The Partnership In Commendam: Tax Consequences and Business Risks

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THE PARTNERSHIP IN COMMENDAM: TAX CONSEQUENCES AND BUSINESS RISKS

In ventures requiring considerable outlay of capital—among them real estate development, oil and gas production, housing construction, and cattle feeding and farming operations—investors are attracted in part by such tax advantages as deductions for interest on borrowed capital and depreciation. The limited partnership or, in Louisiana, the partnership in commendam, has emerged as a popular business form for extensively capitalized ventures, not only because it allows efficient utilization of available tax advantages but also because it permits each investor to limit his liability exclusively to the amount of capital he has invested. Despite the benefits the limited partnership or partnership in commendam may confer, participation in this investment vehicle does not inevitably lead to financial success: the investor is subject to pitfalls in the formation of the limited partnership as well as in the ordinary course of business which may expose him to unlimited risk and strip away anticipated tax benefits. The purpose of this comment is to explore the tax consequences and, secondarily, the business risks one encounters in the limited partnership in Louisiana.

Historical Introduction

Article 2839 of the Louisiana Civil Code defines a partnership in commendam as one

by which one person or partnership agrees to furnish another person or partnership a certain amount, either in property or money, to be employed by the person or partnership to whom it is furnished, in his or their own name or firm, on condition of receiving a share in the profits, in the proportion determined by the contract and of being liable to losses and expenses to the amount furnished and no more.

The partnership in commendam and its common law counterpart, the limited partnership, apparently originated in the Italian commercial centers of Pisa and Florence in the twelfth century.¹ Beneficial to both investor and entre-

¹ 2 R. ROWLEY & D. SIVE, ROWLEY ON PARTNERSHIP 550 (2d ed. 1960) [hereinafter cited as 2 ROWLEY & SIVE].
preneur, its purpose was twofold: to counteract the doctrines of mutual agency and solidary liability imposed upon commercial partnership ventures by limiting the liability of non-managing partners, and to raise capital for such ventures by permitting the owners of wealth, primarily the nobility and clergy, to invest without being known or named. The Louisiana Digest of 1808 incorporated the concept from the French Code of Commerce, where it was termed *la société en commandite*, and expanded its application to commercial and ordinary partnerships. In other American jurisdictions, the limited partnership originated in 1822, when New York used the French *société en commandite* as the basis for this country's first limited partnership act. The Uniform Limited Partnership Act (ULPA), an outgrowth of the New York legislation and French law, was adopted and recommended to the state legislatures by the Conference of Commissioners on Uniform State Laws in 1916. Today all but Louisiana and Delaware have ratified the ULPA.

### Rights and Obligations of the Partners

Both the Civil Code and the ULPA balance the commendaatory partnership's interests in limited investor liability and the use of accumulated risk capital with the interests of society generally by regulating the relation of the general and limited partners to each other and to the public. As between the partners, the general rule is that a limited partner may...
act only in the passive capacity of an investor while general partners must assume full control of the venture. Thus under both the Civil Code and the ULPA, a limited partner may contribute money or property to the partnership, but may neither render services,\(^8\) a prerogative of the general partner alone, nor act as agent for the partnership,\(^9\) the operation and management of the enterprise belonging exclusively to the general partner.\(^{10}\) A limited partner may loan money to or deal with the partnership as any third person,\(^{11}\) however, he cannot withdraw the capital or property he has furnished the partnership at a time when it is failing or when reasonable apprehension exists that it will become insolvent;\(^{12}\) nor can he be required by the general partner to return profits he has received from the partnership, provided he has received them in good faith at a time stipulated in the partnership agreement and when the partnership was solvent.\(^{13}\) The limited partner's share of the losses and profits of the venture with respect to the general partner may be determined entirely by the partnership agreement.\(^{14}\)

With regard to the public, both the Louisiana Civil Code and the ULPA provide that the general partner is liable to third parties with whom the partnership deals precisely as he would be if the partnership were formed without limited partners,\(^{15}\) but that the liability of each limited partner extends only to the sum he agreed to contribute to the partnership regardless of any specific terms contained in the partnership agreement and whether or not his contribution has in fact been paid.\(^{16}\) A limited partner cannot be required

