

THE SPONSORING OF LOW- AND MODERATE-INCOME HOUSING THROUGH LOCAL LIMITED PARTNERSHIPS HAVING NONPROFIT CORPORATE GENERAL PARTNERS

INTRODUCTION

The National Housing Act of 1949 called for "the early realization . . . of a decent home and suitable living environment for every American family."¹ Although some progress has been made toward this goal,² there remains a continuing need to provide satisfactory housing, at affordable rents, to lower-income families.³ In 1967, the President's Committee on Urban Housing (the Kaiser Committee) was given the task of quantifying the national housing need and making recommendations for the fulfillment of two basic housing goals.⁴ The first goal was to accelerate "the production and rehabilitation of decent housing for the poor."⁵ The second was to maximize "private participation in developing, sponsoring, and managing federally-subsidized housing."⁶

The Committee determined that satisfaction of the national housing need in the seventies would require at least twenty-six million new and rehabilitated units; of these, the Committee recommended that six to eight million be federally-subsidized dwellings for families unable to compete in the private housing market.⁷ The Committee also determined that the traditional sources of housing production would be inadequate to meet these goals.⁸ A survey of business attitudes prepared for the Kaiser Committee indicated that American industry had not been sufficiently attracted to the low- and moderate-income housing

¹ Housing Act of 1949, ch. 338, § 2, 63 Stat. 413, as amended, 42 U.S.C. § 1441 (1970).

² Kristof, *Urban Housing Needs Through the 1980's: An Analysis and Projection*, Research Rep. No. 10, xi, 4 (1968) (prepared for the Nat'l Comm'n on Urban Problems) [hereinafter cited as Kristof]. Much of the progress is attributable to the efforts of non-profit sponsors of low- and moderate-income housing, who have participated in federally-assisted programs. As of June, 1967, 62,000 units of § 221(d)(3) below-market-interest-rate housing were either completed or under construction. Approximately one-half of these units were produced by profit-motivated sponsors and one-half by nonprofit and cooperative sponsors. Under the § 202 program for elderly housing, 23,000 units were sponsored by nonprofit corporations. Report of the President's Comm. on Urban Housing, *A Decent Home* 64 (1968) [hereinafter cited as *A Decent Home*.]

³ Kristof, *supra* note 2, at xiv.

⁴ Appointed by the President in June, 1967, the Kaiser Committee was assigned the task of "find[ing] a way to harness the productive power of America . . . to the most pressing unfulfilled need of our society. That need is to provide the basic necessities of a decent home and healthy surroundings for every American family now imprisoned in the squalor of the slums." *A Decent Home*, *supra* note 2, at 1.

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at 8. The report noted that since the beginning of federal housing subsidy programs in the 1930's, only 800,000 subsidized units had been built; the annual rate of production at the time of the report was approximately 50,000 units. Thus the report recommended a twelve to fifteen hundred percent increase in annual average production of federally subsidized units. *Id.* at 9.

⁸ *Id.* at 47.

field.⁹ The primary reasons for this disinclination appeared to be (1) the uncompetitively low rate of return on housing investment; and (2) the lack of experience on the part of private industry in the management of housing for low- and moderate-income families, and the inability of private industry to devote "substantial time to occasional housing ventures."¹⁰

In order to increase the attractiveness of private participation; the Kaiser Committee recommended the creation of a new instrument of private enterprise: the National Housing Partnership (NHP). As conceived by the Committee, and later enacted by Congress in the Housing and Urban Development Act of 1968,¹¹ the NHP is a limited partnership consisting of a corporate general partner (the National Corporation for Housing Partnerships),¹² and investors who are stockholders in the corporation or limited partners in the limited partnership, or both.¹³ The function of NHP is to sponsor low- and moderate-income housing by entering into limited partnerships with local developers and nonprofit groups.¹⁴ NHP participates in these local limited partnerships as a limited partner and it may also participate as a general partner. However, it usually obtains the tax benefits distributable to its national investors by participating as a limited partner.¹⁵

In addition to creating NHP, Congress recognized the possibility of using purely local limited partnerships, without NHP participation, but employing the same tax incentives, in order to further the same housing goals.¹⁶ However, in contrast to the detailed provisions for the design of NHP, the Act prescribes no formula for the structure of purely local partnerships having no NHP participation. The legislation indicates only that the creation of NHP in no way precludes the creation of other partnerships to achieve the same congressional objectives,¹⁷ and sponsors are presumably free to organize local partnerships in accordance with the laws of their own jurisdictions. Both the local limited partnerships and the NHP are designed to overcome the private investors' objections to participation in the development of low- and moderate-income housing. Inducement is provided by (1) increasing

⁹ *Id.* at 85.

¹⁰ Message of President Johnson, *The Crisis of the Cities*, Feb. 1968, in *A Decent Home*, *supra* note 2, at 86.

¹¹ Housing and Urban Development Act of 1968 §§ 901-11, 42 U.S.C. §§ 3931-41 (1970).

¹² 42 U.S.C. §§ 3933(a), 3936(b)(2), 3937(d) (1970).

¹³ 42 U.S.C. §§ 3933(c), 3937(f),(g) (1970).

¹⁴ 42 U.S.C. §§ 3936(b)(1),(2),(4),(5) (1970).

¹⁵ See Burgess & Friedberg, *NHP—A New Opportunity For Housing*, 39 *Geo. Wash. L. Rev.* 870, 884-87 (1971).

¹⁶ 42 U.S.C. § 3932(c) (1970) provides, in relevant part:

Nothing in this chapter shall be construed to preclude private persons from creating other corporations and organizing other partnerships, joint ventures, or associations for the purposes set forth in this chapter. . . .

Id.

¹⁷ *Id.*

the investors' return through use of the limited partnership form, which allows depreciation losses to be "passed through" to each investor; and (2) permitting investors to assume a passive position by the delegation of management responsibility to the general partner.¹⁸

Thus, as a result of the Act, local investors and organizations, including nonprofit corporations, can sponsor federally-assisted housing by either joining with NHP or organizing purely local partnership syndicates. For several reasons, many potential local sponsors may find use of the purely local limited partnership to be a more attractive device for developing publicly-assisted housing. Some sponsors may feel that involvement with NHP creates a layer of remote bureaucracy and reduces local control; or that NHP involvement is unnecessary since talent and capital are locally available; or that such a relationship would bestow upon the national investors benefits which are otherwise locally distributable. For such local sponsors who do not desire NHP involvement, a local limited partnership having a nonprofit corporate general partner and profit-motivated limited partners seems to satisfy the aims of both the nonprofit and profit motivated participants and to implement the congressional objectives expressed in the Housing and Urban Development Act of 1968. This vehicle offers many of the advantages derivable from NHP participation; but it also presents certain disadvantages not present with NHP participation.

The advantage for the nonprofit corporate general partner wishing to sponsor federally-assisted housing is the availability of additional capital derived from private limited-partner investors.¹⁹ While

¹⁸ See *A Decent Home*, supra note 2, at 86. The tax benefits which the owners of new rental residential property receive are of two types. Some were allowed prior to the Tax Reform Act of 1969 and were retained for all new rental residential property. Others were enacted in the Tax Reform Act as incentives for participation in low- and moderate-income housing. Among the changes made were (1) limiting the use of double declining balance and sum of the years' digits depreciation methods solely to new residential rental property, Int. Rev. Code of 1954 § 167(j)(2)(B); (2) reducing the depreciation allowances for commercial, industrial, and used residential uses, id. at § 167(j)(1),(4),(5); (3) requiring 100% recapture of post-1969 excess depreciation as ordinary income rather than capital gains for real property other than residential rental property; and (4) allowing residential rental real property other than certain federally-assisted housing to continue to be eligible in order to avoid excess recapture, but only at 1% per month when held after 100 full months, id. at § 1250(a)(1)(C)(iii).

