,000. In this example, fund flow is $55,000 (general accounting net income before depreciation less mortgage amortization). Earnings and profits for tax purposes (taxable income after tax depreciation) are minus $20,000. Net income after general accounting depreciation is $30,000. Therefore, if the REIT distributes its $30,000 net income, it will be deemed a return of capital which reduces the shareholder's basis, because the corporation has no earnings and profits. If the nondividend portion of the distribution exceeds the shareholder's basis in the shares, there the excess over basis is treated as capital gain to the shareholders.\textsuperscript{83} Since tax depreciation deductions exceed income, a net operating tax loss will result. If this occurs in the limited partnership, we have observed that the loss is passed through to the partners and is available as an offset against their income from other sources. This is not true in the REIT. The loss is not passed through to the shareholders, nor is it available to the REIT as a carry-over as in the case of a normal corporation.\textsuperscript{84}

Clearly, the unavailability of the net operating loss deduction to the individual REIT shareholder is a serious drawback in terms of its attractiveness as a tax shelter. This would be particularly true for large investors who are looking not only for sheltered investment income, but for an offset against other high bracket income. However, it is also an equally serious drawback from the point of view of the smaller investor who is primarily interested in a tax

\textsuperscript{82} Id. § 857(a)(1).

\textsuperscript{83} Earnings and profits of a REIT are determined under CODE § 857(d) and Treas. Reg. § 1.857-5. The distribution in excess of earnings and profits is treated in the same manner as a similar distribution by a corporation under CODE § 301(c).

\textsuperscript{84} CODE § 857(b) (2) (E). The earnings and profits deficit can presumably be used as an offset to undistributed earnings and profits of other years. Cf. Treas. Reg. § 1.857-5(b). But this possibility will not be of aid in those years where distributions are made and the trust has current earnings and profits. Id.; CODE § 316(a) (2). See also Tax Reform Act of 1969, § 452, H.R. 13270, 91st Cong., 1st Sess. 270-71 (1969).
sheltered investment. It frequently happens that an investment in which accelerated depreciation exceeds the rate of mortgage amortization will result in net operating losses. If the net operating loss is not available as a deduction to the shareholders, then there is no real shelter for income from other sources. The production of a net operating loss means that there are no earnings and profits for the year, hence the distribution will reduce the shareholders basis in the REIT stock. When this basis has been reduced to zero, further distributions in the absence of earnings and profits will result in income taxed at capital gain rates. Obviously, the limited partner in the ordinary syndicate is better situated from a tax point of view, since the availability of loss pass through to him does create a more efficacious tax shelter.

III. LIMITED PARTNERSHIPS FOR LOW AND MODERATE INCOME HOUSING PRODUCTION: SPECIAL FINANCING AND TAX EFFECTS

A. Effects of Federal Mortgage Insurance on Cash Contribution Required of the Sponsor.

A limited partnership may qualify as a limited distribution entity eligible for federal mortgage insurance under the National Housing Act. As such, it can obtain debt financing of its low and moderate income housing operations in an amount up to 90 percent of construction costs.

1. New Construction.—The limit on final mortgage insurance endorsement ($I_m$) in a new construction project can be stated generally as 90 percent of the sum of actual cost of physical improvements ($A$) plus the market value of land in the project ($L$). Actual cost, however, includes: amounts paid on a construction contract ($K$); costs other than those incurred on a construction contract ($C$); and a sponsor's profit on 10 percent of $C$. This can be expressed by the following formula:


88 24 C.F.R. § 221.550a(c) (1969). Improvement costs ($C$) other than amounts paid under a construction contract would include architect's fees, offsite public utilities not provided under the construction contract, organizational and legal expenses, and "other items of expense approved by the [FHA] Commissioner." 24 C.F.R. § 221.550 (b)(2)-(5) (1969).
Thus, the loan limit for new construction is 99 percent of real costs, other than construction contract costs and land value, plus 90 percent of the latter two items. Under ideal circumstances, therefore, the limited partnership’s cash contribution could be a relatively small portion of real costs. To illustrate, suppose a new construction model wherein land for construction of low and moderate income housing is purchased for $200,000, an amount which represents its market value. Non-land costs (other than sponsor profit) amount to $700,000 to be paid on a construction contract and $100,000 for other expenses. In such a case, federal mortgage insurance would be available in a maximum amount as follows:

\[
I_a = 0.9(A + L) = 0.9(C + 0.1C + K) + L = 0.9(1.1C + K + L) = 0.99C + 0.9K + 0.9L
\]

Such a project would require a cash contribution from the sponsor in the amount of $91,000, or 9.1 percent of the million dollar real cost package.\(^89\)

Special note should be taken of the fact that the formula for computing the maximum insurable mortgage for new construction includes 90 percent of the value of the land in the project.\(^90\) Purchase price of the land is not controlling. Thus, if the land in the

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\(^{89}\) There are several fees involved in the organization of an FHA insured project, including application and commitment fees totaling .3 percent of the loan commitment, 24 C.F.R. §§ 221.503, .504 (1969); an inspection fee not to exceed .5 percent of commitment, 24 C.F.R. § 221.505 (1969); a possible mortgagee financing fee of no more than 2 percent of the original amount of the mortgage, 24 C.F.R. § 221.508 (1969); and an insurance premium of .5 percent, 24 C.F.R. §§ 221.755, 207.252 (1969). The commitment and inspection fees may be cancelled by the FHA Commissioner, 24 C.F.R. § 221.507 (1969), and the insurance premium is not applicable to below market interest rate (BMIR) loan programs, 24 C.F.R. § 221.518(b) (1969); 34 Fed. Reg. 499, amending 24 C.F.R. § 221.755 (1969). In any event, the above fees may be included in actual cost \((A)\).

If special mortgage assistance is sought from the General National Mortgage Association (GNMA), an additional fee of about 1.5 percent of the loan will be incurred. This fee is not generally certifiable as part of actual costs, but, under FHA practice, will be allowed as part of actual costs to the extent that the sponsor is able to show savings in construction costs over his initial estimates.

Finally, the limited distribution sponsor may be required to deposit in escrow certain other amounts to cover such things as the equipping and renting of the project, 24 C.F.R. § 221.540 (1969), although some of these requirements can be met by a letter of credit.

new construction model could have been purchased for $109,000 instead of $200,000, there would be no cash contribution required of the sponsor\(^1\) since the real costs of the project would then equal the maximum insurable mortgage.

Where an "identity of interest" exists between the mortagagor and the general contractor, the formula for computing the maximum insurable mortgage for new construction shifts a bit. While the general rule remains 90 percent of actual cost \((A)\) plus 90 percent of the market value of land \((L)\), the term "actual cost" now includes a sponsor's profit of 10 percent of all costs \((C_a)\), including those involved in construction (except, of course, a builders fee, which the 10 percent sponsor's profit is meant to supplant)\(^2\). The formula then becomes:

\[
I_m = .9 \left( (C_a + .1C_a) + L \right) = .99C_a + .9L
\]

Assuming that land for a new construction project is purchased at its fair market of $200,000 and that other costs (not including a builder's fee) will amount to $800,000, the maximum insurable mortgage would be computed as follows:

\[
I_m = .9 \left( (800,000 + 80,000) + 200,000 \right) = 720,000 + 72,000 + 180,000 = 972,000
\]

In this situation, the actual cash contribution required of the sponsor would be $28,000 (2.8 percent), and even this could be avoided if the land had been purchased at $172,000.

