

Direct Participation Programs

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Using this study guide.

This study guide is intended for use prior to attempting the accompanying exam. Read the complete study guide at your convenience before beginning the exam. You may cover the material in one session or break the material into several shorter sessions, whichever best fits your learning style. All answers to exam questions are covered in this document.

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Direct Participation Programs

Introduction

There are several basic types of businesses including proprietorships, general partnerships and corporations. A limited partnership is a variation of a general partnership that is comprised of at least one person known as the general partner who manages the business and limited partners who have a minimum of participation in the business. The Internal Revenue Service sets a minimum of at least a 1% financial investment in a company in order to be considered a general partner. The general partner invests his time and skills rather than a great deal of money. He is under contract with the limited partners and will be compensated based on his performance. The limited partners provide the money and will be compensated if the general manager is successful. Limited partners have the right to vote, but the general manager makes most of the day-to-day decisions for the company. The limited partner's liability is limited to the amount of his original investment and he is not responsible for the debts of the business. Essentially, the general partner retains the responsibilities and the liabilities of the entire company. The Agreement of Limited Partnership sets forth the rights, duties, and the degree of liability of all parties involved. Limited partners may inspect and copy the books, demand accurate and full information about the partnership dealings, sue the general partner for damages, and receive profits and other distributions as set forth in the agreement. Resale or transfer of ownership is restricted by the terms in the Agreement of Limited Partnership.

When a limited partnership is formed a Certificate of Limited Partnership is filed with the state in which the partnership is created. This document sets forth the identity, business purpose, anticipated life of and capital contributions to the limited partnership. Any amendment to the certificate such as name change or partners change must be approved by a majority vote of the limited partners. However, many decisions such as refinancing the partnership's property or hiring and firing are left to the discretion of the general manager and do not require an amendment to the certificate.

Limited partnerships are created to engage in business activities for a predetermined time period. After its goals are reached, a limited partnership is terminated. Businesses that form as limited partnerships naturally involve only a finite existence. These include real estate development, oil and gas

drilling, equipment leasing, condominium conversions, government housing projects, cattle breeding and feeding, thoroughbred horses, etc.

Securities firms often search for investors whose objectives are met by limited partnership investments. The SEC includes limited partnerships in its definition of a security and limited partnership units are usually marketed and sold by registered representatives. Most of these are sold as private rather than public placements and the rules of Regulation D of the 1933 Act apply.

The Internal Revenue Code treats a limited partnership as a “flow through vehicle” which provides certain tax advantages to the partnership. The profits flow through to the owners of the company who then pay taxes based on their individual tax brackets. On the contrary, corporations must pay taxes as an entity themselves before profits are passed on to stockholders. In most cases, at least one-third of the corporation’s profits go to taxes prior to dividend pay-outs to stockholders.

The IRS and the National Association of Securities Dealers both call a “flow through vehicle” a direct participation program (DPP). The profits or losses of the company flow directly through to the partners. The general partner must file Form 1065 with the IRS and the limited partners are given Schedule K-1 to compute their own tax returns. In this way, the IRS is accurately informed about profits and losses and limited partners may be accurately taxed.

Since limited partnerships are further identified by the IRS as passive endeavors, the income or loss is called passive income or passive loss. Passive income is fully taxed at the investor’s ordinary tax rate. Passive losses are only applicable to the tax year in which they are created and offset only the passive income received from other passive activities. However, losses may be suspended and used at a later time. That is, a carry forward provision allows all unused passive losses to later be used to offset income either at the termination of the partnership, when the investor liquidates his ownership prior to termination or to offset future passive income. Income from stocks, bonds, saving accounts, annuities, mutual funds, etc. is classified as portfolio income by the IRS and cannot be offset by passive losses.

Most investors do not view tax avoidance as the big advantage they did in earlier years. Most analysts currently hold the opinion that limited

partnership units must compete with other securities as to yield, rate of return, long-term performance, and appreciation rather than rely on tax avoidance as an enticement to investors.

Tax Advantages of Limited Partnerships

Limited partners may benefit from tax advantages that are passed through under the flow-through concept. These advantages fall into four different categories: interest expense, operating and maintenance expense, tax credits, and depreciation and other amortization.

The tax deduction taken for investment interest expense cannot be greater than the taxpayer's amount of net investment income. Net investment income includes dividends, taxable interest, and net capital gains. A limited partnership may borrow money to carry on business and may deduct the interest with almost no limitation. If the business is properly managed, the borrowed money will be used to make profits for the enterprise. This way of making money with borrowed money is called leverage. The yearly interest on the borrowed money can reduce current taxable income. Since profits will occur later, taxes will be due at a future time rather than now.

