

R. Walker
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AN ANALYSIS OF LIMITED PARTNERSHIPS AS ONE TYPE OF INVESTMENT

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by

Scott A. Miller

Thesis Director

Robert W. Walker

Robert W. Walker

Ball State University
Muncie, Indiana
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I. INTRODUCTION

According to the Revised Uniform Limited Partnership Act of 1976, "a limited partnership is a partnership formed by two or more persons under the laws of this state and having one or more general partners and one or more limited partners."¹ For a further explanation of limited partnerships, a brief description of its process is as follows: "The sponsors or general partners raise money by selling units to thousands of investors. The general partners pool the money and buy large equity positions in as many as several dozen fledgling enterprises that have not yet gone public. Finding the companies and investing in them generally takes about two years. Then there are several years of incubation while the companies grow and mature. By year five or six the partners begin to look for a return. If it all goes well, their companies are gobbled up in acquisitions or go public, either way, the partnership hits the jackpot. In the distribution process, often the limited partners - the investors who have put up the money - get all the profits until their investment is paid back; thereafter the general partners usually take 20 percent and the limited partners 80 percent. But, of course, many of these venture capital investments flop and the partnership ends up a loser."² Ultimately, the value of

most limited partnerships hinges on the price of a tangible ^{items} like oil, real estate, cattle, or leased equipment. And since these items are prone to wide fluctuations, risk is increased in the limited partnership. These items will be discussed later.

II. UNIQUE FEATURES OF LIMITED PARTNERSHIPS

A. DIFFERENCES BETWEEN GENERAL AND LIMITED PARTNERSHIPS

The biggest difference between a general and a limited partnership is that a general partner has unlimited liability which would allow partnership creditors to satisfy the debts of the partnership out of the general partner's personal assets. A limited partner risks only his investment in the project. His investment may consist of cash, property, obligations, contribution of services and promises to contribute cash, property, and services.³ Thus, the general partner is at much greater risk than the limited partner.

The formation of these two types of partnerships also differs. The formation of a general partnership agreement can be oral, written or implied, as long as it involves two or more persons. To form a limited partnership, state permission is necessary, along with the filing of a signed certificate of limited partnership with the appropriate state or local agency. Also, there must be at least one general partner and at least one limited partner for a limited partnership to exist. More

will be discussed later about the creation of the limited partnership.

Another difference is that general partners have rights in the management and conduct of the partnership's business while a limited partner does not. If a limited partner does get involved in the management process, then he is treated like a general partner and has unlimited liability but only to third parties who know of this involvement in management.⁴ A limited partner is not considered to be managing when he acts as an agent or employee of the limited partnership, consults with the general partners about business, approves or disapproves amendments to the limited partnership agreement or votes on the dissolution of the limited partnership or removal of a general partner.⁵

Dissolution of both types of partnerships is similar but yet somewhat different. In both if the general partner dies, withdraws, becomes insane, is removed or files for bankruptcy, then dissolution occurs unless stated in the partnership agreement that business should continue. Also, a partnership will dissolve if it is stated in the agreement. The death of a limited partner, however, does not terminate the partnership. Instead, the limited partner's heirs or estate would continue in his place.

One other difference between a general and a limited partnership involves profit or loss sharing. In both

types, profits or losses are shared as agreed upon in the previous agreement. If, however, this is not specifically stated, then in a general partnership profits and losses are shared equally, but in a limited partnership, they are shared based on the percentages of capital contribution. Thus, a limited partner who contributes more will receive more if the agreement is silent but in the same situation, all the general partners would receive an equal share.

B. DIFFERENCES BETWEEN CORPORATIONS AND LIMITED PARTNERSHIPS

The biggest difference, of course, between the limited partnership and the corporation is that a partnership's income, losses and write-offs pass directly to the partner and thus are only taxed once. "But the corporation's income is taxed twice, first at the corporate level and then at the shareholder's rate and also should there be any losses, the corporation, not the shareholder, will sustain them and other write-offs until income is generated."⁶ Another difference is the right to participate in management. As stated before, a limited partner has no rights in management. But a shareholder in a corporation does indeed have management rights. He can vote on who is elected to the Board of Directors and on other issues such as whether or not to have a stock split or stock dividend.

