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The Agency Form in Tax Shelter Investments: A Viable Alternative

I. INTRODUCTION

Among the benefits of tax sheltered investments are the deferral of income taxes on other income through large deductions in the first few years and the possible conversion of ordinary income to capital gain on disposition of the investment.¹ The form most commonly used for the tax shelter has been the limited partnership.² It is particularly well suited because it provides limited lia-

1. See generally R. HAFT & P. FASS, *TAX SHELTERED INVESTMENTS*, 4A SECURITIES LAW SERIES (2d ed. 1974); 2 W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERS AND PARTNERSHIPS* ch. 18 (1977) [hereinafter cited as MCKEE]; 2 A. WILLIS, *PARTNERSHIP TAXATION* chs. 59-67 (2d ed. 1976); Leder, *Tax Shelter Reform*, in 22D ANN. TAX CONF., C. OF WILLIAM & MARY 151, 153 (1977); Tannenbaum, *Leverage Shelter Operations: Oil & Gas, Motion Pictures and Other Theatrical Shelters*, 31 N.Y.U. INST. FED. TAX. 777 (1973).
2. In order to assure limited liability for all investors, a limited partnership may be formed with a corporation as the sole general partner. The corporation is typically formed specifically for its role as general partner in the specific investment by the promoter(s) and will have only minimal capitalization. The Service, in Rev. Proc. 74-17, 1974-1 C.B. 438, has attempted to limit this scheme somewhat by requiring, for advance ruling purposes, that a corporate general partner have at least a one percent interest at all times "in each material item of partnership income, gain, loss, deduction or credit." A previous revenue procedure, Rev. Proc. 72-13, 1972-1 C.B. 735 imposes four other requirements for ruling purposes, which are: (1) the limited partners must not own more than 20% of the stock of the corporate general partner; (2) the corporate general partner must have a net worth at all times equal to a specified percentage of the aggregate contributions to the partnership; (3) the purchase of a limited partnership interest must not require or provide an option to purchase any security of the corporate general partner; and (4) the limited partnership must be organized under an appropriate state partnership statute. See generally Mann, *Rev. Proc. 74-17 Diminishes Chances of Favorable Ruling on Limited Partnership*, 42 J. TAX. 16 (1975); Weiler, *Limited Partnerships with Corporate General Partners: Beyond Rev. Proc. 72-13*, 36 J. TAX. 306 (1972); Note, *Limited Partnership—Limited Control Through a Corporate General Partner*, 53 WASH. L. REV. 775 (1978). For a general discussion of limited partnerships in tax shelter investments, see Friedberg, *Limited Partnerships: A Non-Tax Analysis*, 32 N.Y.U. INST. FED. TAX. 1363 (1974); Lee, *Tax Shelters Under the Tax Reform Act of 1976*, 22 VILL. L. REV. 223 (1976-77); Sperling & Lokken, *The Limited Partnership Tax Shelter: An Investment Vehicle Under Attack*, 29 U. FLA. L. REV. 1 (1976); Stiss, *Limited Partnerships; The IRS At-*

bility for the investor while the tax benefits pass through to the partners. There are, however, alternative forms which can provide substantially the same results.³ This comment compares one such alternative, the agency contract, with the more typical partnership agreement, analyzing the agency relationship from both the operational and tax viewpoints.

II. AGENCY IN TAX SHELTER

A. Why the Agency Form is Selected

One of the reasons for using an agency agreement is that the promoter is only willing to involve investors on that basis. Typically, the promoter will have special skills in a particular investment area, such as oil and gas, cattle or equipment leasing. He will be a "known commodity" in his particular field and may not want to give up his individuality by forming a partnership. More importantly, he will not want to subject himself to unlimited liability as a general operating partner in a limited partnership.⁴ Nonetheless, he will typically desire to restrict the rights of investors so as to minimize any interference with the operation of the investment venture.

Other reasons for choosing the agency form include avoidance of the application of securities laws.⁵ If significant duties are allocated to the principal, the agency may not be regarded as a "security" since the profits will not be due solely to the efforts of others.⁶

tack on Tax Shelters, 6 TAX ADVISOR 659 (1975); Taft, *Limited Partnership*, 174 N.Y.L.J. 1 (1975).

3. Other forms which can be used include a sole proprietorship and a corporation electing Subchapter S status under I.R.C. § 1372. See generally B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 6.01, at 6-1 (3d ed. 1971); 2 McKEE, *supra* note 1, ¶ 2.02(3).
4. This assumes that the promoter does not decide to incorporate or cannot safely meet the requirements of Rev. Procs. 74-17 and 72-13. See note 2 *supra*.
5. If the securities laws are applicable, then the agency must register under both federal and state law, unless it qualifies under one of the applicable exemptions. Failure to properly comply under federal law could result in a civil suit by the investors for damages and rescission and potential criminal liability. Similar penalties are also imposed at the state level. See generally R. HAFT & P. FASS, *supra* note 1, ch. 2.
6. Section 2(1) of the Securities Act of 1933 (15 U.S.C. § 77(b)(1) (1976)) defines "Security" broadly to include, among other things, an "investment contract," "participation in any profit-sharing agreement" and a "fractional undivided interest in oil, gas, or other mineral rights . . ." The Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) held that an investment contract "means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . ." *Id.* at 298-99. On this basis, where there is no active participation in the management or control of the venture by the investor, the investment will constitute a security. Since a limited investor in a

Also, an agency may be used where the promoter does not want to make a personal cash investment. The promoter can receive a return on the investor's money through compensation payments.⁷ Finally, an agency may be selected on the basis that it affords a great deal of flexibility in meeting the tax and risk objectives of the investor.⁸ If the investor dies or his objectives change, the terms of the agency relationship are simply altered to meet those needs. If the investor was in a partnership with a number of partners, the risks and tax objectives of the whole partnership could not be changed to meet the needs of one partner and the only alternative would be to sell the interest.

B. How is the Agency Formed?

Although an agency relationship can be created through apparent⁹ or inherent authority¹⁰ or by the ratification of acts,¹¹ the tax shelter agency should be formalized in a written agreement which grants the promoter express authority.¹² The agency should be set up with a specific investment goal such as oil and gas. The technical language peculiar to oil and gas should then be carefully defined in order to familiarize the investor with the terms of the trade while giving effect to the intent of the parties within the framework of the investment. As an example, where the promoter is compen-

limited partnership may not participate in the management of the business under Article 7 of the Uniform Limited Partnership Act, a security would exist due to the reliance on third parties. See *McGregor Land Co. v. Meguiar*, 521 F.2d 822 (9th Cir. 1975). With an agency relationship, however, the investor-principal does have the right to participate in the decision-making process. In addition, the principal has the ultimate power of discharge over the agent at any time and for any reason. It could also be argued as a policy matter that the securities laws were not meant to cover an agency in which there is a one-on-one relationship with the agent being subject to the control and discretion of the investor-principal. Overall, although the substance of the relationship will control, since it has been recognized that a general partnership interest in a limited partnership will probably not qualify as a security, it would appear that an agency relationship would have even a stronger argument against the classification as a security. See generally R. HAFT & P. FASS, *supra* note 1, § 2.02; L. LOSS, *SECURITIES REGULATION* 483 (2d ed. 1961); 2 A. WILLIS, *supra* note 1, ch. 66; Aslanides, Cardinali, Haynsworth, Lane & Niesar, *Limited Partnerships—What's Next and What's Left?*, 34 BUS. LAW. 257, 273 (1978).

7. See § II-B of text *infra*.

8. A partnership will offer equal flexibility if the promoter agrees to be the general partner in a limited partnership.

9. RESTATEMENT (SECOND) OF AGENCY § 8 (1958) [hereinafter cited as RESTATEMENT].

10. *Id.* § 8A.

11. *Id.* § 82.

12. *Id.* § 11.

sated on a percentage of cash flow,¹³ a clear understanding of this term is dependent upon an explanation of the types of expenditures which will be subtracted from receipts such as lifting costs, production payments and delay rentals, and the drilling expenditures incurred on exploratory wells. Since the principal is directing the agent to take certain actions, the agreement should be as complete as possible with regard to the technical requirements of the investment.