A limited partnership is the same as any other business as far as operating and maintenance expenses go. The expenses are all legal deductions from the business entity's income; the higher the operating expenses, the lower the taxable income.

Tax credits reduce taxes directly; tax deductions are expense items that reduce taxable income. The two major expenditures which meet the qualifications for tax credits are rehabilitation expenditures for some commercial and historic buildings and low-income housing credit for the construction of, the purchase of, or the renovation of qualified low-income housing projects. The Tax Reform Act of 1986 limits the use of tax credit. The IRS operates on the premise that tax credits for limited partners are "passive credits." That is, tax credits can be used to offset taxes only on "passive income." Tax credits may be suspended and be used at a later date. A few exceptions to this rule do allow tax credits against ordinary taxes, however. A lump sum credit is given for rehabilitation of buildings in service before 1936 and for those named by the Secretary of the Interior as certified historic buildings. These credits may be used to offset tax due on up to \$25,000 of non-passive income.

The IRS stipulates that when a business buys equipment for use and to make money, the expense is deductible, but not entirely in the first year. Only a part of the expense will be deductible the first year because the equipment will last longer than one single year. The IRS has varied depreciation schedules that list the amounts of allowable deductions the first year and each subsequent year. The idea of reducing value over a period of years is usually known as amortization. Depreciation is the actual write-off of the real cost of equipment. If the IRS specifies that a particular piece of equipment is ten-year equipment, the company must take ten years to deduct its total cost. One way, known as straight-line depreciation, allows 1/10th the cost to be deducted each year and after ten years, the total expense will be written-off. Another way, known as Accelerated Cost Recovery System (ACRS), may be used only for personal property (not real estate) and allows more depreciation in the early years than in the later years.

It is possible for a business enterprise to show an operating loss by allowing its cash operating and other expenses to exceed its total revenues. This operating loss flows through to limited partners. This business loss reduces taxes by offsetting passive income. This creates a basic tax deferral plan by providing operating losses in the early years of the business and probable profits in future years. Depreciation may help a business show paper losses when in truth the business is bringing in more revenues than it is spending for expenses. Yearly depreciation expenses are not really annual cash expenses.

The book value of any fixed asset is its cost less the amount of depreciation to date. If an investor sells a fixed asset at a price higher than its book value, the situation is known as recapture. It is taxed as ordinary income unless the asset is real estate. In the case of real estate, the excess is capital gain and the depreciation must be straight-line, not accelerated.

Both depletion and obsolescence are losses in value of some asset. Depletion is the loss of value of a resource supply due to extraction or removal. An example is an oil deposit. Companies in the natural resource business must consistently deal with depletion. There are two types of allowable depletion: cost depletion and percentage depletion. The deduction on percentage depletion is 15%. Obsolescence is the loss in value of an asset due to technological advances and can be a real factor in business expenses and costs.

Various Types of Direct Participation Programs

Real Estate

Real estate programs are by far the most popular direct participation program. In the past, real estate investments have given the investor a hedge against inflation because of capital appreciation. Often, real estate produces income, but the income will likely be taxed since the Tax Reform Act of 1986 dictates that the straight-line method of depreciation must be used. With new construction, there is a better chance of capital appreciation and maintenance costs are lower than with existing properties. But, cash flow may become a disadvantage since the space must be leased after it is completed and overbuilding in an area may limit demand. It is difficult to accurately predict costs because of fluctuating prices and changing interest rates for financing. When cost projections are lower than actual expenses, assessments for overruns are normally charged to the limited partners.

The advantages of government assisted housing programs are that the IRS is unlikely to challenge the value assigned to the project and probably will not audit it, there is usually a large tax shelter in the early years, **and** the government provides rent subsidies. Disadvantages include lower cash flow, lack of appreciation, government policy changes **and** a greater risk of foreclosure.

Existing properties often provide tax credits for rehabilitating specific historic buildings, more capital appreciation than government assisted housing, a more reliable economic projection, and a more accurate property appraisal. But, there may be higher maintenance costs as equipment ages and the existing lease agreement may restrict cash flow.

Raw land carries a substantial possibility for capital appreciation, but it lacks cash flow and it is not subject to depreciation. Additionally, raw land investors must be willing to stick with the project indefinitely and must be willing to pay interest and taxes.

