Tax Considerations in Real Estate Syndication

Sidney H. Asch
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INTRODUCTION.

A REAL ESTATE syndicate is simply a group of persons who have come together for the purpose of acquiring an interest in real estate. In the last few years there has been a phenomenal growth in the number of syndicates which have been organized to enable persons of relatively limited means to participate in real estate ventures beyond the financial capacity of any one of the individuals. There are many advantages to this type of investment. The focus of this article is upon the tax advantages and disadvantages which accrue in connection with organizing and managing the syndicate.

Investors who participate in real estate syndicates may have any one of a number of different goals. They may wish income; they may wish to hold the property for development and sale; they may wish to acquire the property for speculation. A syndicate organized to attain one of these goals may well have different tax problems from a syndicate having a different goal.

If the goal of the syndicate is the production of income from a long term leasehold or ownership of real estate, then the tax objective is to keep taxes down over a long period of time. There is the expectation of a fair yield on the amount invested and also the possibility that the property might go up in value. This possible increase in the value of the building cannot be overlooked in completing the tax picture. The developer of residential property seeks his profit from quick sales. The developer of rental producing property, whether residential, business or commercial, can either sell or hold for income. The person who buys real estate for speculation expects a substantial profit sometime in the future.

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II.

SELECTING THE FORM OF BUSINESS ORGANIZATION.

There are a number of different forms of business organization by which multiple ownership of real property can be achieved. The syndicate may take the form of a corporation, a partnership, a trust, a tenancy in common, or some variant of one of these. No matter which form is used, the syndicate member should acquire an undivided proportionate interest in the land.

Each of these forms of business organization has advantages and disadvantages from the legal point of view. To complicate the problem of selection, that which is otherwise most suitable legally may not be favorable taxwise, and that which makes the best sense taxwise may not be wholly satisfactory from another legal point of view. Thus, in setting up a real estate syndicate we must harness two horses.

1. Partnership.

In most jurisdictions the law provides that title to real property can be held by a partnership and can be transferred by the partnership as such.\(^1\) This obviates some of the problems of management that exist where a tenancy in common is employed. However, a general partnership does not avoid personal liability either in tort or on contractual obligations.\(^2\)

A. General Partnerships—Where the number of individuals is not great and mutual confidence in all of the partners exists, a general partnership may be indicated as the proper form for the syndicate. It is to be preferred over a tenancy in common, for under partnership law and under most partnership agreements, the title to the realty will not


be incumbered by court proceedings in the event of the death of one of the general partners. The surviving partners can execute any deeds which may be needed to transfer title. The agreement itself can provide that all of the deceased partner's rights in the partnership may be acquired by the survivors and that there be an accounting to the estate of the deceased partner for his interest in the property. In this connection, of course, it is important to note that the legal title remains in the partnership and can be transferred in the partnership name by the surviving partners. The problems of accounting for the interest of the decedent and of disposing of such interest in accordance with the provisions of the agreement, do not affect the title to the property.

In light of the above, it is of the utmost importance, in using a partnership form, whether a general or a limited partnership, that title to the property be taken in the name of the partnership as set forth in the certificate of doing business filed by the partnership. It should not be taken in the names of the individuals constituting the partnership who are doing business as copartners under the assumed name.

B. Limited Partnerships—Assume that between twenty and fifty individuals desire to invest in the project and acquire a proportionate share thereof. It would be a very difficult matter to have that many general partners, because of the problems that occur when each partner has the rights and privileges incident to a general partnership. The investors have usually agreed to invest because they have confidence in the individual or groups who are the organizers. Presumably the organizers have adequate experience and integrity, so that the investors are satisfied to permit the operation and management of the properties to be placed under their control and supervision. Thus, the organizers are made the general partners and the investors become the limited partners.

The prime advantage of a limited partnership form of ownership is the limited liability on the part of the limited partners, that is, the maximum amount of their risk in the ownership of the property is their stated investment therein.