The business should be described with a statement of foreseeable uses of the agency's capital. This provision will clarify the understanding of the parties and will protect the promoter-agent from claims that he is operating outside the scope of the agreement. Such claims could arise because the law of agency imposes a duty on the investment manager to act within the terms of the agency agreement.¹⁴ Also, by stating the purpose of the investment and the specific intent of the investor, the agreement will reflect the often speculative nature of the investment and will authorize the agent to take the requisite business risks on behalf of the investor-principal.

The agent should be appointed for a stated term and his authority and limitations should be enumerated. Common restrictions on the scope of authority include acts in contravention of the agreement, confessions of judgment, disposition of the investment, borrowing funds in excess of a stated amount, and investing in property which is not specifically described in the agreement without the consent of the investor.

The promoter will normally enter into a number of similar agency investment agreements. Thus, the agreement should provide that the agent has the permission of the investor-principal to enter into such other business ventures. Absent this provision, agency law provides that an agent as a fiduciary¹⁵ has an obligation of loyalty and an implied duty not to compete with the principal.¹⁶

The agency can be terminated in a number of ways. An agency is a consensual relation for the benefit of the investor-principal, and can be terminated by any stated event or change in circum-

13. See notes 22-29 & accompanying text *infra*.

14. RESTATEMENT, *supra* note 9, § 385 provides that "Unless otherwise agreed, an agent is subject to a duty to obey all reasonable directions in regard to the manner of performing a service that he has contracted to perform."

15. *Id.* § 1 (1958).

16. As a fiduciary, the agent has a duty of loyalty, which implies a duty not to compete unless he has the consent of the principal. *Id.* § 394. However, the agent does have to act fairly between the principals and he must disclose all facts which "would reasonably affect the judgment" of the principals in their decision regarding the competing arrangement. *Id.* § 392.

stances,¹⁷ or by lapse of time.¹⁸ Similarly, termination will result where the principal or agent dies¹⁹ or becomes bankrupt.²⁰ Practically, the agency agreement should be limited to a specified period of time as determined by the expected life of the particular investment. In addition to a stated time for termination, the agreement should specify the events causing dissolution of the relationship. Common provisions include the withdrawal or bankruptcy of the agent, the sale of the investment and the written request of the owner or the expiration of the stated term of the agreement.

Once the methods of termination are agreed upon, two other factors should be resolved in the agreement. First, the agreement should provide instructions on how the assets of the agency are to be distributed upon dissolution. Often, the agent will insist on a percentage share of the investment which may range from five to fifteen percent. In this event, the investor should consider making the dissolution interest contingent on a stated worth of the investment and provide for a forfeiture if dissolution results from an act of the agent such as a breach of the agreement or bankruptcy. A second consideration is the protection of the promoter-agent on termination of the agency relationship. The promoter should make it economically disadvantageous for the investor-principal to "fire" him for a period of time after he has set up the investment. Otherwise, the investor could wait until the promoter has utilized his talents in putting the deal together and then terminate the relationship at the probable cost of only the agreed upon compensation up to that point.²¹ Accordingly, the agent should insist that it

17. *Id.* § 38, Comment (b).

18. *Id.*

19. Subject to two exceptions relating to banking transactions, the principal's death automatically terminates the authority of the agent. *Id.* § 120 (1958). Similarly, the authority terminates upon the death of the agent. *Id.* § 121.

20. *Id.* § 113 provides that:

the bankruptcy or insolvency of an agent terminates his authority to conduct transactions in which the state of his credit would so affect the interests of the principal that the agent should infer that the principal, if he knew the facts, would not consent to the further exercise of the authority.

Comment (b) explains that the bankruptcy of the agent "may not be of importance to the principal, and even if it is of some importance, it may not be of such great importance as to prevent the agent from dealing with third persons or completing transactions which he has been authorized to conduct for the principal."

Section 114 states that where the agent has notice, the bankruptcy of the principal will terminate "his authority as to transactions which he should infer the principal no longer consents to have conducted for him."

21. The *Restatement* provides that in the situation where there is a lump sum payment to the agent upon completion of the transaction, such as a real estate broker, then the agent will be entitled to the full amount of the agreed compensation where the agency is terminated without justification if the

be stated in the agreement that if the agency is terminated within a stated period by the investor, the promoter would be entitled to the future agreed compensation over the life of the investment, or to a stated separation payment.

An important characteristic of the agency relationship is the flexibility afforded the parties in structuring the agent's compensation.²² One alternative is to pay the agent a flat management fee. Typically the agent-promoter will not agree to this method of compensation because if the agent has special skills, he will want to share in the anticipated profits which will result from his expertise. Similarly, it will not be in the principal's interest to agree to a flat fee, because he should provide a dollar incentive for the agent to use his best efforts to make the investment profitable. For these reasons, the agent should be compensated on a straight percentage of "cash flow" (which will generally equal "net profits") or on a varying percentage which increases as the investor's initial investment is recovered. Under this varying percentage method, the agent will be paid a percentage of profits as a management fee until the investment is recovered. The agent will then receive the same fee plus an incentive management fee which can increase up to certain specified levels. This type of agreement would provide for the basic protection of the investor's initial capital outlay while maximizing the incentive of the agent to use his skills by investing in productive ventures.

The compensation arrangement raises important partnership tax questions. By paying the agent a percentage of profits, he might be regarded as a partner.²³ Assuming that the agency agreement allocates the profits, losses and tax benefits between the parties, the tax consequences should not be affected as this agreement will control for partnership tax purposes.²⁴ However,

agent has virtually completed the deal. *Id.* § 454 (1958). However, as the promoter-agent is likely to be paid over the life of the investment this provision would not be applicable and absent an agreement to the contrary, the agent would only be entitled to the amounts earned up to that time. *Id.* § 454, Comment a.

22. *Id.* § 443(a) provides that the amount of compensation expressly agreed between the parties will control.

23. See § IV-A of text *infra*.

24. I.R.C. § 704(a) provides that a "partner's distributive share of income, gain, loss, deduction or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement." The allocation stated in the agreement will control unless such agreement lacks "substantial economic effect." I.R.C. § 704(b)(2). This limitation essentially requires that the allocation must affect the economic relations of the parties as distinguished from mere tax consequences. S. Rep. No. 938, 94th Cong., 2d Sess. 100, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 2897, 3536. See generally 2 MCKEE, *supra* note 1, ¶ 10.02; Allen, *Partnership "Retroactive" and "Special" Allocations:*

as the agency may now constitute a general partnership for state law purposes, the agent, as a general partner, could be individually liable to the creditors of the "partnership."²⁵

Secondly, under partnership tax law there is some question as to whether a "profits interest" transferred to the promoter-general partner might be a taxable event at the time of the transfer, rather than in each subsequent year when the payments are made. In *Sol Diamond*²⁶ the Tax Court held that the profits interest from the partnership was taxable in its entirety in the year of receipt. It is questionable whether the case has such broad applicability. The major problem with the immediate taxation of a profits interest is valuation. The service partner in *Sol Diamond* had sold his interest for \$40,000 less than three months after the partnership agreement was signed. Accordingly, *Sol Diamond* can arguably be limited to its facts. In support of this conclusion, there have been a number of recent decisions which have not followed *Sol Diamond*. The Service, in Private Letter Ruling 7817080²⁷ stated that a profits interest to be paid for future services rendered by the general partners to a limited partnership was not recognizable in the year of the formation of the partnership. Similarly, the Tax Court in *Pratt v. Commissioner*²⁸ held that a management fee payable to the general partner, based on a percentage of profits of the partnership, was intended for the payment of future compensation (rather than for past services rendered) and therefore was not taxable in the year of the partnership agreement. It is significant that *Sol Diamond* was not cited in either of these opinions.

A final issue pertaining to the agency agreement is whether each investor should enter into a separate agreement with the promoter, or whether several investors could sign one contract. As will be discussed more fully below, where several investors sign the same agreement, it can be viewed by the Service as another factor indicating that a partnership was intended by their common intent to invest in the same transaction. The agency agreement would then constitute a partnership agreement with the profits

Impact of the Tax Return Act of 1976, 55 TAXES 183 (1977); Comment, *New Restrictions on Tax Shelter Limited Partnerships*, 56 NEB. L. REV. 300 (1977).