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8. LA. CIV. CODE art. 2849; § 7 ULPA.
9. LA. CIV. CODE art. 2844; § 7 ULPA.
10. LA. CIV. CODE art. 2849; §§ 7 & 9 ULPA.
12. LA. CIV. CODE art. 2851; § 16 ULPA.
13. LA. CIV. CODE art. 2843; § 15 ULPA.
15. LA. CIV. CODE art. 2840; § 9 ULPA. See Tatum v. Acadian Products Corp., 35 F. Supp. 40 (E.D. La. 1940). LA. CIV. CODE art. 2840 provides that a partnership in commendam is simply “a modification, of which the several kinds of partnerships are susceptible, rather than a separate division of partnerships.”
16. LA. CIV. CODE arts. 2841-42; §§ 7, 17(1) ULPA.
by partnership creditors to return any profit he has received under the conditions stated above, but he is bound by a judgment against the partnership to the extent of his individual interest in it. Although a limited partner is not a necessary party to a suit against the partnership if he has paid his promised contribution, the Louisiana Supreme Court has held that partnership creditors may sue him or his estate directly to recover debts up to the amount of his separate contribution if partnership assets are insufficient to meet damages and the limited partner's promised contribution has not in fact been made. Although the limited partner may make loans to the partnership, a partner in commendam holding a mortgage on partnership property may not enforce his right until all partnership obligations to third parties have been satisfied. The ULPA prohibits a limited partner from securing his interest in partnership property with a mortgage.

**Formation of the Commendatory Partnership**

Investors in a commendatory partnership must be mindful of both the mandatory formative requirements and the special restrictions that the Louisiana Civil Code and the ULPA impose. In Louisiana, and with some variation in states having adopted the ULPA, the contract forming the

19. *In re M.F. Dunn & Bros.*, 115 La. 1084, 40 So. 466 (1906) (partner in commendam is bound by a judgment rendered after service of process on one of the general partners but is not a necessary party to the suit when the partnership is solvent and all partnership contributions have been paid in). Regarding proper service of process on the partnership, see La. Code Civ. P. art. 1263, which provides that service on one partner, or on an employee of the partnership if no partner is available, is effective as to the partnership. Also see La. Code Civ. P. art. 737 which provides that the partnership must be joined where suit on a partnership debt is brought against a single partner. Section 26 of the ULPA provides that a limited partner is not a proper party to proceedings by or against a partnership "except where the object is to enforce a limited partner's right against or liability to the partnership."
20. LaChomette v. Thomas, 5 Rob. 172 (La. 1846), aff'd 1 La. Ann. 120 (1846); De Lizardi v. Gossett, 1 La. Ann. 138 (1846). Under La. Civ. Code art. 2842, the partner in commendam is liable only for that part of his promised contribution that remains unpaid.
22. § 13(1) (a) ULPA.
23. *Id.* § 2, lists fifteen formative requirements which are variations of the Louisiana requirements discussed in the text beginning at note 23.
partnership in commendam must be a written instrument that stipulates the amount furnished or agreed to be furnished, the proportion of profits the commendatory partner is to receive, and the expense and losses he is to bear. The instrument must further state whether the contribution is in goods or money and whether the contribution has been received; if it has not been received, written stipulation must be made that it will be paid or delivered. All partners must sign the instrument in the presence of at least one witness. The instrument must be recorded within six days of execution by the officer authorized to record mortgages in the partnership's principal place or places of business. Failure to record as prescribed subjects the partner in commendam to liability as a general partner for obligations incurred by the partnership before recordation, but subsequent recordation relieves him of general liability for obligations incurred thereafter.

Because of their effect upon limited investor liability and the accumulation of risk capital, two important restrictions relating to the commendatory partner should be considered in the provisions of the formative contract. First, under both the Louisiana Civil Code and the ULPA, if the partner in commendam or limited partner allows his name or credit to be used by the partnership, he becomes liable as a general partner. The Civil Code further provides that, if a general partner uses the name or credit of a partner in commendam without his consent, the latter may withdraw his capital investment and avoid liability to his partners and to third parties by publishing notice of his withdrawal in two public newspapers. Consequently, prospective partners should agree that the partnership will neither use the name of a commendatory partner in the course of its business nor, if the general partner is an individual rather than a corporation, will he add the phrase "and company" to his business name or use similar language which might represent to third parties that he operates as a partnership.

24. LA. CIV. CODE arts. 2845-46.
25. Id. art. 2846.
26. Id.
27. Id. arts. 2846-47.
28. Id. art. 2845.
29. La Chomette v. Thomas, 5 Rob. 172 (La. 1843), aff'd 1 La. Ann. 120 (1846).
30. LA. CIV. CODE art. 2849; § 5 ULPA.
31. LA. CIV. CODE art. 2850.
32. Id. art. 2849; § 5 ULPA. Generally, the ULPA is less restrictive than
the Civil Code and the ULPA, the commendatory partner who violates the prohibition against management and control becomes liable as a general partner.\textsuperscript{33} However, the jurisprudence of both Louisiana and other jurisdictions holds that a partner \textit{in commendam} or limited partner may protect his investment without unduly participating in the management of the partnership if, for example, he gives limited advice to or consults with the general partner regarding the partnership business or examines the books and records of the enterprise and otherwise takes all legal steps necessary to preserve his interests.\textsuperscript{34} Therefore prospective partners should agree upon the means by which a partner \textit{in commendam} may look into the business of the partnership to protect his investment, perhaps following the guidelines set forth in the ULPA, which permit a limited partner to inspect the partnership books, to have on demand full information of all things affecting the partnership, and to have a formal account of partnership affairs whenever circumstances render it just and reasonable.\textsuperscript{35}