Buying a condominium may be considered a security purchase if there is a rental pool and if the purchaser has "investment intent." Condominiums carry a good possibility for capital appreciation, carrying costs and expenses

may be offset by cash flow, and operating expenses and depreciation may be deductible. On the flip side, to meet the residency test, investors may not use the property more than 14 days or 10% of the number of days the unit is rented (whichever is greater). Poor rental management may cause income to be reduced even though expenses must be paid. Since most of these properties are in resort areas, the investment is less stable than traditional condominium purchases.

Oil and Gas Programs

Exploratory gas and oil programs are very risky because the drilling is done in an unproven area. Gas or oil is hit only about 10% of the time and most of the hits are not commercially viable. Costs for clearing the land, drilling, labor, fuel, and food are often exorbitant, but at least the costs are deductible. All these costs are called intangible drilling and development costs (IDC). Because natural resources are eventually exhausted, over the years the annual deductible expense will be depletion and can be written off against income or revenues from their sales. “Dry holes” are often hit, so the risk of loss is great. But if there is a “hit,” profits may be large.

A “dry hole” is much less likely with a developmental program because drilling takes place in an area that is already known to have oil or gas. Because the landowner will be paid more, profits may be less to the investor than with the exploratory program.

With an income or production purchase program, there is no risk of a “dry hole” because the partnership buys an existing producing well. There are no start-up expenses and no IDC; the main problem is that the oil or gas may soon run out. A geologist can be very helpful to investors with this type program because his report can help predict how successful the project will be. Deductions for depletion are applicable for income programs.

Equipment Leasing

With equipment leasing, program monies are used mostly to buy equipment and lease it to businesses that require its use. Depreciation benefits, operating expenses, and interest on loans flow through to the partnership. But obsolescence due to technological advancement and bad credit of the lessee could be major problems. The credit worthiness of the

lessee is of utmost importance to the success of any equipment leasing program.

Limited Partnership Qualifications

In order to qualify as a limited partnership with the IRS, a business must meet very specific criteria. All the advantages of the “flow through” concept will be lost and the IRS will treat the company as an association if these requirements are not met. For this reason, a competent independent tax counsel gives an opinion in the prospectus that the business has met all the IRS mandates to be a limited partnership. The IRS rules require a business to avoid at least two of the following: limited liability, continuity of life, free transferability of ownership interests, or centralized management.

To avoid limited liability, the limited partnership assigns full liability to the general partner or partners. To avoid continuity of life, the limited partnership sets a date of termination or the events that will cause termination in its Certificate of Limited Partnership. To avoid free transferability of ownership interests, the Limited Partnership Agreement restricts the limited partners’ rights to selling or transferring their partnership units. That does not mean a limited partner can never sell out; it simply means in most cases that the general partner must approve the transfer or sell. To avoid centralized management is more difficult than any of the other requirements, but the IRS requires that only two of the four be avoided, so most limited partnerships **do** in fact operate with centralized management. Centralized management simply means that paid managers who are salaried employees and have no ownership in the company run the company on a day-to-day basis.

Alternative Minimum Tax (AMT)

If a taxpayer has any tax preference items, a tax is placed on those items. An investor's ordinary tax is compared to the AMT and whichever is higher is due to the IRS. Tax preference items include **excess depreciation** caused by using accelerated depreciation instead of straight-line, **excess percentage depletion** on oil and gas which may show on paper that no oil or gas is in the ground when, in fact, the well continues to pump, and **excess intangible drilling costs** which relates to the extent by which the intangible drilling costs exceed a certain percentage of the investor's net income from the wells.

Tax Basis

An investor's tax basis for a Direct Participation Program is the amount the investor has at risk or the amount the investor could lose. Any earnings in a DPP that stay in the program increase the investor's tax basis. Any additional contributions to the DPP such as cash investments also increase the tax basis. Any money the investor contributes through recourse debt increases the tax basis. Any distributions from the DPP reduce the amount at risk and reduce the tax basis. If any profits are used to pay off debt or if the DPP generates any losses, the investor's tax basis is reduced. In the case of real estate only, non-recourse financing (for which the creditor cannot come after the investor personally) can increase the investor's tax basis if the loan comes from a qualified lender.

The general partner cannot make loans to the partnership as a qualified lender. The advantages of non-recourse loans to the investor are that he has no personal liability, the interest is deductible and is passed through to the limited partners, **and** his tax basis gives him a higher potential tax loss.