2. Rehabilitation.— In connection with rehabilitation, where there is no identity of interest between the sponsor and the general contractor, the maximum insurable mortgage is calculated by using a formula which is slightly different from that employed in the new construction context. As in new construction, 90 percent of the actual cost \((A)\) of physical improvement is covered. Again, actual cost includes a 10 percent sponsor profit on costs \((C)\) other than amounts paid on a construction contract \((K)\). However, unlike the new construction computation, the land factor is based on 90 percent of the lower of cost to the sponsor or market \((L_{cmin})\)\(^3\). Thus, for a rehabilitation model involving costs of land and buildings of $500,000, amounts paid on a rehabilitation construction contract of

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\(^1\) Except to the extent that the sponsor may be required to make certain escrow deposits or to pay GNMA fees described in note 89 supra.

\(^2\) 24 C.F.R. § 221.550a(b) (1969).

\(^3\) Id. § 221.556(c) (1969).
$400,000, and other costs of $100,000, the mathematical expression of maximum insurable debt would be:

\[
I_m = 0.9 \left( A + L_{cem} \right) \\
= 0.9 \left[ (C + 0.1C + K) + L_{cem} \right] \\
= 0.9 \left[ (100,000 + 10,000 + 400,000) + (500,000) \right] \\
= 90,000 + 9,000 + 360,000 + 450,000 \\
= 909,000
\]

The sponsor would be required to make a $91,000 (9.1 percent) cash contribution. This contribution could not be eliminated, as it could have been in connection with new construction, by purchasing the land for $91,000 less than its market value.

If an identity of interest exists between the sponsor and the general contractor, then the method of determining maximum insurable debt modulates again to 90 percent of actual cost (A) plus 90 percent of the lower of cost or market of land in the project \((L_{cem})\), where actual cost includes a sponsor's profit of 10 percent of all costs \((C_n)\) except a builder's fee.\(^9\) If it be assumed that the rehabilitation model includes land and building costs of $500,000, construction costs of $400,000, and other costs of $100,000, the maximum insurable mortgage would be arrived at as follows:

\[
I_m = 0.9 \left[ C_n + 0.1C_n + L_{cem} \right] \\
= 0.9C_n + 0.9L_{cem} \\
= 0.99 \left( 500,000 \right) + 0.9 \left( 500,000 \right) \\
= 945,000
\]

Actual cash contribution required of the sponsor would be $55,000, or 5.5 percent of the million dollar real cost project.

**B. Limitations on Cash Distributions.**

A critical factor in tax shelter arrangements is a high ratio of debt to equity. In the production of low and moderate income housing, an unusually high borrowing capacity is facilitated by mortgage insurance. Previous discussion has demonstrated the relatively small equity contribution that may be required, especially in new construction, if the enterprise qualifies for federal mortgage insurance as a limited distribution mortgagor.\(^9\)

In order to be eligible for 90 percent federal mortgage insurance, a limited partnership would have to restrict its cash distributions to six percent of initial equity investment. This applies

\(^9\) Id. § 221.550a(b) (1969).

\(^9\) See note 85 supra.
to both new construction and rehabilitation projects.\textsuperscript{96} Precisely what is meant by the phrase "initial equity investment" is unclear.

1. New Construction; Prior Regulations.—Prior Regulations specified a cash distribution limit with respect to new construction of "6 percent of the product of 11.11 percent times the finally endorsed amount of the insured mortgage."\textsuperscript{97} The rationale of this restriction seems to be that private inurement ought not exceed 6 percent of 10 percent of a total amount of which 90 percent is borrowed. It should be observed that 11.11 percent of the debt element of a project is also 10 percent of an amount of which the debt constitutes a 90 percent part.

Using the new construction model already mentioned, where it is assumed that an insured mortgage of $909,000 could be obtained, it appears that cash distributions would be limited under the old Regulations to 6 percent of 11.11 percent of $909,000, or about $6,060. This result is based on the presumption that the equity investment of the limited distribution sponsor is 11.11 percent of the insured loan, or, put another way, 10 percent of a total package of which $909,000 constitutes 90 percent. In this manner, the constructive total package is $1,010,000 and the \textit{imputed} equity investment of the limited distribution sponsor is $101,000. As we have seen, the initial cash contribution for such a project would actually amount to about $91,000, and could be considerably less than that. The interesting upshot of the prior restriction is that, upon an actual cash contribution of $91,000, a distribution of net income of $6,060, or 6.7 percent, would have been permissible.

2. Present Regulation.

a. New Construction.—The present regulatory control on distribution is not so mechanical, however, and it is difficult to say whether the notion of imputed equity will be perpetuated in determining initial equity investment. One alternative would be to limit the concept to the actual cash contribution made by the sponsor. Referring again to the new construction model, it has already been shown that the actual cash investment consisted of real costs not covered by the insured loan in the amount of $91,000. If this figure were used as the base for the 6 percent limit, the maximum distribution would be about $5,460.

This tack does not appear to be the one which HUD is taking

\textsuperscript{97} 24 C.F.R. § 221.532(a) (1968), as amended, 24 C.F.R. 221.532(a) (1969).
under the revised regulatory language. Rather, it appears that FHA is following a practice of computing initial equity investment by subtracting the amount of the finally insured mortgage from the sum of actual cost of improvements plus value attributable to land.\textsuperscript{98} Since actual cost includes a sponsor's profit, the equity base for determining maximum allowable distributions will continue to contain an imputed equity factor. For instance, based on the new construction model where there is no identity of interest between the sponsor and the general contractor, initial equity investment would be computed as follows:

\[
\begin{array}{l}
\text{Actual cost of physical improvements} \quad \$ \ 810,000 \\
\text{Value of land} \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad 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tribution required to be made by a limited partnership in a federally insured low and moderate income new construction project ranged from a maximum of 9.1 percent to a minimum of zero percent of real costs. In rehabilitation, the required contribution varied from a maximum of 9.1 percent to a minimum 5.5 percent of real costs. For purposes of further discussion, reference will be made primarily to the 9.1 percent models, since they seem to represent conservative approaches to fairly realistic million-dollar projects.

C. How Does It All Work? An Operational Prototype.

So far, the analysis has dwelt upon (1) the best organizational vehicle for tapping the tax incentives offered by accelerated depreciation, (2) the manner in which federal mortgage insurance diminishes the equity investment required of limited distribution sponsors of low and moderate income rental housing, and (3) the limitations on cash distributions available to profit-motivated sponsors who avail themselves of the high debt-to-equity leverage made possible by FHA backing. What remains is to illustrate how this mixture of tax law and specialized mortgage financing can be blended to produce a feasible and attractive opportunity for private investment in desperately needed rental housing. For purposes of pro forma analysis, the $1 million new construction model (where there is no identity of interest between the general contractor and the sponsor) will again be drawn into service — with some embellishments necessary to facilitate subsequent discussion.

The partners of a limited partnership have made an actual cash contribution of $91,000 toward a million dollar project — borrowing the remaining $909,000 pursuant to a loan which is federally insured under section 236 of the National Housing Act. The partners' aggregate tax basis will be $1,000,000. If the $1 mil-

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100 See discussion accompanying notes 87-89 supra.
102 If there are one general partner and nine limited partners, and they all contribute $9,100 to the project, each will have a basis of $100,000, provided they have agreed to share profits equally and provided also that the $909,000 debt is not the personal obligation of the partnership or any of the general partners. See discussion accompanying notes 65-74 supra. In the context of FHA financing, the requirement that neither the limited partnership nor the general partners be personally liable on the debt may cause severe problems. On the one hand, it is hardly likely that FHA will insure a mortgage for a nominee or dummy entity which is to be personally liable on the mortgage but which will immediately transfer the mortgaged property to another operating entity, such as a limited partnership, "subject to" the mortgage. On the other hand, the Commissioner apparently will object to limited partners adding a portion of the debt to their basis, unless the general partners have no personal liability on the mortgage.
lion total package, $200,000 will be allocated to the purchase of non-depreciable land, $750,000 to new depreciable structures, and the remaining $50,000 to non-capital expenses or nondepreciable items.

