LIMITED PARTNERSHIPS VS. THE NEW S CORPORATION: A NEW ALTERNATIVE FOR REAL ESTATE INVESTORS?

by Stanley R. Stansell and William D. Wallace

In recent years an extraordinary increase in real estate investment has occurred. Rapidly appreciating property values and generous tax shelters have combined to form an asset with wide investor appeal. Since real estate is generally not easily divisible and usually requires a substantial amount of investment, some form of fractional ownership is necessary.

Limited partnerships have become increasingly important as an investment ownership form. The ability to fully flow through tax benefits to investors is critically important. In spite of their inherent drawbacks, including the cost and time required to set one up, limited transferability, limited lifetime and cumbersome management structure, the partnership's ability to flow through tax savings to investors and their limited liability exposure to investors have resulted in their widespread use in real estate investment.

Real estate brokerage firms are actively beginning to market limited partnership shares in large public syndications. Preliminary data indicates that such sales exceeded $4 billion in 1982, up from $293 million in 1977.[1] Some of the public partnership syndications have produced extremely attractive rates of return in recent years.

Information on privately-owned limited partnerships is difficult to obtain. It is safe to say that they are widely used, and the amount of assets owned is substantial.

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The objective of this study is to examine the use of the newly authorized S Corporation, a modification of the old Subchapter S Corporation. Recent changes in tax laws have created an opportunity for the use of this ownership vehicle which will combine some of the best attributes of both a limited partnership and a corporation.

A Comparison Of The Attributes

The comparative advantages and disadvantages of the various ownership forms are summarized in the Table[2]. Comparisons between a limited partnership and the new S Corporation are perhaps the most appropriate for this study. Both have the significant advantage of allowing full flow through of tax benefits from passive

income, an area in which the new S Corporation is a distinct improvement over the old Subchapter S Corporation.

Theoretically, the S Corporation has an unlimited life, an advantage over a limited partnership. Shares in an S Corporation, while not highly liquid due to the small number of allowed shareholders, are more easily transferable than an ownership position in a limited partnership. Control in an S Corporation is based on proportionate shares of ownership, unlike a limited partnership where the investor typically has little if any voice in the operation of the investment. Establishing an S Corporation is almost certain to involve less time and cost than establishing a new limited partnership. Liability exposure to a stockholder in an S Corporation is at best as limited as that of a limited partner.

In general, the S Corporation seems to offer the best of both worlds to the investor if the maximum number of stockholders limitation is not critical. The chief disadvantage is that income cannot be allocated on any basis other than a proportionate share of ownership. Partnerships have some flexibility in that respect.

Changes Due To The Revision Act

The Subchapter S Revision Act of 1982 makes significant changes regarding the way shareholders of Subchapter S Corporations (officially termed "S Corporations" by the Act) are taxed. Generally, the taxation of S Corporations and shareholders is the same as that of general partnerships and general partners. In essence, the taxpayer may now choose the corporate form of organization for nontax purposes and the partnership form for tax purposes. In addition, the Act establishes rules that are more lenient in allowing the formation, eligibility, and maintenance of an S Corporation. Changes having the most impact upon shareholders are discussed in detail and may be categorized as follows:

1) Eligibility of the corporation to be an S Corporation;
2) Cessation of the corporation to be an S Corporation;
3) The passive income test; and
4) Taxation of the shareholders and corporation.

Eligibility

Changes in the requirements of corporations eligible to become S Corporations involve the relaxation of restrictions pertinent to the equity of the ownership. The first change is the increase in the maximum number of shareholders allowable in an S Corporation from 25 to 35.[3] In essence, this allows a "small business corporation" to be larger.

The second change involves a restriction that a small business corporation can have only one class of stock. That one-class restriction is still in effect, but shares of stock that have different voting rights will not be construed as two classes of stock.[4] In addition, "straight debt" will not be classified as a stock class, but is defined as being any written unconditional promise by the corporation to pay on demand on a specified date a definite sum as long as the instrument meets certain conditions defined in Section 1361(c).

