St. Mary's Law Journal

Volume 12 | Number 4

Article 5

12-1-1981

Basics of Real Estate Syndications Symposium - Real Estate Finance - An Emphasis on Texas Law.

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BASICS OF REAL ESTATE SYNDICATIONS

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I. INTRODUCTION

Real estate syndications[1] have been used for years as a means of financing the development of real property.[2] Activity in this area has increased dramatically in recent years. Factors contributing to this increase include amendments to the Internal Revenue Code of 1954 (Code) that eliminated tax benefits previously available from other investments,[3] a long period of sustained appreciation of real property values that has far exceeded the average appreciation of most other investments,[4] a high rate of inflation that has resulted in many people being pushed into higher tax brackets,[5] and high interest rates that have caused developers to turn more frequently to syndications as a source of capital.[6]

Real estate syndications can be extremely complex and difficult transactions. Many federal and state tax, securities, partnership, and real estate laws must be considered in structuring each syndication. This article discusses some of the fundamental aspects of

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1. A real estate syndicate is basically a group of persons who pool their investment capital in order to improve the size, number, and quality of their real estate investments and to reduce their risks through diversity. The syndicate is normally comprised of passive investors who rely on a promoter to provide the necessary supervision and conduct of the business and affairs of the syndicate. *See* L. MOSBURG, REAL ESTATE SYNDICATE OFFERINGS: LAW & PRACTICE 5 (1974).

2. *See* Hrusoff, *Securities Aspects of Real Estate Partnerships*, 11 CAL. W.L. REV. 425, 425 (1975). Advantages which syndications afford the investor include: (1) ownership of an interest in a substantial amount of income producing property; (2) diversification of risks through participation in several syndications; (3) benefits associated with the expertise of professional management; (4) substantial tax shelter for cash distributions as well as other income; (5) realization of capital gain upon the sale of the property; and (6) limitation of liability to the amount invested in the property.

3. *See* Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763; Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

4. This rate of appreciation is reflected in the homeownership factor of the Consumer Price Index published by the Bureau of Labor Statistics, which increased from a base of 100 in 1967 to 323.8 in October 1980. 66 Fed. Res. Bull. app. 49 (Dec. 1980). In comparison, the New York Stock Exchange common stock price index increased from a base of 50 in 1965 to just 75.17 in October 1980. 66 Fed. Res. Bull. app. 26 (Dec. 1980).

5. The all-items Consumer Price Index published by the Bureau of Labor Statistics increased 12.6% from October 1979 to October 1980. 66 Fed. Res. Bull. app. 49 (Dec. 1980).

6. The weighted average annual percentage rate for conventional mortgages on new homes compiled by the Federal Home Loan Bank Board in cooperation with the Federal Deposit Insurance Corporation increased from 9.3% in 1978 to 12.2% in October 1980. During the same period, the average amount of fees and charges paid to obtain such loans, expressed as a percentage of the loan amount, increased from 1.39% to 2.16%. 66 Fed. Res. Bull. app. 38 (Dec. 1980).

the real estate syndication process.

II. The Limited Partnership

The limited partnership[7] is the preferred type of investment vehicle used in real estate syndications. The use of the limited partnership permits the tax benefits associated with real estate investment to "pass through" to the investors.[8] While the general partner or partners have unlimited liability, the liability of the limited partners is limited to the amount of their investment, unless they take part in the control of the business of the partnership.[9] Limited partnerships also have the advantages of centralization of management[10] and continuity of life.[11] Other types of investment

7. A limited partnership is formed by two or more persons, one or more of whom are designated as general partners and one or more of whom are designated as limited partners, filing in the appropriate state office a sworn certificate containing certain required information, including the name, character, and place of business of the partnership, the name and residence address of all partners, the capital contributions of the limited partners, and each limited partner's share in the profits of the partnership. *See* Tex. Rev. Civ. Stat. Ann. art. 6132a, § 3(a)(1) (Vernon 1970); Revised Uniform Limited Partnership Act § 201; Uniform Limited Partnership Act § 2. In Texas, the certificate is filed with the Secretary of State and must be accompanied by a filing fee in the amount of one-half of 1% of the limited partner's capital contributions, with a minimum fee of $100 and a maximum fee of $2,500. *See* Tex. Rev. Civ. Stat. Ann. art. 6132a, § 3(a)(2) (Vernon Supp. 1980-1981).

8. *See* I.R.C. § 702(a). The partnership is not a taxpayer; it is a reporting entity through which taxable items of the partnership pass. These items are then reflected on the individual returns of the partners, regardless of whether partnership income is distributed to the partners or retained by the partnership for future business purposes. *See* H. Reuschlein & W. Gregory, Agency and Partnership § 256, at 398 (1979).

9. *See* Tex. Rev. Civ. Stat. Ann. art. 6132a, § 8 (Vernon Supp. 1980-1981); Revised Uniform Limited Partnership Act § 303; Uniform Limited Partnership Act § 7.

10. The management of a limited partnership is conducted by the general partner or partners. A general partner of a limited partnership has most of the rights and powers of a partner in a partnership without limited partners. *See* Tex. Rev. Civ. Stat. Ann. art. 6132a, § 10(a) (Vernon 1970); Revised Uniform Limited Partnership Act § 403; Uniform Limited Partnership Act § 9.

11. On the death of a limited partner, his executor or administrator succeeds to his partnership interest. *See* Tex. Rev. Civ. Stat. Ann. art. 6132a, § 22 (Vernon 1970); Revised Uniform Limited Partnership Act § 705; Uniform Limited Partnership Act § 21. The retirement, death, or insanity of a general partner dissolves the partnership, unless the business is continued by a remaining general partner under a right to do so stated in the partnership certificate or with the consent of all partners. *See* Tex. Rev. Civ. Stat. Ann. art. 6132a, § 21 (Vernon 1970); Revised Uniform Limited Partnership Act § 801; Uniform Limited Partnership Act § 20. The term for which the partnership is to exist is to be stated in the partnership certificate. *See* Tex. Rev. Civ. Stat. Ann. art. 6132a, § 3 (Vernon 1970); Revised Uniform Limited Partnership Act § 201; Uniform Limited Partnership Act § 2.

vehicles, such as joint ventures and general partnerships, do not offer limited liability,[12] and ordinary corporations do not permit a pass-through of the tax benefits.[13] Although tax benefits may be passed through to the shareholders of Subchapter S corporations,[14] such corporations are often unsuitable for real estate syndications because of the requirements that there be no more than fifteen shareholders[15] and that no more than 20% of the gross receipts of the corporation constitute "passive investment income" such as rents.[16] The amount of losses which may be passed through to a shareholder of a Subchapter S corporation or to a partner of a partnership is limited in both instances to the adjusted basis of his investment in the entity.[17] The adjusted basis of a partner in a partnership, however, includes the partner's share of the liabilities of the partnership.[18] Therefore, the use of leverage through partnership borrowings enables the partner to deduct losses which may exceed his actual cash contribution to the partnership.

The limited partnership interests may be sold to investors directly by the developer or by a firm or entity which regularly engages in real estate syndications, such as a securities broker or a real estate broker, which may or may not be affiliated with the developer. Such professional syndicators, or their affiliates, may receive compensation in the form of real estate commissions, commissions on the sale of interests to the limited partners, management fees, leasing fees, or a "carried" ownership interest in

12. *See, e.g.*, Woolard v. Mobil Pipe Line Co., 479 F.2d 557, 561 (5th Cir.), *cert. denied*, 414 U.S. 1025 (1973) (Texas doctrine of "joint venture" makes each joint venturer the agent of the other for purposes of tort liability); Misco-United Supply, Inc. v. Petroleum Corp., 462 F.2d 75, 79 (5th Cir. 1972) (Texas law authorizes one joint venturer to contractually bind other joint venturers when acting in furtherance of the joint enterprise); Tex-Co Grain Co. v. Happy Wheat Growers, Inc., 542 S.W.2d 934, 936 (Tex. Civ. App. - Amarillo 1976, no writ) (rights, duties, and liabilities of joint venturers parallel those of partners). In Texas, all partners are liable jointly and severally for all debts of a general partnership. *See* TEX. REV. CIV. STAT. ANN. art. 6132b, § 15 (Vernon 1970). The uniform act provides that contractual liability is joint rather than several. *See* UNIFORM PARTNERSHIP ACT § 15.

13. Ordinary corporations are taxable entities for federal income tax purposes under the Code, and are taxed on their income. *See* I.R.C. § 11.

14. *See id.* § 1372. Subchapter S of the Code permits "small business corporations," as defined therein, to elect not to be subject to the taxes imposed on ordinary corporations. *Id.* §§ 1371-1379.

15. *Id.* § 1371(a)(1).

16. *Id.* § 1372(e)(5).

17. *Id.* §§ 1374(c)(2), 704(d).

18. *Id.* § 752(a).

the limited partnership.[19] Because some developers are relatively inexperienced in dealing with outside investors and are reluctant to expose themselves to potential claims of investors, a two-tier partnership arrangement may be used. In this arrangement, the professional syndicator will act as the general partner of a limited partnership having the investors as limited partners. This limited partnership then becomes the limited partner of another limited partnership of which the developer is the general partner. The two-tier arrangement also permits the limited partnership of which the investors are limited partners to participate in several projects with various developers as general partners.[20]

In syndications for the purpose of constructing apartments, office buildings, condominiums, shopping centers, and similar projects, the developer-contractor is often the general partner. In addition to construction of the project, the general partner usually contracts with the partnership to undertake other financial and managerial obligations with respect to the project, such as leasing, management, arranging or guaranteeing financing, or guaranteeing against operating losses for a specified period of time. In exchange for its services, the developer or its affiliates will receive certain fees which are intended to yield a profit for the developer.

The limited partnership may be formed prior to the acceptance of subscriptions from investors for various reasons, such as the acquisition of land or the borrowing of money in the name of the partnership. This usually is accomplished by naming an employee of the general partner as the original limited partner in the limited partnership certificate. Upon closing of the sale of limited partnership interests to the investors, the certificate is amended to admit the investors as limited partners, and the original limited partner usually is returned his nominal capital contribution and withdraws from the partnership.

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19. The receipt of a partnership interest in exchange for services may constitute taxable income. *See* Treas. Reg. § 1.721-1(b)(1).

20. Under some circumstances, the upper tier partnership in a two-tier partnership arrangement may be required to register under the Investment Company Act of 1940. 15 U.S.C. §§ 80a-1 to 80a-52 (1971). *See* 17 C.F.R. § 276.8456 (Aug. 9, 1974), *reprinted in* [1980] 4 Fed. Sec. L. Rep. (CCH) ¶ 47,357.

III. TAX ASPECTS

A. *Taxation of Limited Partnerships*

A limited partnership is treated as an entity for tax purposes in computing income, gain, loss, credit, and other tax aspects of its activities.[21] The partnership, however, is not subject to tax.[22] The tax effects of the activities of the partnership "pass through" to the partners to the extent of their respective shares of such items as income, gain, loss, and credit.[23] This pass-through avoids the double taxation inherent in the ordinary corporation.[24] The character of each item passed through to the partners is "determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."[25] Limited partnerships in the real estate field, therefore, are able to provide "tax shelter" for the other income of the partners by passing through the benefits of depreciation and other deductions, to the extent that they exceed the income of the partnership.[26]

Each partner's share of partnership income, gain, deduction, or loss is referred to as his distributive share.[27] The distributive share of each partner will not necessarily coincide with cash flow from the partnership. The partnership agreement determines the distributive share of each partner unless the allocation provided by the partnership agreement lacks "substantial economic effect."[28] If the allocation does not have substantial economic effect, the distributive share of each partner is determined by taking into account all surrounding facts and circumstances.[29] An allocation to a

21. I.R.C. § 702.

22. *Id.* § 701.