Additional tax benefits for those sponsoring new federally-assisted housing under § 236 of the National Housing Act involve (1) permitting recapture reduction for post-1969 excess depreciation under the pre-1969 method of a 1% reduction per month after the first 20 full months holding period, id. at § 1250(a)(1)(C)(ii); a 10 year holding period thus fully avoids recapture of depreciation as ordinary income; and (2) encouraging developers to sell the project to tenants and to reinvest in other federally-assisted projects. Section 1039 provides that no gain will be recognized to a taxpayer-sponsor on a qualified sale to tenants if within the allowed reinvestment period such sale proceeds are fully reinvested in other federally-assisted low-income housing, id. at § 1039. See Ritter & Sunley, *Real Estate & Tax Reform: An Analysis and Evaluation of the Real Estate Provisions of the Tax Reform Act of 1969*, 30 Md. L. Rev. 5 (1970).

¹⁹ *A Decent Home*, supra note 2, at 91.

nonprofit sponsors have proved to be significant and successful producers of housing for low- and moderate-income families without using the partnership device,²⁰ they have frequently been undercapitalized²¹ and unable to provide either pre-construction project development funds or community facilities and social services. The tenant counselling; child care and other ancillary community facilities which nonprofit groups wish to provide are made possible by the additional capital from private investors. As a tax-exempt organization, the nonprofit corporation does not benefit from the tax shelters generated by a large rental project.²² Consequently, part of the benefits which the corporation makes available to its limited partners would be valueless if retained by the former. Moreover, as a general partner, the nonprofit corporation maintains control of the project management.²³

For the private investor, the limited partnership is an attractive investment form, permitting him, as a limited partner, to confine his liability to the amount of his contribution. His liability will remain limited as long as he does not participate in the control of the business.²⁴ The limitation on liability is essential for the purpose of marketing the interests on a competitive basis with other portfolio investments. In addition, limited partners enjoy a passive position which requires little participation beyond the initial investment.²⁵ Unlike the corporate form,²⁶ the limited partnership permits full distribution of profits to the partners without incurring double taxation.²⁷ Losses may similarly be "passed through" to the partners to offset other income.²⁸ Thus, the nontax corporate advantages and the tax advantages of a noncorporate form make the limited partnership form desirable as a vehicle for investment in a federally-subsidized housing development.

Nonetheless, there may be disadvantages in not joining with the NHP. Without NHP participation, a local limited partnership may risk increased exposure to the dangers which the enabling legislation

²⁰ See note 2 *supra*.

²¹ See *A Decent Home*, *supra* note 2, at 91.

²² Treas. Reg. § 1.6033-1 (1971) requires exempt organizations to file only an informational return.

²³ Under the Uniform Limited Partnership Act § 7, limited partners may not take part in the control of the business without losing their limited liability status.

²⁴ *Id.* §§ 7, 17(1).

²⁵ *Id.* § 7.

²⁶ Int. Rev. Code of 1954, § 11 imposes a tax on corporate income; § 1 imposes a tax on individual income, and § 61(a)(7) includes dividends in individual income. Hence the income of a corporation is taxed both at the corporate level and when distributed to stockholders.

²⁷ Int. Rev. Code of 1954, § 701 provides that partnerships are not subject to the income tax and that only the partners as individuals have tax liability. *Id.* at § 704 permits the partnership losses to pass through to the individual partner. The owners of an FHA-insured project may take depreciation deductions for the entire cost of the project even though 90% is financed with borrowed money. *Id.* at §§ 167(j),(k). See also Burgess & Friedberg, *NHP—A New Opportunity for Housing*, 39 *Geo. Wash. L. Rev.* 870, 876 (1971).

²⁸ Int. Rev. Code of 1954, § 704.

eliminated with respect to NHP. Indeed, fundamental questions affecting the creation and viability of the local limited partnership having a nonprofit corporate general partner were left unanswered by the congressional legislation. The principal issues are (1) the capacity of a nonprofit corporation to become a partner; (2) the effect which such participation has on the nonprofit corporation's federal income tax exemption; and (3) the classification of the limited partnership for federal income tax purposes.

In respect to the NHP, Congress explicitly authorized the National Corporation for Housing Partnerships to operate as the general partner of the partnership²⁹ and assured that the tax savings would pass through to individual investors.³⁰ However, no such specific authorization or assurance appears with respect to local partnerships.³¹ Indeed, it is questionable whether Congress could enter this area of local law. Furthermore, the Housing and Urban Development Act of 1968 makes no mention of the status of the tax exemption of a nonprofit corporation when such a corporation participates in a partnership which generates benefits for the limited partners.

The purpose of this comment is to analyze these problems in order to determine the feasibility of using a local limited partnership to achieve the national housing objectives expressed in the Housing and Urban Development Act. The comment concludes that:

1. In an increasing number of jurisdictions there is a present trend, reversing the common law prohibition; toward permitting corporations, including nonprofit corporations, to join partnerships. For example, in Massachusetts and in those states which have adopted the relevant provision of the ABA-ALI Model Nonprofit Corporation Act, nonprofit corporations are authorized to become partners.
2. Based upon the purpose and practices of nonprofit corporations in local limited partnerships which sponsor federally-assisted housing, and the requirements of the Internal Revenue Code and the relevant case law, strong arguments can be made for a federal income tax exemption for such corporations. The arguments are twofold: the provision of low- and moderate-income housing is a function warranting an exemption; and the benefits accruing to the investing partners are merely incidental to that exempt function.
3. A local limited partnership having a nonprofit corporate general partner is able to qualify as a partnership for the purpose of using the same tax advantages used by the

²⁹ 42 U.S.C. § 3937(d) (1970).

³⁰ See *A Decent Home*, *supra* note 2, at 86.

³¹ 42 U.S.C. § 3932(c) (1970) is silent on the question of tax benefits to investors in non-NHP partnerships.

NHP in low- and moderate-income housing ventures. The major obstacle which must be overcome in achieving partnership tax classification is not the test articulated in the Treasury Regulations, but a series of guidelines used by the Individual Income Tax Rulings Branch.

I. CORPORATE PARTICIPATION IN PARTNERSHIPS

The first consideration in determining the feasibility of using local limited partnerships to achieve national housing objectives is whether a nonprofit corporation can be a general partner in a limited partnership. Both partnership and corporation law bear on the problem. Partnership law is relevant insofar as it relates to those eligible to become partners, while corporation law determines whether corporations have the power to join partnerships. In jurisdictions which have adopted both the Uniform Partnership Act (UPA) and the Uniform Limited Partnership Act (ULPA),³² corporations appear eligible to become both general and limited partners. Both acts require only that partners be "persons."³³ Since corporations are considered persons,³⁴ they appear to be eligible for partnership participation under the uniform acts.³⁵

However, corporate power to enter partnerships is primarily determined by corporation, not partnership law.³⁶ Under the common law, the courts generally adhered to a strict interpretation of corporate power and purposes, finding that corporate membership in partnerships was *ultra vires*, unless the corporate enabling statute or the corporate charter provided explicit authorization.³⁷ In Massachusetts, for example, it was early held, in *Whittenton Mills v. Upton*,³⁸ that a cotton manufacturing company lacked power to enter a partnership because there existed no express authorization for the corporation to enter a partnership under either the corporate enabling act or the corporate charter.³⁹ Absent such authorization, the court stated, the common law prohibition against the corporate partner would control.⁴⁰

The court justified the prohibition on the ground that the mutual agency relationship of partners, which permits each partner to bind

³² Thirty-eight states and the District of Columbia have adopted both the UPA and the ULPA. The states which have adopted only the UPA are Delaware, Kentucky, Oregon and Wyoming. Those which have adopted only the ULPA are Hawaii, Iowa, Kansas and Mississippi. New Hampshire, Alabama, Louisiana, and Maine have adopted neither. 6 Uniform Laws Ann. 5, 25 (Master ed. Supp. 1971).

³³ Uniform Partnership Act § 6(1); Uniform Limited Partnership Act § 1.

³⁴ Uniform Partnership Act § 2.

³⁵ This view has found judicial support in *Port Arthur Trust Co. v. Muldrow*, 155 Tex. 612, 616, 291 S.W.2d 312, 315 (1956).