Amortization of debt principal for the first year of operation will be estimated at $18,750,103 and, for the purpose of dramatizing the tax shelter effects of accelerated depreciation, it will be assumed that the book net income of the project, after deduction of all expenses including straight line depreciation, will be exactly equal to amortization payments on the mortgage.\textsuperscript{104} The straight line depreciation percentage on a 40 year useful life will be 2.5 percent, or $18,750 based on the $750,000 allocated to depreciable property. Double declining balance tax depreciation will be $37,500.

On the above assumptions, the following analysis results:

\begin{center}
\textit{Partnership Taxable Income}
\begin{tabular}{l c}
Net income after straight line depreciation & \$18,750 \\
Less: additional depreciation using 200\% declining balance & \$18,750 \\
\end{tabular}
\end{center}

\begin{center}
\textit{Partnership Taxable Income} \hspace{1cm} \underline{-0-}
\end{center}

\begin{center}
\textit{Fund Flow}
\begin{tabular}{l c}
Net income after straight line depreciation & \$18,750 \\
Add back: book depreciation & \$18,750 \\
Less: amortization & \$37,500 \\
\end{tabular}
\end{center}

\begin{center}
\textit{Fund flow} \hspace{1cm} \underline{\$18,750}
\end{center}

Some very interesting conclusions can be drawn from this financial picture. First, net income has been completely sheltered from taxes. The net income figure represents a return on the partnership investment of over 20 percent. Since there will be no tax to the partners, this return is equivalent to a fully taxable net income of nearly $37,500 or about 41 percent of investment, assuming the income would be taxed to the partners at a 50 percent bracket rate. Even if it be assumed that the rental housing plant is in fact depreciating at the straight line rate, the partnership is, in effect, pur-

\textsuperscript{103} This figure is not unrealistic in view of the debt service reduction payments which are made by HUD, pursuant to section 236, to the mortgagee of an insured project. Such payments make the sponsor's share of debt service very close to that involved in a 1 percent loan.

\textsuperscript{104} This assumption, while seemingly conservative, is probably not unusual in the real world of inner-city rental housing.
chasing an undepreciated portion of the project out of currently tax-free net income.\(^\text{105}\)

Because fund flow equals $18,750, cash distributions could be made in amounts up to the FHA maximum of $6,060\(^\text{108}\) or 6.7 percent of investment. Being currently tax free, the distribution is tantamount to more than a 13 percent payout taxed to the recipient at a 50% bracket rate. Upon such a distribution, the aggregate basis of the partners' interests in the partnership would be reduced by $6,060.\(^\text{107}\)

A simple variant of the preceding analysis portrays an even more striking picture of tax sheltering effects. If, for example, as much as $850,000 were to be allocated to depreciable structures, straight line depreciation would be increased to $21,250 and 200 percent declining balance would rise to $42,500. Assuming first of all that net income and taxable income after straight line depreciation increased to $21,250, the partnership would have tax-free net income of $21,250 and fund flow of $23,750. Alternatively, if it be assumed that net and taxable income after straight line depreciation remained at $18,750, the partnership would have tax-sheltered net income of $18,750 and a depreciation pass-through to the individual partners of $2,500 which, if the partners had taxable income from other sources in the 50 percent bracket, would result in a tax saving of $1,250.\(^\text{108}\)

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\(^{\text{105}}\) Because the net income used to purchase nondepreciated portions of the project will probably be taxed — as capital gain, at least — when the rental housing is ultimately sold, a long range appraisal of the investment return might more properly be $18,750 less the future capital gains taxes for a 50 percent bracket taxpayer. Ignoring the currently operative surtax, net income after capital gains taxes would then exceed $14,000, or over 15 percent of investment. See text accompanying notes 121-24 infra. Regarding the question of whether gain upon sale will be taxed as ordinary or capital gain, see the second paragraph of note 108 infra.

\(^{\text{106}}\) See discussion accompanying notes 95-99 supra.

\(^{\text{107}}\) \text{CODE §§ 705(a) (2), 733(1).}

\(^{\text{108}}\) The text examples deal only with new construction. In rehabilitation projects, the effects of accelerated depreciation will be attenuated because basis attributable to pre-1954 structures, acquired after 1953, can be depreciated at a maximum of 150 percent declining balance, if the taxpayer is not the original user. \text{CODE § 167(c)(2); Treas. Reg. § 1.167(b)-0(b) (1956).} Of course, that portion of the structure which is new will create a reconstruction basis, depreciable at the 200 percent rate. \text{Treas. Reg. § 1.167(c)-1(b)(1) (1956).}

As this article is about to be printed, Congress appears to be on an erratic and confusing course — at least with respect to tax incentives for the production of low and moderate income housing. On the one hand, a very fast five year depreciation of rehabilitation costs would be added to \text{Code} section 167. \text{Tax Reform Act of 1969, § 521 (a), H.R. 13270, 91st Cong., 1st Sess. 303-05 (1969).} On the other hand, the reform package will eliminate the 150 percent declining balance depreciation which can now be taken by non-original users with respect to non-reconstruction basis. \text{Id. at 302-03.} Further, the gradual reduction of depreciation recapture over a ten year
D. Other Attractions.

1. The National Housing Partnership.— It has been shown that the amount of cash investment required of a limited distribution sponsor may be relatively small when compared with the total real costs of a project. Nonetheless, it may happen that the amount of equity required to produce rental housing on an economically efficient scale cannot be raised by private investors at the local level. For instance, let it be assumed that a group of investors have pooled $68,250 for construction of new low and moderate income rental housing. Let it be further assumed, however, that adequate economies of scale cannot be achieved unless a million dollar real cost project is initiated. The conservative new construction model indicates that an equity investment of $91,000 will be required. Whence the other 25 percent?

Title IX of the Housing and Urban Development Act of 1968 purports to supply the answer. This legislation envisions three tiers of financial commitment: a National Corporation, created pursuant to Title IX and the District of Columbia Business Corporation Act; a National Limited Partnership, created pursuant to Title IX and the District of Columbia Uniform Limited Partnership Act, in which the National Corporation would be the general partner; and a local partnership, general or limited, or a local joint venture, in which the National Partnership would be a partner or joint venturer along with local investors.

To assure single-level taxation and maximum tax shelter for all investors, from the top of the structure on down, shareholders of the National Corporation will presumably make the bulk of their investment by way of limited partnership interests in the National Limited Partnership. Thus, most of the tax attributes arising from period would be deleted from Code section 1250 with respect to depreciation in excess of straight line taken after July 24, 1969, including the fast five year depreciation taken under the new section applicable to rehabilitation costs. Id. § 521(b), at 305-07. These latter two amendments, together with the new limitation on so-called "preference" deductions, id. § 301(a)(1), at 165-69, would seriously impair the effectiveness of the tax shelter incentive for private investment in low and moderate income housing under FHA programs. See discussion accompanying notes 117-24 and 164-69 infra.

109 See discussion accompanying notes 81-89 supra.
111 42 U.S.C.A. § 3932(a) (1969)
112 Id. §§ 3937(a), 3937(b) (1969).
113 Id. § 3937(d) (1969). The National Corporation's functions are not limited to being general partner in the National Limited Partnership. See id. § 3936 (1969). However, this appears to be one of its primary functions.
114 Id. § 3937(c) (1969).
The National Limited Partnership is authorized to take up to 25 percent of the equity investment of local partnerships engaged in

\[116\] It appears that 500 shareholders will initially purchase $2.5 million worth of National Corporation stock and at the same time take $47.5 million worth of National Limited Partnership interests pro rata according to their percentage interests in the corporation, with no shareholder holding more than 5 percent of the National Corporation's shares. Some portion of the National Corporation's capital would presumably be invested in the National Limited Partnership. See Wall Street J., Feb. 5, 1969, at 1, col. 1 (midwest ed.). The contemplated financial structure would, were it not for corrective devices built into the statute, raise some severe tax and limited partnership problems. On the tax side, apart from the question of whether the National Limited Partnership may be treated as an association for tax purposes, see discussion accompanying notes 41-55 supra, there is the problem of whether National Limited Partnership interests will be treated as stock of the National Corporation because the national-level investors have pro-rata interests in the National Corporation and the National Limited Partnership and because the lion's share of their investment is in the latter organization. This kind of financing arrangement appears to be a rather transparent attempt to give the limited partners control of the general partner while preserving single tier taxation with optimum tax shelter potential. See discussion accompanying notes 151-57 infra. In an attempt to skirt the distinct possibility that the Commissioner would insist that all income of the National Limited Partnership be treated as a tax attribute of the National Corporation, Title IX provides that "[t]he interest of a limited partner in the partnership shall not be treated as a stock interest in the corporation, notwithstanding that such interest of a limited partner may be proportionate to his stock interest in the corporation." 42 U.S.C.A. § 3937(g) (1969).