C. Joint Ventures—For the purposes of this discussion joint ventures are treated the same as partnerships. Probably the chief distinction between a venture and a partnership is that the former is a special combination formed for a specific enterprise without any

intention of assuming the obligations of an actual partnership.\textsuperscript{4} Although one or more ventures may be given the authority, in a representative capacity, to act for all, provisions which have the effect of limiting liability of participants, permitting transferability of interests without consent and maintaining continuity in event of death, are likely to lead to characterization as an association taxable as a corporation.\textsuperscript{5}

It appears clear that from the practical viewpoint a limited partnership should be preferred over a joint venture. The partnership agreement could provide for the limitation of the purpose for which it is organized to a specific enterprise. It would also have the benefits of limited liability, delegation of authority to representatives who are to act for the enterprise as general partners and, what is more important, it would have the benefit of the statutory and judicial determinations relating to partnerships, which are lacking in so far as they affect joint ventures.\textsuperscript{6}

D. Tax Problems of the Partnership Syndicate—While there may be an advantage taxwise in organizing a syndicate as a partnership, the disadvantages may outweigh the tax savings. In this situation, the limited partnership may serve some of the investors almost as well as a corporation in obtaining the legal protection of the latter form and the tax advantage of a partnership. It is quite common to try to organize syndicates which will provide all of the tax advantages of the partnership form and the other non-tax advantages of the corporate form.

E. Partnership Classified as Corporation—The chief tax problem of the syndicate in the form of a partnership is to overcome the pitfalls of being classified as an association and therefore taxable as a corporation.


Burk-Waggoner Oil Association v. Hopkins, 269 U.S. 110 (1925), in which an unincorporated joint stock association, considered a partnership in Texas, was held taxable upon its income as a corporation. Justice Brandeis, writing for the court, stated at page 114: "But nothing in the Constitution precludes Congress from taxing as a corporation an association, which, although unincorporated, transacts its business as though it were incorporated."


5 Taubman, The Joint Venture and Tax Classification, c. VI, "Joint Venture and Corporate Tax Classification" (1957).

6 The case law, the statutes concerning partnerships and the Uniform Partnership Act provisions are not all applicable to joint ventures.
Taxwise, there are two choices, to be taxed as a corporation or to be taxed as a partnership, as every syndicate will be taxed as one or the other. The principal feature of corporate taxation is that earnings are taxed first to the corporation and, when distributed as dividends, are taxed again to the shareholders (with credit against their tax for four per cent of the dividends). The principal feature of partnership taxation is that the earnings are not taxed at all to the firm but each partner must include his pro rata share in his personal income, whether or not the earnings have actually been distributed to him. Before considering the tax factors which bear upon the choice between the two, let us look briefly at the tax principles which determine whether a syndicate is to be taxed as a partnership or a corporation. The outward form does not necessarily control.

The status of a partnership under the law of the state does not control for the purpose of federal income tax. Under the provisions of the Internal Revenue Code and the Treasury Regulations thereunder, partnerships are defined so as to include an unincorporated organization which is not a trust, estate or corporation within the meaning of the Code. Under section 770(a)(3) of the Code, corporations include "associations" so as to subject to the corporate tax rates entities which are deemed corporations although their legal forms may be different. Under Regulation § 1.761.1, associations are defined so that a limited partnership with the attributes of continuity of existence, transferability of the interest of a general partner and centralized control in one or more persons acting in a representative capacity is included. Such a limited partnership is treated as a corporation for tax purposes. If the partnership does not have these essential characteristics it is not treated as a corporation for tax purposes.

Commercial and real estate trusts treated as associations present a similar problem because the consequence of admitting new limited partners is analogous to that of issuing trust certificates to a number of beneficiaries. Before 1935, the cases of Crocker v. Malley and Hecht v. Malley caused lack of assurance as to the law because they

8. Ibid.
10. Ibid.
11. INT. REV. CODE OF 1954 §§ 761(a), 7701(a) (2); U.S. Treas. Reg. § 1.761.1(a).
12. Section 7701 corresponds to Section 3797 of the Internal Revenue Code of 1939. Regulation § 1.761.1 illustrates partnerships treated as partnerships and those treated as corporations, for tax purposes.
enunciated conflicting rules in deciding whether a trust or association existed.

The law today is based upon the case of *Morrissey v. Commissioner* 15 and three other cases 16 decided at the same time by the United States Supreme Court. In the *Morrissey* case, the Court stated that it was bound by the powers set out in the trust indenture rather than to what the partners did under it. It was not persuaded by the fact that the authorized powers were not used. 17 The Court, in the *Morrissey* case, was convinced that the following factors spelled out an association: conducting a business, close central control by representatives of the members, continuity of the undertaking, limited personal liability and title to the property in the name of the entity. The Court felt that similarity with corporate form and operation was sufficient, identity was not necessary. While the employment of corporate form and organization might demonstrate the existence of a corporation, the absence of these factors is not decisive on its being something else. In the usual trust situation, the beneficiaries do not contemplate a common plan of action or engage in the carrying on of a business activity.