³⁶ 6 Uniform Laws Ann., Uniform Partnership Act § 6(1), Comment 1 (Master ed. 1969).

³⁷ See generally Annot., 60 A.L.R.2d 917, 920 (1958).

³⁸ 76 Mass. (10 Gray) 582 (1858).

³⁹ Id. at 597.

⁴⁰ Id.

the other, conflicts with the statutory requirement that a corporation be controlled by its board of directors.⁴¹ This mutual agency creates the danger that the corporate assets may be exposed to risks which the stockholders had not contemplated at the time of their investment.⁴² For example, the partnership might choose to enter a new area of commercial activity involving greater risks than that in which the corporate stockholders initially sought to invest. *Whittenton* engendered a series of decisions which followed the strict prohibitory rule.⁴³ In other jurisdictions, the mutual agency argument and public policy have been emphasized in reaching the same conclusion.⁴⁴

The common law prohibition against corporate participation in partnerships is a manifestation of the suspicion and antipathy which greeted the expanded use of the corporate form in the last century.⁴⁵ Corporate activity has traditionally been carefully limited. Indeed, "[u]ntil comparatively recent times . . . corporations were burdened with sharp statutory restrictions on their longevity and size."⁴⁶ Frequently, corporations were limited by fixed terms of existence and ceilings on capital.⁴⁷ Today, however, there is no longer a public policy or a general legislative intent to unduly restrict implied corporate powers, "provided these implied powers are not opposed to positive law, and are necessary or convenient in the furtherance of [the corporation's] express powers."⁴⁸ The popularity of the corporate form is evidenced by the fact that most of the business in the United States is done by corporations.⁴⁹ The continuously expanding use and wide acceptance of the corporate form renders the common law prohibition against the corporate partner archaic and impractical;⁵⁰ the rule unnecessarily restricts corporate activity.⁵¹ The arguments of mutual agency and "uncontemplated risk to capital" are clearly untenable today, as corporations frequently appoint general agents who have the authority to bind the corporation and to expose corporate assets to risks.⁵² It is incongruous to continue to disapprove of corporate mem-

⁴¹ *Id.* at 596.

⁴² *Id.* at 598.

⁴³ See e.g., *Williams v. Johnson*, 208 Mass. 544, 552, 95 N.E. 90, 93 (1911); *Hosher-Platt Co. v. Miller*, 238 Mass. 518, 523, 131 N.E. 310, 313 (1921); *Rosenblum v. Springfield Produce Brokerage Co.*, 243 Mass. 111, 115-16, 137 N.E. 357, 359-60 (1922).

⁴⁴ See *People v. North River Sugar Ref. Co.*, 121 N.Y. 582, 623-24, 24 N.E. 834, 840 (Sup. Ct. 1890); *Sabine Tram Co. v. Bancroft*, 16 Tex. Civ. App. 170, 174-75, 40 S.W. 837, 839 (1897).

⁴⁵ See Rowley, *The Corporate Partner*, 14 Minn. L. Rev. 769, 777 (1930) [hereinafter cited as Rowley].

⁴⁶ 1 CCH Corp. L. Guide ¶ 101 (1971).

⁴⁷ See Justice Brandeis' dissenting opinion in *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 549-54 (1933).

⁴⁸ See Rowley, *supra* note 45, at 777-78.

⁴⁹ 1 CCH Corp. L. Guide ¶ 102 (1971).

⁵⁰ See Rowley, *supra* note 45, at 777.

⁵¹ See generally Rowley, *note 45 supra*.

⁵² *Id.* at 771-73.

bership in partnerships while permitting the same risks to arise elsewhere under the corporate form.

Even assuming some logical relevance of the common law rule to a general partnership, the validity of applying the rule to a limited partnership having a nonprofit corporation as the sole general partner is difficult to discern. As one noted commentator has observed, "[t]he reason for the rule preventing a corporation from forming a partnership . . . namely delegation of authority, does not apply to a partnership agreement by which the entire management of the business is reserved to the corporation."⁵³ A limited partnership with a nonprofit corporate general partner presents precisely such a situation. No mutual agency would bind the corporation, since the limited partners are denied participation in the control of the business.⁵⁴ The nonprofit corporation would have control of its own assets as well as those of the limited partnership. Thus the limited partners could not expose the assets of either the corporation or the partnership to risks without acting in contravention of the partnership agreement and the ULPA.

Realizing that the reasons for the common law rule are outmoded, courts and legislatures in many jurisdictions have either eroded or abrogated the rule. For example, a limited partnership exception to the strict rule was recognized in *Port Arthur Trust Co. v. Muldrow*.⁵⁵ In that case the Supreme Court of Texas ordered the Secretary of State to file the certificate of a limited partnership, having a corporate limited partner, which was intended to serve as trustee for a number of trusts. The charter of the corporation included authorization to serve as a trustee under any lawful express trust. The court held that where the Corporation Code permitted a corporation to act as a trustee, and where this power was granted by the corporate charter, the corporation could enter a limited partnership dealing with trusts.⁵⁶ The court's rationale acknowledged that the assets of a corporation in a limited partnership are not exposed to unanticipated risks created by the mutual agency relationship; since the corporation maintains control of its assets,⁵⁷ and since the corporate directors continue to manage the corporation's business affairs, as required by law. Although the case concerned only the power of the corporation to serve as a limited and not a general partner, it indicates a judicial willingness to regard the traditional common law prohibition differently in a limited partnership situation. The important aspect of the decision is not that the corporation was permitted to act as a limited partner; rather, it is that the court recognized the validity of a corporation's participation in a situation lacking the mutual agency which exists in a general partnership.

⁵³ H. Ballantine, *Ballantine on Corporations* 236 (1946).

⁵⁴ Uniform Limited Partnership Act § 7.

⁵⁵ 155 Tex. 612, 291 S.W.2d 312 (1956).

⁵⁶ *Id.* at 615-16, 291 S.W.2d at 314-15.

⁵⁷ *Id.* at 614, 291 S.W.2d at 314.

In many other jurisdictions, perhaps in response to a desire for consistency with the uniform partnership acts and because of an increased respect for corporations generally, the change has occurred by statute. The Model Business Corporation Act, adopted in a number of jurisdictions, expressly authorizes the participation of business corporations in partnerships.⁵⁸ Similarly, the New York⁵⁹ and Delaware⁶⁰ corporation statutes provide that corporations may become partners. Thus, where the uniform partnership acts have been adopted and where statutory or charter authority exists; business corporations clearly may become partners.⁶¹

Although there appears to be no case regarding the question of the participation of nonprofit corporations in partnerships, the arguments for and against such participation are the same as those regarding participation by business corporations. The recent statutory trend has been toward permitting nonprofit corporations the same powers as business corporations, including the right to enter partnerships.⁶² In jurisdictions which have either wholly or in relevant part adopted the Model Nonprofit Corporation Act, corporations organized under its authority are given the same express power to enter partnerships⁶³ as that provided to corporations organized under the Model Business Corporation Act. Neither of these statutes distinguishes between the

⁵⁸ ABA-ALI Model Business Corporation Act §§ 4(g),(p) (rev. 1969). The Act has been adopted substantially in full by the following states: Wisconsin (1951), Oregon (1953), District of Columbia (1954), Texas (1955), Virginia (1956), North Dakota (1957), Alaska (1957), Colorado (1958), Iowa (1959), Wyoming (1961), Utah (1962), Mississippi (1962), Nebraska (1963), Arkansas (1965), South Dakota (1965), and Washington (1965). 1 CCH Corp. L. Guide ¶ 111 (1965).

⁵⁹ N.Y. Bus. Corp. Law § 202(a)(15) (McKinney 1961).

⁶⁰ Del. Code Ann. tit. 8, § 122(11) (1969).

⁶¹ The CCH Corporation Law Guide indicates that the business corporation statutes in the following thirty-two jurisdictions permit corporations to enter partnerships: Alaska, Arkansas, Colorado, District of Columbia, Florida, Georgia, Hawaii, Illinois, Iowa, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Missouri, Nebraska, Nevada, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, South Dakota, Tennessee, Vermont, Virginia, Washington, Wisconsin and Wyoming. 1 CCH Corp. L. Guide § 649 (1971).