23. *Id.* § 702(a).

24. The income of ordinary corporations is taxed first at the corporate level, *see id.* § 11, and then at the shareholder level when such income is distributed as dividends. *See id.* § 61(a).

25. *Id.* § 702(b).

26. It should be noted that the Internal Revenue Service (Service) has made and continues to make abusive tax shelters one of its priorities for audits. A tax shelter is considered by the Service to be abusive if "the present value of all future income is less than the present value of all the investment and associated costs of the shelter." IRS Audit Guidelines: Real Estate §351, *reprinted in* [1979] 3 FEDERAL TAX COORDINATOR 2d (RIA) 11,621A.

27. *See* I.R.C. § 704.

28. *See id.* § 704(b).

29. *Id.* § 704(b); Treas. Reg. §1.704-1(b)(2).

partner of items which are not in the same ratio as his share of partnership profits is known as a "special allocation." For example, it is common practice to allocate to the limited partners the losses and deductions attributable to the ownership and operation of the project for a specified period of time or until the limited partners have received a specified return on their investment.[30] Whether a special allocation has substantial economic effect generally depends on whether the allocation has the potential for actually affecting the dollar amount of the partners' shares of total partnership income or loss independent of tax consequences.[31] Although there are no definitive rulings, regulations, or judicial decisions, it is believed that substantial economic effect exists if the allocation of income or loss to a partner is reflected as an increase or decrease in his capital account and, upon liquidation of the partnership, distributions to the partners are made in accordance with the balances in their capital accounts.[32] A partner may not be allocated losses or income retroactively for any period prior to his acquisition of his partnership interest.[33]

A partner's distributive share of partnership loss is deductible only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the partnership year in which such loss occurred.[34] Any excess of such loss over the adjusted basis is allowed as a deduction at the end of the partnership year in which the partner's adjusted basis is sufficiently increased.[35] The adjusted basis of a partner's interest in a partnership is equal to the amount of money contributed to the partnership, or his adjusted basis in property contributed to the partnership, increased by his distributive share of taxable income of the partnership and decreased by his distributive share of losses of the partnership and distributions of cash or property to him from the partnership.[36]

An increase in a partner's share of liabilities of a partnership is treated as a contribution of money by the partner to the partner-

30. *See* Treas. Reg. §1.704-1(b)(2), Example 5.

31. Treas. Reg. §1.704-1(b)(2).

32. *See* 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners ¶ 10.02[2] (1977).

33. I.R.C. § 706(a).

34. *Id.* § 704(d).

35. *Id.* § 704(d).

36. *Id.* §§ 705, 722, 733; *see id.* §§ 734, 743, 754.

ship.[37] A decrease in a partner's share of liabilities of the partnership is treated as a distribution of money to the partner by the partnership.[38] Borrowings made by the partnership consequently affect each partner's basis in the partnership. Each partner may be allowed to deduct a greater portion of losses of the partnership because his basis in the partnership, which would otherwise initially be limited to the amount of his contribution, is increased by his share of partnership liabilities. A partner's share of partnership liabilities generally is determined in accordance with his ratio for sharing losses under the partnership agreement.[39] In the case of a limited partnership, however, a limited partner's share of partnership liabilities cannot exceed the difference between his actual contribution and the total contribution to the partnership which he is entitled to make.[40] Nevertheless, if none of the partners have any personal liability with respect to a partnership liability (as in the case of a nonrecourse real estate mortgage), then all partners, including limited partners, share such liability in the same proportion as they share profits.[41]

Upon sale or other disposition of the project, cash flow and distributive share are usually reconciled by means of a "gain chargeback" clause in the partnership agreement. Income and gain upon sale or other disposition are thereby allocated back to the partners who were previously allocated the losses and deductions. The making of cash distributions to the partners in accordance with their respective capital account balances then has substantial economic effect. For example, if little or no cash is realized upon the sale of the project, the partners who had previously taken the losses and deductions and whose capital account balances have been reduced would be the partners who incur the true economic loss.[42]

37. *Id.* § 752(a).

38. *Id.* § 752(b).

39. Treas. Reg. § 1.752-1(e).

40. *Id.*

41. *Id.*

42. *See* Solomon, *Current Planning for Partnership Startup, Including Special Allocations, Retroactive Allocations, and Guaranteed Payments*, in 1 N.Y.U. 37TH ANN. INST. ON FED. TAX. 13-1, -13 to -18 (1979).

B. *Partnership Status*

In order for the income tax deductions of the partnership to pass through to the partners, it is imperative that the partnership be classified for federal income tax purposes as a partnership[43] rather than as an association taxable as a corporation.[44] Treasury Regulations section 301.7701-2 sets forth four characteristics which distinguish a partnership from a corporation or an association taxable as a corporation.[45] The corporate characteristics established by the regulation are: (1) continuity of life;[46] (2) centralization of management;[47] (3) limited liability;[48] and (4) free transferability of interest.[49] The regulation provides that an organization of persons

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43. The term "partnership" is defined in the Code to include "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate." I.R.C. §§ 761(a), 7701(a)(2). Greater in scope than the common law meaning of partnership, this definition includes entities not commonly referred to as partnerships. *See* Treas. Reg. § 301.7701-3.

44. The term "corporation" is defined in the Code to include "associations, joint-stock companies, and insurance companies." I.R.C. § 7701(a)(3). The Code classifies various organizations for taxation purposes and sets out tests for determining such classes. These classes include associations taxable as corporations, partnerships, and trusts. *See* Treas. Reg. § 301.7701-1(b). An organization classified under state law as a limited partnership may be classified by the Code as either an association or a general partnership. *See id.* § 301.7701-3(b).

45. Treas. Reg. § 301.7701-2.

46. "An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization." *Id.* § 301.7701-2(b)(1). In order to insure that the partnership will be treated as a partnership rather than an association taxable as a corporation, the partnership should have a limited term of existence. See note 11 *supra* and accompanying text.

47. "An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed." Treas. Reg. § 301.7701-2(c)(1). See note 10 *supra* and accompanying text.

48. Limited liability exists when local law imposes no personal liability on any member for the debts of or claims against the organization. *See* Treas. Reg. § 301.7701-2(d)(1). The liability imposed upon the general partner as well as upon any limited partners who participate in the control of the partnership's business makes this an unlikely characteristic of a limited partnership. *See id.* See note 9 *supra* and accompanying text.

49. Transferability of interest characterizes an organization where the majority of its members may freely substitute for themselves persons who are not members of the organization. *See* Treas. Reg. § 301.7701-2(e)(1). Transferability of interest does not exist if members can freely assign the right to share in the profits but must have the consent of other members to assign the right to participate in the organization's management. *See id.* An assignee of a limited partner is entitled to his assigned share of profits and other compensation but does not receive all the rights of a limited partner unless all of the

formed to carry on a business and divide the gain therefrom will be classified as a partnership unless it has more corporate than noncorporate characteristics.[50]

In May, 1974, the Service set forth three tests which must be satisfied before it will issue an advance ruling that a limited partnership will be classified as a partnership for tax purposes.[51] First, the interests of all the general partners, taken together (exclusive of interests owned by the general partners as limited partners), in each material item of partnership income, gain, loss, deduction, or credit must equal at least 1% of each such item at all times during the existence of the partnership.[52] Second, the aggregate deductions to be claimed by all partners as their distributive shares of partnership losses for the first two years of operation of the partnership must not exceed the amount of equity capital invested in the partnership.[53] Third, a creditor who makes a nonrecourse loan to the partnership must not own or acquire at any time, as a result of making the loan, any direct or indirect interest in the profits, capital, or property of the limited partnership, other than as a se-

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members consent to the assignee acquiring the status of a substituted limited partner, or the limited partnership certificate gives the assignor the right to constitute his assignee as a substituted limited partner. *See* Tex. Rev. Civ. Stat. Ann. art. 6132a, § 20 (Vernon 1970); Revised Uniform Limited Partnership Act §§ 702, 704; Uniform Limited Partnership Act § 19.

50. Treas. Reg. § 301.7701-2(a)(3). In Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975), the Court of Claims held that the Missouri limited partnership before it lacked all four of the corporate characteristics described in Treasury Regulations section 301.7701-2 and, accordingly, was taxable as a partnership. *See id.* at 745. In Larson v. Commissioner, 66 T.C. 159 (1976), the United States Tax Court reversed its previous decision in the same case, and held that two California limited partnerships possessed only two of the corporate characteristics and were, therefore, taxable as partnerships. *See id.* at 185. The partnerships in *Larson* avoided continuity of life because the bankruptcy of the general partner would cause a dissolution and avoided limited liability because the general partner was not a "dummy" acting as the agent of the limited partners. On March 19, 1979, the Service announced its acquiescence in *Larson* and issued Revenue Ruling 106, 1979-1 C.B. 448, which followed *Larson* in holding that certain factors in addition to the four corporate characteristics described in Treasury Regulations section 301.7701-2 do not have independent significance in the determination of the classification of organizations formed as limited partnerships. The ruling further indicated that the Service would not consider such other factors unless their impact is "unmistakable." Rev. Rul. 106, 1979-1 C.B. 448. For a discussion of the standards applied to distinguish a limited partnership from a corporation, see Sperling & Lokken, *The Limited Partnership Tax Shelter: An Investment Vehicle Under Attack*, 29 U. Fla. L. Rev. 1 (1976).

51. Rev. Proc. 17, 1974-1 C.B. 438.

52. *Id.*

53. *Id.*

cured creditor.[54] In the case of limited partnerships with a corporation as the sole general partner, an additional condition to an advance ruling is that the corporate general partner have a minimum net worth.[55] If the corporate general partner has an interest in only one partnership and the total capital contributions to that partnership are less than $2,500,000, the net worth of the general partner must, at all times, be at least $250,000 or 15% of the total capital contributions, whichever is less.[56] If the partners have made contributions in excess of $2,500,000, the corporate general partner must maintain a net worth of at least 10% of the total contributions.[57] If the corporate general partner has an interest in more than one partnership, the net worth tests are applied to each partnership, and the general partner's net worth must equal or exceed the aggregate of the amounts required of it for each partnership.[58]

It is noteworthy that these rules are intended to be applied only in determining whether an advance ruling will be issued, and are not intended as substantive rules for determining whether an organization should be classified as a partnership. In most syndications an advance ruling is not requested and the partnership relies on an opinion of counsel that the partnership should be classified as a partnership rather than an association taxable as a corporation.[59]

C. *Deductions and Credits*

1. *Fees.* There are often several substantial fees paid by the partnership to the general partner or its affiliates upon the formation of the partnership or shortly thereafter.[60] Payments made to a partner which are not of a capital nature may be deductible pro-

54. *Id.*

55. Rev. Proc. 13, 1972-2 C.B. 735.

56. *Id.*

57. *Id.*

58. *Id.*

59. Such opinions are based on the provisions of Treasury Regulations section 301.7701-2 and the *Zuckman* and *Larson* decisions. See note 50 *supra.* The Service has proposed the adoption of a rule setting standards relative to attorneys' opinions used in the promotion of tax shelters. *See* 1980-42 I.R.B. 23. The proposed rule would "confront the problem of tax attorney opinions in abusive tax shelters by imposing certain duties upon a practitioner providing a tax shelter opinion." *Id.* at 24.