The Court put it as follows:

"What, then, are the salient features of a trust—when created and maintained as a medium for the carrying on of a business enterprise and sharing its gains—which may be regarded as making it analogous to a corporate organization? A corporation, as an entity, holds the title to the property embarked in the corporate undertaking. Trustees, as continuing body with provisions for succession, may afford a corresponding advantage during the existence of the trust. Corporate organization furnishes the opportunity for a centralized management through representatives of the members of the corporation. The designation of trustees, who are charged with the conduct of an enterprise, who act 'in much the same manner as directors,' may provide a similar scheme, with the corresponding effectiveness. Whether the trustees are named in the trust instrument with power to select successors, so as to constitute a self-perpetuating body, or are selected by, or with the advice of those beneficially interested in the undertaking, centralization of management analogous to that of corporate activities may be achieved. An enterprise carried on by means of a trust may be secure from termination or interruption by the death of owners of beneficial interests and in this respect their interests are distinguished from those of partners and are akin to the

17. Wholesalers' Adjustment Co. v. Commissioner, 88 F.2d 156 (8th Cir. 1937).
interests of members of a corporation. And the trust type of organization facilitates, as does corporate organization, the transfer of beneficial interests without affecting the continuity of the enterprise, and also the introduction of large numbers of participants. The trust method also permits the limitation of the personal liability of participants to the property embarked in the undertaking.18

In spite of the Morrissey case, there is still a need for a clear rule to guide the would-be syndicator. The cases are still decided on an empirical basis, seeking to hew to the line established by the Supreme Court in that case.

In Glensder Textile Company,19 the Board considered the State law, the partnership agreement and the certificate of partnership filed with the county clerk in holding that a New York limited partnership was in fact a partnership. It based its decision upon the following factual determinations: central direction by general partners not analogous to direction by corporate directors: they act for themselves and not in a representative capacity; limited partners could not control or remove general partners in the same manner as stockholders can control directors; additional limited partners could be added to bring in new capital but they could not thereby acquire shares in control; reservation of power in surviving general partners to continue the business on the death, incapacity or retirement of a general partner is not the same as continuity of corporate existence: continuity was assured only if the surviving partners agreed to it;20 interest of general partner was not transferable; limited partners' interest was transferable, but the interest so transferred was restricted; limited liability of limited partner not conclusive factor; general partner subject to unlimited personal liability; real estate held in name of entity but each partner had undivided but separate right.

Apparently, central control and perpetuity of existence are controlling factors in determining to treat a business organization as an association, while other elements, such as unlimited liability, are not.21

In two similar cases there was found to be a partnership. The first is J. A. Riggs Tractor Company,22 where the court decided that the business was a partnership on the evidence presented. It placed emphasis on the fact that there were strict limitations on the admission

19. 46 B.T.A. 176 (1942).
22. 6 T.C. 889 (1946).
of additional partners. All the partners participated in the carrying on of the business and their vote was not in proportion to invested capital; the partner who was the manager had the final say. The court felt that no continuity could be found simply because surviving partners had authority to continue the business until settlement of the estate of a dead partner. The mere fact that the partners themselves agreed on the formula as to profits and loss, did not create limited liability. The second case is George Brothers, which involved the classification of an association of people engaged in the manufacturing business. It was deemed to be an ordinary partnership having an active and silent partners. This determination was acquiesced in by the Commissioner.

Employing the rationale of the Morrissey case, the Board of Tax Appeals in N. B. Whitcomb Coco-Cola Syndicate held that the syndicate was not an association under the tax law. The court took the position that an agency relationship had been created rather than a joint tenancy. In Western Contract Company, the court held that a limited partnership organized under the laws of Washington was a partnership, following the rationale of the Glensder case. In Giant Auto Parts, Ltd., where the business was conducted in correct fashion although it was not organized as a corporation, the court characterized the petitioner as an association for tax purposes. It emphasized the factors of transferability, continuity and limited liability under the agreement and the statutes of Ohio.