⁶² ABA-ALI Model Nonprofit Corporation Act § 5(g) (1964 ed.) The Model Nonprofit Corporation Act was drafted in 1952, revised in 1957 and again in 1964 by the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association. The revisions were made for the purpose of "bringing the text still more closely in accord with the Model Business Corporation Act." ABA-ALI Model Nonprofit Corporation Act Practice Handbook viii (1964). The expected result is that decisions and commentaries under the Model Business Corporation Act will be helpful in interpreting and applying the Model Nonprofit Corporation Act. This Act has been adopted in Wisconsin (1953), Alabama (1955), North Carolina (1956), Virginia (1956), Nebraska (1959), and the District of Columbia (1962). *Id.* at x. In addition, the statutes of Illinois, Missouri and Ohio are "similar to the Model Act in substantial respects." *Id.*

⁶³ ABA-ALI Model Nonprofit Corporation Act § 5(g) (1964 ed.) provides that corporations have the power to "purchase, take, receive, subscribe for, or otherwise acquire, own, hold, vote, use, employ, sell, mortgage, lend, pledge, or otherwise dispose of, and otherwise use and deal in and with . . . partnerships"

powers to join general or limited partnerships. In these jurisdictions the common law arguments against the corporate partner apparently have been overcome by the practical need for flexibility in corporate activity.

In Massachusetts the *Whittenton* rule has finally been statutorily abrogated. In 1969 the Legislature amended the Business Corporation Act to permit business corporations to become partners if authorized to do so by their articles of organization.⁶⁴ Two years later, nonprofit corporations in Massachusetts were also permitted to include in their articles of organization a provision authorizing partnership membership.⁶⁵ Where, as in Massachusetts, the nonprofit and business corporation statutes are not simultaneously amended, nonprofit corporations desiring to participate in local housing syndicates may seek to circumvent the problem by forming business corporation subsidiaries. This technique was one used in Massachusetts before the recent amendment permitting nonprofit corporate partners.⁶⁶ However, in addition to the confusion and the unnecessary organizational problems created, this situation may seriously compound the question of the nonprofit parent corporation's federal income tax exemption—another fundamental question which must be resolved before a nonprofit corporation enters a local partnership.

II. FEDERAL INCOME TAX EXEMPTION

Once the question concerning the capacity of a nonprofit corporation to participate in a limited partnership has been affirmatively resolved, the feasibility of such participation under the federal tax laws must be determined. The initial inquiry is whether a nonprofit corporation can retain its tax exempt status while sponsoring low- and moderate-income housing through a limited partnership. The basis for the tax exempt status of nonprofit corporations is found in Sections 501(c)(3) and (4) of the Internal Revenue Code of 1954. Under these sections an organization is exempted from federal income taxation if it is operated "exclusively for religious, charitable . . . or educational purposes . . ."⁶⁷ or "exclusively for the promotion of social

⁶⁴ Mass. Gen. Laws ch. 156B, § 9A as amended, Acts & Resolves of 1969, ch. 392, § 7 provides that "to the extent authorized by its articles of organization, a corporation may be a partner in any business enterprises which said corporation would have power to conduct by itself."

⁶⁵ Mass. Gen. Laws Ann. ch. 180, § 6, as amended by Acts & Resolves of 1971, ch. 819, § 6.

⁶⁶ Letter from Fred R. Becker, Ropes and Gray, Boston, Massachusetts to Paul F. McDonough, March 1, 1972 [on file at the office of the Boston College Industrial and Commercial Law Review].

⁶⁷ Int. Rev. Code of 1954, § 501(c)(3). In defining "charitable" the Treasury Regulations include activities such as:

Relief of the poor and distressed or of the under-privileged . . . erection or maintenance of public buildings . . . lessening of the burdens of Government . . . promotion of social welfare . . . [and those helping] (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend

welfare"⁶⁸ Additional prerequisites for the exemption are that the organization's net earnings not inure, either wholly or partly; to private individuals⁶⁹ and that they not be utilized to further nonexempt purposes.⁷⁰

In order to determine whether an organization's activities qualify for the exemption under these statutory provisions, the Internal Revenue Service (IRS) applies both organizational and operational tests.⁷¹ The organizational test requires that the corporate purposes stated in the charter be limited to those specified by the Code as exempt,⁷² and that the express powers of the corporation be restricted so as to preclude corporate action in furtherance of nonexempt purposes, except to an "insubstantial" degree.⁷³ The operational test limits the tax exemption to organizations engaged "primarily in activities which accomplish . . . exempt purposes. . . ."⁷⁴

The relevant case law indicates that providing low-cost housing and related services to low-income families is an exempt purpose when a community interest is served and when government authorization, assistance and participation are present. For example, in *Scofield v. Rio Farms*,⁷⁵ the Federal Farm Security Agency had helped to organize a corporation for the purpose of training; educating and housing low-income farmers. In addition, the Agency had sold surplus federal real estate to the corporation and had provided necessary guidance in order to promote achievement of the program objectives. The corporation was granted an exemption because its function satisfied a public need and because the extent of the Farm Security Agency's involvement indicated a governmental commitment to the success of the project. The importance of a finding of such governmental commitment is illustrated in *Commissioner v. Lake Forest, Inc.*,⁷⁶ where a corporation sponsoring the sale of a former federal defense housing project to veterans was denied an exemption. The court reasoned that the government had participated in the transaction only as a vendor, and that no overriding public purpose was served in the sale of housing to veterans.⁷⁷ When measured against the guidelines set forth in these

human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

Treas. Reg. § 1.501(c)(3)-1(d)(2) (1971). The Regulations define "educational" as:

(a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or (b) The instruction of the public on subjects useful to the individual and beneficial to the community.

Treas. Reg. § 1.501(c)(3)-1(d)(3)(i) (1971).

⁶⁸ Int. Rev. Code of 1954 § 501(c)(4).

⁶⁹ Id. § 501(c)(3).

⁷⁰ Id. § 501(c)(4).

⁷¹ Treas. Reg. § 1.501(c)(3)-1(a) (1971).

⁷² Id. § 1.501(c)(3)-1(b)(1)(i)(a) (1971).

⁷³ Id. § 1.501(c)(3)-1(b)(1)(i)(b) (1971).

⁷⁴ Id. § 1.501(c)(3)-1(c)(1) (1971).

⁷⁵ 205 F.2d 68 (5th Cir. 1953).

⁷⁶ 305 F.2d 814 (4th Cir. 1962).

⁷⁷ Id. at 818-19.

cases, the participation of a nonprofit corporation in a plan to provide housing under federally-assisted programs presents a strong case for exemption. The existence of a public purpose is evidenced by the substantial, long-term government commitment to the elimination of blighted areas and the improvement of housing conditions.⁷⁸ Furthermore, extensive governmental involvement is found in the government's participation in planning the project as well as in providing subsidies for forty-year mortgage terms.⁷⁹

Nonetheless, because the corporation will be acting to achieve the housing objectives from within a limited partnership form of association, additional problems involving the corporation's exempt status may arise. In particular, the corporation's involvement in a real estate venture which generates benefits for profit-motivated investors might result in a challenge to the exemption based on the contention that these nonexempt purposes constitute more than an insubstantial portion of the corporation's activities. However, in *Garden Homes Co. v. Commissioner*,⁸⁰ an exemption was granted to a corporation which, with state and local government assistance, had organized, planned and developed over one hundred homes for low-income families on a nonprofit basis. The exemption was granted despite the fact that part of the project's financing had come from the sale of stock to private investors who received dividends. The Seventh Circuit Court of Appeals compared the dividends to interest payments, that is, the necessary cost of obtaining capital needed in order to achieve the beneficial social purpose of providing housing to needy families.⁸¹ Thus the fact that a housing project generates financial benefits for passive investors has been held not to preclude exemption. In the context of the present problem, one of the "costs" of obtaining capital for low-income housing is the benefit accruing to the partners. It follows that the generation of these benefits should not be reason to deny an exemption. The fact that the nonprofit corporation's relationship with the limited partners is found to constitute commercial activity should not, standing alone, bar an exemption; rather, such a finding should require the nonprofit corporation to show that its primary purpose and activities are exempt and that only an insubstantial portion of its activities relates to the alleged commercial functions.⁸²

Although there are no cases or rulings which examine the exemption of a nonprofit corporation involved in a limited partnership, there is case law concerning the question of the permissible commercial activities of exempt corporations in general. In *Trinidad v. Sagrada Orden de Predicadores*,⁸³ the IRS alleged that a large, exempt religious

⁷⁸ Report of the President's Comm. on Urban Housing, A Decent Home 59-68 (1968) [hereinafter cited as A Decent Home].