60. *See* Weiss, *Payments Between Partners and Partnerships,* in 1 N.Y.U. 35TH ANN. INST. ON FED. TAX. 169 (1977).

vided such payments are for services rendered by the partner other than in his capacity as a member of the partnership.[61] Such fees might include leasing fees, management fees, stand-by loan commitment fees, negative cash flow guaranty fees, and non-competition fees. Most of the "tax shelter" generated in the initial months or years of the project's operations results from the payment of such fees. The Service is likely to argue, however, that such fees are not deductible because they are unreasonable in amount,[62] distort the income of the partnership,[63] or should be capitalized on the ground that the partnership is not engaged in a trade or business until the project is completed and occupied by tenants.[64] Additional payments to a partner, which are determined without regard to income of the partnership and are commonly referred to as "guaranteed payments," are deductible only if they represent ordinary and necessary business expenses which are reasonable in amount.[65]

2. *Organization Expenses and Syndication Fees.* It is the general rule that no deduction will be allowed to the partnership or any partner for amounts paid or incurred for the purpose of organizing the partnership or of promoting the sale of an interest in the partnership, such as selling commissions.[66] The partnership may, however, elect to amortize over a period of not less than sixty months amounts paid or incurred which are incident to the creation of the partnership, are chargeable to capital account, and are of a character which, if expended incident to the creation of a part-

61. Treas. Reg. § 1.707-1(a). In Pratt v. Commissioner, 550 F.2d 1023 (5th Cir. 1977), the United States Court of Appeals for the Fifth Circuit held that payments made by a limited partnership to its general partners for management services which were contemplated as part of the partnership agreement do not constitute deductible expenses but instead represent a portion of the general partners' distributive share of the partnership's net income. *See id.* at 1027.

62. *See* I.R.C. § 162.

63. *See id.* § 446(b).

64. *See* Goodwin v. Commissioner, No. 12561-77 (T.C. Dec. 29, 1980); Francis v. Commissioner, 46 T.C.M. 706 (1977); Cagle v. Commissioner, 63 T.C. 86 (1974), *aff'd*, 539 F.2d 409 (5th Cir. 1976).

65. I.R.C. § 707(c). *See id.* § 162. *But see* Blitzer v. United States, No. 426-76 (Ct. Cl. Mar. 12, 1981) (function of the "trade or business" requirement of section 162(a) of the Internal Revenue Code is simply to render nondeductible "personal" or "family" expenses, and not to render nondeductible ordinary expenses merely because the business enterprise is not yet in a position to earn income).

66. *Id.* § 709(a).

nership having an ascertainable life, would be amortized over such life.[67]

3. *Construction Period Interest and Taxes.* Any interest or real estate taxes paid or accrued during the construction period must be capitalized by the partnership and may be amortized over a specified period, rather than deducted in the year paid.[68] The "construction period" begins on the date construction of the project is commenced and ends on the date the project is ready to be placed in service or is ready to be held for sale.[69]

4. *Depreciation and Recapture.* For federal income tax purposes, depreciation deductions permit recovery of the cost of an asset over the period during which the asset will be used.[70] Generally, the deduction for depreciation of a real estate project is based on the total cost of the project, exclusive of land costs.[71] Various methods of depreciation can be used depending upon the character of the project. In the case of new residential rental property, where at least 80% of the gross rental income for the year is from dwelling units, such as most apartment projects, the 200% declining balance method of depreciation may be used.[72] With respect to other types of new construction, such as office buildings, hotels, shopping centers, and warehouses, the 150% declining balance method may be used.[73] Used residential property with a remaining useful life of twenty years or more may be depreciated using the 125% declining balance method.[74]

Use of the accelerated methods increases the deductions during the early years of the partnership's operations. When real property which has been depreciated using an accelerated method is disposed of through sale, foreclosure, or otherwise, any gain, to the extent of the excess of the depreciation actually taken under the

67. *Id.* § 709(b).

68. *Id.* § 189(a). This provision, added by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, eliminated what had theretofore been significant deductions taken by many partnerships in the early years of their existence.

69. I.R.C. § 189(e)(2).

70. *Id.* § 167.

71. The cost of land is excluded because land is not subject to the type of ordinary and predictable exhaustion, wear, and tear for which the depreciation deduction is intended to make allowance.

72. *Id.* § 167(b), (j)(2).

73. *Id.* § 167(j)(i).

74. *Id.* § 167(j)(5).

accelerated method over straight-line depreciation, is subject to taxation at ordinary income rates.[75] The taxation of excess depreciation at ordinary income rates is known as "recapture."

5. *Investment Tax Credit.* The investment tax credit is available on the components of a real estate project to a limited extent. Section 38 of the Code[76] provides a credit against the taxpayer's tax liability for a portion of his investment in certain depreciable, tangible personal property. This property is defined to include: (1) tangible personal property other than air conditioners and heating units, and (2) elevators and escalators the original use of which commences with the taxpayer.[77] The investment tax credit has been allowed with respect to the following types of tangible personal property: wall-to-wall carpeting;[78] dehumidifiers and chlorinaters;[79] display racks and shelves;[80] emergency diesel generators;[81] exhaust fans and exterior ornamentation on a building;[82] fire extinguishers;[83] identity symbols which are attached to the exterior or interior of buildings other than billboards;[84] exterior lighting;[85] machinery and office equipment;[86] movable partitions;[87] refrigerators;[88] special electrical, plumbing, or air conditioning equipment which is used directly with a specific item of machinery or equipment, such as air conditioning for computers;[89] and water pumps and portable sprinklers.[90]

75. *Id.* § 1250.

76. *Id.* § 38. The amount of the credit is equal to the sum of the regular percentage, the energy percentage, and the employee plan percentage multiplied by the amount of the qualified investment. *Id.* § 46(a)(2)(A). The regular percentage, with which most investors are concerned, is 10%. *Id.* § 46(a)(2)(B).

77. *Id.* § 48(a)(1); *see* Treas. Reg. § 1.48-1(c); Rev. Rul. 75-178, 1975-1 C.B. 9.

78. Rev. Rul. 67-349, 1967-2 C.B. 48.

79. Rev. Rul. 70-103, 1970-1 C.B. 6.

80. Treas. Reg. § 1.48-1(c).

81. Rev. Rul. 70-103, 1970-1 C.B. 6.

82. SENATE COMMITTEE ON FINANCE, REPORT ON THE REVENUE ACT OF 1978, 95th Cong., 2d Sess. 117 (1978).

83. Rev. Rul. 67-417, 1967-2 C.B. 49.

84. Rev. Rul. 70-103, 1970-1 C.B. 6.

85. *Id.*

86. Treas. Reg. § 1.48-1(c).

87. Rev. Rul. 75-178, 1975-2 C.B. 9.

88. Treas. Reg. § 1.48-1(c).

89. Rev. Rul. 66-299, 1966-2 C.B. 14.

90. Rev. Rul. 69-273, 1969-2 C.B. 30.

D. *Receipt of Partnership Interest in Exchange for Services*

Generally, no gain or loss is recognized by a partnership or any of its partners as a result of a contribution of property in exchange for an interest in the partnership.[91] A partner who receives an interest in exchange for the performance of services, however, generally must recognize taxable income in an amount equal to the fair market value of the partnership interest received.[92] In limited partnerships formed in connection with real estate syndications, certain partners may receive partnership interests in exchange for services rendered.

The exact tax consequences resulting to the partner performing the services depend on the type of partnership interest received and the nature of the recipient's ownership rights in the interest. A partner who performs services and receives an unrestricted interest in partnership capital must recognize taxable income in the amount of the value of the interest at the time of the receipt.[93] The partnership, or the partner for whom the services are performed, will treat the payment of the partnership capital as a deduction or capital expenditure, depending on the nature of the services performed.[94] The tax treatment of the receipt by a partner performing services of an interest solely in future partnership profits is more uncertain. The United States Tax Court and the United States Court of Appeals for the Seventh Circuit have determined that a partner who renders services to the partnership must recognize taxable income in the amount of the value of the interest in partnership profits received in consideration for such services.[95]

If the right of a partner performing services to full enjoyment of a partnership interest is subject to a contingency, such as the performance of future services, the taxation of the receipt of the interest may be deferred until the contingency lapses.[96] In that event, the taxable income to be recognized by the service partner will be the value of the interest at the time the contingency lapses.[97]

91. I.R.C. § 721(a).
92. Treas. Reg. § 1.721-1(b)(1).
93. *Id.*
94. *Id.*
95. Diamond v. Commissioner, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).
96. I.R.C. § 83(a).
97. *See* United States v. Frazell, 335 F.2d 487, 489-90 (5th Cir. 1964).

IV. SECURITIES ASPECTS

A. *Limited Partnership Interest as a Security*

There is little doubt that the interest of a limited partner in the typical real estate syndication is a "security."[98] The definition of "security" in the Securities Act of 1933 (1933 Act) includes an "investment contract."[99] The landmark case of *SEC v. W. J. Howey Co.*[100] outlined the concept of an "investment contract." Specifically, the United States Supreme Court defined "investment contract" as "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 . . . ."[101]

The Securities and Exchange Commission (Commission), in a joint release with the Maryland Division of Securities, the Virginia Division of Securities, and the Public Service Commission of the District of Columbia, took the following position with respect to real estate syndications:

> Under the Federal Securities Laws, an offering of limited partner-

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98. *See, e.g.*, Burton, *Real Estate Syndications in Texas: An Examination of Securities Problems*, 51 TEXAS L. REV. 239, 240 (1973) (individuals involved in the sale of interests in real estate syndications may no longer ignore applicable securities laws); Glazier, *Securities Regulation Exemption Structures And The Texas Real Estate Syndicator: Providing A Ladder Of Professional Development*, 20 S. TEX. L.J. 49, 50 (1979) (well-settled that a limited partnership interest is a security and the promotion of a limited partnership is a security issue); Hrusoff, *Securities Aspects of Real Estate Partnerships*, 11 CAL. W.L. REV. 425, 428 (1975) (limited partnership interest generally recognized as a security).

99. Section 2(1) of the 1933 Act, 15 U.S.C. § 77(b)(1) (1976), defines a "security" as any "certificate of interest or participation in any profit-sharing agreement, . . . investment contract, . . . or in general, any interest or instrument commonly known as a 'security' . . . ." similar definitions appear in the Securities Act of Texas, *see* TEX. REV. CIV. STAT. ANN. art. 581-4(A) (Vernon 1964), and other state securities or "blue-sky" laws.

100. 328 U.S. 293 (1946). In *Howey*, investors had been offered interests in a citrus grove development, together with a contract for the promoter to cultivate and manage the groves. The Court held that the investors had been offered "securities" within the meaning of the 1933 Act. *See id.* at 300.

101. *Id.* at 298-99. Courts have modified the *Howey* test in recent years. In particular, the requirement that the investors rely for their profits "solely" upon the efforts of others has been replaced by a test of whether the investors rely upon others for the managerial efforts which are "essential" to the realization of profits. *See* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1973) (quoting SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973)). "[T]he critical inquiry is 'whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.' " *Id.* at 483.