Since the line of difference between an association and a limited partnership under tax law is not too clear, the draftsmen of the agreement should make it as clear as possible that the intent is to organize a partnership. The entity should more closely resemble an ordinary partnership than a corporation. The written agreement should seek to avoid both centralized control by a few people and continual existence. It is important to include the usual attributes of partnership, such as unlimited personal liability of the general partners, termination upon the death, incapacity or withdrawal of a general partner, a requirement for the consent of the general partners to the addition of new general partners, voting on the basis of individuals participating rather than in ratio to the amount of investment. If a business is carried on like a corporation it may be regarded for tax purposes as a corporation. If a partnership is characterized as an association it will be treated as a

23. 41 B.T.A. 287 (1940).
24. 35 B.T.A. 1031 (1937).
corporation for tax purposes and the partners will be taxed as shareholders in a corporation.\textsuperscript{27}

F. Preparation of Tax Return of Partners—The use of the form of partnership involves another tax problem. While it may appear that this problem is not too significant, realistically it frequently presents a risk. When upon audit of the taxpayers' accounts the revenue agent is required to make a change in the net taxable income of the partnership, he adjusts a proportionate share of the taxable income of each of the partners. Since this may involve considerable administrative difficulty in a syndicate involving a large number of participants, the work involved may discourage the revenue agent from making minor changes to net income. However, in the case where the revenue agent goes ahead with his adjustment to taxable income, each and every one of the syndicate members is to have his tax return changed appropriately. This gives the Internal Revenue Service another chance to go over each of the other items in the individual tax returns with the possibility of new problems for the individual taxpayers.

G. Choice of Fiscal Year—Partnership presents still another important tax disadvantage. Under the Code, a partnership does not have the right to select a fiscal year to suit its purposes unless the Commissioner has given prior consent.\textsuperscript{28}

2. Corporation.

A. Corporation Generally—The most simple organization for a syndicate which is to acquire ownership of real property is the corporation. Title is taken in the name of the corporation, and the investors own stocks and bonds in it. Aside from the fact that the corporation lends itself to flexibility in management, it has other advantages. The individual syndicate members are insulated against liability in tort or upon contractual debt. Control of management is focused in the hands of the officers and directors. It is possible to delegate it to a committee or percentage of the stockholders. The relationships between the board and the stockholders, the officers and the stockholders and the relationships among the stockholders themselves are fairly well-defined by the law of the jurisdiction. Deeds, mortgages, leases and other instruments can be executed on behalf of the corporation by an officer. The prop-

\textsuperscript{27} See Taubman, Joint Venture and Tax Classification, e. VI, "Joint Venture and Corporate Tax Classification" (1957).

property owned by the corporation cannot be levied upon by executors of stockholders; the only assets which can be touched are the shares of stock themselves. Stockholders without a majority interest, or even more than a majority if so provided in the bylaws, cannot compel dissolution of the corporation or liquidation of the assets. The corporation affords ownership in perpetuity.

B. Tax Problem of the Corporation—A fairly substantial hazard in the case of a syndicate holding income producing real estate relates to the distribution of earnings. To obviate this difficulty a device frequently used is that of the "thin corporation." If a taxpayer is careful in his preparation and sensible handling of the thin corporation, the situation may provide some fair likelihood of success for the taxpayer.

A thin corporation is one in which the capital investment is inadequate as compared to the total capital required to accomplish the purposes for which the corporation was organized. For many years corporations organized for the acquisition of real property were organized with a nominal amount of capital, and the remainder of the investment was made in the form of loans to the corporation which were repaid out of the net earnings of the corporation. It may be argued that loans originally made constituted in essence actual capital investment, and that the repayments out of earnings constituted dividends and were taxable as such. To avoid such a determination a corporation should be adequately capitalized; and wherever possible, loans should be made by interests other than the capital owners, and not in the same proportions as the stock holdings.

C. Distribution of Earnings—Apparently there is no magic talisman which can be used to predetermine exactly what the tax court is going to do. The tax court has approved a debt to capital relationship of three and one-half to one. Yet just recently the tax court has held a twenty-five to one debt to capital ratio was not acceptable. The repayment of obligations were considered to be dividends.

D. Collapsible Corporations—Many syndicates have recently employed the partnership form principally because of the hazard created


by the provisions in the Internal Revenue Code relating to collapsible corporations.\textsuperscript{32} These provisions were included in the Code for the purpose of preventing the conversion of ordinary income into capital gain through means of the corporate form. Another factor has been that partnership furnishes some shield, predicated upon past action by those conducting the syndicate. These attacks have led to capital gain being taxed as income.