⁷⁹ FHA Handbook 4442.1, Rental Housing for Lower Income Families 12 (1968).

⁸⁰ 64 F.2d 593 (7th Cir. 1933).

⁸¹ Id. at 598.

⁸² Treas. Reg. § 1.501(c)(3)-1(c)(1) (1971).

⁸³ 263 U.S. 578 (1924).

and educational organization which managed a substantial endowment fund was engaged in nonexempt activities because the organization received 2.8 percent of its operating income from the commercial sale of wine, chocolates and other articles. In holding the organization exempt, the United States Supreme Court articulated a "destination of income" test to determine the exemption status of organizations involved in commercial activities. The Court indicated that the source of the revenues from commercial activity was immaterial as long as they were used in pursuit of an exempt purpose.⁸⁴

The destination of income test was used in a series of cases⁸⁵ to justify an exemption where the income from commercial activity amounted to considerably more than the 2.8 percent of operating income involved in *Sagrada*. For example, in *C. F. Mueller Co. v. Commissioner*,⁸⁶ a corporation was organized for the purpose of benefiting New York University Law School, an exempt educational organization. The corporation acquired ownership of a large manufacturer of macaroni and other pasta products whose profits were paid to the law school. The court applied the destination of income test and found the corporation exempt.⁸⁷

The scope of the *Sagrada* doctrine was narrowed, however, in *People's Educational Camp Society v. Commissioner*,⁸⁸ where a camp, founded as part of an exempt educational organization, had expanded and continued as an exempt institution long after the founding organization had been dissolved. The camp controlled extensive recreational facilities and charged rates competitive with private nonexempt resorts in the area. The Second Circuit Court of Appeals held that the Society was nonexempt on two grounds: first, that the Society competed with private resort operators; and second, that there existed a disproportionate relationship between expenditures claimed for the educational and cultural exempt purposes on the one hand and the total aggregation of income and other expenditures on the other.⁸⁹ The court noted that although the revenues of the Society were not turned over to private persons, there was some question as to the amount of social benefit the public received from the organization's

⁸⁴ *Id.* at 581.

⁸⁵ See *C. F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951), *Boman v. Commissioner*, 240 F.2d 767 (8th Cir. 1957), *Lichter Foundation, Inc. v. Welch*, 247 F.2d 431 (6th Cir. 1957).

⁸⁶ 190 F.2d 120 (3d Cir. 1951).

⁸⁷ *Id.* at 122. The 1969 Tax Reform Act added provisions to tax the unrelated business income of exempt organizations in response to the Mueller-type situation. Int. Rev. Code of 1954 §§ 511-514. However, the nonprofit corporation in a limited partnership should not be subject to the tax because of participation in a housing partnership, as long as the corporation receives no distribution of partnership capital or assets. If the corporation should receive developmental, organizational, or founders' fees from the investors, these may be characterized as taxable, unrelated business income.

⁸⁸ 331 F.2d 923 (2d Cir. 1964).

⁸⁹ *Id.* at 931.

activities.⁹⁰ The court examined the Society's accumulation of funds and allocation of revenue to capital expansion which, in turn, generated more revenue and stated that "where . . . so much of [an organization's] revenues are devoted to expanding its commercial facilities and increasing its surpluses, and so little . . . is spent for social welfare activities, that it is actually clear that the primary purpose of the organization is not really the promotion of social welfare but the running of a commercial operation," no exemption would issue.⁹¹

It is submitted that a nonprofit corporation engaged in a local limited partnership clearly meets the destination of income test of *Sagrada*. When all revenues are used to provide tenant services and facilities and to meet other project expenses and, as *Garden Homes* indicated, if the payment of some of the rental income to the limited partners is considered such an expense, the "destination" of the revenue must necessarily be viewed as part of a tax exempt purpose. The situation in *People's Camp* is clearly distinguishable from the activities of the nonprofit general partner involved in a housing limited partnership. In that case the principal activity of the Society was the operation of a recreational resort facility, and a comparatively small amount of the Society's activities were devoted to charitable, educational and social welfare causes. This situation contrasts sharply with the activities of a nonprofit corporation in a local limited partnership; where nearly all of the corporate functions involve providing safe, decent and sanitary housing to low-income families at subsidized rates. Only incidentally do the activities of the corporation financially benefit the profit-motivated investors. The latter's participation is merely a source of capital for achieving the social welfare purposes of the nonprofit corporation, by facilitating the financing of low-cost housing.

A challenge by the IRS, based on the *People's Camp* theory of impermissible competition with private, profit-making developers would be unjustifiable since the latter receive sizable tax subsidies as inducement for their investment and participation.⁹² It would certainly be inconsistent to deprive the nonprofit general partner, responsible for the actual project management and provision of services, of his exemption when his income will be used to further the declared national goal of a decent home for every American family.⁹³ Thus the activities of a nonprofit corporation involved in a housing partnership seem to fall within the boundaries for exemption expressed in *People's Camp*. To deny exemption to such a corporation would require a far narrower interpretation of acceptable commercial activities than the decision in *People's Camp* indicates.

⁹⁰ Id. at 932.

⁹¹ Id. at 933.

⁹² See note 18 *supra*. The same tax benefits are available to profit-motivated sponsors even without the involvement of a nonprofit corporation.

⁹³ 42 U.S.C. § 1441 (1971).

III. FEDERAL INCOME TAX CLASSIFICATION

The third important consideration in determining the feasibility of using a local limited partnership having a nonprofit corporate general partner to develop low- and moderate-income housing is whether the local partnership will be classified for federal tax purposes as a partnership, rather than as an "association taxable as a corporation."⁹⁴ If the partnership is taxed as a corporation, it will be unable to "pass through" the accelerated depreciation benefits to the investors; the attractiveness of the investment will therefore be diminished. While this problem was settled for the NHP by the 1968 Housing Act,⁹⁵ the problem remains unresolved for the purely local partnership.

In order to receive a partnership classification, the limited partnership must show both that it more closely resembles a partnership than a corporation,⁹⁶ and that the general partner is adequately capitalized.⁹⁷ To determine whether the first of these requirements has been met, the Treasury Regulations set forth a "resemblance test." This test involves an analysis of an organization with respect to six corporate characteristics: (1) the existence of associates; (2) the objective of carrying on a business and dividing the gains therefrom; (3) the continuity of the organization's "life"; (4) the centralization of management; (5) the limitation on liability and (6) the free transferability of interests.⁹⁸ Because the first two characteristics are shared by both partnerships and corporations; they are considered irrelevant to the classification procedure.⁹⁹ Thus the four remaining characteristics are used to determine the classification.¹⁰⁰ If a limited partnership is found to possess three or more of these characteristics, it will be considered a corporation for tax purposes and it will not obtain the pass-through tax advantages.¹⁰¹ It is therefore important to understand precisely each of the four characteristics which the IRS uses in making its determination:

(1) *Continuity of Life*.—This characteristic refers to an organizational identity which is not dissolved under local law by the death, insanity, bankruptcy, retirement, resignation or expulsion of any member.¹⁰² "Dissolution" in this context means "an alteration of the identity of an organization by reason of a change in the relationship be-

⁹⁴ Treas. Reg. § 301.7701-1 (1971).