\textbf{Tax Consequences of the Partnership in Commandam}

Beyond providing the general partner with a means of financing his enterprise and allowing a partner \textit{in commendam} to join a venture with limited personal liability, the commendatory partnership offers considerable advantages in the area of taxation.\textsuperscript{36} The federal partnership tax structure

\textsuperscript{33} LA. CIV. CODE art. 2849; \S\,7 ULPA. The sanction of LA. CIV. CODE art. 2849 has been relaxed by cases holding that management by the partner \textit{in commendam} must be relied upon by creditors before it produces general liability. See, e.g., \textit{In re M.F. Dunn & Bros.} 115 La. 1084, 40 So. 466 (1906); R.W. Rayne & Co. v. Terrell, 33 La. Ann. 812 (1881).


\textsuperscript{35} \S\,10 ULPA.

\textsuperscript{36} For treatment of various tax advantages and problems of the limited partnership, see A. WILLIS, PARTNERSHIP TAXATION (1971); Ben-Horin, \textit{Real Estate Syndications, Limited Partnerships}, S. CAL. TAX INSTITUTE 71 (1972); Schwartz, \textit{How to Find Tax Shelter as a Limited Partner}, 1 REAL ESTATE REV. 54 (1971); Shapiro, \textit{Tax Planning for Equity Financing by Real Estate Developers}, 50 TAXES 530 (1972).
may benefit general and limited partner alike, for under the Internal Revenue Code of 1954 and the subsequent Treasury Regulations, the partnership remains a nontaxable entity while the individuals who conduct business as a partnership are liable for income tax in their separate capacities, with partnership liabilities often providing a sought-after "shelter" for income earned from other sources.

The tax liability of each partner is based upon the partnership's taxable income, which is derived from three computations and filed in the purely informational partnership return (Form 1065). First, as in an individual return, the ordinary income or ordinary loss of the partnership is computed by deducting all business expenses (including fixed-rate salaries and interest paid to partners) from the general income of the partnership, which consists of gross profit or loss, dividends, interest, rents, royalties, and other income. Second, to the ordinary income or loss of the partnership are added certain income (or loss) items that are segregated and stated separately in order to determine their character as capital gain or ordinary income at the partner's level and the extent to which they are includible, excludable, or deductible from the partner's gross income. Such income items include long-term and short-term capital gains and losses, section 1231 gains and losses, dividends, bad debt recoveries, charitable contributions, and income specially allocated under the partnership agreement. Finally, the taxable income of the partnership is computed by subtracting from the sum of the partnership's ordinary income (or loss) and segregated income (or loss) items certain segregated deductions, including investment tax credit, charitable contributions, foreign taxes paid, certain nonbusiness expenses, and expenses specially

37. INT. REV. CODE OF 1954 § 701; Treas. Regs 1.701-1.
38. Id. § 703(a). The general rule is that the taxable income of a partnership is computed in the same manner as that of an individual (subject to the exceptions noted hereafter). However, § 703(a) provides that in the computation of the ordinary income or loss the partnership may not include deductions personal to the partners, e.g., the 50 percent capital gains deductions (§ 1202), the capital loss carryover deduction (§ 1212), the optional standard deduction (§ 141), the deduction for personal exemptions (§ 151), the charitable contributions deduction (§ 170), and such itemized nonbusiness deductions as medical expenses and alimony (§§ 212-18), nor may it include the net operating loss deduction (§ 172), a business deduction, since each partner includes in his individual return his distributive share of a partnership loss in the year the loss is incurred.
39. Id. § 702(a).
allocated under the partnership agreement.\footnote{40} Once computed at the partnership level, all income and all losses pass through to the individual partners, retaining their character as ordinary or capital gain or loss.\footnote{41} In accordance with the partnership agreement, or on a pro rata basis if the agreement is silent, each partner is liable for his distributive share of the segregated income items, the segregated deductions or credit items, and the remaining partnership income or loss.\footnote{42}

Because of the "passthrough" feature of partnership taxation and the flexibility offered by the partnership agreement, the partnership \textit{in commendam} is potentially more rewarding as an investment vehicle than other conventional business forms. Though the shareholders of a corporation may ordinarily be said to have limited their liability to the extent of their investment in the manner of limited partners, they enjoy none of the depreciation and operating loss passthrough conferred by the partnership form and are burdened further by a tax at the organizational level in addition to their own individual income tax on corporate dividends and distributions received.\footnote{43} Shareholders in a Subchapter S corporation enjoy taxation in the manner of investors in a partnership venture, avoiding the double taxation of the ordinary corporation,\footnote{44} but the number of investors is limited to ten and no more than twenty percent of the gross income from their venture in any year may be derived from such