25. General partners are subject to joint (but not several) liability on all partnership debts. Uniform Partnership Act § 15(b) (1914) [hereinafter cited as UPA]. In Nebraska, it is codified at NEB. REV. STAT. §§ 67-301 to -343 (Reissue 1976).
26. 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974). See generally Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The Diamond Case*, 27 TAX. L. REV. 161 (1972).
27. Priv. Let. Rul. 7817080 (Jan. 27, 1978) (Ruling 3).
28. 64 T.C. 203 (1975), *aff'd on this issue*, 550 F.2d 1023 (5th Cir. 1977).

and losses being divided accordingly.²⁹ For this reason, it is advisable to execute separate agency agreements. Also, any language linking the relationships should be omitted. This distinction based on the form of the venture may be more illusory than real, however, because a partnership can still be held to exist where separate agreements are signed and the promoter pools the funds and uses them in the same ventures. The form is, at best, only one factor to consider.

III. STATE LAW COMPARISON OF PARTNERSHIP AND AGENCY

A. Formal Organization Requirements

One of the disadvantages of using a limited partnership is the initial formalities which are imposed by the Uniform Limited Partnership Act.³⁰ Section 2 of the ULP A requires that two or more partners file a statement with the county clerk where the principal place of the partnership's business is located. Among other things, the document must disclose the name and location of the business; the name and location of each general and limited partner; the value of all contributions made by limited partners; and the share of profits of each limited partner. In contrast, absent other statutory filing provisions such as banking or alcohol, agencies are not subject to any disclosure requirements and investors and promoters are therefore assured of anonymity.

A somewhat obscure but related issue to the organizational requirements of a partnership and agency is the applicability of the usury laws. Looking at the partnership or agency as an entity, the initial question is whether it is subject to the usury limitations at all. In Nebraska, loans to partnerships are specifically excluded from the eleven percent³¹ interest rate ceiling.³² However, investment agencies will be subject to the usury limits because they do not qualify under any of the stated exceptions. In contrast, it is not clear that agencies formed in Illinois are subject to the usury laws.³³ The Illinois statutes provide that business loans "to a person owning and operating a business as sole proprietor or to any

29. See note 24 *supra*.

30. Uniform Limited Partnership Act (1916) [hereinafter cited as ULP A]. Only Louisiana has not adopted the Act. In Nebraska, it is codified at NEB. REV. STAT. §§ 67-201 to -232 (Reissue 1976).

31. NEB. REV. STAT. § 45-101.03 (1978 Cum. Supp.).

32. NEB. REV. STAT. § 45-101.04 (1978 Cum. Supp.) states that "the limitation on the rate of interest provided in section 45-101.03 shall not apply to: . . . (2) Loans made to any corporation, partnership or trust."

33. ILL. ANN. STAT. ch. 74, § 4 (Smith-Hurd 1978).

person owning and operating a business as joint venturers . . .,"³⁴ are exempted from the usury limitations. It is arguable that while an investment agency should be excepted as a policy matter, it still might be subject to the limits because it does not fit into the literal language of the statute. Therefore, if any loans are made to or from third parties or if the capital investment is treated as a loan to the promoter-agent, the investor (or third party) in Nebraska and possibly Illinois, could be subject to the criminal penalty provisions for violation of the usury laws.³⁵

An example of the application of the usury laws to transactions within the entity is presented in *Johns v. Jaeb*.³⁶ A bank official personally invested \$5,000 in a limited partnership as a limited partner.³⁷ Although all of the partnership documents were properly executed and filed, the court held that the unconditional obligation on the part of the general partner to "purchase" the banker's \$5,000 interest at a stated price of \$6,500 was in fact a usurious loan.³⁸ The court noted that the agreed "purchase price" had no relation to the actual value of the business and the \$5,000 was not subject to the general risks of the business enterprise.³⁹ As capital invested in an agency might be regarded as a loan, the obvious lesson for agency investors is not to require repayment of their principal investment in an amount which exceeds the permitted interest rate. Also, as the agency itself may be subject to the usury limits, the parties should check their applicable state law before any loans are made to prevent unexpected liability.

B. Control and Rights of Investors

1. Agency vs. General Partnership

In a general partnership all of the partners are regarded both as principals and as agents for each other.⁴⁰ The Uniform Partnership Act (UPA) specifically provides that all of the partners will be

34. *Id.* § 1(c).

35. NEB. REV. STAT. § 45-101.07 (1978 Cum. Supp.).

36. 518 S.W.2d 857 (Civ. App. 1974).

37. *Id.* at 859.

38. *Id.* at 860.

39. *Id.*

40. UPA § 9(1); NEB. REV. STAT. § 67-309(1) (Reissue 1976), states that:

Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.

bound by the individual acts of every other partner.⁴¹ The potential liability is not without limits. Partners will not be liable where a partner did not have the authority to act on behalf of the partnership and the other party to the transaction had knowledge of the lack of authority.⁴² Also, acts of a partner which are beyond the scope of the usual trade or business of the partnership will not bind the partnership unless authorized by the co-partners.⁴³ The UPA states that the partners will be jointly and severally liable for the wrongful acts of a co-partner but only jointly liable for the debts and obligations of the partnership.⁴⁴ Since the UPA provides that each partner has an equal right to participate in the management of the business,⁴⁵ partners must be carefully chosen. Obviously, the risk of liability increases with the number of general partners due to their power to bind the partnership.

The agency relationship is similar in that the agent has the power to contract for the principal and to subject him to personal liability.⁴⁶ One of the advantages of an agency is that the principal has a right to state what the agent can and cannot do.⁴⁷ The agent then has a duty of obedience to follow the instructions of the principal.⁴⁸ Also, the potential risks of the investor-principal can be minimized through explicit directions in the agency agreement. As stated above,⁴⁹ common restrictions include a limitation on the amount of money which may be borrowed by the agent and an explicit statement regarding the type of investment activity which is to be entered into by the agent. If the agent exceeds his authority, agency law provides that absent a ratification⁵⁰ or the creation of apparent authority through direct communications between the principal and the third party,⁵¹ the principal may be relieved from responsibility and the agent alone will be personally liable.⁵²

As a specialist in the particular investment field, the agent may request a two or three-year irrevocable delegation of authority so as to minimize any "interference" by the investor-principal. In

41. UPA § 9(1); NEB. REV. STAT. § 67-309(1) (Reissue 1976).

42. UPA § 9(1); NEB. REV. STAT. § 67-309(1) (Reissue 1976).

43. UPA § 9(2); NEB. REV. STAT. § 67-309(2) (Reissue 1976).

44. UPA § 15; NEB. REV. STAT. § 67-315 (Reissue 1976).

45. UPA § 18(e); NEB. REV. STAT. § 67-318(e) (Reissue 1976).

46. RESTATEMENT, *supra* note 9, § 7.

47. *Id.* §§ 1, 14.

48. *Id.* § 385.

49. See § II of text *supra*.

50. "Ratification is the affirmation by a person of a prior act which did not bind him but which was done or professedly done on his account, whereby the act, as to some or all persons, is given effect as if originally authorized by him." RESTATEMENT, *supra* note 9, § 82.

51. See notes 74-76 & accompanying text *infra*.

52. RESTATEMENT, *supra* note 9, § 329.

view of the general duty of obedience,⁵³ the agent must follow the directions of the principal set out in the agency agreement. These directions will control so long as an illegal purpose is not contemplated.⁵⁴ Therefore, an irrevocable delegation of authority can be made if the parties so agree. In spite of any agreement to the contrary, the principal always possesses the power to revoke the authority of an agent at any time.⁵⁵ The effect, then, of an absolute delegation of authority would be a reduction in the principal's ability to interfere in the day-to-day activities of the investment venture while recognizing that the principal could terminate the relationship at any time.