III. REQUIREMENTS OF A LIMITED PARTNERSHIP

A. REGULATIONS

Limited partnerships are regulated by statutes of the various states. The majority of states have enacted the Revised Uniform Limited Partnership Act which deals with the rules and requirements for limited partnerships. If they do not comply with the state law, then the limited partnership will be treated as a general partnership in which personal liability applies.⁷

As stated previously, in order to form a limited partnership, two or more persons must execute a certificate of limited partnership and it should be filed with the Secretary of State. And to avoid treatment as a general partner, this certificate should be filed in each state where doing business. Basically, this certificate serves two functions: "first, to place creditors on notice of the facts concerning the capital of the partnership and the rules regarding additional contributions to and withdrawals from the partnership; second, to clearly delineate the time at which persons become general partners and limited partners."⁸ This certificate must be amended "when the partnership changes its name or the contribution of any limited partner; a partner is substituted as a limited partner; an additional limited partner is admitted; a general partner is admitted; a general partner dies, retires, or becomes

insane and the business is continued; the character of the business is changed; or there is a false or erroneous statement in the certificate. The certificate shall be cancelled when the partnership is dissolved or all limited partners cease to exist."⁹ A table of contents of a typical limited partnership agreement is shown in Exhibit I.

B. FEDERAL SECURITIES ACT OF 1933

Since a limited partnership interest is typically considered to be a security, the sale of limited partnership interests may require compliance with the Federal Securities Act of 1933 or state "Blue Sky" laws.¹⁰ This means that registration is necessary unless one of the requirements of exemptions from registration is met. Securities that have to be registered are called public placements. "Each prospective investor must be provided with a prospectus, which is a synopsis of the registration statement filed with the SEC. Securities that are exempt from public registration are referred to as private placements. Instead of a prospectus, investors receive an offering circular that contains similar disclosure materials and information."¹¹ Regulation D refers to exemption rules and these exemptions can be very important since registration is a costly and lengthy process.

IV. THE MAJOR EFFECTS OF THE TAX REFORM ACT OF 1986 ON LIMITED PARTNERSHIPS

A. PASSIVE-LOSS RULES

The Tax Reform Act of 1986 (hereafter referred to as TRA of 1986) completely changed the face of limited partnerships. "They used to be strictly for top-bracket investors gambling \$5,000 and up on risky ventures in oil and gas, cattle, and real estate and looking more for big tax deductions up front than for profits later."¹² These tax shelters were the main reason limited partnerships lured people to invest in them. But the TRA of 1986 drastically altered this kind of investment. It brought to the end the creation of limited partnerships geared toward generating write-offs and deals that thrived on the promise of huge paper losses. No longer is it possible to deduct losses generated by a limited partnership from any kind of income or earnings. The TRA of 1986 revised this so these losses could only be used to offset income from other "passive" activities. "Passive activities, include investments in a business in which you don't 'materially' participate - including all limited partnerships - and rental activities whether you pass the participation test or not."¹³ There were, however, some important exceptions to this rule. Any extra losses that were leftover could be carried forward

to future years and used when passive income occurs. A phase-in period was also developed so this change would not happen all at once. The change did not affect 1986 losses that were reported but in 1987, only 65 percent of the losses that exceed passive income were deductible against ordinary income. In this year, 1988, 40 percent will be deductible; in 1989, 20 percent; and in 1990, 10 percent. In 1991, the passive-loss rule will be fully effective.¹⁴ This phase-in period was only available to limited partnerships created before October 22, 1986. Any created after this date were fully subject to the changes of the TRA of 1986. Also, any taxpayers liable for the alternative minimum tax could in no way benefit from the phase-in and thus starting in 1987, the passive-loss rule was fully effective for them.