A collapsible corporation is one as defined in section 341 of the Internal Revenue Code. As it applies to real estate corporations it definitely includes any corporation organized for the purpose of acquiring real estate, and there are some very well-known tax counsel who are of the opinion that any real estate acquisition comes within the provisions of the collapsible corporation statutes. The effect of a corporation being held a collapsible corporation is that in the event of a sale of the property of the corporation or of the stock of such a corporation within a period of three years from the date of completion of construction of the property owned by the corporation or the acquisition of an existing structure, and in the further event that the gain recognized by such sale is more than seventy per cent attributable to the property owned by the corporation, instead of the gain being taxed at capital gain rates, it is taxed at ordinary income tax rates.\textsuperscript{33}

Under the provisions of the Code relating to collapsible corporations, gain made on the sale of incorporation stock will not be considered ordinary income if the sale is made three years after the completion of the construction or development of the property by stockholders who hold less than five per cent in value of the stock of the corporation \textsuperscript{34} or, if less than seventy per cent of the gain is realized from the appreciation in value of the real estate assets so constructed or developed.\textsuperscript{35} Just recently the tax court in its first construction of section 117(m) of the Code states that in applying the seventy per cent rule, it will exclude gain attributable to such non-reconstruction activities, such as rezoning or full occupancy.

E. Compensation of Officers—Where the compensation to be given the promoters of the syndicate is settled beforehand and made part of the syndicate agreement, there is generally no tax problem.

If the individual promoter is in a high personal tax bracket he may find it advantageous to create a wholly owned corporation which

\textsuperscript{33} See, 26 U.S.C.A. § 341, Reg. § 1.341.
\textsuperscript{34} \textit{Ibid}.
\textsuperscript{35} \textit{Ibid}. 
will provide the services and collect the compensation therefor. Fees for the management of real estate properties can be paid to the corporation rendering such services on the basis of a flat fee or a percentage of the rental. Where real estate is being developed, the promoter may organize a corporation which will erect the structure or building on a cost-plus or fixed fee basis. However, a caveat must be added. The promoter must be careful to avoid the tax problem inherent in a personal holding company.\textsuperscript{98}

F. \textit{Use of Multiple Corporations}—In a situation where a group of individuals who are all in a high tax bracket desire to acquire jointly the ownership of a larger parcel of property, it may be found beneficial taxwise for each investor to organize a corporation and have the multiple corporations jointly acquire ownership of the real estate. An agreement may be made designating a managing agent for the operation of the property. Assume that a parcel of property shows an income of 100,000 dollars; it would be advantageous to organize separate corporations with each of the investors subscribing to the capital stock of one of the corporations. Assume four investors; they would organize four corporations which would then each own a twenty-five per cent interest in the property. The income to each corporation would then be that corporation’s proportionate share of the net income from the property, or the sum of 25,000 dollars. This would have an effective tax rate of about thirty per cent on the normal income and eventually a twenty-five per cent capital gains tax on the accumulated earnings upon a sale or liquidation of the investment. As has been shown, this could be considerably less than individual taxes, and it lends itself to a fine estate planning program for each investor, possibly resulting in the transfer of income to low income tax bracket beneficiaries.

Since these properties are customarily acquired with large mortgages, the tax consequences of accumulation of surplus under section 531 of the Code would have little or no effect.

3. Trust.

A. \textit{Deeds in Trust}—In some instances groups of investors organized for the purpose of acquiring title to real property have vested title in the name of one or more individuals as trustees under a deed of trust. The trustees issue trust certificates to evidence the proportionate share in the trust indenture. It was believed that this method of owner-

\textsuperscript{36} 26 U.S.C.A. § 542.
ship of property vested the title in the trustee with the certificate of trust as the evidence of the beneficial ownership, that the record title would be unencumbered by the ownership of the trust certificates by the beneficiaries of the trust.

It has been held, however, in a number of cases, that the owners of the beneficial interests acquired a vested interest in the real estate. In some instances serious consequences have resulted because titles could not be transferred in the absence of the consent and deeds of all the beneficial interests. The problem involves the obtaining of the signatures to deeds from all of the beneficiaries together with affidavits that they are all of age and competent to execute the same. Further problems result from the deaths of the holders of any of the certificates of trust and the devolution of their interests to their estates, which may include minors, with all of the proceedings in probate courts that are necessary.

It is always questionable whether the trust and the issuance of trust certificates will be accepted by the taxing authorities as evidence of individual ownership of proportionate interests of the property. If not so accepted, the trust will be treated as an association and hence as a corporation and taxed as such.

B. The Simple Trust—A simple trust is merely a method by which title to the real estate is taken in the name of and held by a trustee or trustees for the benefit of the members of the syndicate. The authority of the trustee is limited merely to holding title without any management or discretionary functions. It is sometimes referred to as a "naked" trust. The trust usually continues for an agreed period or may be terminated at any time by one or more of the members of the syndicate. Deeds and mortgages may be executed without the signature of all members of the syndicate, but otherwise the simple trust does not accomplish the advantages of a corporation.