> ship interests and interests in joint or profit sharing real estate ventures generally constitute an offering of a "profit sharing agreement" or an "investment contract" which is a "security" within the meaning of Section 2(1) of the Securities Act of 1933. The Supreme Court has said that an "investment contract" is a contract, transaction or scheme whereby a person invests money in a common enterprise and is led to expect profits from the efforts of the promoter or a third party. . . . In other words, the investor provides the captial and shares in the risk and the profits; the promoter or third party manages, operates and controls the enterprise, usually without active participation on the part of the investor. . . .
>
> In determining what is an investment contract, substance and economic reality prevail over the form of the transaction involved. Interests in novel and uncommon ventures fit the broad definition of an "investment contract." Therefore, if the promoters of a real estate syndication offer investors the opportunity to share in the profits of real estate syndications or similar ventures, particularly when there is no active participation in the management and operation of the scheme on the part of the investors, the promoters are, in effect, offering a "security."[102]

The United States courts of appeals, when confronted with the issue, also have held that limited partnership interests are "investment contracts" and therefore "securities" for purposes of the federal securities laws.[103] It has been held, however, that when a limited partnership is formed for the sole purpose of acquiring undeveloped land and holding it for appreciation, the limited partnership interests will not be considered "securities" because the investors' expectations of profit rest upon external market factors rather than upon the managerial efforts of others.[104]

B. *Exemptions from Registration*

Section 5 of the 1933 Act[105] makes it unlawful for any person to use any means of communication in interstate commerce or the

102. 17 C.F.R. § 231.4877 (Aug. 8, 1967), *reprinted in* 1 [1973] FED. SEC. L. REP. (CCH) ¶ 1046.

103. *See* SEC v. Murphy, 626 F.2d 633, 640-41 (9th Cir. 1980); Goodman v. Epstein, 582 F.2d 388, 406-09 (7th Cir. 1978); McGreghar Land Co. v. Meguiar, 521 F.2d 822, 824 (9th Cir. 1975).

104. *See* Adickes v. Andreoli, 600 S.W.2d 939, 943-45 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ).

105. 15 U.S.C. § 77e (1976).

mails to sell securities unless a registration statement has been filed with the Commission. Section 7 of the Securities Act of Texas[106] also requires registration of securities sold in Texas. Unless a syndicator selling limited partnership interests has registered such interests or has complied with an exemption from registration, any purchaser of a limited partnership interest will have the right to sue for rescission of his purchase and recovery of the consideration paid, plus interest less any income received, or for damages if he no longer owns the interest.[107] Because of the expense, complexity, and delay inherent in registering limited partnership interests with the Commission,[108] the Texas Securities Commissioner, and possibly other state securities law administrators, many syndicators attempt to comply with applicable exemptions from registration, the more significant of which will be discussed herein. It should be noted that the exemptions from registration do not exempt the syndicator from statutory prohibitions against fraud, fraudulent practices, or misstatements or omissions of material facts.[109]

1. *Private Offering Exemption.* Section 4(2) of the 1933 Act exempts from the registration provisions of the Act "transactions by an issuer not involving any public offering."[110] The landmark case in interpreting the exemption afforded by section 4(2) is *SEC v. Ralston Purina Co.*,[111] in which the United States Supreme Court held that an issuer claiming the protection of the section 4(2) exemption had the burden of proving that the offerees had the ability to "fend for themselves" and had access to the kind of information which registration would disclose.[112] The judicial decisions addressing section 4(2) have generally been unfavorable to issuers,

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106. TEX. REV. CIV. STAT. ANN. art. 581-7 (Vernon Supp. 1980-1981).

107. *See* 15 U.S.C. § 771 (1976); TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 1980-1981).

108. The costs of registration of an offering with the Commission are estimated at between $150,000 and $200,000. *Hearings Before the Senate Select Committee on Small Business on Capital Formation*, 95th Cong., 2d Sess. 589, 614 (1978) (written response of Commission Chairman Harold M. Williams to question raised by Senator Weicker).

109. 15 U.S.C. §§ 771, 78j(b) (1976); TEX. REV. CIV. STAT. ANN. art. 581-33(A)(2) (Vernon Supp. 1980-1981). *See generally* Burton, *Real Estate Syndications in Texas: An Examination of Securities Problems*, 51 TEXAS L. REV. 239, 240-43 (1973).

110. 15 U.S.C. § 77(d)(2) (1976).

111. 346 U.S. 119 (1953).

112. *Id.* at 125-26.

with few clear-cut guidelines having been established for determining when the exemption will be available.[113]

With the expressed purpose of creating greater certainty in the application of the section 4(2) exemption, the Commission adopted rule 146,[114] effective June 10, 1974, as a "safe harbor" for issuers desiring to avail themselves of the section 4(2) exemption. The main conditions to be satisfied in order for rule 146 to be available are: (1) the securities may not be sold by means of any form of general solicitation or general advertising;[115] (2) offers can be made

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113. The United States Court of Appeals for the Fifth Circuit has been particularly active in construing the section 4(2) exemption. In Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971), the court stated that some of the important factors to be considered in determining the availability of the exemption were the number of offerees and their relationship to each other and the issuer, the number of units offered, the size of the offering, and the manner of offering. *See id.* at 687-89. The court found the exemption unavailable under the facts of the case, even though the offer had been made to sophisticated investors, on the ground that the offerees had not been given access to the type of information which registration would disclose. *See id.* at 690. In SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972), the court indicated that the offerees must have such a relationship with the issuer that their present knowledge and facilities for acquiring information about the issuer would make registration unnecessary for their protection. *See id.* at 158. The court was not persuaded by lengthy investment letters signed by all purchasers stating that they had been given access to information about the issuer. *See id.* at 160. Although the *Continental Tobacco* decision might be interpreted as limiting private offerings under section 4(2) to high-level insiders of the issuer, the court in Woolf v. S. D. Cohn & Co., 515 F.2d 591 (5th Cir. 1975), *vacated on other grounds*, 426 U.S. 944 (1976), stated that the *Continental Tobacco* decision should not be construed as meaning that all offerees must have insider status, but rather that disclosure alone is not enough to establish the private offering exemption. *See id.* at 610. Similarly, in Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977), the court stated that *Continental Tobacco* should not be read as requiring insider status because to do so would inhibit the ability of businesses to raise capital without the expense and delay of registration under circumstances in which the offerees did not need the protection of registration. *See id.* at 908. In a recent decision addressing the availability of the section 4(2) exemption, Swenson v. Engelstad, 626 F.2d 421 (5th Cir. 1980), the court reiterated that the ultimate test in determining the availability of the exemption is whether the particular class of persons affected needs the protection of the 1933 Act. *See id.* at 425. The court set out four factors as "useful reference points" in evaluating the character of a given offering: (1) the number of offerees and the relationship of the offerees to the issuer and to each other, (2) the number of offered units, (3) the size of the offering, and (4) the manner of the offering. *See id.* at 425. There is authority indicating that whatever standards of sophistication and access are required, the issuer has the burden of proving them to be satisfied as to all offerees in order for the exemption to be available. *See* Henderson v. Hayden, Stone Inc., 461 F.2d 1069, 1071-72 (5th Cir. 1972); Lively v. Hirschfield, 440 F.2d 631, 633 (10th Cir. 1971).

114. 17 C.F.R. § 230.146 (1980). Rule 146 was adopted in 17 C.F.R. § 231-5487 (Apr. 23, 1974), *reprinted in* [1974] 1 FED. SEC. L. REP. (CCH) ¶ 2710.

115. 17 C.F.R. § 230.146(c) (1980).

only to persons whom the issuer reasonably believes has sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of the investment or can bear the economic risk of the investment;[116] (3) sales can be made only to persons who either alone, or together with an offeree representative, have sufficient knowledge and experience in financial and business matters and can bear the economic risk of the investment;[117] (4) each offeree must have access to or be provided the same kind of information which would be disclosed by registration;[118] (5) there can be no more than thirty-five purchasers in the offering, subject to exclusion of certain purchasers;[119] and (6) reasonable care must be exercised to assure that the purchasers do not resell the securities in violation of the registration provisions of the 1933 Act.[120] Preliminary note 1 to rule 146 states that attempted compliance with rule 146 does not act as an election. Issuers, therefore, may still rely on the section 4(2) exemption by complying with the administrative and judicial interpretations of the exemption.[121]

Specifically prohibited are the use of newspapers, magazines, television and radio, seminars and meetings, except where only qualified offerees are present, and any written communications except to qualified offerees.[122] The determination of whether an offeree is qualified should be made as part of the initial contact between the issuer and the potential investors. This can be accomplished by having each potential investor complete a detailed questionnaire concerning his experience in financial and business matters and his economic status, and by limiting the offering only to persons who meet specified net worth standards. If the contact with the potential investor reveals that he probably does not have sufficient expe-

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116. *Id.* § 230.146(d)(1).

117. *Id.* § 230.146(d)(2).

118. *Id.* § 230.146(e).

119. *Id.* § 230.146(g).

120. *Id.* § 230.146(h).

121. *Id.* § 230.146, Preliminary Note 1. The nonexclusive nature of rule 146 was reemphasized by the Commission in 17 C.F.R. § 231.5975 (Sept. 8, 1978), *reprinted in* [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,708. The release incorporated the following language within the rule itself: "Transactions by an issuer which do not satisfy all of the conditions of this rule shall not raise any presumption that the exemption provided by Section 4(2) of the Act is not available for such transactions." 17 C.F.R. § 230.146(b)(2) (1980).

122. 17 C.F.R. § 230.146(c) (1980). The qualifications for offerees are set forth in rule 146(d). *Id.* § 230.146(d).

rience with the particular type of investment to evaluate its merits and risks, the investor should be required to designate an offeree representative.

Under the judicial and administrative interpretations of the section 4(2) exemption, the offeree was himself required to possess adequate financial sophistication. This requirement effectively precluded the availability of the private offering exemption for sales to many wealthy investors who, for various reasons, lacked knowledge and experience concerning the particular type of investment. The offeree representative concept originated with rule 146.[123] Offeree representatives are often attorneys, accountants, or investment counselors having a preexisting relationship with the investor. The syndicator should require that any offeree representatives appointed by prospective investors also complete detailed questionnaires in order to assure that they have sufficient knowledge and experience to evaluate the merits and risks of the investment on behalf of the investor. The offeree representative can be compensated for his services by the syndicator, so long as certain conditions are met.[124]

Rule 146(e) states that access to information exists only by reason of the offeree's having either an employment or family relationship with the issuer or economic bargaining power that enables the offeree to obtain the information necessary to evaluate the merits and risks of the investment.[125] Because most syndications are not limited to insiders or investors with substantial economic bargaining power, the offerees are normally furnished a private offering memorandum prepared by counsel for the syndicator. Information furnished to offerees must be the same information which

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123. *Id.* § 230.146(a)(1).

124. The offeree representative must disclose to the offeree, prior to being designated as an offeree representative, any material relationship between the offeree representative, his affiliates, and the issuer or its affiliates, either then existing, mutually contemplated, or existing during the previous two years, and any compensation received or to be received as a result of such relationship. *Id.* § 230.146(a)(1)(iv). Although the Commission proposed to amend rule 146 so that a person receiving compensation directly or indirectly from the issuer would not qualify as an offeree representative, 17 C.F.R. § 231.5913 (Mar. 6, 1978), *reprinted in* [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,532, this proposal was subsequently withdrawn by the Commission. *See id.* § 231.5976, *reprinted in* [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,709.

125. 17 C.F.R. § 230.146(e) (1980).

would be disclosed by registration.[126] It is consequently imperative that the private offering memorandum be prepared in accordance with Guide 60 of the Guides for Preparation and Filing of Registration Statements,[127] which is the basic guide for the preparation of real estate prospectuses in public offerings. Rule 146, however, does permit the use of unaudited financial statements, the omission of nonmaterial details, and the condensation of information so long as the statements made are not misleading.[128]

In computing the number of purchasers for purposes of rule 146, spouses and relatives sharing the same home, and any trust, estate, corporation, or other organization in which such persons possess all the beneficial and equity interests, are counted as one purchaser.[129] Corporations, partnerships, and other organizations are counted as one purchaser unless the entity was organized for the specific purpose of acquiring the securities offered, in which event each beneficial owner of equity securities or equity interests in such entity must be counted as a separate purchaser.[130] The Commission staff has determined that general partners and original limited partners who withdraw from the partnership upon admission of the investors need not be counted as purchasers.[131]

Perhaps the most significant exclusion from the computation of the number of purchasers is for any person who purchases or agrees in writing to purchase for cash, in a single payment or installments, securities of the issuer in the aggregate amount of $150,000 or more.[132] This provision has given rise to what might be

126. *Id.* § 230.146(e)(1)(ii).