B. OTHER TAX REFORM CHANGES

Some other changes in TRA of 1986 that hurt limited partnerships were the raising of the depreciation period from 19 to 27.5 years for residential property and to 31.5 years for commercial property, mandatory use of the straight-line method for depreciation, and the raising of the maximum capital gains rate.¹⁵ Because of the depreciation changes, less could be written off in the early years and the capital gains rate rise meant more tax when the investment was sold.

C. INCOME-PRODUCING LIMITED PARTNERSHIPS

It was predicted that, because of these changes caused by the TRA of 1986, limited partnership would steadily decline and cease to exist. But that was not the case. "With tax rates lower, sponsors of limited partnerships avoided extinction by emphasizing plans that produce income rather than shelter it."¹⁶ These new limited partnerships are geared more for the investor since a person can buy in for as little as \$1,000 and they are usually meant to be held seven to ten years. They are like bonds, in being yield-oriented with a finite life, but also have the potential for big capital gains or losses.¹⁷ And even though TRA of 1986 took away most of the tax advantages of these particular investments, there are still a few left. As stated earlier, partnership income, unlike corporation income, is only taxed once and there is also some tax deferral since the distributions are considered a tax-free return of capital until they exceed the original investment.¹⁸ Still though, the most enticing thing about these new limited partnerships are the potential high yields. But this could also be a downfall. Since uncertainty usually reigns over limited partnerships, these investments may be overly optimistic about how much they can return. For example, oil prices could sag or equipment could become damaged or obsolete or it might even depreciate

faster. Since no one can predict the future, the high yields predicted for some of the new limited partnerships may be overstated, and if that is the case, could be less attractive to the investor in the long run.

V. DIFFERENT KINDS OF LIMITED PARTNERSHIPS

A limited partnership is usually permitted to engage in any business that a general partner may carry on. However, the most common limited partnerships involve real estate, oil, and gas, and leased equipment. Master limited partnerships are simply more liquid limited partnerships that are listed on the stock exchanges. A brief description of each of these is as follows.

A. REAL ESTATE LIMITED PARTNERSHIPS

Real estate is a popular form of investment since investors are comfortable with it because they can see, feel, and touch it. It is also a good hedge against inflation. "Real estate limited partnerships fall into three categories: residential, which includes multi-family apartment buildings, garden apartments, and condominiums; commercial, which includes commercial office buildings and shopping centers; and government-subsidies, which includes commercial office building programs for the elderly, or the low- or moderate-income residents, and for the handicapped.¹⁹

The advantage of real estate limited partnerships are that they offer most of the benefits of owning real estate, including tax breaks, but an investor escapes the burden of managing the property and the personal liabilities of an owner."²⁰ "The tax advantages are that an investment in real estate can produce tax losses that can be used by the investor to offset income from other passive sources and still produce a positive cash flow."²¹ However, these investments are also very risky because of the lack of liquidity and the lack of diversification. So, even though an investor may be comfortable with real estate, he should still invest carefully.

B. OIL AND GAS LIMITED PARTNERSHIPS

There are really three types of oil and gas limited partnerships. The first are exploratory programs that try to discover new petroleum reserves. The success rate is not that high since exploration usually takes place in untested areas. And even if something is found, it then must be developed and the investor will be asked for more money.²² The tax benefits come from the development drilling costs. There are significant risks involved, but if everything works out, there might be a very high return on capital.

The second type is a development program. These programs set up wells near existing oil reserves in areas

where production is already under way. Once again the benefits come from the development drilling costs. Chances to find something are higher than in exploratory programs, but the return on capital is lower.²³

Income programs are the third type. These involve the lowest risk because they purchase producing properties rather than develop drilling sites. An investor gets income over the life of the oil or gas well and his tax write-offs come from the depletion of their oil reserves rather than from development drilling costs, like the first two types.