With respect to the state law of partnerships, a pro-rata overlap between ownership of stock of a corporate general partner and ownership of limited partnership interests, where all the stock of the general partnership is owned by limited partners, would almost surely lead to the conclusion that the limited partners have lost their limited liability status. The same can be said for any limited partners who are also directors or officers of the corporate general partner. See discussion accompanying notes 151-54 infra. In apparent anticipation of this difficulty, Title IX negates unlimited liability for corporate limited partners which own no more than 5 percent of the stock of the National Corporation general partner or whose officers and directors are also officers and directors of the National Corporation. 42 U.S.C.A. § 3937(g) (1969). No such protection is afforded non-corporate organizations or individuals who are limited partners and at the same time own stock or occupy management positions in the corporate general partner.

Title IX does not seem to address itself to the possibility that the National Limited Partnership might be taxed as a corporation. If the National Corporation is deemed not to have substantial assets other than those in the National Limited Partnership and if the National Corporation is considered a mere agent (or dummy) for the limited partners — both of which elements may likely be present — the corporate attribute of limited liability will attach, provided the limited partners have not lost their limited liability status. See discussion accompanying notes 51-55 supra. Hence, if the $2.5 million of stock proceeds are not contributed to the partnership, the personal liability of the corporate general partner will probably be recognized, even though the partnership will be engaged in transactions involving much larger sums. See Treas. Reg. § 301.7701-2(d)(2) (1965). If however, all the National Corporation's assets are invested in the partnership, the further question of whether the corporate general partner
the production of low and moderate income housing. It could, therefore, furnish the remaining $22,750 necessary to produce the hypothetical million dollar project. Indeed, the National Limited Partnership may take more than a 25 percent slice of the equity where its National Corporation general partner decides that the balance "is not readily obtainable from other responsible [local] investors . . ."116

2. Non-profit "Take-Out" Sponsors.— As the holding period of depreciable property grows longer, the benefits of the tax shelter grow smaller. While book depreciation and net income remain constant, amortization payments increase and accelerated tax depreciation decelerates. When tax depreciation begins to trail book depreciation, no net income is sheltered from taxes. Even before this occurs, however, amortization may begin to exceed tax depreciation so as to remove the tax shelter from distributable fund flow.117

When the effective return on a rental housing investment is no longer competitively attractive because of dwindling tax depreciation, it becomes necessary to rotate depreciable assets. The depreciated-out property must be sold and new property acquired so that fast write-offs can be continued. Quite naturally, then, a ready method of disposing of project property is of particular importance to the limited distribution sponsor. It is also essential that the property be sold at the highest possible price, since it is at the point

is simply the agent of the limited partners becomes critical. In view of the fact that limited partners will own all or the vast majority of the stock of the general partner and the further fact that the agents of the limited partners are likely to constitute the management of the general partner, there is a substantial probability that the National Corporation will be classified as a dummy. Since Title IX also negates unlimited liability for limited partners, even though they exercise control over management of the partnership, see 42 U.S.C.A. § 3937(g) (1969), chances are great that the National Limited Partnership would be deemed to possess the corporate quality of limited liability. Centralization of management could be avoided if the National Corporation has a substantial interest in the assets of the partnership. But what is a substantial interest? If the $2.5 million raised by the National Corporation is invested entirely in the National Limited Partnership, the ratio of its contribution to that of the limited partners will be 5 percent. This is not enough. See note 50 supra. On the positive side, if the National Limited Partnership will be dissolved upon the withdrawal of the National Corporation, continuity of life is missing. Finally, if limited partnership interests cannot be transferred with full rights of substitution without the consent of other partners, the element of free transferability cannot be established. In sum, the National Limited Partnership can escape corporate tax treatment, but there will be little room to spare.

116 Interests in the National Corporation, the National Limited Partnership, and local partnerships are declared to be legal investments for national bank portfolios. 12 U.S.C.A. § 24 (1969).
117 See note 19 supra.
of sale that the sponsor must recover its initial equity investment as well as net income which has gone toward amortization of principal. Unfortunately, it is not likely that the limited distribution sponsor will be swamped with attractive purchase offers — the dearth of buyers being due largely to the fact that full accelerated depreciation cannot be taken by the second owner of the rental property.\footnote{118}

Section 236(j)(3) of the National Housing Act\footnote{119} purports to fill this troublesome hiatus in the tax shelter process. It does so by making it possible for non-profit sponsors to obtain 100 percent mortgage financing for the purchase of rental housing from a limited distribution sponsor. The maximum purchase price is limited to "appraised value," but this phraseology is further modified by a provision that "value shall be based upon a mortgage amount on which the debt service can be met from the income of the property when operated on a nonprofit basis, after payment of all operating expenses, taxes, and required reserves."\footnote{120} Unfettered by the requirement for showing a net income, the nonprofit sponsor will perhaps be able to pay more than a profit oriented purchaser. Consequently, the limited distribution seller may well recoup not only its initial equity investment and net income spent on amortization but also part of book depreciation as well.

Upon the disposition, a section 1250 gain would be taxed at ordinary rates.\footnote{121} However, section 1250 gain can be generated...
only by depreciation in excess of straight line\textsuperscript{122} and is inversely proportional to the length of the holding period.\textsuperscript{123} Upon a disposition occurring 120 mounts after acquisition, no depreciation taken in excess of straight line will be taxed as ordinary income.\textsuperscript{124} Gain over and above section 1250 gain will presumably receive capital treatment.

Of course, if the sale price is equal to or less than net book value (\textit{i.e.}, if the property value has actually decreased in line with book depreciation), and if the limited distribution sponsor still has to pay taxes because accelerated depreciation has been used for tax purposes, then the shelter of net income in prior years has not been complete. By using the technique of a nonprofit sponsor take out, however, it is not inconceivable that the property could be sold at more than its net book value. Such excess would represent additional book net income which might be sufficient to offset all taxes resulting from the disposition. If such were the case, the tax shelter of income during previous operational periods would truly be complete.

IV. Types of Investors: Refinements of the Limited Partnership Structure

A. Who Will Invest?

In order to provide the large sums necessary for equity financing, it will be necessary to obtain investment from outside the community in which the rental housing is built. The question is: What sort of outside investor can be drawn to the project?

Presumably, the tax motivations which render untroubled real estate investment attractive to the ordinary investor will operate with equal force in the low and moderate income housing field. The entire philosophy of the National Limited Partnership is predicated on the “tax magic” of accelerated depreciation and financial leverage.\textsuperscript{125} Theoretically, then, there should be no great difficulty in attracting outside private capital to the local housing partnership.

We have noted that participation by the private investor is a theoretical consequence of the tax considerations which motivate any real estate investment. In practice, however, will private capital

\textsuperscript{122} Id. \textsection 1250(b)(1).

\textsuperscript{123} Id. \textsection 1250(a)(2).

\textsuperscript{124} Id. \textit{But see} note 108 \textit{supra}.

