

Seller of LPs needs to know tax ramifications

By TIMOTHY J. O'CONNOR

In the 1980s hundreds of thousands of Americans were sold limited partnerships by securities brokerage firms with the promise of a safe investment with an assured double-digit annual return on investments. Given the established rate of return on indexed and blue chip mutual funds, why were investors steered into limited partnerships?

There is a saying that hope springs eternal, but the answer more likely lies in the fact that sales commissions and related fees on limited partnerships generally range anywhere from a loose standard of 8 percent to 12 percent to as high as 25 percent, so how can an investor expect a reasonable return

on his or her investment when only 75 percent of the money paid to the brokerage firm or the general partner for the limited partnership investment are put to work?

A limited partnership is basically an investment of money wherein an investor entrusts his or her money to a general partner with the hope of a profitable return with the understanding that his or her at-risk investment money are limited to the amount of the investment.

There is a joke circulating in the securities brokerage industry that goes something like this: Limited partnerships are a profitable

experience—the general partners get all the profits and the limited partners walk away with the experience. This article focuses more on private or public limited partnerships other than on those publicly traded on the national securities exchanges.

More than \$15 billion worth of limited partnerships were sold to the investing public in the '80s and they mostly turned out to be a miserable experience for the average investor.

Many limited partnerships lost their tax advantage benefits with the Tax Reform Act of 1986, which limited the deductibility of the tax losses. In addition to these market forces, the profitability of many limited deals were bogged down with brokerage, management, appraisal, legal and accounting, and advertising fees; taxes; and litigation expenses.



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Thousands of limited partnership investors have been successful in pursuing claims against their brokers in arbitration and court proceedings with claims that their brokers misrepresented the profitability, safety or suitability aspects of limited partnership investments. Many claims also have been brought against the brokerage firms because of unsavory contacts with the general partners of limited partnerships engaging in wasteful management practices, gross conflicts of interest, fraud or the charging of excessive management fees and commissions.

From a suitability perspective, many investors were sold tax-motivated limited partnerships in their individual retirement accounts and retirement pension-type accounts, even though such investment vehicles are wholly unable to make any use of tax losses. Several large national brokerage firms have admitted to selling limited partnership interests as alternatives to certificates of deposit for prudent investors.

Unlike annual reports for mutual funds in blue chip stocks, annual reports for many limited partnerships are poorly written, over-technical and sporadic in frequency, and generally fail to apprise the small investors of what precisely is happening with their hard-earned money that had been entrusted to the general partner of the limited partnership.

When a parent, spouse or other relative leaves an estate with an inventory of limited partnership interests, the executors, estate attorneys and beneficiaries are presented with the difficult task of deciding what to do with these holdings, how to value them for estate tax purposes, and how to divide them evenly among the beneficiaries.

Many limited partnerships are thinly traded and within any given limited part-

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nership venture, there may be only one or two purchase or sale transactions per year. Some limited partnerships can have as few as 20 or 30 investors spread throughout the country or even around the globe. The task of finding a buyer for a limited partnership interest in such a setting is a difficult one.

When brokers are approached by their customers seeking a means to sell the limited partnership holdings, investors often are told to hang onto the investment and not to worry—the limited partnership will work out as intended and there will be a payoff in the end.

In reality, most brokers do not want to tell their clients that their investment is gone, that the underlying business of the partnership is defunct and that there is no ready market for their limited partnership holding.