An additional factor which appeals to the investment advisor is that unlike a general partnership,⁵⁶ a third party generally has no cause of action against an agent where the principal is disclosed.⁵⁷ The theory is that the other party is relying on the credit and business reputation of the principal, so the identity of the agent is unimportant to the transaction. This exemption from liability is not absolute however.⁵⁸ The agent will be personally liable to the third party when it is specifically provided that the agent is to be named as a party to the contract.⁵⁹

2. Agency vs. Limited Partnership

The limited partnership has been the most common form used in tax shelter investments.⁶⁰ Its popularity is based in part on the fact that limited partners are liable only to the extent of their investments in the partnership.⁶¹ The tradeoff for limited liability is that limited partners may not participate in the management of the business.⁶² While this restriction does not generally present any problems for the partners from a business standpoint, it can be an

53. *Id.* § 385.

54. The agent will not be liable to the principal for failure to perform his stated duties if such duties are illegal. *Id.* § 411. See also *id.* § 34, Comment (g).

55. "A statement in a contract that the authority cannot be terminated by either party is effective only to create liability for its wrongful termination." *Id.* § 118, Comment (b). But see *id.* § 450.

56. See note 40 & accompanying text *supra*.

57. RESTATEMENT, *supra* note 9, § 320 states that the agent is not a party to the contract. The third party then is liable directly to the principal pursuant to the terms of the contract. *Id.* § 292.

58. See note 74 & accompanying text *infra*.

59. RESTATEMENT, *supra* note 9, §§ 146, 293.

60. See note 2 *supra*.

61. ULPA § 1; NEB. REV. STAT. § 67-201 (Reissue 1976).

62. ULPA § 7 provides that where the limited partner participates in the management of the business, he will be subject to personal liability as a general partner. NEB. REV. STAT. § 67-207 (Reissue 1976).

obstacle to maximizing tax benefits.⁶³

All limited partnerships must have a general partner who will be ultimately liable for the obligations of the partnership.⁶⁴ If the promoter has special investment skills, it is very unlikely that he will agree to be a general partner due to the exposure of personal liability.⁶⁵ It will be equally unacceptable under the ULPA to make the promoter a limited partner because such a partner can contribute only cash and not services⁶⁶ and he may not manage the enterprise.⁶⁷ Under these circumstances where a limited partnership is not available as a practical matter, an agency may be the only viable alternative in which to set up the investment. Initially, it appears that the agency investors will have lost all control over their potential personal liability. However, through the use of insurance and debt-limiting language in the agency agreement, the problem of liability can be resolved. In addition, by forcing the investor and promoter to deal with the liability issue, the merits of the investment rather than simply the tax results will be more carefully analyzed. If losses are ultimately incurred by the agency, they should be fully deductible against unrelated income of the investor to the extent of the money invested⁶⁸ plus any liabilities if the investor is personally liable under the "at risk" rules of section 465.⁶⁹

C. Indemnity for Liabilities to Third Parties

The principal is not liable, absent apparent authority⁷⁰ or ratification through acceptance of the benefits,⁷¹ for the acts of an agent which are not authorized or are beyond the scope of actual authority.⁷² Thus, if the agreement stated that the agent does not have the authority to borrow funds, but he signs a note purportedly for the principal, the agent will be personally liable for the debt.⁷³ The agent's liability is based on a breach of warranty theory, that is, an implied warranty that he has the authority to bind the principal. However, the principal will remain liable to the third party where

63. See § IV-E of text *infra*.

64. "A limited partnership is a partnership formed by two or more persons . . . having as members one or more general partners and one or more limited partners." UPLA § 1; NEB. REV. STAT. § 67-201 (Reissue 1976).

65. *Id.* § 9; UPA § 15; NEB. REV. STAT. § 67-315 (Reissue 1976).

66. ULPA § 4; NEB. REV. STAT. § 67-204 (Reissue 1976).

67. *Id.* § 7.

68. I.R.C. § 165(c)(2).

69. See § IV-F of text *infra*.

70. See notes 74-76 & accompanying text *infra*.

71. See note 50 *supra*.

72. See note 52 *supra*.

73. *Id.*

the agent has apparent authority to complete the transaction.⁷⁴ Apparent authority is created where the principal directly notifies the third party with whom the agent will deal, and asserts that the promoter is his agent.⁷⁵ In contrast, actual authority is a grant of authority made directly to the agent.⁷⁶ Therefore, an agent who has been given apparent authority to deal with a third person might not have the actual authority to do so under the agency agreement. Assuming that the acts of the agent are authorized and the principal is disclosed, the agent will not be liable because he is not a party to the contract.⁷⁷ In such a case, the third party will have a cause of action directly against the principal.⁷⁸

With respect to tort liability, the principal will be directly liable in most cases for the tortious conduct of the agent under the theory of respondeat superior if there is a master-servant relationship.⁷⁹ This relationship will not exist if the principal does not have a right to control the physical acts of the agent.⁸⁰ The tax shelter promoter should be regarded as an independent contractor (and this should be expressly stated in the agreement) because the investor will lack day-to-day control over his activities.⁸¹ Therefore, absent direct fault by the investor, any tort liability resulting from the actions of the agent should not be imputed to the investor-principal. As a practical matter however, a primary concern in any investment is maximizing the protection of the investors from large liability claims. Not only must the investor be satisfied of the financial solvency of the agent, but he must analyze the potential risks inherent in the particular investment. The probability of an accident and the resultant liability will vary greatly depending on whether the agency is involved in oil and gas or in computers. Regardless of the type of investment, and even

74. "Apparent authority is the power to affect the legal relations of another person by transactions with third persons, professedly as agent for the other, arising from and in accordance with the other's manifestations to such third persons." RESTATEMENT, *supra* note 9, § 8.

75. *Id.* See *id.* § 8, Comment (a).

76. *Id.* See, e.g., *System Investment Corp. v. Montview Acceptance Corp.*, 355 F.2d 463 (10th Cir. 1966).

77. See note 57 *supra*.

78. RESTATEMENT, *supra* note 9, §§ 144, 149.

79. *Id.* § 219.

80. *Id.* § 220.

81. Other factors which will be relevant in the determination of the status of the agent include: (1) Whether the agent is engaged in a business which is distinct from the employer; (2) Whether the agent's work is usually done under the employer's direction or by a specialist without supervision; (3) Whether the employer supplies a place to work and the tools used; (4) the length of the employment; (5) whether payment is made by the amount of time spent or by the job; and (6) the amount of skill necessary to perform the work. *Id.* § 220(2).

though the investor may not be primarily liable, he should make sure that the liability limits are adequate and he should receive copies of all policies and any termination notices directly from the insurance company.

D. Duty and Liability to Investors

The agent is a fiduciary with respect to the principal.⁸² Implicit in the role of a fiduciary are certain duties. These include a duty of care and obedience,⁸³ a duty to notify the principal of matters affecting the subject of the agency,⁸⁴ a duty of loyalty which requires that the agent not compete with the principal without his consent⁸⁵ and a duty not to take a position which is in conflict with the principal's without his prior consent.⁸⁶ The *Restatement of Agency* provides that a breach of any of these duties is both a breach of the agency agreement and a tort based on fraud.⁸⁷ The principal therefore has a number of alternative remedies. Regardless of any personal gain on the part of the agent, the principal can void the transaction and terminate the relationship. The principal may also either sue for violation of the agreement and recover any lost profits, or sue in tort for punitive damages based on bad faith.

While a fiduciary obligation generally cannot be contracted away, an agent is permitted to compete and act in a manner which conflicts with the principal with his consent.⁸⁸ As it is likely that the promoter-agent will desire to enter into other agency relationships, it should be explicitly stated in all agency agreements that the principal consents to such activity. Since the partners to a partnership are both agents and principals,⁸⁹ the same fiduciary obligations generally exist as discussed above.

IV. TAX COMPARISON OF AGENCY AND PARTNERSHIP

A. Is the Agency a Partnership?

The investment agreement should clearly state that an "agency" relationship is contemplated by the parties. However, if certain objective factors exist, the venture will be taxable as a partnership irrespective of statements to the contrary.⁹⁰ This problem arises due to the broad definition of "partnership" for federal tax

82. *Id.* § 1.

83. *Id.* § 379.

84. *Id.* § 381.

85. *Id.* § 387.

86. *Id.* § 394.

87. *Id.* § 399.

88. *Id.* §§ 391, 392.