⁹⁵ See *A Decent Home*, supra note 78, at 86.

⁹⁶ Treas. Reg. § 301.7701-2(a)(1) (1971).

⁹⁷ Rev. Proc. 72-13, I.R.B. 1972-2, published on January 10, 1972, sets forth minimum net worth requirements that a corporation which is the sole general partner of a limited partnership must meet before the IRS will consider advance rulings concerning classification of this type of organization as a partnership for tax purposes. See discussion at pp. 930-32 infra.

⁹⁸ Treas. Reg. § 301.7701-2(a)(1) (1971).

⁹⁹ Treas. Reg. § 301.7701-2(a)(2) (1971).

¹⁰⁰ Id.

¹⁰¹ Id. § 301.7701-2(a)(3) (1971).

¹⁰² Id. § 301.7701-2(b)(1),(2) (1971).

tween its members as determined under local law.¹⁰⁸ A corporation possesses this attribute since its existence is not affected by the withdrawal of a shareholder. The corporate charter, not the continued involvement of the owners, determines the term of corporate life. Upon death, the shares owned by a corporate shareholder pass to his successors as does his other personal property. If he transfers his shares, the transferee succeeds to his interest.¹⁰⁴ Thus a corporation has a "continuing identity which is detached from the relationship between its stockholders" and a continued existence which is unaffected by the withdrawal of its members.¹⁰⁵

A limited partnership, organized under the ULPA, differs from this corporate model in several respects. A partnership, unlike a corporation, is not an independent legal person; but rather is an association of persons which requires continued membership in order to preserve its organizational identity. Thus, under the ULPA, a partnership is dissolved upon the death or withdrawal of a partner;¹⁰⁶ and, even where the business may be continued by the remaining members of the partnership,¹⁰⁷ the power of a partner under local law to dissolve the partnership will be sufficient to prevent the finding of continuity of life.¹⁰⁸ For this reason the Treasury Regulations indicate that a limited partnership organized under a statute corresponding to the ULPA will be found to lack continuity of life.¹⁰⁹ The same result obtains even where the general partner is a nonprofit corporation. Although corporations do not die, retire or lose capacity, they may withdraw from the partnership,¹¹⁰ dissolve,¹¹¹ or go into bankruptcy.¹¹² Thus, if the limited partnership were organized under the ULPA and the agreement provided that in the event of the withdrawal, dissolution or bankruptcy of the corporate general partner the partnership would be dissolved, the limited partnership would be found to lack continuity of life.¹¹³

(2) *Centralization of Management.*—This characteristic is defined as the "concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization."¹¹⁴ The paradigm of an association having centralized management is the corporation. In the corporate form of conducting business, a board of directors is

¹⁰⁸ Id. § 301.7701-2(b)(2) (1971).

¹⁰⁴ H. Ballantine, *Ballantine on Corporations* 3 (1946).

¹⁰⁵ Treas. Reg. § 301.7701-2(b)(2) (1971).

¹⁰⁶ Uniform Limited Partnership Act §§ 9, 10; Uniform Partnership Act § 31.

¹⁰⁷ Uniform Partnership Act § 20.

¹⁰⁸ Treas. Reg. §§ 301.7701-2(b)(2),(3) (1971).

¹⁰⁹ Id. § 301.7701-2(b)(3) (1971).

¹¹⁰ Uniform Limited Partnership Act § 9(1), Uniform Partnership Act § 31(1)(b).

¹¹¹ ABA-ALI Model Nonprofit Corporation Act § 51 (1964 ed.).

¹¹² 11 U.S.C. § 23(i) (1970). If all general partners are adjudged bankrupt, the partnership is bankrupt.

¹¹³ Treas. Reg. § 301.7701-2(b)(1) (1971).

¹¹⁴ Id. § 301.7701-2(c)(3) (1971).

elected to represent the interests of the shareholders and to manage the business on their behalf.¹¹⁵ Elected management, however, is but one form of centralized management. Another is presented by a limited partnership, where the general partners conduct the business for both themselves and the limited partners. Even though this is a situation in which management is centered in less than all of the owners, it will not be considered "centralized" for tax purposes if the general partners have a significant interest in the partnership.¹¹⁶ The apparent rationale for this rule is that where the general partners have a substantial interest, they will be managing on their own behalf and in furtherance of their own interests.¹¹⁷

The question of whether a general partner has sufficient interest in the partnership to warrant a finding of noncentralized management depends upon the relative interests of the general and limited partners. The question of substantiality thus depends upon the *percentage* of capital contributed by the general partners, and not merely on the amount contributed. Although the Treasury has not established a figure by which to determine the substantiality requirement, the Regulations provide that, where the limited partners contribute \$5,000,000, and the general partners \$300,000 (six percent of the total amount contributed), the general partners' contribution, while substantial in the absolute sense, is insubstantial when compared to the contribution of the limited partners.¹¹⁸ The Regulations are silent on the question of how much capital beyond the six percent level would be necessary to establish substantiality; however, the leading case construing the tax classification of limited partnerships held that no centralized management existed where the general partners had contributed forty-two percent of the total capital.¹¹⁹ Thus the minimum capital contribution needed to meet the requirement of substantiality appears to lie somewhere between six and forty-two percent of the total contributed.

The foregoing guidelines do not appear to be onerous. Where the limited partnership is engaged in the development of low- and moderate-income housing, the total capital contribution of both the non-profit general partner and the limited partners can be expected to be minimal, since the partnership, as a limited dividend sponsor, would be eligible for an FHA insured mortgage covering ninety percent of the development costs.¹²⁰ If, for example, the total development cost were \$1,000,000, the limited partnership would be eligible for a ninety percent mortgage (\$900,000), and would be required to contribute only a ten percent equity (\$100,000). If six percent of the total is an unacceptable minimum to constitute a substantial interest and forty-two

¹¹⁵ H. Ballantine, *Ballantine on Corporations* 122 (1946).

¹¹⁶ *Treas. Reg.* § 301.7701-2(c)(4) (1971).

¹¹⁷ *Id.*

¹¹⁸ *Id.* § 301.7701-3(b)(2) (Example 1) (1971).

¹¹⁹ *Glensder Textile Co. v. Commissioner*, 46 B.T.A. 176 (1942).

¹²⁰ 24 C.F.R. §§ 221.514(a)(2)(ii), 236.10(c) (1968).

percent meets the requirement, then a contribution by the nonprofit corporation of an amount between \$6,000 and \$42,000 would be necessary to avoid a finding of centralization of management. If it is remembered that the corporation will have control of a \$1,000,000 development, such a contribution constitutes a reasonable capital requirement. Even an undercapitalized nonprofit corporation would ordinarily be able to make a sufficient contribution to qualify as the owner of a substantial interest in the partnership and thereby avoid a finding of centralization of management. However, even if the nonprofit corporation were undercapitalized to the extent that it would fail to contribute sufficient capital in order to avoid the centralization of management standard, this failure by itself would not cause the limited partnership to be classified as a corporation under the "resemblance test." As noted previously, a limited partnership must be found to possess three or more corporate characteristics before it will be held to have failed the test.

(3) *Limited Liability*.—Limited liability exists in a business association when no member is personally liable for the debts of the organization, except to the extent of his investment.¹²¹ This limitation on liability is, of course, one of the primary advantages of doing business in the corporate form. In a limited partnership, the *limited* partners enjoy a similar limitation on liability.¹²² However, the *general* partner has unlimited personal liability for partnership debts in the event partnership assets are insufficient to meet creditors' claims.¹²³ Thus, while the limited partners enjoy a form of limited liability similar to that of a corporate stockholder, the general partner possesses the personal liability necessary to avoid a finding that the organization has the limited liability characteristic of a corporation.