\footnote{40}{Id. §§ 702(a), 703(a).}
\footnote{41}{Id. § 702(b).}
\footnote{42}{Id. § 704(a). Section 704(b)(1)-(2) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall be determined by the partnership agreement unless the agreement is silent, whereupon the distributive share shall be determined on a pro rata basis, or unless the chief purpose of the special allocation of such items is the avoidance of tax. In determining whether there is a motive of tax avoidance, Treas. Reg. § 1.704-1(b) T.D. 6771, 29 Fed. Reg. 15571 (1964) indicates that the "surrounding facts and circumstances" will be considered: "Whether the partnership or partner individually has a business purpose for the allocation; whether the allocation has a 'substantial economic effect,' that is, whether [it] may actually affect the dollar amount of the partner's shares or the total partnership income or loss independently of tax consequences; . . . whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; . . . and the overall tax consequences of the allocation."}
\footnote{43}{See B. BITTKER & J. EUSTICE, \textsc{Federal Income Taxation of Corporations and Shareholders} (3d ed. 1971) for a thorough and lucid commentary on corporate taxation [hereinafter cited as BITTKER].}
\footnote{44}{See BITTKER § 6-1.
forms of "passive" income as rents or royalties.\textsuperscript{45} Investors in a real estate investment trust (REIT) enjoy some of the tax benefits of partnership investors, notably long term capital gain passthrough in trust distributions,\textsuperscript{46} but the REIT is hampered by a myriad of restrictions affecting the number of investors in the trust, the pro rata ownership, the composition of assets, and the sources of income.\textsuperscript{47} In contrast, investors in a limited partnership venture avoid the restrictions of their counterparts in other business forms and enjoy instead the benefits the passthrough feature of the partnership tax structure may confer. Limited partners, for example, may pass through to themselves projected operating losses caused by high initial costs or a slow start, with a corresponding decrease in their capital accounts,\textsuperscript{48} as an offset or shelter for income earned from other sources.\textsuperscript{49} They may similarly offset in the early years of their undertaking long term depreciation losses by acceleration and the selective determination of useful asset lives.\textsuperscript{50} Finally and most importantly, partners may tailor the particulars of their venture to their personal financial circumstances by allocating in the partnership agreement, provided that there is a legitimate business purpose for such special allocations, each individual partner's distributive share of profits and losses, capital gains and depreciation, depletion of contributed property, charitable contributions, liquidation of a retired partner's interest, and the like.\textsuperscript{51}

\footnotesize{45. INT. REV. CODE OF 1954 §§ 1371(a)(1), 1372(e)(5).}
\footnotesize{46. Under INT. REV. CODE OF 1954 § 857 and Treas. Reg. 1.857-4(b) T.D. 6598, 29 Fed. Reg. 17810 (1964), if the REIT meets the statutory tests of INT. REV. CODE OF 1954 §§ 856-58, it will receive a deduction equal to the earnings it distributes to the shareholders; the portion of the distribution that arose as long-term capital gain will retain that stature in the tax liability of the recipient shareholder, and the remainder will be reported as ordinary income on the shareholder's return. For the advantages and disadvantages of the REIT, see Grant & Scheifly, Tax Business Planning for the Real Estate Investment Trust, 15 S. CAL. TAX INSTITUTE 197 (1963); Hrusoff & Cazares, Formation of the Limited Partnership, 22 HASTINGS L.J. 87 (1970).}
\footnotesize{48. INT. REV. CODE OF 1954 §§ 701-02.}
\footnotesize{49. INT. REV. CODE OF 1954 §§ 701-02.}
\footnotesize{50. Id. §§ 167(b) (2)-(3).}
\footnotesize{51. Id. § 704(a); Treas. Reg. 1.704(a) T.D. 6771, 29 Fed. Reg. 15571 (1964). If the motive for a special partnership allocation is the avoidance of tax, the IRS will determine the partners' distributive shares on a pro rata basis. See}
Risks and Abuses Inherent in the Partnership in Commendam

Despite the tax shelter it offers, the commendatory partnership is flawed with inherent problems of such magnitude that investors who fail to resolve them in the planning stages of their venture will place their capital in serious risk. Leaving to other commentaries a summary of the difficulties encountered in the registration requirements of state and federal securities law, the remainder of this discussion will focus on the problems of inadvertent tax consequences and potential management abuse to which the investing partners are subject.