89. See note 40 & accompanying text *supra*.

90. Raymond W. Schmitz, 47 T.C.M. (P-H) ¶ 78,317 (1978); Rev. Rul. 68-344, 1968-1

purposes.⁹¹ Section 761(a) of the Internal Revenue Code (Code) states that "the term 'partnership' includes a syndicate, group, pool, joint venture or other unincorporated organization . . . which is not . . . a corporation or trust or estate." The Supreme Court in *Commissioner v. Culbertson*⁹² ruled that the issue of whether a partnership exists will not be based on any specific factors but will be decided according to the true intent of the parties as evidenced by a consideration of the objective facts.⁹³ Despite the Supreme Court's disapproval of specific factors to be considered, the Tax Court in *Hubert M. Lunai*⁹⁴ stated that the following factors will be indicative of partnership status:

The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.⁹⁵

These factors have been condensed into three general prerequisites which must be evident before an agency will be regarded as a partnership for tax purposes: (1) the business must be formed with an intent to produce economic profits; (2) such profits must be shared jointly by the principal and agent; and (3) the persons sharing the profits must be co-proprietors.⁹⁶ The first two requirements will be satisfied where the promoter is compensated on a percentage of profits basis because profits will clearly be shared and the promoter has a direct interest in producing more than just

C.B. 569; *Haley v. Commissioner*, 203 F.2d 815 (5th Cir. 1953); *Walsh Constr. Co. v. Church*, 247 F. Supp. 808 (S.D.N.Y. 1965).

91. The statutory definition of a "partnership" is recognized as being much broader than the common law definition. *Hubert F. Baughn*, 38 T.C.M. (P-H) ¶ 69,282 (1969); *Treas. Reg. § 301-7701-3* (1967). For this reason, the common law or state partnership definition will not control for federal tax purposes. *Burk Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110 (1925); *Hecht v. Malley*, 265 U.S. 144 (1924); *Rev. Rul. 77-332*, 1977-2 C.B. 484. However, state law has been considered as a factor in determining partnership status for federal income tax purposes. *Haley v. Commissioner*, 203 F.2d 815 (5th Cir. 1953); *Buckley v. United States*, 76-1 U.S.T.C. (CCH) § 9473 (W.D. Tex 1976); *M.H.S. Co.*, 45 T.C.M. (P-H) ¶ 76,165 (1976), *aff'd*, 575 F.2d 1177 (6th Cir. 1978).

92. 337 U.S. 733 (1949); *Commissioner v. Tower*, 327 U.S. 280 (1946).

93. *Commissioner v. Culbertson*, 337 U.S. at 742.

94. 42 T.C. 1067 (1964).

95. *Id.* at 1077-78.

96. 2 McKEE, *supra* note 1, ¶ 3.02(2).

"tax profits." The central question then is whether the principal and agent are co-proprietors.⁹⁷ Factors to consider in this determination include: (1) whether the agent has made a contribution to capital, thus appearing a co-owner in the venture;⁹⁸ (2) whether losses are allocated to the agent;⁹⁹ and (3) whether the principal and agent have mutual control over the venture, including the right to purchase and sell major assets.¹⁰⁰

Employment and agency relationships have presented difficult problems for the courts because a percentage of profits compensation plan is a common tool used to provide additional incentives.¹⁰¹ For this reason, the sharing of profits is not a determinative characteristic in favor of partnership status.¹⁰² In *Estate of Smith v. Commissioner*,¹⁰³ the taxpayer was involved in a venture called LACO which engaged in commodities trading.¹⁰⁴ LACO had devised a plan whereby investors (called "cash participants") agreed to contribute \$50,000 and LACO would use their skill and expertise to trade in the commodities market.¹⁰⁵ The agreement called the relationship a "joint venture" and stated that, although the futures contracts were purchased in the name of the investor, LACO and the investors would hold them as co-owners.¹⁰⁶ Profits and losses were allocated sixty percent to the investors and forty percent to LACO and either party had the right to terminate without cause.¹⁰⁷

In affirming the Tax Court's decision that LACO and the investors were not in a partnership, the Eighth Circuit stated that LACO was performing managerial services and therefore only had

97. *Pounds v. United States*, 372 F.2d 342 (5th Cir. 1967); *Estate of Smith v. Commissioner*, 313 F.2d 724 (8th Cir. 1963); *Luna v. Commissioner*, 42 T.C. 1067 (1964); *Hartley F. Satnick*, 47 T.C.M. (P-H) ¶ 78,289 (1978); *Ian T. Allison*, 45 T.C.M. (P-H) ¶ 76,248 (1976); *Paul J. Kelly*, 29 T.C.M. (CCH) 1090 (1970); *Rev. Rul. 75-3*, 1975-1 C.B. 383.

98. *Evans v. Commissioner*, 54 T.C. 40 (1970), *aff'd*, 447 F.2d 547 (7th Cir. 1971), *acq.*, 1978-2 C.B.2. The Seventh Circuit held that where capital is a material income-producing factor, a person will be a partner if he owns a capital interest in the partnership. 447 F.2d at 551.

99. *Claire A. Ryza*, 46 T.C.M. (P-H) ¶ 77,064 (1977).

100. *Parker v. Commissioner*, 5 T.C. 1355 (1945); *Schermerhorn Oil Corp. v. Commissioner*, 46 B.T.A. 151 (1942); *Jesse James Finch*, 24 T.C.M. (P-H) ¶ 55,179 (1955).

101. *See generally* Spada & Ruge, *Partnerships—Statutory Outline and Definition*, 161-2d TAX MNGM'T (BNA) A-16, A-17 (1975).

102. *Silling v. Commissioner*, 27 T.C. 701 (1957), *acq.*, 1971-2 C.B. 3; *Maurice Grober*, 41 T.C.M. (P-H) ¶ 72,240 (1972); *Hubert F. Baughn*, 38 T.C.M. (P-H) ¶ 69,282 (1969); *Elizabeth Mayer*, 23 T.C.M. (P-H) ¶ 54,120 (1954).

103. 313 F.2d 724 (9th Cir. 1963).

104. *Id.* at 726.

105. *Id.* at 730.

106. *Id.* at 730-31.

107. *Id.* at 731.

an interest in trading profits rather than an economic interest in capital.¹⁰⁸ This compensatory interest was confirmed by the fact that LACO's right to withdraw cash was restricted and any capital remaining upon dissolution was payable only to the investors.¹⁰⁹ The court also noted that there was little chance that LACO would be subject to liability for any trading losses because any losses would simply be offset against the initial \$50,000 investment.¹¹⁰ Finally, the court held that since LACO had not presented any evidence showing that a partnership was intended to contradict their interest in being compensated for its services, the intent test of *Culbertson* had not been met.¹¹¹

In Revenue Ruling 75-43,¹¹² the Service ruled on the tax status of a cattle owner who delivered cattle to a corporate feed lot operator. The service agreement provided that the operator was to feed and care for the animals in preparation for market. All feed was to be purchased from the operator and the cattle were separated from the other cattle and were separately insured against casualty losses by the feed lot. The five-year agreement provided that the owner was to advance \$50,000 to maintain the cattle and it specifically stated that the operator was an independent contractor and that no partnership was intended. The operator was to receive ten percent of the owner's net proceeds in compensation for its services. Under these terms, the Service held that this arrangement was not a partnership because: the owner had control over and in fact owned the cattle; the profits interest was in payment for the operator's services and facilities; and there was no intent to conduct the business as a partnership.

It is apparent, then, that a profits interest in an agency agreement will not automatically classify the agent as a partner. However, because one factor is not determinative, the following should not be included in an agency agreement without a careful consideration of the consequences. The agent should not be allocated any losses from the venture and should not make a contribution to capital. The investor should be the stated owner of the investment property and should retain the power to terminate the relationship at any time. It is also advisable to restrict the agent's power to sell or dispose of the investment without the investor's consent. Finally, it is important to carry out the operation of the investment as an agency rather than as a partnership. This can be done by not representing the operation to be a partnership to third parties, by

108. *Id.* at 732.