A somewhat different situation is presented where the only general partner in a partnership is a corporation. Here the rule is that the partnership has no limited liability when the corporation has "substantial assets" outside the partnership.¹²⁴ The reason for this rule is that, in a situation where the sole general partner is a corporation having no assets outside the partnership, creditors would be able to look only to the partnership's assets for satisfaction.¹²⁵ In this situation, a de facto limit on liability identical to that of corporate limited liability would exist. As in a corporate veil situation, the limited partnership form would permit limited partners to use an undercapitalized corporate general partner as a device for avoiding creditors' claims. By requiring the corporate general partner to possess substantial assets outside the partnership, the IRS has made it less desirable for limited partners to use a "dummy" corporation for the purpose of avoiding liability.

¹²¹ Treas. Reg. § 301.7701-2(d)(1) (1971).

¹²² Uniform Limited Partnership Act §§ 1, 17(1).

¹²³ Id. § 9(1), Uniform Partnership Act § 15.

¹²⁴ Treas. Reg. § 301.7701-2(d)(2) (1971).

¹²⁵ Id.

The purpose behind the "substantial assets outside the partnership" requirement is broader than merely to provide a cushion for creditors' claims, however; where it is shown that the general partner is not a "dummy" corporation, personal liability will exist for tax purposes even though the corporation does not own substantial assets outside the partnership.¹²⁶ Hence the avoidance of limited partner control over the general partner seems to be of more importance than the availability of sufficient assets to satisfy creditors' claims. A limited partnership will thus avoid the characteristic of corporate limited liability by demonstrating that the general partner owns substantial assets outside the partnership, or by showing that the corporate general partner is not a dummy acting as the agent of the limited partners.¹²⁷

(4) *Free Transferability of Interests*.—An organization will be found to have this characteristic for tax purposes when the owner of an interest in the organization possesses the power to substitute a non-member for himself without obtaining the consent of the remaining members.¹²⁸ In a corporation, the interests of the investors are usually freely transferable.¹²⁹ Limited partnership interests, on the other hand, are not;¹³⁰ a partnership is a carefully controlled, private membership organization.¹³¹ A limited partnership organized under the ULPA does not normally have free transferability of interests. The ULPA permits a limited partner to substitute an assignee only when authorized by the partnership agreement, or with the consent of all members of the partnership.¹³² If a partnership agreement governed by the ULPA requires consent of all members before an assignee can become a substituted partner, the partnership interests will not be considered freely transferable for tax purposes.

The foregoing analysis of the "resemblance test" indicates that, with proper attention to the formation of the partnership, limited partnerships organized under the ULPA may avoid the three or more corporate characteristics which would result in their being taxed as corporations. This conclusion finds support in the judicial construction given to the resemblance test in *Glensder Textile Co. v. Commissioner*,¹³³ the leading case construing the test. In *Glensder*, the Tax Court, examining an IRS classification decision, applied the resemblance test to the following fact situation. The Glensder Textile Co. was a general partnership which had dissolved and reorganized under the New York Uniform Limited Partnership Act.¹³⁴ In dissolving and reorganizing, the four partners of the old partnership had allocated the

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.* § 301.7701-2(e)(1) (1971).

¹²⁹ H. Ballantine, *Ballantine on Corporations* 736 (1946).

¹³⁰ Uniform Limited Partnership Act § 19.

¹³¹ H. Ballantine, *Ballantine on Corporations* 7-8 (1946).

¹³² Uniform Limited Partnership Act § 19(4).

¹³³ 46 B.T.A. 176 (1942).

¹³⁴ N.Y. Partnership Law §§ 90-119 (McKinney 1948).

\$300,000 net worth of the old partnership in the ratio of 5/12ths (\$125,000) to themselves as general partners and 7/12ths (\$175,000) to their wives and children as limited partners in a new, limited partnership. The profits of the new association were to be distributed in the same ratio as the capital contributed. The limited partnership agreement provided that, upon the death, retirement or insanity of one or more of the general partners, the remaining general partners had the right to continue the business. The agreement further provided that the limited partners could assign their interests and could confer upon assignees the rights of a substituted limited partner.

The IRS contended that the limited partnership more closely resembled a corporation. The Tax Court disagreed, concluding that the partnership lacked the necessary characteristics under the resemblance test.¹³⁵ The court found that the partnership lacked "continuity of life" in the corporate sense. Although the general partners had the right to continue the business in the event of the death, retirement or insanity of one or more partners, this continuity was unlike that of a corporation, where the organization continues "regardless of the death or resignation of its directors or stockholders."¹³⁶ The court noted that the partnership *could* continue but there was no assurance that it would. Furthermore, the court determined that even if the remaining partners chose to continue, a new partnership would, in effect, result.¹³⁷ This decision goes beyond the criteria of the Regulations to find a lack of corporate continuity of life. The Regulations seemingly indicate that, in order to avoid a finding of continuity of life, the partnership agreement must require either that the business cannot be continued or that it can be continued only with the consent of the remaining partners.¹³⁸ Nevertheless, the Tax Court concluded, in effect, that a limited partnership *cannot* have corporate continuity because the continuation of the business will always be contingent upon a decision of the remaining partners. Since the IRS acquiesced in this decision,¹³⁹ it would appear that ULPA limited partnerships will not be found to have continuity of life.

With regard to the corporate attribute of centralized management, the court ruled that the centralized control of the business by the general partners was not analogous to corporate centralization of management. The court distinguished the control exercised by the general partners from corporate management on two grounds. First, the general partners, unlike corporate managers, could not be removed by the nonmanaging owners—*i.e.*, the limited partners.¹⁴⁰ Second, the general partners, as owners of 5/12ths of the partnership interests, were man-

¹³⁵ 46 B.T.A. at 186-87.

¹³⁶ *Id.* at 185.

¹³⁷ *Id.*

¹³⁸ Treas. Reg. § 301.7701-2(b)(1) (1971).

¹³⁹ 1942-1 Cum. Bul. 8.

¹⁴⁰ 46 B.T.A. 176, 185 (1942).

aging in furtherance of their own proprietary interests rather than as mere representatives of the limited partners.¹⁴¹ Moreover, with regard to corporate limited liability, the court determined that it did not exist in the partnership because, although the *limited* partners had limited liability, the *general* partners had personal liability under the New York Uniform Limited Partnership Act.¹⁴² In examining the transferability of interests, the court found that the partnership agreement permitted the limited partners to assign their interests and to substitute other limited partners; but since there were no ownership certificates, a practical barrier to transfer existed.¹⁴³ The court therefore concluded that no free transferability of interests existed, and held that the limited partnership possessed none of the four corporate characteristics.

The decision in *Glensder* demonstrates a judicial willingness to find that the relationship among the members of a limited partnership is different from that among corporate owners. In particular, the court's treatment of the continuity of life and transferability of interest characteristics indicates a reluctance to view a limited partnership as a corporation, despite a strong similarity between the two forms. Thus the Tax Court revealed an inclination to apply standards of construction more favorable to partnership classification than the standards provided in the Treasury Regulations. The acquiescence of the IRS in the decision indicates that the Service is willing to follow the *Glensder* view, and that there is little likelihood that a limited partnership conforming to the ULPA will be classified as a corporation for federal tax purposes.

Nonetheless, in addition to the requirements of the "resemblance test," the Individual Income Tax Rulings Branch of the IRS has imposed an additional requirement on a limited partnership which must be met in order for it to receive a ruling of partnership tax classification—the so-called "net worth test." This test, which is not included in either the Code or the published Regulations, consists of several guidelines which the Rulings Branch uses in addition to the resemblance test in order to determine a limited partnership's tax classification.¹⁴⁴ The net worth test requires that, before a limited partnership may be ruled taxable as a partnership, if the total contributed capital of the partnership is \$2,500,000 or less, the corporate general partner

¹⁴¹ *Id.*

¹⁴² N.Y. Partnership Law §§ 90-119 (McKinney 1948).

¹⁴³ 46 B.T.A. 176, 186 (1942).

¹⁴⁴ NHP Associates Operations Guide § IX, at 6 (1971).