The Partnership in Commendam as a Taxable “Association”

Although a venture may qualify as a partnership under Louisiana law and thus ordinarily enjoy the passthrough feature of partnership taxation, the Internal Revenue Service may classify it as an “association” taxable at the corporate rate if it exhibits a preponderance of the four corporate characteristics defined by Treasury Regulation section 301.7701 (section 7701): continuity of life, centralization of management, liability for partnership debts limited to partnership property (limited liability), and free transferability of interests.53

note 42, supra. Legitimate business purposes for special allocations, i.e., those having “substantial economic effect,” include paying to a partner a higher percentage of profit from a specific operation conducted by that partner in a foreign country where he resides, or allocating a greater portion of the gain received from the sale of securities to two of three partners under circumstances where the bulk of that gain was demonstrably attributable to appreciation prior to the time the third partner bought into the partnership. See Treas. Reg. § 1.704-1(b), T.D. 6771, 29 Fed. Reg. 15571 (1964) examples 1-5.

52. See Heyman & Parnall, Use (or Abuse) of the Limited Partnership in Financing Real Estate Ventures in New Mexico, 3 New Mex. L.R. 251 (1973); Long, Partnership, Limited Partnership, and Joint Venture Interests as Securities, 37 Mo. L.R. 581 (1972); Comment, Can Rights Required to be Given Limited Partners Under New Tax Shelter Investment Regulations be Reconciled with Section 7 of the Uniform Limited Partnership Act, 26 Okla L.R. 289 (1973); Comment, Proposed Regulation of Limited Partnership Investment Programs, 6 U. Mich. J.L. Reform 465 (1973); Comment, Regulation of Real Estate Syndicates: An Overview, 49 Wash. L.R. 137 (1974).

53. The regulation actually includes two additional corporate characteristics (having associates and having an objective to carry on business for gain) which are disregarded in making the association determination since
Section 7701 provides that continuity of life will exist if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will not cause a dissolution of the organization. The partnership may avoid this characteristic either by agreement or by the operation of state law. The Louisiana Civil Code provides that a partnership will dissolve upon the death, interdiction or bankruptcy of a partner unless the partnership agreement stipulates otherwise, and it allows a partner to dissolve a partnership if he does so reasonably and in good faith or if he has just cause when the partnership was formed with a limitation of time. Thus an agreement forming a partnership in commendam that does not contravene the foregoing provisions of the Civil Code will avoid the corporate characteristic of continuity of life.

Section 7701 also provides that centralization of management exists when the authority to make operational decisions rests with a person or group of persons constituting less than all of the members of the organization. Though a partnership in commendam would seemingly have centralized management by definition since the commendatory partners may not participate in the operation of the enterprise, section 7701 indicates that centralized management will not exist unless substantially all the interests in the partnership are owned by the limited partners. Whether the interest of a general partner may be comprised of capital investment, a share of anticipated profits (a "carried interest") or either, remains a matter of speculation, however,


54. Id. § 301.7701-2(b) (1), (2) T.D. 6797, 30 Fed. Reg. 1116 (1965).

55. Under Treas. Reg. §§ 301.7701-2(b) (2), (3) T.D. 6797, 30 Fed. Reg. 1116 (1965), a partnership will not be deemed a taxable association if local law provides that any of the occurrences noted above causes a dissolution, or if local law authorizes a partner to terminate the partnership agreement despite any provisions therein against terminating prior to a stated date or to the completion of a specified undertaking, or if the partnership continues by election of the surviving partners after the death or withdrawal of a general partner has dissolved the partnership under local law.

56. LA. CIV. CODE arts. 2881, 2883.

57. Id. arts. 2884, 2887.


60. The Rulings Branch of the Internal Revenue Service has taken the view that, if the general partner owns twenty percent of the partnership interest, the limited partners will not be considered owners of substantially
as does whether the substantiality of this interest is to be computed on the basis of its absolute cash value or upon its proportional value in the aggregated partnership interests.\textsuperscript{61}

Limited liability exists under section 7701 when the general partner of a commendatory partnership has assets so insufficient as to effectively insulate him from personal liability for third-party claims against the partnership and therefore he acts merely as a dummy or agent of the limited partners.\textsuperscript{82} The Internal Revenue Service has not clarified the matter of the sufficiency of the general partner's assets. If the general partner is an individual, section 7701 apparently means that he must have substantial assets to put at the risk of the business but not necessarily enough to pay all the debts of the partnership upon default;\textsuperscript{63} if the general partner is a corporation, the Service requires that it have a specific net worth dependent upon the capitalization of the partnership venture.\textsuperscript{64}

\textsuperscript{61} One writer has noted that a recent private ruling of the Internal Revenue Service concluded that a limited partnership would \textit{not} be taxed as a corporation although the cash contribution of the general partner totalled only $1,500,000, or 1.8 percent of the aggregate partnership interests of $80,000,000. Comment, \textit{Texas Limited Partnership as a Vehicle for Real Estate Investment}, 3 ST. MARY'S L.J. 13, 20 [1971]. Treas. Reg. § 301.7701-3(b)(2) (1960), however, hypothesizes that centralized management \textit{will} exist where the limited partners invest $5,000,000 and the general partners contribute $300,000, or 5.66 percent of the total investment. It remains unclear not only whether IRS guidelines are based upon the proportional or the cash value of the general partner's interest, but if upon the proportional value, what that value is. The leading case construing the tax classification of the limited partnership held that no centralization of management existed where the general partner contributed forty-two percent of the total capital. Glenned Textile Co. v. Comm., 46 B.T.A. 176 (1942). The fighting zone of the IRS thus lies somewhere between the 1.8 percent of the private ruling and forty-two percent of the Glenned case.