109. *Id.*

110. *Id.*

111. *Id.*

112. 1975-1 C.B. 383.

keeping separate books and by refraining from any temptation to file a partnership tax return.¹¹³

If the agency is classified as a partnership for federal tax purposes, a partnership tax return must be filed for the taxable year.¹¹⁴ Since partnership status will typically not be determined until after the first few years of operation, the past tax returns of the principal and agent will have to be amended to reflect any changes in the allocation of income and expenses. Before 1979, criminal penalties could be imposed for the failure to file a partnership return, and such failure had to have been "willful."¹¹⁵ The 1978 Act expanded the penalty provisions by adding section 6698. It provides for a dollar penalty equal to fifty dollars times the number of partners, for each month that the return was delinquent.¹¹⁶ In any event, the penalty cannot be imposed in excess of five months.¹¹⁷ Agencies treated as partnerships should escape the penalty because section 6698(a)(2) provides that the penalty will not be imposed where there is "reasonable cause" for the failure to file the return.

B. Investors as Partners

Even if the individual investor and the promoter-agent are not classified as a partnership, caution must be exercised so the investors will escape classification as being in partnership with each other. This situation can arise where large amounts of capital are required to invest in real estate or oil and gas. The promoter, rather than forming a partnership with the investors, will enter into separate agencies with each of them, pool their money and purchase the investment for the investors as tenants in common. The agent typically does not make a personal investment but will utilize his skills in managing the property in exchange for a percentage of profits.¹¹⁸ As discussed above,¹¹⁹ this scheme appears to fit neatly into the definition of a partnership under section

113. See generally *Halstead v. Commissioner*, 296 F.2d 61 (2d Cir. 1961); *Maletis v. United States*, 200 F.2d 97 (9th Cir. 1952); *Jordan K. Smith*, 47 T.C.M. (P-H) ¶ 78,416 (1978); *McManus v. Commissioner*, 65 T.C. 197 (1975), *aff'd*, 583 F.2d 443 (9th Cir. 1978); *Richard O. Wheeler*, 47 T.C.M. (P-H) ¶ 78,208 (1978); *Ian T. Allison* 45 T.C.M. (P-H) § 76,248 (1976); *Estate of McDaniel*, 30 T.C.M. (P-H) § 61,302 (1961).

114. The return must state the gross income and deductions of the partnership and "shall include in the return the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual." I.R.C. § 6031.

115. I.R.C. § 7203.

116. I.R.C. § 6698(b).

117. *Id.*

118. See notes 22-24 & accompanying text *supra*.

119. See note 91 & accompanying text *supra*.

761(a) as an "unincorporated organization" used for the purpose of carrying on a business "venture."¹²⁰

The regulations do provide some immediate relief.¹²¹ While it reiterates the Code definition of a "partnership," regulation section 1.761-1(a) provides that "mere co-ownership of property which is maintained, kept in repair and rented or leased does not constitute a partnership."¹²² Nonetheless, co-ownership may constitute a partnership, according to the regulation, when a business is actively conducted and the profits are shared by the owners.¹²³ The regulation provides a few examples to clarify the distinction. A simple lease of farm land in exchange for a set fee or a percentage of the crops will not be a partnership. However, a partnership will be created where, in addition to the leasing of apartments, the co-owners of the building also provide additional services, whether individually or through their agent. On this basis, co-ownership will lead to partnership status if, in addition to the performance of ordinary maintenance and upkeep activities consistent with the ownership of such property, significant additional services are rendered which indicate the active operation of a business.

The "safe harbor" then, is that any services provided by co-owners or their agents should be limited to the maintenance and direct leasing of the premises with no "extras" added in. However, in Revenue Ruling 75-374,¹²⁴ the Service approved of an ideal method of circumventing partnership status while rendering additional services to the tenants. An insurance company and a real estate investment trust were undivided one-half owners of an apartment complex. They selected an unrelated agent to manage the property whose duties included renting and maintaining the apartments and paying all of the expenses of operation including taxes and insurance. Additional expenses included the cost of unattended parking, water, heat, air conditioning and garbage service, which were furnished to the tenants at no extra charge. The agent's compensation which was paid equally by each co-owner was a percentage of the operating gross profits from the apartment complex. In order to provide additional services to the tenants, the agent was authorized to furnish at additional expense attended

120. *Id.*

121. Treas. Reg. § 1.761-1(a), T.D. 7208, 1972-3 C.B. 396.

122. *Id.* at 397. See generally John McShain, 68 T.C. 154 (1977); Lena Hahn, 22 T.C. 212 (1954); Lulu Luna Powell, 36 T.C.M. (P-H) ¶ 67,032 (1967); Charles E. Tibbals, 27 T.C.M. (P-H) ¶ 58,044 (1958); Almy Gilford, 21 T.C.M. (P-H) ¶ 52,049 (1952), *aff'd*, 201 F.2d 735 (2d Cir. 1953); Priv. Let. Rul. 7826012 (March 28, 1978); Priv. Let. Rul. 7743024 (July 27, 1977), *amended*, Priv. Let. Rul. 7803060 (Oct. 27, 1977).

123. Treas. Reg. § 1-761-1(a), T.D. 6500, 7208, 1972-2 C.B. 396.

124. 1975-2 C.B. 261.

parking, covered patios and other utilities such as electricity. The agent was solely liable for the costs of these optional features and all profits were retained by the agent as additional compensation for its efforts. In holding that the two investors would not be treated as partners for tax purposes, the Service recognized that the investors themselves were only providing services related to the maintenance of the complex. They were not rendering additional services through their agent because the agent alone was responsible for the cost of such services and would realize all of the profits from them.

If a promoter desires to pool the contributions of many investors in order to make a major investment such as into an apartment building, a number of guidelines should be considered. Separate agency agreements should be executed which authorize the purchase of the investment and enumerate the management duties of the promoter. Each investor should have the right to terminate the agency and there should not be any requirements that an agency interest can be sold only upon a majority vote of the other investors. Any on-going business activity should be carried on solely by the agent as described in Revenue Ruling 75-374. Title to the property should list the owners of the undivided interests and separate accounts should be maintained for each investor. Finally, if the agency owns separate assets, such as cattle (as opposed to an undivided interest in an oil and gas or real estate venture), they should be separated from other cattle and kept in their own area. If for some reason these guidelines are not followed and the venture is classified as a partnership, relief is available because the investors are permitted to elect out of Subchapter K.¹²⁵

C. Electing out of Partnership Status

If an agency is held to be taxable as a partnership, section 761(a) allows the members to elect to be excluded from Subchapter K.¹²⁶ Section 761(a) states that only two types of unincorporated organizations qualify for exclusion: one which is used for investment purposes or one which involves "the joint production, extraction, or use of property . . ."¹²⁷ In order to elect out, the members of the organization must be able adequately to determine their income without having to compute partnership taxable

125. Treas. Reg. § 1.761-2(a)(2), T.D. 7208, 10-3-72. See § IV-C of text *infra*.

126. The procedural requirements for electing out are set forth in Treas. Reg. § 1.761-2(b), T.D. 7208, 10-3-72. See generally Heller, *Electing Exclusion from the Partnership Provisions: Safety Valve for Co-Owners*, 56 TAXES 330 (1978).

127. I.R.C. § 761(a)(1) & (2); Treas. Reg. 1.761-2(a)(2) & (3), T.D. 7208, 1972-2 C.B. 396.

income. Also, the election is not available to an association taxable as a corporation.¹²⁸

As a practical matter, the members of the typical agency will not qualify as one of the two types of organizations which may elect out. The stumbling block for agencies is that the regulations state that in order to elect out as an investing partnership, the participants must be co-owners of the property.¹²⁹ The second category, involving the joint extraction or use of property, similarly requires that the participants "own the property as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights"¹³⁰ This second category for exclusion has generally been used by oil and gas or mining activities.¹³¹ For this reason, the language "or other form of contract granting exclusive rights" is aimed at the situation where the participants obtain an operating lease together from a third party rather than in the form of a contract from one participant as owner to the other as operator. Although the meaning of the above-stated language might be applicable to a tax shelter agency with a separate owner and operator, the safe route is to carefully structure the agency relationship so as to avoid partnership status entirely.