127. *Id.* § 231.5465, *reprinted in* [1976] 1 FED. SEC. L. REP. (CCH) ¶ 3820.

128. 17 C.F.R. § 230.146(e)(ii)(b) (1980). An amendment to rule 146, *id.* § 230.146 (e)(1)(ii)(d), adopted in 17 C.F.R. § 231.5975 (Sept. 8, 1978), *reprinted in* [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,708, lessens the disclosure requirements for offerings of securities having an aggregate sales price of $1,500,000 or less by permitting the use of an offering memorandum containing the information required by Schedule I of Regulation A. *See* [1976] 2 FED. SEC. L. REP. (CCH) ¶ 7327.

129. 17 C.F.R. § 230.146(g)(2)(i) (1980).

130. *Id.* § 230.146(g)(2)(ii).

131. *See* SEC No-Action Letter, Brentwood Village Apartments, Ltd. (June 20, 1980), *reprinted in* [1980] 561 SEC. REG. & L. REP. (BNA) C-1; SEC No-Action Letter, Thunderbird Apartments, Ltd. (Apr. 16, 1979), *reprinted in* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,185.

132. 17 C.F.R. § 230.146(g)(2)(i)(d) (1980). *Compare* No-Action Letter, Gordon Ranch Associates (Sept. 10, 1979), *reprinted in* [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,360 (investor who contributes $100,000 in cash and is personally liable for addi-

termed "public private offerings," which require a minimum investment of $150,000 or more and are typically sold through one or more broker-dealers. The amount of money raised by such offerings can be as large or larger than is raised by many registered public offerings. Although purchasers of $150,000 or more are not counted for purposes of the thirty-five purchaser limitations, all the other requirements of rule 146 still must be met.[133] This can be extremely difficult to monitor where several broker-dealers are making offers to hundreds or even thousands of potential investors. Because failure to comply with all the requirements of rule 146 as to all offerees and purchasers renders the rule unavailable,[134] and the magnitude of such an offering makes it virtually impossible for the syndicator to claim the section 4(2) exemption outside the rule,[135] syndicators engaged in such offerings run a great risk of being exposed to investor claims for rescission.

Rule 146 imposes upon the issuer a duty of exercising reasonable care to assure that the purchasers are not "underwriters" as defined in section 2(11) of the 1933 Act.[136] Such care must include, but is not necessarily limited to, the following: (1) making reasonable inquiry to determine if the purchaser is acquiring the securities for his own account; (2) placing legends on the certificates or

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tional contributions totalling $50,000 upon occurrence of certain contingencies cannot be excluded from the computation of number of purchasers for purposes of rule 146) *with* SEC No-Action Letter, Hilliard-Lyons Barge Partners, 1979-2 (Sept. 21, 1979), *reprinted in* [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,359 (investor who contributes cash and a full recourse promissory note can be excluded from the computation of number of purchasers for purposes of rule 146 when the cash invested and the principal installments required under the promissory note total at least $150,000).

133. 17 C.F.R. § 230.146(b) (1980).

134. *Id.* § 230.146, Preliminary Note 3.

135. *See* cases and text in note 113 *supra*.

136. 17 C.F.R. § 230.146(h) (1980). Section 2(11) of the 1933 Act defines the term "underwriter" as:

> [A]ny person who has purchased from the issuer with a view to, or offers or sells for an issuer in connection with, the distribution of a security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

15 U.S.C. § 77b(11) (1976).

other documents representing the securities stating that the securities have not been registered under the Act and referring to restrictions on transferability; (3) issuing stop transfer instructions to the transfer agent, if any, or making a notation in the appropriate records; and (4) obtaining the written agreement of the purchaser that he will not sell the securities without registration under the Act or an exemption therefrom.[137]

A report must be filed on Form 146 upon the first sale of any securities in any offering made in reliance on the rule.[138] The report is to be filed with the Commission's Regional Office for the region in which the issuer's principal business operations are conducted or are proposed to be conducted in the United States.[139] The information required by Form 146 includes the name, address, and telephone number of the issuer, the type of business in which the issuer is engaged, the names of all chief executive officers, general partners, promoters, controlling persons, organizers, sponsors, and offeree representatives, and the class and amount of securities sold.[140] Some syndicators have expressed a reluctance to file the Form 146 because of its perceived effect of providing the Commission with a target for investigation. Unless the notice is filed, the rule 146 exemption will be unavailable even though all the other conditions may have been satisfied.[141]

In a report to Congress in May, 1980, the General Accounting Office recommended that even greater restrictions be placed on the use of the private offering exemption, because of what it perceived as misuse of the private offering exemption to defraud investors of hundreds of millions of dollars.[142] In a memorandum in October, 1980, the Commission responded to the General Accounting Office

137. 17 C.F.R. §230.146(h) (1980).

138. *Id.* § 230.146(i). Form 146 is reprinted in [1979] 2 FED. SEC. L. REP. (CCH) ¶ 7415.

139. 17 C.F.R. § 230.146(i) (1980). An issuer having or proposing to have its principal business operations outside the United States must file the form with the Commission's Regional Office for the region in which the offering is primarily conducted or proposed to be be conducted. *Id.* § 230.146(i).

140. *See id.* § 231.5912 (Mar. 3, 1978), *reprinted in* [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,524.

141. 17 C.F.R. § 230.146(b) (1980).

142. *See* [1980] 522 SEC. REG. & L. REP. (BNA) A-6. One recommendation was to limit the availability of the private offering exemption to sales to institutional investors or to persons purchasing a minimum dollar amount.

report.[143] It urged Congress to defer any action to further limit the private offering exemption, stating that such action could result in widespread, inadvertent violations of the federal securities laws and could unnecessarily restrict the capital formation process.[144]

The provisions of rule 146 have been characterized by one commentator as "elaborate and crippling."[145] In an effort to resolve some of the problems existing under the current system of regulation, the Federal Securities Code proposed by the American Law Institute[146] would replace the private offering exemption of section 4(2) and rule 146 with an exemption for a "limited offering," which is defined as one in which (1) the initial purchasers are institutional investors and not more than thirty-five other persons, and (2) resales, other than pursuant to registration or an exemption therefrom, within three years after the last sale to the initial purchasers, other than institutional investors, which do not result in there being more than thirty-five holders of the securities, excluding institutional investors and persons who acquire the securities other than by purchase.[147] The proposed limited offering exemption would be less onerous and provide a greater deal of certainty of compliance than rule 146.[148]

2. *Intrastate Offering Exemption.* Section 3(a)(11) of the 1933 Act[149] exempts from the registration requirements "[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation,

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143. *See* [1978] 576 SEC. REG. & L. REP. (BNA) I-1.

144. *See id.*

145. Throop, *The Proposed Federal Securities Code: A Response to Its Critics*, 33 U. MIAMI L. REV. 1597, 1608 (1979).

146. ALI FEDERAL SECURITIES CODE (1980).

147. *See id.* § 202(41)(B). The Commission would have the authority to impose additional conditions on the use of the exemption by an issuer which is not a "one-year registrant," *see id.* § 202(41)(B), which is defined as an issuer registered with the Commission for a period of one year. *See id.* § 202(113). In the case of one-year registrants, the restriction on resale would apply for one year rather than three. *See id.* § 202(41)(B). Because real estate limited partnerships will not typically be one-year registrants, the conditions which the Commission might impose on their use of the exemption will be extremely significant if the proposed Code is adopted.

148. *See generally* Cheek, *Exemptions Under the Proposed Federal Securities Code*, 30 VAND. L. REV. 355, 362-71 (1977); Kripke, *Securities Law Reform and the ALI Federal Securities Code*, 33 U. MIAMI L. REV. 1453, 1457 (1979).

149. 15 U.S.C. § 77c(a)(11) (1976).

incorporated by and doing business within, such State or Territory."[150] Often called "the intrastate offering exemption," its availability does not depend on the absence of the use of the mails or the instruments of interstate commerce. There is no requirement that all offers or sales be transmitted or effected within the confines of one state. Rather, it is the nature of the issuer and the offeree or purchaser which are determinative of the availability of the exemption.[151]

If the issuer is not a corporation, it must be a resident of the appropriate state.[152] In the case of an offering of limited partnership interests, the Commission staff has taken the position that the section 3(a)(11) exemption is unavailable where the general partner who took the initiative in organizing the partnership was a nonresident corporation.[153] This conclusion was based upon a finding that the general partner rather than the limited partnership was the issuer, notwithstanding that in other situations the staff had taken the position that the issuer was the limited partnership itself.[154]

Section 3(a)(11) requires that the issuer be "doing business" within the appropriate state. It does not delineate, however, the amount of the issuer's business which must be conducted within the state. In 1937, the Commission took the position that the issuer "must be narrowly limited to activities substantially within a single state."[155] The Commission affirmed this position in 1961, stating that "in view of the local character of the . . . exemption, the requirement that the issuer be doing business in the State can only be satisfied by the performance of substantial operational activities in the State . . . ," and that the conduct of some functions in the particular state, such as bookkeeping or the offering of securities in the state, will not satisfy the doing business require-

150. *Id.*

151. 17 C.F.R. § 231.1459 (May 29, 1937), *reprinted in* [1973] 1 FED. SEC. L. REP. (CCH) ¶¶ 2260-62.

152. 15 U.S.C. § 77c(a)(11) (Supp. IV 1980).

153. SEC No-Action Letter, American Plan Inv. Corp. (Feb. 9, 1971), *reprinted in* [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,044.

154. SEC No-Action Letter, Boetel & Co. (Aug. 20, 1971), *reprinted in* [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,343.

155. 17 C.F.R. § 231.1459 (May 29, 1937), *reprinted in* [1973] 1 FED. SEC. L. REP. (CCH) ¶¶ 2260-62.

ment.[156] In the context of the typical real estate syndication, if the project is located within the state where the limited partnership is formed and where the partners reside, there should be no question that the issuer is "doing business" within the state.

In order for the section 3(a)(11) exemption to be available, the entire issue must be offered and sold exclusively to residents of the state in which the issuer is organized and does business. A single offer, even though not resulting in a sale, to a nonresident will destroy the exemption for the entire issue.[157] Residency under section 3(a)(11), with respect to individual offerees and purchasers, has been interpreted as being synonymous with the constitutional concept of domicile.[158] In the case of corporations, the prevailing view has been that a corporation is to be considered a resident of the state of incorporation, in its capacity as an offeree, purchaser, and issuer.[159] Regarding unincorporated organizations, the Commission staff has taken the position that the residence of the partners or other beneficial owners, including the limited partners of a limited partnership, is controlling.[160]

A difficult problem arises when the purchaser of a security offered in reliance on section 3(a)(11) resells the security to a nonresident. Such resales by purchasers to nonresidents have been termed "quite permissible" by the Commission but only when the entire issue has "come to rest" in the hands of resident investors.[161] For many years it was thought that resales to nonresidents could be made after the original purchaser had held the securities

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156. 17 C.F.R. § 231.4434 (Dec. 6, 1961), *reprinted in* [1973] 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2270-77.

157. *See* Shaw v. United States, 131 F.2d 476, 480 (9th Cir. 1942) ("'issue' . . . includes all the shares of common character originally though successively issued by the corporation"); 17 C.F.R. § 231.1459 (May 29, 1937), *reprinted in* [1973] 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2260-62. *See generally* 1 L. Loss, Securities Regulation 591-95 (2d ed. 1961).