\textsuperscript{63} \textit{Id.} Subsection (d)(2) provides that if the organization is engaged in financial transactions which involve large sums of money, and if the general partners have substantial assets, personal liability exists although the assets of such general partners would be insufficient to satisfy any substantial portion of the obligations of the organization.

\textsuperscript{64} Under Revenue Procedure 72-13, where the limited partners contribute $1-$1,666,667, the corporate general partner must have a net worth of fifteen percent of that sum; where the limited partners contribute $1,666,668-$2,500,000, the corporate general partner must be worth $250,000;
The corporate characteristic of free transferability of interest exists under section 7701 if the members owning substantially all the interests of the partnership have power to substitute one not a member of the organization for themselves without the consent of the other members. The power of substitution must include all attributes of the transferor's interest. Free transferability will not exist, therefore, if the limited partner has the right to assign his interest but may not substitute a new limited partner without the consent of the general partner, nor if the partnership agreement permits him to assign his right to share in the profits but not his ownership of the partnership interest. The transferability of interest will be considered "modified" if each limited partner must give first right of refusal to the other partners. Because "modified" transferability has not been ruled a corporate characteristic, what significance it will have in determining whether taxable association status exists remains unclear.

The Need for Financing without Personal Liability

Although the partnership tax structure seems especially favorable to business ventures incurring losses from excessive initial operating costs, heavy depreciation, or high mortgage debt, the Internal Revenue Code provides that such losses may be passed through to a partner only to the extent of his basis in the partnership. According to principles of general partnership taxation, any increase in a partner's share of partnership liability incurred by depreciation, mortgage indebtedness, and the like, is considered a cash where the limited partners contribute more than $2,500,000, the general partner must have assets totalling ten percent of the contribution. Each partnership for which the corporation serves as general partner will be computed separately; all additional contributions of the limited partners must be taken into account for the purpose of determining the required capitalization of the corporate general partner. In addition, the limited partners in aggregate may not own directly or indirectly more than twenty percent of the corporate general partner. The criteria of Revenue Procedure 72-13 are not tests which may impose the characteristic of limited liability upon the commendatory partnership but are conditions precedent to obtaining a private ruling on that issue alone.

66. Id.
67. Id.
69. INT. REV. CODE OF 1954 § 704(d).
contribution by the partner and correspondingly increases his basis in his partnership interest.\textsuperscript{70} In a commendatory partnership, however, the limited partner's share of such partnership liabilities cannot exceed the difference between his actual contribution and the total contribution he is required to make under the partnership agreement.\textsuperscript{71} Thus a limited partner having made his agreed-upon contribution has no share in the partnership liabilities and any increase in those liabilities adds nothing to his basis: he may not benefit from a passthrough of subsequent losses to the partnership.

The Treasury Regulations provide for an exception to the foregoing rule, however, in the event the partnership obtains financing without any one of the partners assuming personal liability for the mortgage debt. Under Treasury Regulation section 1.752, all of the partners will be deemed to share the liability for interest costs pursuant to additional mortgage financing in the proportion in which they share profits, with a corresponding increase in their individual basis in the partnership. Consequently, if investors in a commendatory partnership seek a tax shelter, they must obtain financing either through a nonrecourse loan, where the creditor may look only to the collateralized partnership asset for payment in the event of default, or through a mortgage loan executed by a "nominee" who later transfers the secured property to the partnership.\textsuperscript{72} Nonrecourse financing may be difficult to obtain, and the use of a nominee transferor may invite the Internal Revenue Service to claim that the partnership is not the true owner of the freely assigned property. If either of these methods of financing fail, of course, the general basis rule prevails and the passthrough of interest costs to each limited partner will be restricted to the value of his initial or promised contribution.