D. Association Taxable as a Corporation

Another potential trap for the agency form is the possibility of being classified as an association taxable as a corporation.¹³² The regulations state that an "association" is an organization which has the essential characteristics of a corporation.¹³³ The characteristics to be used in this determination are: centralization of management; continuity of life; limited liability; and free transferability of interest.¹³⁴ If the agency has more than two of these qualities, then it will be an association taxable as a corporation. Absent unique provisions to the contrary, the tax shelter agency will lack at least three of these characteristics.

The agency will not have continuity of life because the death or expulsion of the agent will cause the termination of the relation-

128. Treas. Reg. § 1.761-2(a)(1), T.D. 7208, 1972-2 C.B. 397.

129. Treas. Reg. § 1.761-2(a)(2)(i), T.D. 7208, 1972-2 C.B. 397.

130. Treas. Reg. § 1.761-2(a)(3)(i), T.D. 7208, 1972-2 C.B. 397.

131. 2 MCKEE, *supra* note 1, ¶ 3.05(1), n.108.

132. Fisher, *Classification Under Section 7701—The Past, Present, and Prospects for the Future*, 30 TAX LAW. 627 (1977); Koch, *Limited Partnerships—Tax Status as Partnerships or Associations*, 76-7 TAX MGT. MEMO. 3 (1976); Sexton & Osteen, *Classification as a Partnership or As An Association Taxable as a Corporation*, 24th TUL. TAX INST. 95 (1975).

133. Treas. Reg. § 301.7701-2 (1967), *amended*, T.D. 7515, 1977-2 C.B. 482.

134. Treas. Reg. § 301.7701-2(a)(2) (1967), *amended*, T.D. 7515, 1977-2 C.B. 482.

ship.¹³⁵ In addition, although the agency agreement may state that it is to last for a period of years, section 301.7701-2(b)(3) of the regulations provides that irrespective of such agreement, if any person has the power to dissolve the agency, as the principal does,¹³⁶ then continuity of life does not exist. With respect to centralization of management, the regulations specifically state that this factor is not present "when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal."¹³⁷ Finally, since the principal will remain personally liable to the creditors of the agency,¹³⁸ the element of limited liability is not a characteristic of an agency relationship. While the agency form will not fall within the association provisions, it does not present any significant advantages over a limited partnership. The regulations state that limited partnerships formed under the Uniform Limited Partnership Act will generally not be associations, as they lack continuity of life¹³⁹ and will not have limited liability,¹⁴⁰ absent a corporate general partner with no substantial assets.¹⁴¹

E. The Agency as a Farm Syndicate

If the tax shelter agency is formed to invest in cattle or other farm related activity, section 464 may operate to severely limit the tax advantages of such investment.¹⁴² Essentially, it prevents the shifting of substantial amounts of unrelated income, where cattle are purchased and the cost of feed is prepaid and deducted in year one while the cattle are fed and sold in year two, with the income being reported in the following year. Specifically, section 464 states that "farm syndicates" cannot deduct feed expenses (or other farm supplies) except in the year in which the feed is actually used.¹⁴³ Also, the cost of poultry held for the laying of eggs must be capitalized over their life or twelve months, whichever is less.¹⁴⁴ If poultry is purchased for resale, then the costs are deductible only in the year of sale.¹⁴⁵ Farm syndicate includes any organization other than a corporation: (1) which has offered interests for sale which have been registered pursuant to state or fed-

135. See note 19 & accompanying text *supra*.

136. See note 55 & accompanying text *supra*.

137. Treas. Reg. § 301.7701-2(c)(1)(3) (1967), *amended*, T.D. 7515, 1977-2 C.B. 482.

138. See note 46 & accompanying text *supra*.

139. Treas. Reg. § 301.7701-2(b)(3) (1967), *amended*, T.D. 7515, 1977-2 C.B. 482.

140. Treas. Reg. § 301-7701-2(d)(1) (1967), *amended*, T.D. 7515, 1977-2 C.B. 482.

141. Treas. Reg. § 301-7701-2(d)(2) (1967), *amended*, T.D. 7515, 1977-2 C.B. 482.

142. See note 2 *supra*.

143. I.R.C. § 464(a).

144. I.R.C. § 464(b)(1).

145. I.R.C. § 464(b)(2).

eral securities law;¹⁴⁶ or (2) which allocates thirty-five percent or more of the losses to limited partners or limited entrepreneurs.¹⁴⁷ The Code further provides five categories of taxpayers whose interest will be excluded from the thirty-five percent test, but these exceptions are narrow in scope and do not present any great "loop-hole" for non-farming investors.¹⁴⁸

The key to the continued viability of the agency as opposed to the limited partnership in tax shelter farm investments lies in the definition of "limited entrepreneur." Section 464(e) (2) states that a "limited entrepreneur" is meant to include a person who is not a limited partner and does not actively participate in the management of the farming enterprise. The 1976 Committee Report outlined a number of factors which will be considered in the determination of whether the principal-investor actively participates in the venture.¹⁴⁹ Factors supporting active participation include the making of decisions involving the management and the operation of the farm, actually living or working on the farm, or the direct hiring and firing of employees rather than such power only over the farm manager. Factors illustrating a lack of participation include little control over management and operation of the farm, having the power only to fire the farm manager rather than the

146. I.R.C. § 464(c) (1) (A).

147. I.R.C. § 464(c) (1) (B).

148. I.R.C. § 464(c) (2) states that individuals falling within one of these five categories will not be regarded as a limited partner or limited entrepreneur for the purposes of the 35% test in section 464(c) (1) (B):

(A) in the case of any individual who has actively participated (for a period of not less than 5 years) in the management of any trade or business of farming, any interest in a partnership or other enterprise which is attributable to such active participation,

(B) in the case of any individual whose principal residence is on a farm, any partnership or other enterprise engaged in the trade or business of farming such farm,

(C) in the case of any individual who is actively participating in the management of any trade or business of farming or who is an individual who is described in subparagraph (A) or (B), any participation in the further processing of livestock which was raised in such trade or business (or in the trade or business referred to in subparagraph (A) or (B)),

(D) in the case of an individual whose principal business activity involves active participation in the management of a trade or business of farming, any interest in any other trade or business of farming, and

(E) any interest held by a member of the family (or a spouse of any such member) of a grandparent of an individual described in subparagraph (A), (B), (C), or (D) if the interest in the partnership or the enterprise is attributable to the active participation of the individual described in subparagraph (A), (B), (C), or (D).

149. STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 537 (Committee Print 1976), *reprinted in* 1976-3 (Vol. 2) C.B. 549.

employees individually, having a manager who is an independent contractor rather than an employee and being subject only to limited liability for farm losses.

With these factors in mind, the agency agreement can be drafted so as to provide for material participation on the part of the investor in order to avoid the farm syndicate rules. The agreement should state that the investor will make regular visits to inspect the farm or ranch and the agent's power to sell the investment should be restricted. Also, the decisions relating to the management and operation of the investment should be made by the investor and not the agent. If the investment was in cattle, typical instructions to the agent include the weight and color of the heifers and the date and location of the feed lot where the purchase is to be made. Finally, the investor alone would have the authority to hire and fire employees.

There are two problems which are readily apparent. First, it has been assumed throughout this comment that the agent is a specialist in the particular investment field and will demand a certain amount of autonomy in order to use his skills.¹⁵⁰ Therefore, it may be very difficult to find an agent who would agree to all of these above-stated conditions. Second, remembering the time-worn "substance over form"¹⁵¹ argument, it would be difficult to argue that a New York orthopedic surgeon has the requisite knowledge and time to actively manage a cattle feeding operation. However, if the doctor has some prior experience in the particular investment area his or her participation obviously becomes more meaningful.

F. The "At Risk" Rules

The primary benefit of tax shelter investments in past years was the ability to invest small amounts of cash and borrow large amounts of capital on a nonrecourse note.¹⁵² Although not subject to personal liability, the investor could deduct losses up to the total cost of the investment against unrelated income. In 1976, the attractiveness of the tax shelter was reduced with the enactment of section 465. It provides that losses arising from investments in motion pictures, farming, equipment leasing, and oil and gas¹⁵³ are deductible only to the extent the investor is "at risk."¹⁵⁴ The

150. See note 4 & accompanying text *supra*.

151. See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Gregory v. Helvering*, 293 U.S. 465 (1935).

152. See notes 1-2 *supra*.

153. I.R.C. § 465(c)(1). After 1978, section 465 will apply to all activities engaged in as a trade or business or for the production of income. I.R.C. § 465(c)(3).