Cessation as an S Corporation

The S Corporation may cease to qualify due to actions of the shareholders, whether the actions be voluntary or involuntary. In either event, when a corporation ceases to be an S Corporation, the effective date is the date that the voluntary revocation specifies,[5] or the day the corporation ceases to qualify as an S Corporation.[6]

Prior to the 1982 Act, the shareholders could not specify the effective date of the revocation: Timing of the revocation determined whether the effective date was the first day of the tax year in which the revocation was made or the next tax year. Also, prior to the Act, the cessation of the corporation to qualify as a small business corporation made the termination effective the beginning of the tax year in which the cessation occurred.

The Passive Income Test

An important change relevant to investors real estate is the change in the "passive income" requirements of the S Corporation. Prior law stated that the S Corporation was to be terminated involuntarily if more than 20 percent of income was passive income. Excess passive income, that is, over 25 percent, will be taxed at the highest corporate tax rate (currently 46 percent).[7] However, termination may still result if the corporation has passive income over 25 percent of gross receipts for each of three consecutive tax years *and* the corporation has accumulated Subchapter C earnings and profits at the end of each of the three tax years.[8] Since Subchapter C earnings and profits occur only to "regular corporations," an S Corporation that has never been a Subchapter C regular corporation will have no concern about termination of S Corporation status due to excessive passive income.

Two more notes concerning termination of the S Corporation are important: First, prior law stated that a new shareholder could force termination of the small business corporation election by affirmatively refusing to consent to the election. This was possible due to and consistent with the requirement that all shareholders must have consented to the Subchapter S election. Both provisions have been changed. The new shareholder no longer has the ability in all cases to foul up the plans of the other shareholders, since only shareholders collectively owning more than 50 percent of the stock may elect the revocation.[9]

The second factor involves inadvertent termination. The Internal Revenue Service may treat an inadvertent failure to meet the requirements of a small business corporation as though the failure had not occurred.[10] There should be no tax avoidance intent from continued S Corporation status in order for the IRS to ignore the violation of the small business corporation rules.[11]

TABLE

A Comparison of Organizational Attributes

Organization Type	Tax Status	Duration (Life)	Transferability	Management Form	Method of Formation	Liability Exposure
Individual	Full flow through[1]	Terminated by death	Transferable	Personal management	Personal	Unlimited
General partnership	Full flow through[1]	Terminated by withdrawal of partner, death, or bankruptcy	Nontransferable	By agreement; usually each partner has equal power	Partnership agreement	Unlimited
Limited partnership	Full flow through[1]	Specified in agreement	Limited transferability	By agreement; general partner manager	Partnership agreement	Limited to limited partners
Ordinary corporation	No flow through[2]	Unlimited	Easily transferable	Shareholder control	State charter	Limited
Subchapter S Corporation (Old Law)	No flow through[1]	Unlimited[4]	Easily transferable[5]	Stockholder control	State charter	Limited
S Corporation (New Law)	Full flow through[1]	Unlimited	Easily transferable[6]	Stockholder control	State charter	Limited
Land Trust	Full flow through[1]	Specified in agreement; can be terminated by trustees	Transferable	Beneficiaries	Trust agreement	Limited
REIT	Partial flow through[3]	Unlimited	Easily transferable	Managed by trustees	State charter	Limited

1. Subject to taxation at only one level
2. Subject to taxation at two levels
3. Tax losses can't exceed distribution of cash
4. Could be terminated by election of only one shareholder
5. Maximum number of stockholders was 25
6. Maximum number of stockholders is 35

Taxation

Prior to the 1982 Act, undistributed taxable income was taxed to the shareholder on the last day of the tax year of the S Corporation. Choice of the tax year was unrestricted, allowing the taxpayer to choose the timing of the recognition of his/her share of income of the corporation. The Act restricts the choice of the tax year of new S Corporations to the calendar year. Existing S Corporations may maintain existing tax years, but may not have free rein on changing the tax year. They have the same restrictions as new corporations.[12] This change and the change requiring that the taxpayers' shares of income be prorated on a daily basis[13] reduce tax-planning opportunities available under prior law.

There are favorable changes, however, that allow the taxpayer to report on his/her separate return on any item of income, loss deduction, or credit that can affect the computation of tax liability. The tax treatment is now parallel to the tax treatment provided partnerships. If an S Corporation incurs a net long-term capital gain in 1983, each shareholder will now report on his/her individual return his/her share of the net long-term capital gain.