Suitability

DPPs are most suitable for clients who need tax advantages on passive income. Usually, such clients are in the top personal tax bracket. It should be noted that, for the most part, DPPs are good investments for obtaining appreciation of capital. Historically, the liquidity of direct participation programs has been very low, but increasingly, there are some publicly traded DPPs with market liquidity. By and far, however, DPPs should be considered long term investment and should not be used by investors who want to invest now and sell for a profit in the near future or for anyone who might need his money for an emergency. DPPs are for those investors who can well afford to completely lose their investment since the risk of loss is 100%.

NASD requires that in-depth records be kept on clients who are sold limited partnerships. These records must include suitability tests and disclosures about the lack of liquidity of the investment, if relevant. The firm which sells the limited partnership must be certain the client understands the ramifications of not having a high enough tax bracket or not enough passive income to receive the benefit of the partnership's flow-through concept. The offering document will contain a suitability statement indicating the minimum net worth and /or minimum net income requirements for an investor as well as a blank to be signed indicating the client's understanding of the risks involved. Even if an investor insists, he cannot buy a DPP without meeting the suitability requirements.

Evaluation of DPPs

The most important factor in choosing a DPP is economic soundness. A DPP must be judged on its economic merits, not its tax benefits. The client's investment objectives must match the objective of the DPP. If the client desires income, safety, or wants to speculate, there are suitable DPPs available. The track record of the sponsor must be reviewed. Past performance of a DPP may indicate its future success.

Certainly, the most important factor in evaluating a real estate DPP is location. The economic characteristics of the particular area to be developed must be reviewed. Is the area geographically suited for the project being planned? Is climate an issue?

The projection of anticipated return on investment found in the prospectus must be reviewed. There are two ways to evaluate the investor's return: cash on cash and internal rate of return. Cash on cash simply compares the investment return to the total investment. If the return for a \$100,000 investment were \$5,000, the cash on cash return is 5%. The internal rate of return or IRR is more complicated and takes the time value of the money into account.

The prospectus will also specify the front end load or the part of the investor's money that does not monetarily contribute to the program. Operational expenses are included in front end load. Some of these are legal costs to create the partnership, commissions to salesmen and underwriters, acquisition fees, and loan points or origination fees. Front end load may not exceed 15% of the proceeds raised by the DPP.

Also included in the prospectus will be an explanation of fees paid to management. How profits will be shared when the DPP is liquidated should be a part of the offering document as well. Even though general partners rarely have more than a 1% interest in the DPP, his share in the profits at liquidation may be on a 60%-40% or 50%-50% basis. The reasoning here is that the success or failure of the project largely depends on the general partner's time and managerial skills.

Sometimes, sponsors of DPPs make ½ units available to accommodate those clients who find a program which is good for them, but do not have the assets to purchase a full unit. Sometimes the price of the unit is paid over a period of months or years. When considering an oil or gas program, review should be made of how the money will be raised to complete the well and tap into a pipeline if a hit is actually made and whether any future assessments are planned.

Offering Practices

Only a small percentage of DPPs are underwritten through managed offerings. DPPs are usually offered by using the non-managed offering which has no syndicate manager. The sponsor of the program is responsible for the distribution of the units. The general partner may act as sponsor or he may engage someone affiliated with him to be sponsor. The non-managed offering is normally handled by wholesalers who are employed by the

sponsor or his affiliate. The wholesalers work with brokerage offices by highlighting all the benefits of their program and encourage the firms to sell the program to their clients.

Sometimes, the wholesalers are employees of the sponsor and serve other functions in addition to wholesaling. If so, no NASD license is needed. If the wholesaler is not an employee of the sponsor and his primary duties are wholesaling, he must have a securities license.

SEC Guide 4 is used to help sponsors of oil and gas programs write an appropriate prospectus; SEC Guide 5 will help a sponsor of a real estate program. NASD member firms will find an entire appendix of their Rules of Fair Practice as a guideline to help with underwriting compensation. These guidelines stipulate that the maximum front end load is 15% of the total proceeds of the program and that the maximum compensation may not exceed 10% of the total proceeds of the program. Also, any NASD member who performs due diligence may be reimbursed up to .5% as reimbursement of bonafide due diligence expenses. NASD rules also prohibit delivering copies of a program offering to any “center of influence” such as attorney’s, accountant’s or investment adviser’s offices on an unsolicited basis unless these individuals are registered securities personnel.

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