158. The constitutional test of domicile is whether a person has both a residence at a particular place and an intention to remain there for an unlimited period of time. *See* SEC v. Big Top, Inc., SEC Litigation Release No. 2756 (D. Nev. 1963), 17 C.F.R. § 231.4386 (July 12, 1961), *reprinted in* [1956-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,774.

159. Emens & Thomas, *The Intrastate Exemption Of The Securities Act Of 1933 In 1971*, 40 U. Cinn. L. Rev. 779, 786 (1971); McCauley, *Intrastate Securities Transactions Under The Federal Securities Act*, 107 U. Pa. L. Rev. 937, 948 (1959).

160. SEC No-Action Letter, Pacific Income Plan Co. of California (Sept. 7, 1971).

161. 17 C.F.R. § 231.4434 (Dec. 6, 1961), *reprinted in* [1961] 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2270-77; 17 C.F.R. § 231.1459 (May 29, 1937), *reprinted in* [1973] 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2260-62.

for a period of one year.[162] The Commission staff, however, has taken the position that there exists no objective holding period for determining when the securities have come to rest for purposes of the section 3(a)(11) exemption.[163] Furthermore, the Commission has taken the position that a resale to a nonresident before the distribution has been completed destroys the section 3(a)(11) exemption as to the entire issue, regardless of the length of time the security had been held by the original purchaser.[164]

In January, 1974, the Commission announced the adoption of rule 147.[165] Rule 147 was intended to provide some certainty to the intrastate offering exemption by creating a non-exclusive "safe harbor" for issuers intending to rely on the section 3(a)(11) exemption. As is the case with rule 146, all of the conditions of rule 147 must be satisfied in order for an issuer to avail itself of the rule's protection.[166]

For purposes of determining the residence of the issuer under rule 147, a general partnership or other form of business organization which is not organized under state law is deemed to be a resident of the state where its principal place of business is located.[167] Corporations and other issuers organized under state law, such as limited partnerships, are deemed to be residents of their states of incorporation or organization.[168] An issuer will be deemed to be doing business in a particular state for purposes of rule 147 if it meets certain specified conditions concerning the source of its revenues, the location of its assets, the use of the proceeds of the offering, and the location of its principal office.[169] These conditions can be easily satisfied in the typical real estate syndication involving a single project located within the appropriate state.

With respect to the residency of offerees and purchasers, rule 147 sets forth various tests which the Commission has character-

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162. The one year holding period was suggested by the decision in *In re* Brooklyn Manhattan Transit Corp., 1 S.E.C. 147 (1935).

163. SEC No-Action Letter, Blue Dolphin Pools, Inc. (Oct. 24, 1973).

164. 17 C.F.R. § 231.201 (July 20, 1934), *reprinted in* [1977] 1 FED. SEC. L. REP. (CCH) ¶ 2255 (1977).

165. 17 C.F.R. § 230.147 (1980). Rule 147 was adopted in 17 C.F.R. § 231.5450 (Jan. 7, 1974), *reprinted in* [1974] 1 FED. SEC. L. REP. (CCH) ¶ 2340 (1974).

166. 17 C.F.R. § 230.147(a) (1980).

167. *Id.* § 230.147(c)(1)(ii).

168. *Id.* § 230.147(c)(1)(i).

169. *Id.* § 230.147(c)(2).

ized as "having abandoned the domicile test."[170] In the case of an individual, the test used is whether his "principal residence" is within the appropriate state.[171] The requirement that the determinative residence be the principal one of the offeree or purchaser should eliminate, for the most part, any confusion as to a particular individual's residence. The rule also provides that the residence is to be determined at the time of the offer or sale,[172] which means that a change in the actual residence of an offeree or purchaser prior to completion of the distribution will not destroy the exemption. In the capacity of offerees and purchasers, all business organizations are deemed to be residents of the state in which they maintain their principal offices.[173] This is contrary to what was generally believed to be the law prior to the adoption of rule 147.[174] If a business or trust is organized for the specific purpose of obtaining the securities being offered in reliance on rule 147, however, the availability of the exemption will be determined by the residence of the shareholders or other beneficial owners.[175] Resales may be made only to persons resident within the appropriate state for a period of nine months from the date of the last sale of the securities.[176] An issuer relying on rule 147 is required to take certain affirmative precautions against the loss of the exemption, including: (1) placing a legend on the certificates or documents evidencing the securities stating that they have not been registered and setting forth the limitations on resale contained in rule 147(e); (2) issuing stop-transfer orders to the transfer agent, if any, or making a notation in the appropriate records; and (3) obtaining a written representation from each purchaser as to his residence.[177]

The exemption afforded by rule 147 can be particularly useful for the Texas syndicator. Among the advantages of relying on rule 147 rather than rule 146 are the absence in rule 147 of any: (1) special disclosure standards; (2) limits on the number of offerees or

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170. 17 C.F.R. § 231.5450 (Jan. 7, 1974), *reprinted in* [1974] 1 FED. SEC. L. REP. (CCH) ¶ 2340.

171. 17 C.F.R. § 230.147(d)(2) (1980).

172. *Id.*

173. *Id.* § 230.147(d)(1).

174. See text accompanying note 159 *supra*.

175. 17 C.F.R. § 230.147(d)(3) (1980).

176. *Id.* § 230.147(e).

177. *Id.* § 230.147(f).

purchasers; (3) sophisticated or economically secure investor criteria; (4) filings with the Commission; or (5) prohibitions against advertisements or public solicitation.[178] If the offering does not also comply with the exemption from registration afforded by the Texas Securities Act,[179] the offering must nevertheless be registered with the Texas Securities Commissioner,[180] which may not be a satisfactory alternative.[181]

The Federal Securities Code proposed by the American Law Institute[182] replaces the intrastate offering exemption of section 3(a)(11) and rule 147 with an exemption for a "local distribution," which is defined as an offering that:

> (1) results in sales substantially restricted to persons who are residents of or have their primary employment in a single State, or an area in contiguous States (or a State and a contiguous foreign country) as that area is defined by rule or order [of the Commission] on consideration of its population and economic characteristics, and (2) involves securities of an issuer that has or proposes to have its principal place of business in that State or area, regardless of where it is organized.[183]

The exemption will not be available unless "at least 95 percent of all buyers holding of record at least 95 percent of the securities distributed" are within the above-described class of purchasers.[184] The proposed local distribution exemption would be particularly

178. *See* Glazier, *Securities Registration Exemption Structures And The Texas Real Estate Syndicator: Providing A Ladder Of Professional Development*, 20 S. TEX. L.J. 49, 63 (1979).

179. TEX. REV. CIV. STAT. ANN. art. 581-5(I)(a) (Vernon Supp. 1980-1981).

180. *Id.* art. 581-7.

181. The Texas Securities Board Administrative Guidelines for Registration of Real Estate Programs, Tex. Reg. Code §§ 065.09.00.001 - .010 (1975), *reprinted in* [1980] 3 BLUE SKY L. REP. (CCH) ¶ 55,601, require the sponsor to have a minimum of two years relevant experience and a minimum net worth. *See id.* § 065.09.00.002, *reprinted in* [1980] 3 BLUE SKY L. REP. (CCH) ¶ 55,601. In the case of nonspecified property programs, the sponsor is required to have five years experience in the real estate business in an executive capacity and must make a permanent investment in the program of at least $100,000. *See id.* § 065.09.00.006, *reprinted in* [1980] 3 BLUE SKY L. REP. (CCH) ¶ 55,601. Even if the guidelines are complied with and full disclosure is made to potential investors, the Texas Securities Commissioner may deny registration on the grounds that the offering is not "fair, just and equitable." TEX. REV. CIV. STAT. ANN. art. 581-10 (Vernon 1964).

182. ALI FEDERAL SECURITIES CODE (1980).

183. *Id.* § 514(a).

184. *See id.* § 514(a) (Supp. 1980).

useful in the Eastern parts of the country where large metropolitan areas are located adjacent to state borders.[185]

3. *The Integration Concept.* The availability of both the private offering and the intrastate offering exemptions depends on all offers and sales in a particular offering being made pursuant to the requirements of the particular exemption. Integration occurs when non-compliant offers or sales are deemed to constitute part of the offering for purposes of determining the availability of the particular exemption.[186] The problem arises in several situations, such as where an issuer makes more than one offering, one in reliance on a particular exemption and the others in reliance on other exemptions provided by the 1933 Act or pursuant to registration under the Act. The hazard for a real estate syndication made in reliance on rule 146 is that the offering may be integrated with other transactions where the conditions of rule 146 are not met, or where the integration will result in more than thirty-five purchasers.[187] For a syndicator relying on the intrastate offering exemption, the hazard is that the offering may be integrated with transactions involving nonresidents.[188]

Whether apparently separate offerings are to be integrated is considered by the Commission to be a question of fact to be determined from the surrounding circumstances.[189] The Commission has stated the following factors to be relevant:

> [W]hether (1) the different offerings are part of a single plan of financing, (2) the offerings involve issuance of the same class of security, (3) the offerings are made at or about the same time, (4) the same type of consideration is to be received, (5) the offerings are made for the same general purpose.[190]

Of the factors to be considered, it has been suggested that the ulti-

185. *See generally* Cheek, *Exemptions Under the Proposed Federal Securities Code,* 30 VAND. L. REV. 355, 380-84 (1977).

186. *See* 17 C.F.R. § 231.4552 (Nov. 6, 1962), *reprinted in* [1973] 1 FED. SEC. L. REP. (CCH) ¶¶ 2770-83.

187. *See* Shaw v. United States, 131 F.2d 476 (9th Cir. 1942); SEC No-Action Letter, Property Investments, Inc. (Nov. 17, 1972), *reprinted in* [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,201.

188. *See* SEC No-Action Letter, JIC Drilling Companies (Sept. 23, 1976), *reprinted in* [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,765.

189. 17 C.F.R. §231.4552 (Nov. 6, 1962), *reprinted in* [1973] 1 FED. SEC. L. REP. (CCH) ¶¶ 2770-83.

190. *Id., reprinted in* [1973] 1 FED. SEC. L. REP. (CCH) ¶¶ 2770-83.

mate test is whether the transactions to be integrated were part of a single plan of financing, with the other factors merely providing evidence of whether such a plan existed.[191]

Rules 146 and 147 state that offers or sales made more than six months prior to or more than six months after any offers or sales made pursuant to the rule being relied upon will not be integrated with the offering.[192] This should provide some comfort to syndicators who make no more than one offering each year and comply with either rule 146 or rule 147. Any other transactions, however, must still be examined using the five subjective integration standards.[193]

It should be noted that, for purposes of integration, it is possible for someone other than the limited partnership or the general partner to be considered to be the issuer. The United States Court of Appeals for the Ninth Circuit held in the recent case of *SEC v. Murphy*[194] that a corporation which (1) organized or sponsored the organization of limited partnerships, and (2) was primarily responsible for the success or failure of the partnerships, would be considered the issuer for the purposes of determining whether the partnerships should be integrated, even though such corporation was neither technically the issuer of the securities nor the general partner of the partnership.[195]

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191. *See* Sosin, *The Intrastate Exemption: Public Offerings and the Issue Concept*, 16 CASE WEST. L. REV. 110 (1964). Illustrative of this approach is the case of Livens v. William D. Witter, Inc., 374 F. Supp. 1104 (D. Mass. 1974), where the court refused to integrate a series of offerings, all of which were used to pay bills and provide working capital, because the issuer had hoped that the first and each successive offering would be sufficient. Thus, the issuer was found not to have had a "single plan of financing." *See id.* at 1106-07. In a no-action letter relating to the offering of interests in limited partnerships formed to invest in multi-family housing, the Commission staff stated that: (1) separate offerings to limited groups at different times with respect to separate projects financed by separate mortgages on separate sites would not be integrated solely because the partnerships had the same general partner, and (2) that separate offerings to limited groups at separate times to finance successive portions of a single project, or projects in close proximity, built from time to time as the market is tested and proven, would not be integrated so long as the projects are not financially interdependent and there is no scheme to break the project into smaller portions merely to avoid compliance with the registration requirements of the 1933 Act. SEC No-Action Letter, National Ass'n of Home Builders (Oct. 8, 1971).