37. In the absence of proof to the contrary, the beneficiary’s acceptance is presumed, the estate being beneficial to him. Roberts v. Taylor, 300 Fed. 257 (9th Cir. 1924), cert. denied, 266 U.S. 629 (1924); Randall v. Bank of America, 48 Cal. App. 2d 249, 119 P.2d 754 (1941); Devol v. Dye, 125 Ind. 321, 24 N.E. 246 (1890) (citing Blasdel v. Locke, 52 N.H. 238 (1872); Darland v. Taylor, 52 Iowa 503, 3 N.W. 510 (1879)); First Nat. Bank v. Ridenour, 46 Kan. 707, 27 Pac. 150 (1891); Aronian v. Asadoorian, 315 Mass. 274, 52 N.E.2d 397 (1943); Thorp v. Lund, 227 Mass. 474, 116 N.E. 946 (1917); Eagles B. & L. Ass’n v. Fiducia, 135 N.J. Eq. 7, 37 A.2d 116 (1944); Trowell v. Carraway, 10 Heisk. 104 (Tenn. 1872). (But as to savings bank trusts, see Massachusetts cases cited at P-H Trust Course Par. 1245, p. 1243 (New York 1949)). This presumption is rebuttable. Libby v. Frost, 98 Me. 288, 56 Atl. 906 (1906). And it does not arise if the trust imposes onerous burdens on the beneficiaries. Cumniff v. McDonnell, 190 Mass. 7, 81 N.E. 879 (1907).

From an income tax and most other points of view the effect of the simple trust is exactly the same as tenancy in common, that is, each syndicate member is taxable for his fractional share of the net income.\(^{39}\)

C. Complex Trust—This is a trust arrangement in which title is not only taken and held by the trustee but the trustee is given broad powers of management. Frequently, moreover, provisions are worked out for control of the trust or the trust property by less than all of the syndicate members, or through a committee or board. Provision can also be made for facile transfer of interests and for the trust to continue for a period of years.

The purpose of the trust is to obtain the advantages of a corporation without incorporating. It requires a carefully drawn trust agreement to provide for the numerous situations that are governed by the corporation laws of most states but, when properly set up, it provided most of the corporate advantages.

The use of this type of trust can be extremely advantageous where it is desired to distribute income currently which would be subject to corporate as well as individual tax if a corporation were used. The difficulty with its use is that the trust may be treated as an association under section 7701 of the Internal Revenue Code of 1954 and thus taxed in the same manner as a corporation. This will result where the trust continues in spite of the fact that the members of the syndicate change and where its affairs are conducted by a board acting in a representative capacity. It is impossible to state definitely at what point a trust will be treated as an association; but the more it operates like a corporation, the more chance there is of its being taxed as such.

4.

Tenancy in Common.

This form of ownership will preserve to the owners the benefits of individual ownership and taxation of the individual's proportionate share of the income without the double taxation resulting from corporate ownership.\(^{40}\) It presents, however, the problem of transferability of title in the event of the death of one or more of the owners of the common interests. It may be difficult to deal with estates, with infants; and frequently it may require partition actions in order to dispose of properties and interests therein. Serious consideration

\(^{39}\) Swanson v. Commissioner, 296 U.S. 362 (1935); Cleveland Trust Co. v. Commissioner, 155 F.2d 481 (6th Cir. 1940).

\(^{40}\) C. A. Everts, 38 B.T.A. 1039 (1938).
should be given to the organization of a general partnership in lieu of a tenancy in common. Title can then be conveyed by the survivors and thus the record is kept clear, and the accountability requirements remain unchanged.

Tenancy in common has the virtue of being relatively simple, but it has numerous disadvantages:

(a) The members of the syndicate generally have to assume personal liability for financing of the acquisition or improvements of the real estate. This can sometimes be avoided by an agreement with a financial institution that it will look to the mortgage security and not to the individuals. Personal liability can also be avoided if the financing is first arranged by a corporation which then conveys to the individual members subject to the mortgage without assumption by the individuals.

(b) The members of the syndicate are personally liable for any damage claims arising from operation of the real estate. Most of this liability can be covered by insurance.

(c) Unanimous consent of all members of the syndicate is required for leases, improvements, mortgages and sales, making management generally cumbersome. This situation can be alleviated to a limited extent and for limited periods through the use of a power of attorney from the members of the syndicate or through agreements provided for unified management.

(d) Transfer of any syndicate member's interest, either before or after death, is relatively cumbersome.

(e) Each member of the syndicate has the right to require partition of the property, which will frequently result in a forced sale. This can be avoided for limited periods by an agreement among the members.