**Tax Consequences of Disposing of Partnership Property by the Partnership or the Investor**

An inevitable tax problem facing the investor in a partnership \textit{in commendam} arises upon the need to dispose of partnership property, which may occur either by the partnership transferring its property, or by a partner transferring

\begin{itemize}
\item \textsuperscript{70} \textit{Id.} §§ 722, 752(a).
\item \textsuperscript{71} Treas. Reg. § 1.752-1(e) (1960).
\item \textsuperscript{72} See Andeel, \textit{Use of Limited Partnerships in Real Estate Development}, 41 J.B.A. KAN. 371 (1972) for possible solutions to this problem.
\end{itemize}
his interest in the partnership.\textsuperscript{73} Under ordinary circumstances, a sale in either instance will be governed by sections 1001 and 1002 of the Internal Revenue Code, which provide that the amount realized over the adjusted basis of the partner or partnership in the property so sold shall be income subject to taxation. The partnership, however, may often own a single asset, e.g., an apartment complex or shopping center, that is valued in large measure because of the tax shelter it provides, and that has been depreciated past the schedule of mortgage amortization payments so that the unamortized debt is in excess of the partnership's adjusted basis. Should the partnership sell such an asset (and so dissolve) under circumstances in which the buyer assumes or takes subject to the mortgage, the partnership will realize a substantial gain even though it receives only token cash or other property in exchange. Thus under the rule of \textit{Crane v. Commissioner,}\textsuperscript{74} if the fair market value of the property sold equals or exceeds the mortgage debt, the full amount of that debt must be included in the amount realized by the partnership on the sale, regardless of the amount of cash or other property changing hands, with the result that the partnership becomes liable for tax under sections 1001 and 1002 for the sum of the cash, if any, received in addition to the value of the mortgage balance outstanding.\textsuperscript{75}

\textsuperscript{73} Adverse tax consequences may result inadvertently should the partnership sell or exchange fifty percent or more of the total interest in partnership capital and profits within a twelve month period. Under § 708(b)(1) of the Internal Revenue Code of 1954 and Treas. Reg. 1.708-1(b)(1)-(iv) (1960), however fortuitous the circumstances of the disposition, the partnership will be considered to have terminated and a new partnership, consisting of the purchaser and the remaining partners, to have come into being for tax purposes. Because the partnership has been liquidated and reorganized, moreover, the successor partnership may not qualify as the first user of partnership property and thus may not enjoy the benefits of accelerated depreciation.

\textsuperscript{74} 331 U.S. 1 (1947).

\textsuperscript{75} The consequences of sale of property by the partnership may be mitigated if an installment sale election is available under § 453 of the INT. REV. CODE OF 1954. Treas. Reg. § 1.453-4(c) (1960) provides that an installment sale election may be made only if the payments received in the year of sale do not exceed thirty percent of the selling price, which includes cash received plus the amount of any mortgages or liens on the property sold. In addition, Treas. Reg. 1.1245-6(d)(2) T.D. 7084, 36 Fed. Reg. 269 (1971) provides and \textit{Dunn v. Commissioner}, 323 F. Supp. 440 (N.D. Ala. 1971), has held, that the taxable portion of each installment payment constitutes ordinary income to the extent of the depreciation recapture, so that gain on the installment
Related tax consequences arise under the “recapture” provisions of sections 1245 and 1250 of the Internal Revenue Code when a partnership sells depreciable property used in trade or business. Under section 1245, if such depreciable personal property is sold at a gain, the amount of gain attributable to depreciation allowances will be treated as ordinary income.\textsuperscript{76} Gain so attributable is computed by adding to the basis of the asset the depreciation or amortization deductions taken since section 1245 became effective in 1962; gain up to the recomputed basis is ordinary income and the remainder is capital gain or section 1231 gain (treated as capital gain) according to the nature of the asset.\textsuperscript{77} Section 1250 provides for similar recapture of accelerated depreciation deductions taken on real property, that is, deductions in excess of those allowable by the straight-line method of depreciation.\textsuperscript{78}

Similar tax problems beset the partner who seeks to sell his interest in the partnership \textit{in commendam}. Under sections 1001 and 1002 of the Internal Revenue Code, sale of a partnership interest produces gain equal to the excess of the amount realized on the sale over the partner’s adjusted basis for his interest. When the partnership owns mortgaged property, the partner may realize taxable income substantially in excess of the cash he receives because, under Internal Revenue Code section 752(d), he must include his share of the partnership’s liabilities in the amount realized on the sale of his interest regardless of whether he had any personal liability for the debt. Moreover, under section 751(a), gain realized on the transfer of a partnership interest is ordinary income rather than capital gain to the extent that such gain is attributable to substantially appreciated partnership inventory or uncollected receivables, including gain on the sale of depreciable property must be reported initially as ordinary income until all of the recapture income has been absorbed.

\textsuperscript{76} \textit{INT. REV. CODE OF 1954} § 1245(a)(1). The operative provision is that gain from the depreciation of § 1245 property “shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in § 1231” (property used in trade or business held for more than six months)—i.e., as ordinary income rather than capital gain.

\textsuperscript{77} Id. § 1245(a)(1)-(2).