C. LEASED EQUIPMENT LIMITED PARTNERSHIPS

"Many investors favor leased equipment limited partnerships because they are conservative, deal in tangible goods, and are more liquid than real estate. The lease payments provide predictable cash flow, with relatively minor speculative consideration. The tax benefits include depreciation deductions, deductible interest payments and normal operating expenses."²⁴

"Specifics of leasing programs vary widely, but generally the partnerships buy capital equipment, such as heavy machinery, transportation equipment, or computers, and then lease it at monthly rates that bring it up to 42 percent of the purchase price per year. Limited partners, are attracted by the high average annual

yield."²⁵ However, high front-end fees could substantially lower the limited partner's return.

D. OTHER KINDS OF LIMITED PARTNERSHIPS

There are many other kinds of limited partnerships. These can occur in the entertainment field, cattle industry, ranching, mining, and agricultural field. These types usually are legitimate limited partnerships. There are some limited partnerships, though, that are called exotic because of their lack of any realistic possibility to make profits. These center around art paintings, books, gemstones, Bible productions and so on. The IRS continually monitors these types to see if they maintain the limited partnership qualifications.²⁶

E. MASTER LIMITED PARTNERSHIPS

Master limited partnerships simply break limited partnerships, like those listed above, into small units at prices comparable to stocks. Thus, "these investments share the limited partnership's ability to pass tax breaks through to investors without the high front-end costs and illiquidity of limited partnerships."²⁷ They are traded like stocks on the major exchanges. Many people, however, feel that these investments are overpriced and are still a long-term investment.

VI. OTHER CONSIDERATIONS WHEN INVESTING IN LIMITED PARTNERSHIPS

A. GENERAL PARTNERS

The TRA of 1986 may have changed the composition of limited partnerships, but still one of the most important steps to take when investing in one is to find competent and trustworthy general partners. As previously stated, limited partnerships must contain at least one general partner and one limited partner. The general partners should be extensively experienced in the particular field of the limited partnership. They should also be financially sound; they should have enough assets to keep the investment from disintegrating during a sudden calamity. Also, trustworthiness is essential because "after September 1982, a single partner called the 'tax matters partner' has to represent the entire partnership in all tax proceedings."²⁸ Thus, the general partner could conceivably negotiate a settlement that benefitted him, but not the limited partners. So, it can be seen, that reliable general partners are a necessity when investing in a limited partnership.

B. FRONT-END LOADS AND MANAGEMENT FEES

All of the money a person invests for a limited partnership is not used to buy assets directly. Brokers and the general partners, of course, get a commission on

the shares purchased, which is called a front-end load. These are organizational expenses, acquisition fees, and management fees that may scoop up 10 percent to 35 percent of every investment.²⁹ "For example, an 8 percent front-end load and a 2 percent management fee chew up 28 cents on the dollar after ten years. Couple the fees with the 80-20 profit split and a partnership really has to hit pay dirt before an investor sees returns well into the double digits."³⁰ Refer to the chart in Exhibit 2 which shows how these fees vary among different partnerships. Since these fees could eat away a significant part of the investment, they deserve much consideration.

C. SELLING A LIMITED PARTNERSHIP

Getting into a limited partnership is usually fairly easy for the investor - all he does is just put up the money. But getting out of one is much harder. In most cases, a limited partnership is something to be bought and held and unless it is a must-sell situation, this advice should be followed. The main reason for this is because an investor will get only 70 percent of the appraised value of his share of properties when he sells.³¹ "Also, by selling he would forfeit his right to any profit that is made when the assets are liquidated and he would get little or nothing in return for the fees and commissions he paid when he made the investment."³²

Some adverse tax consequences could occur too since he would have to pay income taxes on any profits he got when he sold it and might even have to pay back the government for some of the shelter deductions previously claimed.

If a person is intent on selling, then he should first contact the deal's general partners. Even though it is very unlikely that it will be repurchased, the general partners might give leads on other potential buyers. Another possibility would be to check securities brokers. Those that sell partnerships have internal wire systems that go around to other brokers and thus makes the information more widely available. An investor that wants to unload his investment can list them for sale and ones that want to buy can check to see what is available.³³ If everything else fails, then an investor could list his units with the National Partnership Exchange (NAPEX). "This is an electronic auction market that matches buyers with sellers of public real estate, oil and gas, equipment-leasing and cable-TV partnerships around the country, but the exchange itself does no buying."³⁴ However, only about half of the partnerships listed there are sold and usually at only about 70 percent of their real value.