192. 17 C.F.R. §§ 230.146(b)(1), .147(b)(2) (1980).

193. See text accompanying note 190 *supra*.

194. 626 F.2d 633 (9th Cir. 1980).

195. *See id.* at 642-44. Specifically, the court held "that when a person organizes or sponsors the organization of limited partnerships and is primarily responsible for the suc-

4. *State Exemptions from Registration.*

a. *In General.* Even though an offering may be exempt from the registration requirements of the 1933 Act by reason of the intrastate or private offering exemptions, registration or qualification will usually be required by state securities or blue sky laws unless an exemption is available therefrom.[196] Prior to commencing an offering, a thorough examination should be made of the blue sky laws and regulations of each state in which the securities will be offered in order to determine which exemptions are available.[197] Among the various exemptions are those for offerings to institutional investors,[198] offerings to a limited number of offerees,[199] offerings which result in a limited number of purchasers,[200] offerings which result in a limited number of holders of the securities of the issuer,[201] and offerings which are made in compliance with rule 146.[202] Some states require that additional conditions such as the requirement of a specified minimum investment,[203] the filing of a notice prior to commencing the offering,[204] and the filing of a sales report following completion of the offering,[205] be met in order for the exemption to be available.

The Uniform Securities Act generally exempts from registration transactions pursuant to offers directed to not more than ten per-

cess or failure of the venture for which the partnership is formed, he will be considered an issuer for purposes of determining the availability of the private offering exemption." *Id.* at 644.

196. For a discussion of the historical background of state securities regulation, see J. Mofsky, Blue Sky Restrictions on New Business Promotions 5 (1971).

197. *See generally* Erwin, *Partnership Interests As Securities: An Alice In Wonderland Tour,* 9 Creighton L. Rev. 310 (1975) (discusses application of securities laws in Nebraska); Hrusoff & Cazares, *Formation of the Public Limited Partnership,* 22 Hastings L.J. 87, 108-18 (1970) (sets out federal and state provisions requiring registration of California limited partnerships as securities); Long, *Partnership, Limited Partnership, And Joint Venture Interests As Securities,* 37 Mo. L. Rev. 581, 596-616 (1972) (discusses the general application of federal and state securities laws to investment entities).

198. *See* Del. Code Ann. tit. 6, § 7309(b)(8) (1974).

199. *See id.* § 7309(b)(9).

200. *See* Minn. Stat. Ann. § 80A.15(2)(a) (West Supp. 1981).

201. *See* Tex. Rev. Civ. Stat. Ann. art. 581-I(a) (Vernon Supp. 1980-1981).

202. *See* Conn. Gen. Stat. Ann. § 36-490(b)(9)(A) (West Supp. 1980).

203. *See* N.C. Admin. Code tit. 18, ch. 6, § .0504 (1976), *reprinted in* [1980] 2 Blue Sky L. Rep. (CCH) ¶ 43,405.

204. *See* Mo. Code of State Regs. tit. 15, § 30-54.140 (1979), *reprinted in* [1980] 2 Blue Sky L. Rep. (CCH) ¶ 35,514.

205. *See* Ill. Ann. Stat. ch. 121½, § 137P(6) (Smith-Hurd Supp. 1980).

sons in the state during any twelve month period provided that: (1) the seller reasonably believes that the buyers are purchasing for investment, and (2) no commissions or other remuneration is paid or given directly or indirectly for soliciting buyers in the state.[206] The state securities administrator is given authority to withdraw or further condition the exemption, increase or decrease the number of permitted offerees, or waive the conditions of the exemption with or without the substitution of a limitation or remuneration.[207] In states where the Uniform Securities Act has been adopted,[208] the securities administrator will often waive the condition that no commission or other remuneration be paid to permit the payment of a reasonable commission to a broker registered in that state.

In syndications offered in several states, a great deal of time and effort is necessary to assure that the applicable exemption from registration of each state is satisfied and potential purchasers are sometimes prevented from participating because the exemptions provided by their states are unduly restrictive or unavailable. Congress has recognized that the complexity and disparity of the various state laws operate to hinder the ability of issuers to raise capital, and, by a recent amendment to the 1933 Act, has directed the Commission to cooperate with state securities administrators in "the development of a uniform exemption from registration for small issuers which can be agreed upon among the several States or between the States and the Federal Government."[209]

b. *In Texas.* The basic exemption relied upon for real estate syndications offered in Texas is contained in section 5(i)(a) of the Securities Act of Texas.[210] This section exempts from registration "the sale of any security by the issuer thereof so long as the total

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206. UNIFORM SECURITIES ACT § 402(b)(9).

207. *See id.*

208. The Uniform Securities Act has been adopted or substantially adopted with modifications in the following jurisdictions: Alabama, Alaska, Arkansas, Colorado, Connecticut, Delaware, District of Columbia, Guam, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, Oklahoma, Oregon, Pennsylvania, Puerto Rico, South Carolina, Tennessee, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. *See* [1980] 1 BLUE SKY L. REP. (CCH) 1503.

209. 15 U.S.C. § 77s(c)(3)(c) (Supp. IV 1980), added by Act of October 21, 1980 (Omnibus Small Business Capital Formation Act of 1980, Pub. L. No. 96-477 § 505), *reprinted in* [1980] 1 FED. SEC. L. REP. (CCH) ¶ 763.

210. TEX. REV. CIV. STAT. ANN. art. 581-5(I)(a) (Vernon Supp. 1980-1981).

number of security holders of the issuer thereof does not exceed thirty-five (35) persons after taking such sale into account . . . ," provided that the sale is made without any public solicitation or advertisements.[211]

The Texas Securities Board has promulgated rule V.I,[212] providing that offers and sales will be deemed not to involve the use of "public solicitation" if they are made to well-informed investors who are either sophisticated or have a privileged relationship with the issuer, and who acquire the securities for their own account and not for distribution.[213] These requirements closely parallel the judicial interpretation of the section 4(2) exemption under the 1933 Act.[214]

Rule V.I also sets out a procedure for counting the number of security holders of the issuer.[215] All security holders of the issuers must be counted regardless of whether they are Texas residents or where they acquired the securities.[216] While the procedure for counting the number of security holders is similar to the procedure for counting the number of purchasers set forth in rule 146,[217] there are some significant differences. Whereas rule 146 excludes from the numerical computation purchasers who contribute or agree to contribute in cash or in installments $150,000 or more,[218] Texas rule V.I(11) provides a separate "fat cat" exemption for transactions where certain conditions are satisfied with respect to all Texas investors.[219] The major conditions of the rule V.I(11) exemption are that the minimum purchase must be $100,000, payable entirely in cash at or before the closing of the offering,[220] and,

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211. *Id.*

212. Tex. Reg. Code § 065.05.00.009 (1975), *reprinted in* [1980] 3 Blue Sky L. Rep. (CCH) ¶ 55,557.

213. *See id.* § 065.05.00.009(1), *reprinted in* [1980] 3 Blue Sky L. Rep. (CCH) ¶ 55,557.

214. See cases cited note 113 *supra.*

215. Tex. Reg. Code § 065.05.00.009(3) (1975), *reprinted in* [1980] 3 Blue Sky L. Rep. (CCH) ¶ 55,557.

216. *See id.* § 065.05.00.009(4), *reprinted in* [1980] 3 Blue Sky L. Rep. (CCH) ¶ 55,557.

217. 17 C.F.R. § 230.146(g)(2) (1980).

218. *See id.* § 230.146(g)(2)(i)(d).

219. Tex. Reg. Code § 065.05.00.009(11) (1975), *reprinted in* [1980] 3 Blue Sky L. Rep. (CCH) ¶ 55,557.

220. *See id.* § 065.05.00.009(11)(B), *reprinted in* [1980] 3 Blue Sky L. Rep. (CCH) ¶ 55,557. The Texas Securities Board has proposed to amend this rule to make the exemption available for sales made to installment purchasers who agree to invest at least $100,000 where the deferred balance is evidenced by a full recourse note which is either payable

if the sales are not being made by or through a registered securities dealer, a notice must be filed with the Texas Securities Commission not less than five business days prior to making the offer.[221] Purchasers in sales made in reliance upon the rule V.I(11) exemption are expressly excluded from the computation of security holders under section 5(I)(a).[222]

Under rule 146, it is relatively certain that only the limited partners need be counted for purposes of the thirty-five purchaser test.[223] Section 5(I)(a) of the Securities Act of Texas[224] and Texas rule V.I,[225] however, require that all "security holders" of the issuer be included in the computation. A sale-by-sale determination must be made as to whether or not each sale of a security will cause the issuer to have more than thirty-five security holders. The term "security" is defined in section 4(a) of the Securities Act of Texas to include any "note, bond, debenture, mortgage certificate or other evidence of indebtedness, [and] any form of commercial paper."[226] Although exemptions from registration are provided for the issuance of securities to banks, insurance companies, and other institutional investors,[227] for the issuance of notes or bonds secured by mortgages or vendor's liens upon real estate and personal property,[228] and for negotiable promissory notes issued in the usual course of business with a term of not more than twenty-four months,[229] there is no provision which expressly excludes the holder of a note from the numerical computation of security hold-

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within one year of the closing or is secured by an irrevocable letter of credit. *See* 6 Tex. Reg. 28 (Jan. 9, 1981).

221. *See* Tex. Reg. Code § 065.05.00.009(11)(E) (1975), *reprinted in* [1980] 3 BLUE SKY L. REP. (CCH) ¶ 55,557.

222. *See id.* § 065.05.00.009(11)(F), *reprinted in* [1980] 3 BLUE SKY L. REP. (CCH) ¶ 55,557.

223. *See* SEC No-Action Letter, Brentwood Village Apartments, Ltd. (June 20, 1980), *reprinted in* [1980] 561 SEC. REG. & L. REP. (BNA) C-1; SEC No-Action Letter, Thunderbird Apartments, Ltd. (Apr. 16, 1979), *reprinted in* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,185.

224. TEX. REV. CIV. STAT. ANN. art. 581-5.I.(a) (Vernon Supp. 1980-1981).

225. Tex. Reg. Code § 065.05.00.009(4) (1975), *reprinted in* [1980] 3 BLUE SKY L. REP. (CCH) ¶ 55,557.

226. TEX. REV. CIV. STAT. ANN. art. 581-4(a) (Vernon 1964).

227. *Id.* art. 581-5(H) (Vernon Supp. 1980-1981).

228. *Id.* art. 581-5(J) (Vernon Supp. 1980-1981).

229. *Id.* art. 581-6(H) (Vernon Supp. 1980-1981).

ers for purposes of section 5(I)(a)[230] and rule V.I.[231] Therefore, if the limited partnership has been formed prior to the admission of the investors and has issued one or more promissory notes, it is arguable that the maximum number of investors will be reduced because the partnership already has "security holders."[232] If it appears that this situation will arise, it may be advisable to attempt to comply with the rule V.I(11) exemption for investments of $100,000 or more with respect to the promissory notes, so that the holders of such notes will not be counted for purposes of the thirty-five security holders limitation.