An important change regarding the taxation of the shareholders involves the treatment of net operating loss passthrough. Prior to the Act, the taxpayer could deduct his/her share of loss only to the extent of adjusted bases in stock plus any debt owed him/her by the corporation. If the shareholder's loss share exceeded the total of the adjusted bases of stock and debt, it was forever lost as a deduction.

The Act now allows the taxpayer to carry the excess over to later tax years and to deduct it in a year in which the basis of the stock and/or debt has increased above zero. One should note that the carryover period is indefinite as long as the S Corporation election is in effect. Even after the S Corporation status is terminated, the shareholder may have a limited carryover of any unused loss deduction.[14]

At the corporate level, there are two instances in which the corporation will be subject to a tax liability. As under prior law, the corporation possibly will still have a tax liability if capital gains are significant. As mentioned earlier, there may be a tax due if passive income is present.

The passive income tax rate is the maximum rate for a Subchapter C corporation and is imposed if more than 25 percent of gross receipts are "passive investment income" and the corporation has Subchapter C earnings and profits. If the corporation has never been a Subchapter C Corporation, this tax would never be imposed. The tax rate is applied against the taxable income of the corporation or the "excess net passive income," whichever is less. Net passive income is

defined to be passive income less expenses attributable to earning the passive income. Excess net passive income is best defined by the following formula:[15]

$$\left[\frac{\text{(Passive investment income)} - .25\text{ (gross receipts)}}{\text{Passive investment income}} \times \text{Net passive investment income}\right]$$

Advantages Afforded By The 1982 Act

As far as the real estate profession is concerned, there are two major advantages afforded by the Subchapter Revision Act of 1982: 1) The passive income provisions; and 2) The provisions concerning the net operating loss carryforwards.

Since the definition of passive income for purposes of the S Corporation includes rental income, few S Corporations were used as a business form for real estate ventures. The presence of excess passive income would terminate the small business corporation status, leaving only the partnership and Subchapter C corporate forms as viable alternatives. The 1982 Act changes allow excess passive without terminating the small business corporation status. Since the corporation must have Subchapter C earnings and profits to be subject to the tax on passive income, a newly-formed S Corporation escapes any penalty due to passive income. The end result is that the taxpayer involved may use the legal form of a corporation, avoid personal liability and still have the simplicity and flow-through attributes of a partnership taxwise.

Under prior law, if a corporation's taxable income produced a net operating loss, the deduction passed through to an individual shareholder was limited by the total of the adjusted bases of his/her stock and any debt owed him/her by the corporation. If the shareholder let the bases mentioned above be exceeded for any one year by his/her share of a net operating loss, the loss deduction was gone forever. New law, however, allows a carryforward of the unused loss until the bases are enough to allow deductibility of the loss. This should be attractive especially to investors interested in real estate ventures for tax shelter purposes.

Conclusions

The new S Corporation offers real estate investors some advantages and a few disadvantages relative to limited partnerships, which are summarized below.

Potential advantages of S Corporations:

1) Quicker and less costly to establish
2) All investors have limited liability exposure (not just limited partners)
3) Easier and less costly to transfer
4) Unlimited lifetime
5) Control based on proportionate voting

Features common to both S Corporations and limited partnerships:

1) Full flow through of tax benefits
2) Limited liability exposure to limited partners (but not general partners)

Potential advantages of a limited partnership:

1) Some flexibility to allocate income on some basis other than ownership share
2) Virtually no limit on number of investors (partners)

NOTES

1. See "Luring The Little Guy Into Big Projects," *Business Week* (January 24, 1983), 68.
2. This table is an extension of a similar table in A. J. Jaffe and C. F. Sirmans, *Real Estate Investment Decision Making* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1982), 110.
3. IRC 1361(b).
4. IRC 1361(c) (4).
5. IRC 1362(d)(1)D.
6. IRC 1362(d)(2).
7. IRC 1375.
8. IRC 1362(d).
9. IRC 1362(d)(1).
10. 1362(f).
11. *Subchapter S Revision Act of 1982; Law and Explanation* (Commerce Clearing House, 1982), 117.
12. IRC 1378(a); 1378(b).
13. IRC 1366.
14. IRC 1366(d).
15. IRC 1375.