\textsuperscript{125} \textit{See text accompanying notes} 109-16 \textit{supra}.
find the low and moderate income housing project as worthy of its attention as the expensive luxury high-rise or the downtown office building? It has been suggested that the depreciation rules which create the real estate tax shelter actually operate so as to discourage investment in new and rehabilitated low income housing. In general, it is said that, unlike other commodities, housing is highly durable and that new construction has always been a very small percentage of the existing housing inventory. Because of this fact, existing housing dominates the market and investors in rental realty are attracted to, and prefer to invest in, existing apartment property. The more decrepit and ancient the structure, the shorter is its useful life and the greater the depreciation deduction available to the investor. Moreover, although accelerated depreciation is not available for used housing, the Internal Revenue Service has permitted depreciation of used housing at 150 percent of the straight line rate, thus narrowing the gap between the depreciation benefits accruing to the investor in new housing and those available to the investor in used housing. It has been further suggested that available private capital gravitates toward the glamour investment such as luxury housing and commercial, office, motel, and shopping center structures; that monetary policy plays a critical role in the establishment of interest rates which directly affect loan terms and financial leverage, thus making tax incentives to investment in housing overly dependent upon, and subject to, abrupt changes in monetary policy; and finally, that present depreciation rules favor a frequent turnover of ownership which militates against proper maintenance and the exercise of social responsibility which is necessary in the low and moderate income housing field.

These are serious drawbacks to attracting private capital to low and moderate income housing. It may be, however, that their discouraging effects have been given more weight than is merited. We have seen in recent years a willingness on the part of investors to engage in the tax shelter game with respect to senior citizens housing developments of all kinds and varieties. Granted, they tend to favor developments for the relatively financially secure senior citizen, but a very considerable portion of the total investment in golden age housing is in the moderate income category and con-


127 Treas. Reg. § 1.167(b)-0(b) (1956); Special Ruling, August 30, 1946, reprinted in 4 CCH 1946 Stand Fed. Tax Rep. § 6273. But see note 108 supra.

128 Sporn, supra note 126.
sists of new apartment construction which developers have been able to transfer to investment syndicates. There is no reason to believe that, given the added mortgage protection afforded by the National Housing Act, private investment capital cannot be drawn to the local housing partnership at least as readily as it is now increasingly being drawn to the moderate income senior citizens project.

It is probably true that, even with mortgage insurance and subsidies to mortgagees, it will be difficult to entice private capital into the rehabilitation of existing low and moderate income housing. However, the local partnerships will be engaged in new construction as well as in rehabilitation, so the accelerated depreciation element of the tax shelter will certainly be available as to the new housing. Second, those who argue that present depreciation rules (particularly the availability since 1946 of 150 percent of the straight line rate) have put existing housing approximately on a par with new housing in capacity to attract investors, have actually produced an argument which favors the use of tax incentives in the rehabilitation field. If what they say is true (and they admit that quantitative measurement of any significance is impossible in this area), then the local housing partnership should be able to attract investors who will benefit both from new and rehabilitated low cost housing by way of the tax shelter. Finally, the current vogue in glamour real estate investment is not solely the result of obvious economic benefit based on the tax shelter. It is also the product of sophisticated marketing and well directed propaganda. An aggressive, able local partnership offering the same tax stimuli, can also engage in the marketing of its investment offerings so as to compete respectfully with the glamour investment opportunity in real estate.

Private investors, however, do not constitute the only source of non-mortgage financing. Very recently, the tax exempt foundations have become an important source of financial support for housing programs. By investing a portion of its principal in a local housing partnership, a foundation may participate directly in the creation or rehabilitation of low and moderate income housing. Here, of course, tax incentives are of no significance and the arguments

129 See note 10 supra.
131 FORD FOUNDATION, NEW OPTIONS IN THE PHILANTHROPIC PROCESS (1968).
which apply to private investors have no relation to the motivation of the tax exempt organization.

Tax savings will be relatively insignificant to yet another potential class of investors — the residents of the community in which the housing is built or rehabilitated. In some areas of our cities, it would probably be a social impossibility for “outside” investors to organize a profit-making housing project without giving citizens of the surrounding area an opportunity to share in the profits. To be sure, no vast sums of money will be raised from this source, but there may be a number of neighborhood residents with both the means and the motive to invest small amounts in a community endeavor. In any event, there may be a practical imperative to furnish the opportunity for neighborhood financial involvement.

B. Capital Structure.

Since it appears that tax incentives can attract outside investors to the low and moderate income housing field and that tax exempt foundations as well as low tax bracket community residents can also be reasonably expected to participate, the question is: Given the available investment vehicles, how can the interests of outside investors, foundations, and community participants be integrated into a business form so as to achieve the ends that each group is seeking? The choice of organizational form and capital structure is limited by tax considerations and the provisions of the National Housing Act applicable to limited distribution sponsors. Prior analysis has led to the inexorable conclusion that the limited partnership form should be used to maximize tax benefits for high bracket outside investors. Can the investment goals of tax exempt foundations and low-bracket investors be accommodated within the framework of a limited partnership?

For the outside investor, the goal is clear: tax shelter by virtue of depreciation and financial leverage. He is not interested in moderate net income return except as that return is swollen by the fact that it is tax free. He is even more satisfied when he has a net operating loss to offset against other income. The charitable foundation is not at all interested in tax shelter since it is not a tax-payer anyway. It is, however, interested in a reasonable income

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132 It is too widely known to require citation that the Nixon administration has consistently favored the concept of giving minority groups “a piece of the action.” Housing for profit can certainly be classified as action. Who but the community in which it is located has a better right to a piece of it?

133 See text accompanying notes 16-84 supra.
yield (preferably distributable) from its investment. Similarly, the community resident would be more impressed by the rate of return than by its tax free character or the availability of deduction pass-throughs to shelter his other income.

Obviously, an optimum accommodation of these interests could be achieved if it were possible to separate out the tax attributes of income on the one hand and depreciation (and other deductions) on the other, so that income could be allocated at a fixed high-rate level (say, 7 percent of investment) to the exempt and low-bracket investors, while the remainder of the income plus all depreciation and other deductions could be allocated to the high-bracket investors. This would, in effect, give the exempt and low-bracket investors a preferred status as to income, while giving the high-bracket investor the rest of the income and the full benefit of all the partnership’s depreciation and other deductions.

Within a partnership framework, the Internal Revenue Code does make possible some such accommodation of divergent partnership interests. Section 704(a) provides: “A partner’s distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.” Thus, under the Code, it is possible to alter the usual distribution of tax attributes by an agreement between the partners. Presumably, items of depreciation or other deductions, such as business expenses and interest, could be allocated by agreement to the high-bracket investors, while items of income could be divided in such a way as to give the preferred investors a fixed return on their investment, with the residue going to the nonpreferred limited partners.

However, the procedure is not as simple as it appears. The Regulations have imposed a limitation upon such shifting of tax attributes by providing that any agreement calling for such shifting may be disregarded if its “principal purpose” is to avoid or evade federal income taxes.\(^\text{134}\) Whether the principal purpose of such an agreement is evasion or avoidance of federal income tax turns upon a variety of considerations, including whether there is a business purpose for the allocation and whether it has “substantial economic effect” in that it actually affects the dollar amounts of the partners’ shares of partnership income or loss independently of tax consequences.\(^\text{135}\) It seems that deflection of items of deduction

\(^{134}\text{Treas. Reg. }\S\text{ 1.704-1(b)(2) (1956).}\)

\(^{135}\text{Id.}\)
from exempt and low-bracket partners to high-bracket partners, in the absence of compelling business reasons and without any relation of such deductions to an actual burden or loss borne by the high-bracket investors, is an avoidance of federal income tax. In the case of the housing partnership, the Commissioner could argue that the principal purpose of allocation is the enhancement of the tax shelter possibilities for the high-bracket investor. If this position prevailed, allocation of items of deduction by agreement may simply have to be abandoned as between limited partners whose economic positions in the partnership differ only in terms of general status (high-bracket versus exempt and low-bracket) for federal income tax purposes. Nevertheless, an argument could be made that the high-bracket investor is, in effect, a "junior" interest-holder who bears the highest risk of operational losses for partnership law purposes and that, as such, he should be permitted to take all of the tax depreciation. In other words, such allocation of depreciation does have substantial economic effect. The argument would be especially cogent if the preferred limited partner's right to a fixed return on his investment were cumulative and if he had a liquidation preference in the amount of his original investment plus accrued arrearages. While there is merit in these contentions, they are more than somewhat pallied by the countervailing assertion that no such allocation would be made but for the tax status of the two types of investors. Thus, there is considerable uncertainty in the tax technique of constituting exempt and low-bracket investors a preferred group as to a fixed amount of income and the high-bracket investors a common group as to the remaining income and all deductions.