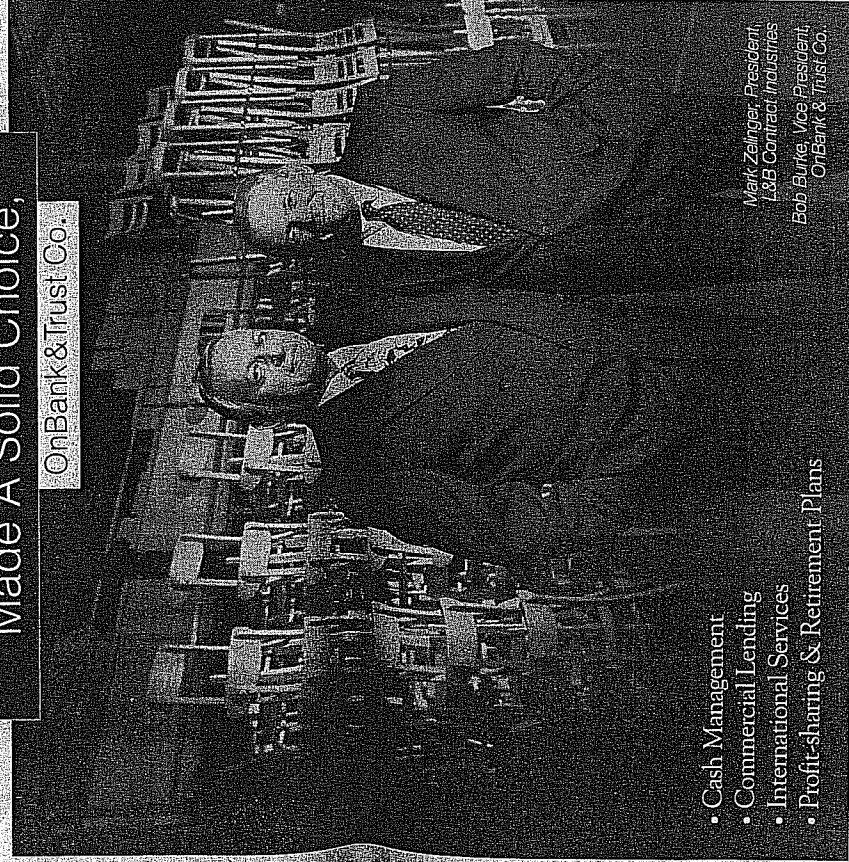
To make matters worse, in 1993, the National Association of Securities Dealers, a self-regulatory organization that exercises jurisdiction over 500,000 securities brokers and brokerage firms, imposed strict commission limitations on the amount of commissions that brokerage firms can charge for brokering the purchase or sale of limited partnership interests in the secondary market.

While the regulations were well-intended, they have had the effect of providing a great disincentive to brokerage firms even to consider becoming involved in the secondary market for the purchase and sale of limited partnership interests.

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Knowing valuation approach can help seller of limited partnership

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Fortunately, the last five years have seen the booming growth of brokerage firms specializing in the purchase and sale of limited partnership interests on the secondary market. The growth in these firms has fostered competition in this area, and many of these firms or partnership exchanges now will give bid prices over the fax machine with a one-day turnaround.

It wasn't too long ago that investors would have to wait weeks, even months, to get a single bid for a limited partnership. Further, there was a time when shrewd firms engaged in the predatory practice of buying limited partnership interests from desperate investors or estates willing to get rid of a frustrating experience for a fire-sale price.

Another problem with limited partnerships arises when a proper valuation is needed for any number of reasons. For example, the Department of Labor and the Department of the Treasury impose fairly strict requirements on valuation guidelines to be followed for limited partnerships held in Employee Retirement Income Security Act-qualified pension plans. This type of valuation, however, differs from the type of valuation that might be required for estate tax purposes and for purposes of inventorying the value of an estate.

The IRS, however, uses yet a third type of valuation approach when assessing the tax liability of individual investors on their annual tax returns. Thus, before seeking out a limited partnership appraisal or valuation, it is important to know what method

of valuation or appraisal is required.

Investors should ask a number of fairly simple questions before deciding whether or not to dispose of a limited partnership interest. Would they be better off keeping the limited partnership as opposed to selling it? Tax considerations should be given to a sale of a limited partnership.

For example, there are various recapture rules that might require the filing of amended returns for previous years in the event of a sale. What are the long-term prospects for limited partnerships' business activities? If they are on the upswing, an investor might be better off holding the limited partnership.

What has been the annual rate of return on the limited partnership?

Although many limited partnerships can bring only a nominal price in the marketplace, they still may pay a favorable of return as measured by the original purchase price. Those considering selling a sizeable limited partnership should get an opinion from an accountant to address the tax ramifications.

Anyone serious about selling a limited partnership should get at least three different bids from different limited partnership exchanges. Limited partnership investors who have reason to think they may have been defrauded or improperly sold a limited partnership interest should consult with a lawyer to consider their chances in an arbitration proceeding or lawsuit.

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