(f) Each member's fractional interest in the real estate is subject to execution by judgment creditor, and a levy of a fractional interest will frequently result in a forced sale.

The income tax aspects of tenancy in common are simple. Each member of the syndicate is taxable for his proportional share of the net income of the real estate. Thus, each member deducts from his income his proportionate share of depreciation.
III.

TAX CONSIDERATIONS IN THE OPERATION OF THE SYNDICATE.

1.

Relationship Between Depreciation, Deduction and Mortgage Amortization.

An extremely significant problem relates to the relationship between the amount expended for amortization of the mortgage and the deduction for depreciation. If the investors are in a high bracket, it may be good practice to utilize a corporation where the amortization exceeds depreciation. The advantage is that the impact of the taxes is reduced as a consequence of having all, or at least part of the profits taxed at the corporate rate of thirty per cent. As a result, additional funds will be available for the purpose of reducing liabilities or to acquire additional real estate holdings.

The second tax at the capital gain rate is put off until the stock or realty is sold or the corporation is liquidated. It may eventually be inherited upon a new step-up basis.

The investor in the high personal bracket may reduce his tax burden in a partnership syndicate by making a gift of his interest to his family by creating either a short term irrevocable trust ("Clifford Trust") or permanently irrevocable trust. During the period of irrevocability, the income will not be taxed to the investor. Syndicates holding income producing realty generally prefer the partnership form. The main reasons are to avoid the problem of the collapsible corporation and because of the ease with which earnings may be withdrawn.

Where the depreciation deduction allowable is more than the mortgage amortization payments, the investor has the advantage of tax-free returns. In this situation, the most appropriate form is the partnership. Under section 705 of the Code, the excess of distribution over taxable income will lower the individual partner's basis. But under section 752 of the Code, the liabilities of the partnership may be added to the individual partner's basis. Because, as a practical matter, income producing realty is generally incumbered by mortgages, the basis of the partner's interest will rarely reach zero. Neither section 752 nor the regulations under it throw light on whether this tax situation is available to limited partners.

Under section 731(a) of the Code, an excess of cash withdrawals over taxable income leads to taxable capital gains to the extent of the excess if the partner's basis is zero or less than zero. Assessment of
capital gain can be prevented by the provision in the partnership agreement charging such partners with a loan due to the partnership in the amount of the excess. As a practical matter, however, it is unlikely that such a loan provision can be implied in a large syndication operation. While taxable losses cannot result in a negative basis, since they are limited to the basis, subsequent taxable income can be reduced by the losses not allowed before.

2. Initial Losses.

A partnership form is desirable for tax purposes during the initial period when a syndicate acquires realty yielding low income but with the expectation of increasing the return by alterations or renovations. If the taxable income does increase to the extent that the members of the syndicate find themselves in high tax brackets, the form of the syndicate may be changed from a partnership to a corporation. This will be considered tax free under section 351 of the Code upon condition that the liabilities which have been transferred do not exceed the basis of the assets. Within sixty days after the close of the year, the syndicate having less than fifty members may elect to be treated as a corporation.41

3. Converting the Form of Syndicate.

A. From Partnership to Corporation—Where the realty has been acquired by the syndicate for the purpose of the construction of income producing buildings, carrying charges may be used as deductions by members of the partnership. Just before the conversion of the construction, however, the participants must decide whether to incorporate or continue as a partnership.42

It is desirable to continue the partnership if the anticipated cash return resulting from rentals indicates that it can be offset to a considerable amount by the high depreciation which can be applied to new assets. If the taxable income is approximately the same as the cash income, however, and the taxable income is subject to high individual tax rates, it may be desirable to convert to a corporate form. The higher depreciation will be available to the corporation if the partnership is converted into a corporation before the construction has been completed.

41. Ibid.
42. INT. REV. CODE OF 1954 § 1361.
If the syndicate has acquired real estate for sale, such as the development of residential homes, this should result in a high ordinary income within a comparatively short period of time. In this situation, it would be wise to use multiple corporations rather than a partnership from the point of view of the tax consequences. This device may be further refined by having one of the functions of the realty development program carried on by the partnership and the other functions carried on by a number of different corporations. This proliferation of function may result in additional savings of taxes. The advantages of this method are available even if all of the corporations created for this purpose will be completely liquidated by the end of the operation.