An alternative would be to sell unsecured partnership debt to exempt and low-bracket investors. The debt would be long term and would probably have to be subordinated to the FHA insured mortgage. This method of funding would remove the tax pitfalls which surround the allocation of tax attributes among preferred and junior limited partners, since creditors of the partnership do not share its tax attributes. Furthermore, the presence of additional debt would increase the basis of the general partners' interests, and, because it represents an additional tax deduction, would en-
hance the tax shelter for the remaining partners, both limited and general.

Of course, the presence of debt in the financial structure does require the partnership to meet the interest expense on a regular basis, whereas a preferred limited partner's share of book net income could be credited to his capital account even though it is being used for partnership purposes.

C. Distributional Problems.

A limited partnership composed of a small group of moneyed investors would probably have a clear path to private offering exemptions from registration under federal and state securities laws. The same can be said for preferred partnership interests or debt sold to a few tax exempt foundations. But what of the securities offered and sold to members of the community? It is difficult to see how registration could be avoided. However, the "small offering" exemption would afford some relief from the full expenses of federal registration in most cases. SEC Regulation A sets out the regimen for abbreviated registration of an offering of $300,000 or less in any one year.

Apart from the securities problems involved in selling partnership interests or debt to neighborhood residents, the mechanics of distribution may raise some significant practical problems. If pre-

139 Securities Act of 1933 § 4(2), 15 U.S.C. §§ 77d(2) (1964); UNIFORM SECURITIES ACT § 402. Some have suggested that limited partnership interests in a partnership formed pursuant to the Uniform Limited Partnership Act might not even be securities. See 1 L. LOSS, SECURITIES REGULATION 504-05 (2d ed. 1961, Supp. 1969). But see Coffey, The Economic Realities of a "Security": Is There a More Meaningful Formula?, 18 W. RES. L. REV. 367, 407-11 (1967). Caution must be exercised when playing the numbers game in connection with the federal private offering exemption. First of all, if number is meaningful in determining the coverage of the exemption, it is the number of offerees that matters — not the number of eventual investors. Second, the number of offerees, no matter how small, may never conclusively establish the exemption. See In re D. F. Bernheimer & Co., 41 S.E.C. 358 (1963).

If the limited partnership interests are deemed to be securities, then they are subject to the anti-fraud provisions of the securities laws, notwithstanding their exemption from registration.

140 Perhaps federal registration could be avoided by seeking the so-called intrastate exemption. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1964). However, this is a rather slippery provision, and great care would have to be exercised to make sure that all the resident investors were domiciled in the state where the partnership does business and that all the purchasers took with an investment intent. For a short but informative analysis of section 3(a)(11) pitfalls, see Sowards, The Intrastate Exemption, 2 REV. SEC. REGULATION 922 (1969).


142 17 C.F.R. §§ 230.251-230.263 (1968). A further reduction in the level of compliance is available for offerings not in excess of $50,000. Id. at § 230.257.
ferred limited partnership interests are used, the limitations of the Uniform Limited Partnership Act as well as the Internal Revenue Code must be dealt with.

The first hurdle is raised by the state law requirement that, whenever a new partner is added, the partnership certificate be amended and signed by all the members, including the new member. This sort of limitation certainly puts a gaff in a prolonged distributional process where the offering is disposed of piecemeal by mail or face-to-face solicitation. The necessity for obtaining the signatures of existing partners every time a new partner is accepted might be obviated by constituting one of the partners attorney-in-fact to sign certificate amendments. But the sheer frequency of amendments might be so discommoding as to render the selling process impractical. One method of reducing the inconvenience of continual amending would be to "batch" prospective investors and have them all sign a single amendment when a sufficiently large group of prospects has been formed.

Selecting long-term debt as the vehicle for resident participation would also remove the distributional obstacles posed by partnership law, because the addition of creditors requires no change in the partnership certificate.

A related problem — though it deals with the period after distribution — is whether partnership interests sold to low-bracket investors should or can be made freely transferable. Prior discussion has indicated that making partnership interests transferable bolsters the Commissioner's argument for taxing the organization as a corporation. But even if the tax risk could be taken, sections 24(2)(b) and 25(1)(b) of the Uniform Limited Partnership Act might hinder the attainment of easy transferability. Although the partnership certificate may give limited partners the right to substitute their assignees as members of the partnership, substitution still requires amendment of the certificate and signing by all old and new partners. Thus, in planning for transferability, some of the same problems raised in the distributional context

144 Quaere, however, whether an attorney-in-fact can meet the "sworn to" requirement of U.L.P.A. § 25 (1) (b).
145 See text following note 55 supra.
146 U.L.P.A. § 19(4).
147 Id. §§ 24(2)(b), 25(1)(b).
will be met.\textsuperscript{148} Again, if long term unsecured debt is used, partnership law will not be a hindrance to transfer.

D. Control of the Project.

Among the other social implications of establishing a profit-motivated housing partnership in the inner city is the rather strong likelihood that the neighborhood residents will seek a substantial voice in its management. The representation sought would be for the community as a whole and not just for residents who have purchased debt or limited partnership interests. At the same time, the outside investors who are furnishing the bulk of the capital will no doubt wish to maintain the greatest possible representation in management consistent with their limited partnership position and countervailing community pressures.\textsuperscript{149}

Clearly, limited partners and debtholders, as such, cannot take part in management. Moreover, it is unlikely that the neighborhood affected can produce individuals willing to take on general partnership responsibilities. A solution to the problem might lie in having a business corporation general partner and dividing its voting stock among the outside investors and the neighborhood residents according to a satisfactory ratio. This suggestion raises a number of serious issues.

To begin with, in order to avoid the corporate attribute of centralized management for tax purposes, the general partner must have substantial assets invested in the partnership.\textsuperscript{150} To meet this requirement, the proceeds from the sale of corporate stock would have to be more than could possibly be raised from the community, and yet the neighborhood may wish to own a considerable block of voting shares. The largest part of the corporate general partner's assets would have to come from the outside investor group. While the problem of selling voting shares to different groups at different prices could be solved by devising a corporate equity structure composed of voting preferred and voting common, the fact remains that the outside investors are interested primarily in the optimum tax shelter potential connected with limited partnership

\textsuperscript{148} See text accompanying notes 143-44 supra.

\textsuperscript{149} Were there no need for community voice in management, the general partner would probably be a person (or group) whose interests were more or less identified with those of the limited partners, although care would be exercised to avoid any direct or indirect relationships of control between the two types of investors. In other words, the general and limited partners would be like-minded if not alike in law.

\textsuperscript{150} See text accompanying notes 49-50 supra.
interests, and they will not be willing to invest substantial sums in the corporate general partner.