\textsuperscript{78} Id. § 1250(a)(1). Residential rental property and rehabilitation property receive more favorable treatment than other kinds of property, but it must be held for 100 months before excess depreciation becomes reduced at the rate of only one percent per month.
preciable property that would have resulted in recapture under sections 1245 and 1250.79

Possible Abuse of the Commendatory Partnership by the General Partner

Beyond the possible abuse to investors caused by nondisclosure or misrepresentation in violation of state and federal securities laws,80 the general partner may exploit the partnership through the powerful bargaining position he enjoys by acting as syndicator or promoter, and later as manager, of an enterprise which typically attracts a number of investors who seek to own small individual interests in the partnership.81 In his role of syndicator and promoter, a general partner may impose upon eager investors a contract of adhesion enabling him to obtain on demand or at scheduled intervals assessments from the limited partners which may protect him from losses occasioned by his own poor management and may also neutralize his investors' leverage or mitigate their limited liability. In addition, the general partner may induce investors to enter a blind pool agreement,

79. A partner may mitigate the tax consequences of selling his partnership interest if an installment sale election under § 453 of the INT. REV. CODE OF 1954 is available to him. Under § 751, the partner must segregate the sale proceeds so that gain attributable to assets subject to depreciation recapture will be considered separately from gain attributable to other partnership assets. Thus a portion of each installment payment will constitute ordinary income because of depreciation recapture provisions of §§ 1245 and 1250 and the balance will qualify as capital gain. A partner may also mitigate tax consequences if he reinvests concurrently the value of his tax liability (so avoided by the depreciation loss passthrough of the partnership venture) into a second venture aiming for appreciation and capital gain or a positive cash flow, or if he incorporates his interest in the tax-sheltered venture into his estate plan on the assumption that, under Internal Revenue Code § 1014(a), his legatees will receive that asset with a stepped-up basis equal to its fair market value at the time of his death or the alternate valuation date.

80. See authorities cited in note 52, supra.

81. For more extensive analysis of this problem, see Augustine & Hrusoff, Public Real Estate Limited Partnerships, 27 BUSINESS LAWYER 615 (1972); Comment, Special Problems of Public Limited Partnerships: Investment Fees and Transferability of Interest, 7 CALIF. WESTERN L.R. 58 (1970); Comment, Proposed Regulation of Limited Partnership Investment Programs, 6 U. MICH. J.L. REFORM 465 (1973); Comment, Regulation of Real Estate Syndications: An Overview, 49 WASH. L.R. 137 (1974); Comment, Public Limited Partnerships in Northwest Real Estate Syndication, 7 WILLAMETTE L.J. 74 (1971).
wherein the investment of partnership funds is limited only generically to land purchases, construction projects, oil and gas ventures, and the like, which maximizes his discretion and puts him in a position to invest only in assets from which he personally derives a profit, perhaps at the expense of the partnership.

Acting as sole manager of the partnership business, a general partner may advance his interests at the expense of his investors by receiving kickbacks from confederates to whom he has distributed the partnership's contracted work or by granting himself, from partnership funds, interest-free loans that subsequently may be forgiven. He may profit at the expense of the partnership by paying to himself or an associate fees for locating or acquiring property, for example, without disclosing that such property has previously been bought or optioned by himself or an agent, or by purchasing property from an associate and selling without disclosure to the partnership at a higher rate, or by selling property already owned by the partnership to an associate at less than fair market value. If the general partner is a corporation, moreover, its directors may abandon the venture at will, leaving new directors with whom the limited partners will have little recourse should the management policies of the partnership subsequently change.\(^\text{82}\)

**Conclusion**

Although the partnership *in commendam* fully deserves the accolades it has received as an effective and adaptable investment vehicle, prospective general and commendatory partners alike should familiarize themselves with its inherent risks. The pitfalls of the commendatory partnership as a business form devolve both from the adversary position of the Internal Revenue Service, which scrutinizes the agreement between the partners and the particulars of their business operation, and from the often conflicting interests of the general and the limited partners, which create the possibility of management abuse. Therefore investors who contemplate joining a partnership *in commendam* as limited partners should do so only under circumstances in which the partnership agreement is in full accord with the ULPA, in addition to

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\(^{82}\) See Note, *Standing of Limited Partner to Sue Derivatively*, 65 COLUM. L.R. 1463 (1965); Note, 40 N.Y.U. L.R. 1174 (1965).
the provisions of the Louisiana Civil Code, and in which their prospective general partner has such integrity and ability as to merit their complete trust. The partnership in commendam may be a beneficial form of business, but its success depends ultimately upon the ability of the limited and the general partner to work together in shaping their venture to meet their mutual interests.

Nicolai von Kreisler

83. For general drafting suggestions for the partnership agreement, see Bernstein, Limited Partnerships—Their Use in Real Estate Syndications, 46 Taxes 549, 554 (1968).