B. From Corporation to Partnership—Where the level of corporate taxation is below that of the individual participants, it may also be advantageous to begin the syndicate as a corporation and to convert it to a partnership after the high interest and amortization period has expired. While the conversion may entail capital gains to the participants, any gain will be reflected in an increased depreciation basis for the property. Since depreciation reduces ordinary income, the capital gains price paid for increased depreciation may represent a worthwhile investment.


From the point of view of the promoters, any stock interest they receive for their services in organizing the syndicate will be taxed as ordinary income. However, they may be given an option to buy shares at some future date at or somewhat below the original issue price and, if certain technical requirements are met, neither the receipt of the option nor its exercise will be taxable and any gain on subsequent sale of the shares will be taxed as capital gain.

If the syndicate is formed to acquire property already owned by a corporation, there may be a number of reasons why it will be advantageous to acquire the stock of the corporation rather than the property. If the corporation has a tax loss, the loss can be made available to the syndicate only by acquiring the stock. If the corporation has been using declining balance or sum of the digits depreciation, the syndicate can continue to use these methods only if it acquires the stock. A special problem is presented where the realty is acquired for speculation. The participants are presented with the hazard of being dealers in real estate because of their efforts in subdividing land. By
having the syndicate hold the realty in the corporation for more than three years after acquisition and subdivision, it is possible to overcome the problem; the hazard of the collapsible corporation will be avoided and the sellers will realize a capital gain from the sale of stock to the buyers who will then liquidate the corporation under section 334 and acquire the realty. If the syndicate continues to carry on its activities, it may be a good idea to have separate parcels bought by separate corporations. Using this technique, the corporate tax at thirty per cent and the subsequent capital gains tax of liquidation together may be less than the single tax imposed on individuals on receipt of ordinary income.

IV.
TAX IMPACT ON TRANSFER OF INTERESTS IN SYNDICATES.

Usually gains accruing from the sale of stock in corporations is considered a capital gain. However, thought must be given to whether the gain comes within the scope of the collapsible corporation provisions of section 341. Gains accruing from the transfer of partnership interests by sale must be carefully considered in view of the provisions of section 751 as they apply to collapsible partnerships. If the assets of the partnership are held for the purpose of sale to customers in the regular course of business the danger is that the gain may be treated as ordinary income for tax purposes. Under the Code of 1954 the basis of partnership assets can be different as applied to different partners. As an example, where there is an increase in the value of realty from an initial cost of 1,000,000 dollars to a subsequent value of 1,500,000 dollars a ten per cent interest in the partnership having a basis of 100,000 dollars is now sold for 150,000 dollars. It is the partnership rather than the partners who can elect to increase the partnership basis of the real estate by the 50,000 dollars gain on the sale of the partners' interest under section 754. A new partner alone has available to him the increase in basis. Under section 735 of the Code the method of allocating the increase in basis among the assets of the partnership is set forth. Therefore, the new partner will enjoy greater appreciation deduction than did the original partners.

The new partner has no choice with respect to his basis. Once the allocation is made by the partnership it applies to all future transactions. Thus, if the partnership assets are sold at a loss the basis of the assets is reduced appropriately. The only way to revoke the allocation is to secure the consent of the Commissioner of Internal Revenue.

43. Ibid.
44. INT REV. CODE OF 1954 § 732.
While such allocation by a partnership will serve as an advantage in a high real estate market, it presents a number of management difficulties where interests are transferred by sale or death of participants.

One additional point deserves consideration. Most syndicates should carefully consider the control of the transferability of interests both for the protection of the syndicate and that of the participants. In addition to the business advantages of "buy and sell agreements," they may serve the tax interests of the members by figuring the estate tax values of their interests at an undisputable figure arrived at by a method or formula selected by the parties, thereby removing all possibility of valuation disputes with the Treasury Department.

V.

Conclusion.

It has not been possible to do more in this survey than to touch upon some of the significant tax problems peculiar to syndicate operations. In addition to the problems herein, organizing any real estate syndicate entails careful tax management of its various operations, and transactions, since all the tax saving opportunities and tax hazards of real estate operation in general confront the syndicate managers. It cannot be over-emphasized that, whatever the vehicle selected, each syndicate operation must be custom designed to suit that particular venture. Just as each property is unique, no two syndicates are wholly identical and each presents its own possibilities and dangers. In more complex operations, as where one syndicate is formed to own a particular property and another to lease or operate it, or where one is to own the property and another to carry the mortgage, the tax factors may be extremely intricate. No rule of thumb can be set forth as a universal guide to the structuring and tax management of syndicates, but it may be stated unequivocally that investigation of the tax factors may be as profitable and vital to success of the venture as investigation of the property itself.