Perhaps the goal of creating substantial assets in the corporate general partner should not be given too high a priority, because the only tax consequence of the corporation's being too "poor" is that the partnership will be deemed to have centralized management. Even if this should occur, the partnership could still escape the other three attributes of limited liability, continuity of life, and free transferability of interest. With this in mind, it might be concluded that a business corporation general partner, whose stock is sold at a nominal price to the community and to outside investors, would provide an excellent vehicle for control allocation. Unfortunately, there are other complications.

The use of a business corporation as the general partner in a housing limited partnership raises a number of problems which have heretofore been mentioned only in passing. These problems arise where individual limited partners in a limited partnership are either stockholders, directors, or officers of the corporation which is the general partner. The problems arise from the basic notion that limited partners enjoy their statutory freedom from liability for partnership obligations only so long as they do not take part in the control of the affairs and business of the partnership.\(^{151}\) The question of when a limited partner has taken part in the control of the business creates an interpretative problem which has greatly troubled the commentators, but it has produced very little litigation.\(^{152}\) If the question of control is troublesome when it concerns only an individual limited partner who involves himself in management, it is doubly so when that limited partner has a concurrent financial interest as a stockholder in the corporate general partner whose board of directors clearly controls the affairs of the partnership. Similar difficulties are encountered where the limited partner does not have an interest in the corporate general partner but does occupy a managerial position therein, that is, as a director or major officer. The question in such cases is whether the occupancy of such dual positions violates the control test of section 7 of the Uniform Limited Partnership Act so as to render the individual limited partner liable as a general partner in respect of partnership obligations.

\(^{151}\) U.L.P.A. § 7.

The two situations in which the control test is most clearly violated are (1) where the limited partner (or several of them) owns or controls a majority of the voting stock of the corporate general partner, and (2) where the limited partner (or several of them) is a director or officer of the corporate general partner. In both, the limited partner is clearly in a position to manage the affairs of the partnership by virtue of his management of the corporate general partner. In the case of the limited-partner director, such control is inevitable, since the director is responsible for all major corporate policy decisions, including decisions concerning the management of the partnership. While majority shareholders are further removed from the decisional process, they nevertheless control the composition of the board of directors and, therefore, should logically be treated in the same manner as a director for purposes of the control test. This is particularly true where the interests of the partners in the partnership and in the corporation are proportional. However, even where the interests in the two entities are not proportional, so long as the limited-partner shareholders hold a majority of stock in the corporate general partner, they do ultimately control its destiny and through it the destiny of the partnership. Thus, they are indirectly involved in control of the partnership.

Where the limited-partner shareholders hold less than majority of the corporate general partner’s voting stock, it might be argued that they ought not be treated as participating to any significant extent in the control of the partnership business, regardless of whether their relative interests in the two entities are proportional or merely random. In either case, they have only a minority interest in the general partner and are unable to dominate its affairs. But if the limited-partner minority shareholders have a right to elect directors of the corporate general partner, the argument against their unlimited liability weakens considerably. After all, their directors will participate in management, and personal liability results if the limited partner “takes part” in control. 153

A limited partner who is also an officer of the corporate general partner (and is not a stockholder or director) would appear to be directly involved in control of the partnership. However, since corporate officers are generally elected by, and serve at the pleasure of, the board of directors and are subject to its control and supervision, the dual position of limited-partner officers might not violate the control requirement.

The fact that the issues herein have not been specifically litigated should not lull planners into a belief that there is no danger lurking in these "concurrent interest" situations. Nor do all the possible surprises lie in the area of partnership law. While a determination that limited partners have lost their limited liability status will not lead to the partnership's being taxed as a corporation, if the shareholders of the corporate general partner hold proportionate interests as limited partners, the two entities are obviously "owned or controlled directly or indirectly by the same interests" as that phrase is used in section 482 of the Internal Revenue Code. Where such a relationship exists, section 482 allows the Commissioner to "distribute, apportion or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses," in order to prevent evasion of taxes or clearly to reflect the income of such related entities. It does not seem entirely beyond the realm of

154 The unexpected and unwelcome results of similar dual interests are well illustrated in Bergeson v. Life Ins. Corp. of America, 170 F. Supp. 150 (1958), aff'd in part, 265 F.2d 227 (8th Cir.), cert. denied, 360 U.S. 932 (1959). In that case, several of the individual defendants formed a limited partnership under the Utah Limited Partnership Act. They caused the partnership to organize a mutual benefit insurance company which was later reorganized as a stock company. When the stock of the insurance company was publicly sold, the limited partners, who were also directors, shareholders, and officers of the company, failed to disclose the fact that they had caused the corporation to enter into an agreement with the partnership which required the corporation to pay certain sums to the partnership in respect of an alleged transfer of property to the corporation and for the payment of commissions on insurance sales. The corporation later issued stock to the limited partners in satisfaction of its alleged liabilities under the contract and for a release of the agreement. A derivative stockholder's suit was filed against the limited partners, who, as directors, had allegedly caused the stock to be issued to themselves without any consideration therefore. One of the defenses raised by the director-partners was that, as limited partners, they were not subject to personal liability in respect of the dealings between the partnership and the corporation. The court rejected the defense on the ground that the only business of the partnership was the formation and operation of the insurance company; that by virtue of their positions as directors and shareholders of the corporation, they engaged in the active conduct of the partnerships affairs; and, therefore, that they could not rely on the limited liability offered by the limited partnership form, since they had disregarded its spirit. 170 F. Supp. at 159. On appeal, this particular issue received no attention, since it was determined that the partnership had not formally complied with the requirements of the Utah Limited Partnership Act and, because of its defective organization, it was a general and not a limited partnership. 265 F.2d at 235. This defect had also been noted in the trial court's opinion, but it had gone on to state that even if the partnership had been validly organized, the dual positions occupied by the director-partners would have been a violation of the control provision of the Act. 170 F. Supp. at 159. Thus, while the issue was not determined on appeal, the statement of the trial court furnishes ample evidence of the danger involved in an arrangement in which limited partners are also directors or shareholders of a corporate general partner. In Bergeson, the corporation was not a member of the partnership at all, and yet the trial court found a violation of the control prohibition. Where the corporation is a general partner, the argument that violation of the prohibition has taken place is even more cogent.

156 See discussion accompanying notes 51-55 supra.
possibility that the Commissioner may take the position that the interests of the limited partners as such are not separate and distinct from their interests in the corporation; that such interests, in fact, represent equity interests in the corporate general partner; and, finally, that under section 482 the income and deductions of the limited partners should be reallocated to the corporation in order to properly reflect true income picture as between the corporate general partner and the limited partners. This result, if judicially sustained, would destroy the optimum tax shelter effects of the limited partnership for local investors. Worse yet, if the National Limited Partnership were to be a partner in the local partnership, the entire fabric of tax incentives, which so carefully seeks to protect income and depreciation pass-through up the line from the local project to the national-level investors, would be torn, and the whole idea would be defeated. Since only the National Limited Partnership would be immune from section 482 reallocation, the idea of the local partnership feeding tax attributes to the limited partners of the National Limited Partnership would be meaningless. This danger, like the control prohibition, is inherent in the present structure of the law, and its ramifications have obviously not been considered.

From the foregoing, the prospects appear dim for successfully using a business corporate general partner as a device for representing both the community and outside investors in project management. On the tax side, the arrangement might successfully ward off the reallocation of income attack, especially if area residents invest in a large portion of the corporation's stock but do not own limited partnership interests. But the outside investor group, having the largest financial stake as limited partners, would demand, at the very least, sufficient voting power to elect a minority of the corporation's directors. In doing so, they might well forfeit their insulation against creditors' claims.

While the business corporation does not appear to be the most desirable means of accommodating the control demands of outside investors and area residents, perhaps the nonprofit, community-based corporation, cast in the role of general partner, offers a reasonable solution. The governing boards of non-profit neighborhood organizations are very often composed of a mix of responsible residents from the immediate area as well as citizens from the larger commun-

156 See discussion accompanying notes 109-16 supra.
157 See note 115 supra.
ity representing churches, city government, the professions, and assorted sectors of industry.