VII. CONCLUSION

As you can see, limited partnerships are complex investments that have changed very much in the past few

years. There are many factors to consider before you invest in one. This paper has shown what a limited partnership is, how it operates, where it stands today, and some things you need to consider before investing in one. As with any investment, a limited partnership should only be invested in when it meets your particular needs. But if a limited partnership is right for you, then hopefully this paper can make the investment process more understandable and easier.

Exhibit 1

- ARTICLE I. Formation of Limited Partnership
- ARTICLE II. Name, Purpose, Place of Business, and Term of Partnership
- ARTICLE III. Definitions
- ARTICLE IV. Capital Contributions, Accounts, and Withdrawals
- ARTICLE V. Duties and Powers of Partners; Partnership Expenses
- ARTICLE VI. Obligations and Agreements of General Partners
- ARTICLE VII. Distributions
- ARTICLE VIII. Profits and Losses
- ARTICLE IX. Termination and Dissolution of the Partnership
- ARTICLE X. Withdrawal and Transfer by Partners
- ARTICLE XI. Records and Accounting
- ARTICLE XII. Elections
- ARTICLE XIII. Power of Attorney
- ARTICLE XIV. Representations and Warranties
- ARTICLE XV. Miscellaneous

Source: Real Estate Limited Partnerships, p. 218.

Exhibit 2

Partnership	Minimum Investment	Fees	Profit Split Investment/Sponsor
A	\$5,000	11% front-end load 2.9% annual	80/20
B	\$10,000	8% front-end load 3% annual	95/5 until payback, then 80/20
C	\$2,500	16.5% front-end load 2% annual	99/1 until payback, then 80/20
D	\$5,000	8% front-end load 2.5% annual	80/20
E	\$5,000	15% front-end load 6% to 1% annual	99/1 until payback, then 80/20

Source: "Every Man A Venture Capitalist." Fortune,
July 20, 1987, p. 108.

ENDNOTES

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³ Gleim, Irvin N. and Patrick R. Delaney, 1987-1988 CPA Examination Review - 14th Edition, Volume 1, (New York: John Wiley & Sons, Inc., 1987), p. 518.

⁴ Gleim, Irvin N. and Patrick R. Delaney, p. 519.

⁵ Gleim, Irvin N. and Patrick R. Delaney, p. 519.

⁶ Lamaute, Denise, "Getting A Piece Of The Action Through Limited Partnerships," Black Enterprise, June 1987, p. 320.

⁷ Gleim, Irvin N. and Patrick R. Delaney, p. 519.

⁸ Lynn, Theodore S., Harry F. Goldberg and Daniel S. Abrams, p. 267.

⁹ Lynn, Theodore S., Harry F. Goldberg and Daniel S. Abrams, p. 5.

¹⁰ Gleim, Irvin N. and Patrick R. Delaney, p. 518.

¹¹ Saenger, Bruce W., Marketing Mutual Funds and Limited Partnerships to Your Life Insurance Clients, (U.S.A.: Farnsworth Publishing Company, 1985), p. 187.

¹² Norman, James R., "Mastering The New Potential Of Limited Partnerships," Business Week, December 29, 1986, p. 124.

¹³ "Tax Shelters After Tax Reform," Changing Times, November 1986, p. 65.

¹⁴ "Tax Shelters After Tax Reform," p. 66.

¹⁵ "Limited Partnerships: Look Before You Leave," Changing Times, September 1986, p. 91.

¹⁶ Serwer, A. E., "Limited Partnerships That Like Tax Reforms," Fortune, August 17, 1987, p. 102.

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- 27 "Tax Shelters After Tax Reform," p. 67.
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