154. I.R.C. § 465(b).

amount "at risk" essentially equals the amount of cash or adjusted basis of property contributed, plus the amount of any loans for which such investor remains personally liable.¹⁵⁵

If the investment was made by a partnership, the application of the loss limitation rules was not restricted to the four activities mentioned in section 465. Prior to 1979, section 704(d) provided that losses were only deductible by partners to the extent of their adjusted basis in the partnership. However, a partner's basis was not increased by any liability regardless of the investment if the partner was not subject to personal liability.¹⁵⁶ Accordingly, an investor could form an agency and invest in an activity other than the four mentioned in section 465 and still deduct losses to the extent of all nonrecourse loans. Under the partnership form, section 704(d) would clearly limit those losses.

This distinct advantage of an agency relationship was struck down in the Revenue Act of 1978.¹⁵⁷ Section 201 of the act extended the at-risk rules so that they now apply to any activity carried on as a part of a trade or business or for the production of income. Activities which remain excluded from the purview of section 465 are investments in real property¹⁵⁸ and section 1245 equipment leasing carried on by a closely held corporation (corporations in which at least fifty percent of the stock is owned by five or fewer persons).¹⁵⁹ In addition, the Act repealed the last two sentences of section 704(d) as they duplicated the expanded application of the "at risk" rules.

G. The Flow of Tax Benefits

While tax benefits derived from the investment flow through to both the partner and the principal, there are certain dollar limitations that are imposed at the partnership level, thus making an agency more attractive. Section 179 permits an additional first year depreciation deduction for property used in a trade or business or held for the production of income equal to twenty percent up to a cost of \$10,000 for single taxpayers and \$20,000 for married taxpayers. Section 179(d)(8) provides that these limitations are to apply at both the partnership and partner level. Therefore, the partners must divide the \$2,000 deduction among them. If one partner has first year depreciation deductions attributable to other property up to the maximum amounts, then his share of the part-

155. *Id.*

156. I.R.C. § 704(d).

157. Revenue Act of 1978, Pub. L. No. 95-600, tit. VII, § 201, 92 Stat. 2815 (1978).

158. I.R.C. § 465(c)(3)(D)(i).

159. I.R.C. § 465(c)(3)(D)(ii).

nership depreciation will not be deductible by that partner.¹⁶⁰ Even if the partners do not deduct their share of the depreciation, the basis of the partnership property is still reduced by the full amount of the excess depreciation claimed by the partnership.¹⁶¹ In contrast, if an agency was formed, each investor would be entitled to claim a first year depreciation deduction of \$2,000, or \$4,000 if married.

Section 48 limits the cost of used section 38 property for investment tax credit purposes to a maximum of \$100,000.¹⁶² The regulations state that this limit is applied at both the partnership and partner levels.¹⁶³ Each partner would therefore only be entitled to a distributive share of the credit up to the \$100,000 maximum at the partnership level even though five partners may have purchased \$500,000 worth of used equipment. With an agency each investor would compute the investment tax credit individually up to the \$100,000 cost limitation.

H. Limitations on Investment Interest

Section 163(d) limits the amount of investment interest which can be deducted to \$10,000 plus the amount by which investment income exceeds expenses.¹⁶⁴ For the purposes of computing the interest limitations for partnerships, the determination is made at the partner level according to each partner's distributive share of interest and income and expenses.¹⁶⁵ As the dollar limits are not applied at the partnership level, there is no advantage to be gained by using an agency. In fact, if a taxpayer and his immediate family own fifty percent or more of a partnership (or corporation),¹⁶⁶ the interest limit is raised to the lesser of \$15,000 or the amount of interest paid annually on a liability incurred in the initial purchase of the partnership.¹⁶⁷ Assuming an interest rate of twelve percent, an investor should consider forming a partnership, rather than an agency, if \$90,000 or more is to be borrowed in order to deduct the additional investment interest.

160. Treas. Reg. § 1.179-2(d)(1), T.D. 6507, 1960-2 I.R.B. 91, *amended*, T.D. 6579, 1961-2 I.R.B. 54 and T.D. 7181, 1972-1 C.B. 291.

161. Treas. Reg. § 1.179-2(d)(2) ex.(1), T.D. 6507, 1960-2 I.R.B. 97, *amended*, T.D. 6579, 11-7-61 and T.D. 7181, 1972-1 C.B. 291.

162. I.R.C. § 48(c)(2)(A).

163. Treas. Reg. § 1.48-3(c)(3), T.D. 6731, 1964-1 I.R.B. 11, *amended*, T.D. 7181, 1972-1 C.B. 291.

164. I.R.C. § 163(d)(1)(B).

165. I.R.C. § 163(d)(4)(B). A partner's distributive share will be determined by the partnership agreement unless it lacks "substantial economic effect". I.R.C. § 704(a) & (b). See note 24 *supra*.

166. I.R.C. § 163(d)(7)(B).

167. I.R.C. § 163(d)(7)(A).

I. Tax Elections

Elections affecting the tax treatment of the partnership and its assets are made by the partnership and not the partners.¹⁶⁸ A list of the more common elections includes the choice of a permissible method of accounting,¹⁶⁹ the method of computing depreciation on partnership property,¹⁷⁰ a section 179 election to deduct additional first year depreciation, an election to deduct intangible drilling and development costs under section 263(c) and the choice of the taxable year of the partnership.¹⁷¹ These elections can present special problems for partners. As an example, where a partner has elected to deduct the maximum additional first year depreciation on assets owned individually, the portion of section 179 additional depreciation on partnership assets allocable to him will be in excess of the limit. Not only will such partner lose the deduction, but the basis of the partnership assets will be reduced by the amount of the depreciation regardless of its deductibility at the partner level.¹⁷² If any of the partners have adopted tax years other than on a calendar basis, the choice of a partnership taxable year will be a difficult task. Under section 706(b), the principal partners (defined as those having a five percent interest in capital or profits)¹⁷³ may not have a tax year different from the partnership. The principal partners must therefore agree on a taxable year and the non-conforming principal partners will be required to change their personal tax years. As an additional burden, if the partners change from a calendar year, the permission of the Commission is required.¹⁷⁴ These problems are totally avoided if an agency relationship is used by each investor.

J. Organization Fees

The organization fees incident to the formation of a partnership may be amortized over not less than sixty months if an election is made by the partnership under section 709(b).¹⁷⁵ Any expenses incurred in the formation of the agency relationship may not be amortized over a period of years but must be deducted in the year incurred. This factor may or may not be a disadvantage to an agency, depending on the particular tax position of the investor-principal.

168. I.R.C. § 703(b).

169. I.R.C. § 446(c).

170. I.R.C. § 167(b).

171. I.R.C. § 706(b)(1).

172. See note 152 & accompanying text *supra*.

173. I.R.C. § 706(b)(3).

174. I.R.C. § 442.

175. I.R.C. § 709(b)(1).

V. CONCLUSION

The agency form is a viable alternative to the more frequently used limited partnership. It may be selected where the investor does not want to be involved with others as partners and desires the flexibility of being able to change the risk factor or tax objectives without the consent of other investors. If the promoter is highly competent in the investment area, an agency may be used simply because the promoter does not want to be subject to liability as a general partner in a limited partnership. In addition, the promoter may not want to personally invest any money in the venture. The agency can also yield significant tax advantages such as the possible escape from the farm syndicate rules and the realization of maximum deductions on certain items which have dollar limitations such as additional first year depreciation and investment tax credit on used equipment.

As with all other forms, the agency does have its drawbacks. It generally cannot be utilized with small amounts of money and minimum investments of \$25,000 to \$50,000 are often required. The investor-principal is not completely shielded from tort liability but the risk will depend on the type of investment. There is always the possibility that the agency may be regarded as a partnership between the investor and promoter or between the investors themselves. The success of an agency investment will depend a great deal on the quality of the promoter and potential investors should inquire into his personal qualifications and into the financial status of past investments. Finally, investors should not participate in any investment until they consult outside sources to determine the quality of the particular investment itself.

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