Within a group such as this, both outside investors and neighborhood residents ought to find adequate representation for their respective views and special interests. On the one hand, the limited partners, who are furnishing the major financial backing, could very likely be satisfied that there are enough "kindred financial spirits" in the organization to insure proper management and investment protection. On the other hand, the residents might be content in the knowledge that those who intimately know and understand their problems will have policy-making power.

It is true that the suggestion of a nonprofit corporate general partner presents a rather loose and unstructured solution to the question of diverse representation. Nor is it denied that a good deal of informal give and take might be necessary to reach mutually agreeable guidelines for the composition of the nonprofit corporation's management. But this "play in the joints" may be what most recommends the concept. More importantly, the nonprofit general partner seems to go a long way toward solving the partnership and tax questions already discussed. Because a nonprofit corporation has no stock or financial interests that can be owned by the limited partners, the Commissioner would be hard pressed to achieve corporate tax treatment by recasting and reallocation. The absence of voting stock also means that the limited partners will not have direct and specific legal power to select management of the general partner, thus reducing the chance that the veil of limited liability will be rent. Finally, though the nonprofit general partner might invest only a nominal sum in the partnership, corporate tax treatment can be avoided because centralization of management is the only corporate attribute which can be established.

V. CONCLUSION

By enacting the Housing and Urban Development Act of 1968, Congress has explicitly adopted the policy of using tax incentives to induce private investment capital to perform a vital national function — the rehabilitation and construction of law and moderate income housing. Title IX of the 1968 Act declares:

The Congress finds that the volume of housing being produced for families and individuals of low or moderate income must be increased to meet the national goal of a decent home and a suitable

living environment for every American family, and declares that it is the policy of the United States to encourage the widest possible participation by private enterprise in the provision of housing for low or moderate income families. The Congress has therefore determined that one or more private organizations should be created to encourage maximum participation by private investors in programs and projects to provide low and moderate income housing.169

Tax shelters have, for some time, been the progeny of accelerated depreciation and financial leverage. To stimulate production of rental housing, Congress has, over the years, added to the tax shelter an array of other subsidies which permit investors to undertake high cost projects with minimal cash commitments and to enjoy very substantial after tax yields while doing so. With the advent of the 1968 Act, however, it becomes crystal clear that Congress intends the use of partnerships, FHA financing, and accelerated depreciation tax shelters — in combination — to produce low and moderate income housing.

Exclusions, preferences and concessions of all kinds have been, for better or for worse, a distinctive feature of our income tax law since its inception. In general, these departures from strict tax neutrality have resulted from the interplay of political and economic forces in the Congressional arena, and not from specific, deliberate governmental intervention aimed at accomplishing some basic purpose or policy. In the case of low and moderate income housing, however, Congress has employed an amalgam of tax incentive and subsidy to woo private investors. This deliberate and contrived use of the tax laws by Congress to further a national policy is a remarkable departure from the usual manner in which tax preferences develop.

While the wisdom of permitting any special preferences, whether they be inspired by special interest pressure or government policy, is now a matter of considerable debate,160 the fact is that the Congress has chosen the tax incentive path in the housing field. The question is: Will it have the desired effect of rallying private enterprise in support of Congressional policy?

We have shown in the foregoing analysis that, theoretically, the tax and subsidy package should be attractive to the potential investor in real estate. Economic conservatives, who might usually be expected to look askance at government incursion into the housing

field, apparently support such intrusion when it consists of tax incentives designed to get private enterprise to do the job. Those who oppose the use of tax inducements cannot quarrel with the National Housing Act on the ground that it creates new and insupportable tax preferences; on the contrary, it merely employs those that are already part and parcel of the tax laws, albeit in a new and more attractive package.

The results are, in fact, beginning to come in. Niagara Mohawk Power Corp. has announced that it proposes to form subsidiaries to sponsor moderate income housing projects under the National Housing Act. The Savings Bank Association of New York State is soliciting major industrial and utility corporations to sponsor its projects under the National Housing Act. Michigan Consolidated Gas Co. has obtained SEC permission to capitalize a non-utility subsidiary to produce low and moderate income housing using the tax shelter.

The inducement has been provided, and, were it not for some very puzzling action taken by the House of Representatives in the pending Tax Reform Act of 1969, it could be expected that private capital would respond. The House reform package, as of this printing, would excise from current tax law several critical components of the total incentive mechanism. Chief among these are the revamping of Code section 1250 so as to achieve 100 percent recapture of excess depreciation without regard to the holding period, the elimination of 150 percent declining balance depreciation for used property, and the general limitation on "preference" deductions, including accelerated depreciation. Is the Congressional memory so short that it cannot recall the explicit legislative charge — handed down only a year ago — urging private investors to seek shelters from taxes in order to produce and improve shelters for

161 See Wall Street J., Feb. 4, 1969, at 16, col. 3 (Midwest ed.).
162 See N.Y. Times, May 1, 1969, at 63, col. 1.
   There is no need to give [the Public Utility Holding Company Act] an inflexible, static historical reading. Companies subject to it are now presented with the Congressionally recognized urban problems of the 1960's and 1970's that could not have been contemplated by the original enacters. The desirability of private capital becoming involved in the rebuilding of our cities is widely recognized and urged, and the posture today of the utility industry is substantially changed, at least in terms of weaknesses at which the Holding Company Act was directed. Equally relevant, there has been evolving since the 1930's a broader motion of corporate responsibility to the community.
164 See note 108 supra.
165 Id.
people. To be sure, the suggested reforms might tend to halt the abuses perpetrated by slumlords who batten on real estate exploitation outside the framework of FHA control and supervision. But the evils noted by the Ways and Means Committee simply do not obtain in the realm of FHA insured housing projects. If an old building is purchased with a federally-backed purchase money mortgage, the property will be rehabilitated and operated in accordance with rather strict administrative rules. This sort of activity is a far cry from the typical "used property rotation" practiced by those who purchase real estate simply to get the 150 percent declining balance depreciation, without taking any steps toward renovation. Why then should the 150 percent privilege be revoked as to the salutary endeavors of those who submit to FHA scrutiny?

With respect to new construction, it is said that the incentives offered by the gradual reduction of accelerated depreciation in Code section 1250 have not produced an influx of private capital into the low and moderate income housing field. With all due deference, it is submitted that one year is hardly a sufficient probation period to test the effectiveness of a Congressional policy, especially since HUD has not published any comprehensive guidebooks for limited distribution sponsors. More important, even if it be true that private capital has continued to ignore low-cost housing ventures, the remedy should be designed to further encourage diversion of funds to such projects. Instead of removing the section 1250 sliding scale for all real estate, it should be deleted for all but low and moderate income housing, making it more profitable for private investors to move into this neglected area.

Finally, it is suggested that the present tax law discourages long range "stewardship." In non-FHA projects, perhaps so. But it has already been noted that FHA supervision eliminates this problem during a limited distribution sponsor's stewardship. More critically, however, the National Housing Act calls for disposition of the property by the profit-motivated sponsor to a non-profit sponsor or cooperative which will continue to operate the property indefinitely under FHA control.

The Congressional vacillation exhibited in H.R. 13720 can only discourage planning by those who have been dunned to become in-

168 See notes 13 and 120 supra.
168 Id.
169 See pp. 758-69 supra.
volved in low-cost housing. For who is likely to rush in ahead of inhibited angles when legislative policy appears to be so evanescent — if not downright meretricious? If the tax reform bill survives in its present form, the issue of private investment in low and moderate income housing will be flung back in the teeth of Congress and a threnody will be intoned for the hope of massive capital infusion by nongovernment sources. More tragic still, a new nadir will be reached in the relationship between the ill-housed and their government. One can only hope that the tax reform compass has not yet been boxed.