These guidelines, used in recent rulings decisions, were published in Rev. Proc. 72-13, I.R.B. 1972-2, which applies *only* to a limited partnership with a sole corporate general partner. See note 97 *supra*. This test differs from that articulated in the NHP Associates Operations Guide in one respect. The latter indicates that in determining the corporation's net worth, the IRS included the corporation's interest in the partnership, when it was not the corporation's only asset, while Rev. Proc. 72-13 indicates that "[i]n computing the net worth of the corporate general partner . . . its interest in the limited partnership and accounts and notes receivable from and payable to the limited partnership will be excluded."

must have a net worth equal to fifteen percent of the total contributions to the partnership or \$250,000, whichever is less; if the partnership's contributed capital exceeds \$2,500,000; the corporate general partner must have a net worth equal to ten percent of the contributed capital.¹⁴⁵ In determining the net worth of the corporate general partner, the following guidelines are to be used: (1) its assets may be calculated on the basis of appraised rather than book value, while its liabilities must be calculated at book value; (2) its interest in the partnership is excluded as an asset, unless the corporation is not the only general partner and its interest in the partnership is not the corporation's only asset; and (3) where there are two general partners, the test will be applied to their combined net worth.¹⁴⁶

The purpose of the net worth test apparently is to prevent the creation of a *de facto* limit on liability through the use of an undercapitalized general partner. This purpose is achieved by denying the limited partnership a favorable tax classification if the corporate general partner's net worth does not meet the standards of the test. Where a corporation is the only general partner, its net worth is measured by its assets outside the partnership. Thus, under the net worth test, the amount of these assets is crucial to a favorable tax classification, whereas, under the resemblance test, the measure of these assets is relevant only to the limited liability characteristic.¹⁴⁷ Where there are two or more general partners, the corporation's net worth includes its interest in the partnership if the corporation also has assets outside the partnership. In this situation, the *total* amount of corporate assets is determinative of a favorable tax ruling. This amount relates to the characteristics of limited liability and centralization of management,¹⁴⁸ neither of which, separately or in combination, determines the tax classification under the resemblance test. While the precise relationship between the net worth and resemblance tests will depend upon the financial structure of individual corporations, it seems clear that the Rulings Branch has made satisfaction of the net worth test the *sine qua non* for partnership classification.

To return to the earlier example of a \$1,000,000 project having \$100,000 of contributed capital; in this situation the net worth test would be met if the nonprofit corporation had a net worth, excluding its interest in the partnership, of \$15,000. Although certainly not an unreasonable amount, the result under the net worth test may not comport with the result under the traditional resemblance test standard. For example, assume that a corporation has a \$10,000 interest in a partnership as a result of its contribution to capital, and that it owns \$4,000 in assets outside the partnership. Under these facts, the

¹⁴⁵ Id. at 6-7; Rev. Proc. 72-13, I.R.B. 1972-2.

¹⁴⁶ NHP Associates Operations Guide § IX, at 7 (1971), as modified by Rev. Proc. 72-13, I.R.B. 1972-2. See note 144, *supra*.

¹⁴⁷ See discussion at pp. 927-28 *supra*.

¹⁴⁸ See discussion at p. 926 *supra*.

corporation would not satisfy the \$15,000 minimum requirement of the net worth test and the partnership would not receive a favorable IRS ruling. However, even assuming that neither the corporation's \$10,000 interest in the partnership nor its \$4,000 in assets outside the partnership would be considered "substantial," the resemblance test would not require that the partnership be ruled taxable as a corporation. According to the Regulations, the lack of substantial assets outside the partnership would affect only the corporate characteristic of limited liability,¹⁴⁹ and even this fact could be dismissed upon a showing that the corporate general partner was not merely a "dummy" acting as the limited partners' agent.¹⁵⁰ Furthermore, a general partner's lack of substantial interest in the partnership would affect only the centralization of management characteristic.¹⁵¹ Under the long-standing resemblance test these criteria alone would not be determinative of corporate tax classification, since three corporate characteristics must be met before an association may be taxed as a corporation.¹⁵²

It is not clear why the IRS has given the net worth test pre-eminence over the criteria enumerated by the Regulations. Nonetheless, because it is applied, the net worth test may discourage use of the limited partnership form. Those participants who meet the resemblance test standards but who do not meet the standards of the net worth test will clearly be discouraged from using the limited partnership device. Further, the uncertainty of the present standard may discourage attorneys, who may feel that the area is in a state of flux, from recommending use of the device at this time.

If the net worth test is retained, a nonprofit corporation with insufficient net worth may still participate in limited partnerships in two ways. First, the nonprofit corporation may find it helpful to include additional, nonmanaging general partners in order to increase the total net worth of the general partners' interests. Second, the limited partnership may seek a waiver of the net worth requirement. The net worth requirement may be waived when additional factors exist, such as the participation of a "deserving minority builder, developer or community group, and the project is otherwise sound as well as desirable."¹⁵³ Thus even the net worth requirement may not be an insurmountable obstacle. However, such additional factors serve to make the net worth requirement even more speculative and to support the position that the net worth test should offer more definitive guidelines upon which potential sponsors of housing may base important planning decisions. The difficulty posed by the net worth test lies less in its substantive requirements than in its form and in the apparent contradiction of the Regulations.

¹⁴⁹ Treas. Reg. § 301.7701-2(d)(2) (1971).

¹⁵⁰ *Id.*

¹⁵¹ *Id.* § 301.7701-2(c)(4) (1971).

¹⁵² *Id.* § 301.7701-2(a)(3) (1971).

¹⁵³ NHP Associates Operations Guide § IX, at 8 (1971). Rev. Proc. 72-13 makes no mention of a waiver of the net worth requirement.

CONCLUSION

The limited partnership form could be a fruitful resource for fulfilling the national goal of a decent home and a suitable living environment for every American family. This form of business association attracts private capital to the low- and moderate-income housing market through the combination of federal tax benefits, insulation from the claims of creditors and freedom from the responsibilities of project management. The involvement of non-profit corporations as managing general partners could further provide increased social services, training, and community facilities within a housing project in order to achieve a fuller complement of life-enriching services for the tenants. In establishing a mechanism capable of providing these services without the involvement of the NHP, the local housing partnership is subject to certain organizational questions which were resolved for NHP but not for the purely local partnership. These are (1) the power of a nonprofit corporation to serve as a partner; (2) the availability of a federal income tax exemption to a nonprofit corporation which joins such a partnership; and (3) the federal income tax classification of the partnership.

In many jurisdictions, the traditional common law prohibition against corporate participation in partnerships has been either judicially eroded or legislatively abrogated. The legislative willingness to permit corporate participation in partnerships is manifest in Massachusetts and in those jurisdictions which have adopted the relevant section of the ABA-ALI Model Nonprofit Corporation Act, wherein nonprofit corporations receive express authorization to join partnerships. Although there have been no cases or rulings by the Internal Revenue Service regarding the question of a tax exemption for a nonprofit corporate partner sponsoring housing through a local limited partnership, strong arguments can be made for such an exemption. The activities of the corporation in providing housing and related services to needy persons on a nonprofit basis seem to meet the requirements of the Internal Revenue Code and the Treasury Regulations.

Further, it appears that a local housing partnership organized under the Uniform Limited Partnership Act will not be classified as a corporation for tax purposes under the four criteria of the Treasury's "resemblance test," since a limited partnership does not conform to the corporate model used as the standard for the test. The major obstacle in organizing the partnership seems to be the procedural "net worth test" used by the IRS Rulings Branch. This test appears to obfuscate the resemblance test established in the Treasury Regulations; it also serves to reduce the efficacy of the tax incentive device because the tax classification determines whether the depreciation benefits "pass through" to investors. However, the net worth requirement does not appear to be an insurmountable obstacle. As noted, since the total capital investment required of the partnership in a federally-subsidized housing project is fairly modest, the nonprofit corporation

having relatively little capital may nevertheless be able to join a local housing partnership. Thus it appears that the various problems of organization surrounding the local limited partnership may be resolved with little difficulty. The increased participation of nonprofit corporate general partners in such partnerships may provide an answer to the nation's urgent need for additional low- and moderate-income housing.

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