The Texas Securities Board has recently adopted an amendment to rule V.I which expressly excludes from the numerical computation of security holders for purposes of section 5(I) any general partner of a limited partnership who is subject to general liability for the obligations of the limited partnership and who actively engages in the control and management of the business and affairs of the partnership.[233] This is consistent with holdings by certain federal courts that the interest of the general partner of a limited partnership does not constitute a "security" for purposes of the federal securities laws,[234] and with the position of the Commission staff that general partners are not to be counted as purchasers for purposes of rule 146.[235]

230. *Id.* art. 581-5(I)(a) (Vernon Supp. 1980-1981).

231. Tex. Reg. Code § 065.05.00.009 (1979), *reprinted in* [1980] 3 Blue Sky L. Rep. (CCH) ¶ 55,557 (1980).

232. There is currently a trend in the federal courts to hold that promissory notes issued in connection with commercial loan transactions are not "securities" for purposes of the federal securities laws even though such notes may come within the literal definition of "securities." *See* Williamson v. Tucker, 632 F.2d 579, 601-05 (5th Cir. 1980); McClure v. First Nat'l Bank, 497 F.2d 490, 494-95 (5th Cir. 1974). It is uncertain, however, whether the distinction between "commercial" and "investment" notes being drawn by the federal courts would apply in Texas.

233. 6 Tex. Reg. 48 (Jan. 9, 1981).

234. *See, e.g.,* Hirsch v. duPont, 553 F.2d 750, 753 n.3 (2d Cir. 1977) (parties in accord that general partnership interest is not a security, particularly when the general partner plays a leading role in management of the firm); Vincent v. Moench, 473 F.2d 430, 436 (10th Cir. 1973) (sale of one partner's interest to another partner did not constitute sale of a security within the meaning of the 1933 Act); Holmes v. Bateson, 434 F. Supp. 1365, 1387 (D.R.I. 1977) (liquidation of partnership's interest is not a sale of a security as defined by the 1933 Act).

235. SEC No-Action Letter, Brentwood Village Apartments, Ltd. (June 20, 1980), *reprinted in* [1980] 561 Sec. Reg. & L. Rep. (BNA) C-1.

C. *Broker-Dealer Registration*

1. *In General.* Even though an offering is made in compliance with the private offering exemption and rule 146, or the intrastate offering exemption and rule 147, the syndicator and its employees may be required to register as brokers or dealers under section 15(a)(1) of the Securities Exchange Act of 1934[236] (1934 Act), which generally provides that it shall be unlawful for any "broker" or "dealer" to use the mails or any instrumentality of interstate commerce to effect transactions in, or to induce or attempt to induce, the purchase or sale of a security unless the broker or dealer is registered with the Commission.

The term "dealer" is defined in the 1934 Act as:

> [A]ny person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of his regular business.[237]

A syndicator and its employees can usually avoid the definition of "dealer" if they engage only in selling the limited partnership interests and not in buying them for their own account.

The term "broker" is defined in the 1934 Act as "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank."[238] Issuers of securities are not considered to be within the definition of broker because they do not effect transactions "for the account of others." Although this so-called "issuer exemption" clearly applies to the limited partnership itself, the question arises as to whether the exemption applies to the syndicator and its employees. Whether or not the syndicator and its employees who engage in selling the limited partnership interests must register as brokers is a question of fact to be determined on the basis of considerations similar to the common law distinction between servants and independent contractors.[239] The Commission staff has indicated that the issuer exemption will extend to a real estate syndicator engaged in a single

236. 15 U.S.C. § 78o(a)(1) (1976).

237. *Id.* § 78c(a)(5).

238. *Id.* § 78c(a)(4).

239. Augustine & Fass, *Broker-Dealer Licensing in the Field of Real Estate Syndication*, 29 Bus. Law. 369, 370 (1974).

offering who remains a general partner, participates in the management of the limited partnership, and receives no separate commission for selling the partnership interests.[240] Although the general partner may be exempt from registration, its employees and other individuals who sell partnership interests nevertheless may be classified as brokers. Some of the factors which the Commission staff has deemed relevant in the past are: (1) whether the compensation of the salesmen is tied to their selling efforts; (2) whether the salesmen have significant backgrounds in the securities business; (3) whether the salesmen are primarily engaged in the activity of selling securities; (4) whether the salesmen were hired for the specific purpose of selling the securities being offered; and (5) whether the salesmen continue to be employed after the offering is completed.[241]

In January, 1977, the Commission proposed the adoption of a new rule 3a4-1,[242] with the expressed purpose of providing guidance to promoters of ventures who often seek to distribute securities. Although the Commission characterizes the proposed rule as a "safe harbor,"[243] the release proposing adoption of the rule concluded with the following statement: "Only unusual circumstances would be expected to support a conclusion that persons who do not come within the provisions of the proposed rule are not brokers within the meaning of Section 3(a)(4) [of the 1934 Act]."[244]

Proposed rule 3a4-1 would provide three categories of persons who would not be deemed to be brokers.[245] The first category is available to persons who either: (1) sell only to registered brokers, insurance companies, banks, or trusts for which a bank or registered investment adviser is the trustee; (2) effect transactions only through a registered broker or dealer; or (3) deal solely in certificates issued by a bankruptcy receiver or trustee or in securities

240. SEC No-Action Letter, DeMatteis Dev. Corp. (Sept. 2, 1971), *reprinted in* [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,415.

241. *See* 2 L. LOSS, SECURITIES REGULATION 1298 (2d ed. 1961); Augustine & Fass, *Broker-Dealer Licensing in the Field of Real Estate Syndication*, 29 BUS. LAW. 369, 371 (1974); Mark & Wertheimer, *Special Problems Of Unregistered Real Estate Securities*, 22 U.C.L.A. L. REV. 1219, 1223 (1975).

242. 17 C.F.R. § 241.13195 (Jan. 21, 1977), *reprinted in* [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,927.

243. *Id.*, *reprinted in* [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,927.

244. *Id.*, *reprinted in* [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,927.

245. *See* [1980] 2 FED. SEC. L. REP. (CCH) ¶ 21,152.

exchanged with existing security holders where no commission is paid.[246] The second category is available to "bona fide" employees of the issuer who: (1) have not participated in the distribution or sale of any securities within the preceding two years; (2) primarily perform, or are intended to primarily perform, substantial duties other than in connection with securities transactions; and (3) are compensated on a basis other than commissions or other special remunerations based on securities transactions.[247] The third category is available to persons who restrict their activities to: (1) the delivery of a prospectus or other communication described in rule 134 under the 1933 Act; (2) responding to inquiries concerning the offering; and (3) the ministerial and clerical work of effecting transactions.[248]

The second category would be the most important in the typical real estate syndication. Its requirement that the person not have engaged in any distribution of securities for a period of two years appears to go well beyond the prior positions taken by the Commission.[249] If adopted, the proposed rule would, in effect, prevent a syndicator from selling interests in more than one limited partnership during a two year period unless it either registers as a broker or engages a registered broker to sell the interests. As a practical matter, it appears that the Commission staff may be following the provisions of the proposed rule in determining whether to issue no-action letters in this area.[250]

Persons "whose business is exclusively intrastate" are specifically exempted from the federal broker-dealer registration requirements.[251] This provision has been interpreted by the Commission staff to mean the salesman's entire business, including business unrelated to the sale of securities, must be "exclusively intrastate."[252]

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246. *See id.*

247. *See id.*

248. *See id.*

249. *Compare id.* (proposed rule 3a4-1) *with* SEC No-Action Letter, DeMatteis Dev. Corp. (Sept. 2, 1971), *reprinted in* [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,415 (issuer exemption extends to real estate syndicator engaged in a single offering who remains a general partner, participates in management, and receives no separate commission for selling partnership interests).

250. *See* SEC No-Action Letter, China Trade Corp. (July 24, 1978), *reprinted in* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,939.

251. 15 U.S.C. § 78o(a)(1) (1976).

252. SEC No-Action Letter, D. H. Burlage (Nov. 17, 1971), *reprinted in* [1971] 130

The Commission has authority under section 3(a)(12) of the 1934 Act to exempt from registration brokers who deal in "unregistered securities, the market in which is predominantly intrastate,"[253] but has not done so.

Syndicators who do not engage a registered broker-dealer to place the limited partnership interests or do not confine their activities to a single state should consider registering as a broker with the Commission. This is important because a syndicator who violates the broker registration requirement is subject to a private action by purchasers for rescission or damages under section 29 of the 1934 Act.[254]

2. *In Texas.* Persons engaged in offering or selling securities in Texas are generally required to register as dealers pursuant to section 12 of the Securities Act of Texas,[255] unless the securities being sold are themselves exempt under section 5 of the Act.[256] Therefore, if the offering qualifies for the thirty-five security holder exemption of section 5.I.(a)[257] and rule V.I,[258] neither the syndicator nor any of its employees engaged in selling the securities will be required to register as dealers in Texas. If the unregistered syndicator engages in any transaction not exempt under section 5,[259] however, the syndicator is liable to purchasers for rescission or for damages under section 33 of the Securities Act of Texas.[260] It should be noted that because of the different methods used for computing the number of purchasers under rule 146[261] and the number of security holders under section 5 of the Securities Act of Texas[262] and rule V.I,[263] some offerings which are exempt from federal registration under rule 146 nevertheless may need to be registered in Texas. Where such an offering is made by or through a

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SEC. REG. & L. REP. (BNA) C-3.

253. 15 U.S.C. § 78c(a)(12) (1976).

254. *Id.* § 78cc(b).

255. *See* TEX. REV. CIV. STAT. ANN. art. 581-12 (Vernon 1964).

256. *See id.* art. 581-5 (Vernon Supp. 1980-1981).

257. *See id.* art. 581-5(I)(a) (Vernon Supp. 1980-1981).

258. *See* Tex. Reg. Code § 065.05.00.009 (1975), *reprinted in* [1980] 3 BLUE SKY L. REP. (CCH) ¶ 55,557.

259. *See* TEX. REV. CIV. STAT. ANN. art. 581-5 (Vernon Supp. 1980-1981).

260. *Id.* art. 581-33(A)(1).

261. 17 C.F.R. § 230.146 (1980).

262. TEX. REV. CIV. STAT. ANN. art. 581-5 (Vernon Supp. 1980-1981).

263. Tex. Reg. Code § 065.05.00.009 (1975), *reprinted in* [1980] 3 BLUE SKY L. REP. (CCH) ¶ 55,557.

registered securities dealer, the Texas Securities Board has provided that the issuer and its directors, officers, agents, and employees may answer questions from offerees without being required to register in Texas as securities dealers, agents, or salesmen.[264]

V. Conclusion

The partnership, tax, and securities laws applicable to real estate syndications are extremely complex and burdensome. Persons engaged in this field must be well informed in order to assure proper compliance. This is particularly true with respect to federal and state securities laws relating to registration of securities and broker-dealers, because inadvertent non-compliance may give dissatisfied investors the right to rescind. Some relief is offered, however, by the current movement toward uniformity among the exemptions available under state securities laws, and the possible adoption of the Federal Securities Code proposed by the American Law Institute for enactment by Congress.[265] If such efforts are successful, the burden of compliance will be eased and a greater certainty will be brought to this area of law.

264. *See id.* § 065.08.00.001(f), *reprinted in* [1980] 3 Blue Sky L. Rep. (CCH) ¶ 55,591.

265. It is anticipated that the proposed Federal Securities Code will be introduced in Congress during the current session. *See* Finn, *The Impact of the Proposed Federal Securities Code Upon the Banking Industry*, 36 Bus. Law. 397, 427 (1981).