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Because the number of investors purchasing tax sheltered investment programs has increased so significantly in recent years, California has begun to more closely scrutinize the sale of these interests. Since such programs qualify as securities, they are governed by the Corporate Securities Law of California, which requires that a permit be obtained from the Commissioner of Corporations certifying that the public offering is fair, just, and equitable. In this article Brian Van Camp, California's Commissioner of Corporations, reviews the administration of the laws and regulations governing the various tax shelter investments and points out the kinds of factors which the Commissioner's office considers in determining the fairness of each type of investment program.

Sales of tax sheltered investment programs in California are climbing to new heights every year. From July until December 1972 alone, this type of investment accounted for over one billion dollars worth of securities registered with the California Department of Corporations (hereinafter referred to as "Department").

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As securities, tax shelter interests must be qualified under the Corporate Securities Law of California and receive a permit from the Commissioner certifying that offerings are fair, just, and equitable. Until the last few years, the qualification of the offer and sale of these program interests was not of significant concern, since they were few in number and were primarily sold to persons in very high income tax brackets. Those persons could usually afford to protect their own interests and therefore did not look to the State for much assistance in determining the fairness of these programs. With the great increase in dollar volume and number of persons participating in these programs, however, tax shelters of necessity have become a major concern to securities law administrators throughout the country. The purpose of this article is to review the administration of these laws as they pertain to tax shelters in real estate ventures, oil and gas drilling activities, cattle feeding and breeding programs, and crop syndications.

Regulators who attempt to arrive at a determination of fairness for each of these investment vehicles must appreciate the differences in risk presented to the public and the different tax needs that each is designed to solve. Hopefully, this review of the Department's present regulation of these different vehicles will show the kinds of factors which enter into the Department's determination of fairness of a particular tax shelter program.

While the primary purpose of blue sky law administrators is to see that the shareholder or limited partner gets a fair shake, the Department also has a concomitant obligation to ensure that the aggregation of capital is not unnecessarily hindered or strangled by governmental regulations which have no sound basis in the furtherance of investor protection.

The business pursuits of most tax shelter programs have been deemed by Congress to be of high social value and therefore deserving of special tax treatment as an encouragement to engage in that business. Thus, national housing goals are furthered by real estate syndicators who provide new housing units, especially those built for low income persons. New oil and gas reserves discovered by drilling funds help combat the energy crisis. Cattle and crops syndications generate funds to increase the production of essential food and fiber products.

When capital is raised from the public by responsible persons on fair terms and is employed successfully in these ventures, the promoters, the investors, and the society all benefit. Making this process work is the task the Department addresses in administering the

Corporate Securities Laws of California.[1]

REAL ESTATE SYNDICATIONS

Real estate syndications through limited partnerships are perhaps the most popular tax sheltered investment vehicle today. There has been a continuing trend to update the regulatory guidelines applicable to real estate syndications and to achieve a harmonious, uniform set of rules to be applied to real estate syndications universally. The California Department of Corporations, the Midwest Securities Commissioners (an organization of 24 state securities law administrators), and the National Association of Securities Dealers have conceived a set of rules that is compatible with the regulatory philosophy of each of the several agencies. In February 1973, the Midwest Securities Commissioners, meeting in San Francisco, adopted guidelines for the offer and sale of real estate syndications. These guidelines will probably be applied consistently by most of the state blue sky law administrators in the country. The new California rules differ only slightly from the final draft adopted by the Midwest Commissioners.[2]

Studies have been made of both successful and unsuccessful syndicates, in order to determine the most important areas of regulation. The final version of the California rules for the offer and sale of real estate programs tightens regulation in many of the areas thought to be the cause of many syndication failures in the past.

Front-End Compensation

In real estate syndications, the front-end compensation and expenses to the partnership include the selling and organizational expenses and the acquisition and developmental fees and commissions paid from the invested capital. In the past, many syndications have encountered difficulty when too much of the invested capital is paid out in fees and commissions leaving an inadequate amount to be put into the property. Under the recently repealed California law, the selling expenses should not exceed 15 percent of the initial invested capital.[3] The new California rule carries this limitation forward.[4]

Organization and offering expenses are defined in the new Cali-

1. CAL. CORP. CODE §25000 *et seq.*
2. This is primarily because the Midwest draft is based largely on an earlier California draft which the author presented as Co-Chairman of the Midwest Committee on Real Estate Limited Partnerships.
3. CAL. ADMIN. CODE tit. 10, §260.140.111(c) (repealed April 6, 1973; effective May 10, 1973).
4. *Id.* §260.140.113.2 (adopted April 6, 1973; effective May 10, 1973).

fornia Real Estate Rules as those expenses incurred in preparing a program for registration and subsequently offering and distributing it to the public, including sales commissions paid to broker-dealers in connection with the distribution of the program.[5] It should be pointed out that organization and offering expenses may only be paid for obligations which are actually incurred. The 15 percent limit is not automatically allowed as compensation.

Whereas the old California guidelines provided that the total amount of compensation of all kinds to promoters had to be reasonable, and that a standard real estate commission would be permissible, if shown to be competitive, the new rules modify this approach. Front-end compensation for acquisition services is subject to the overall test of reasonableness *for each fee.* In addition, the total of all such compensation paid to everyone involved in the transaction by the program and/or any other person shall be deemed presumptively reasonable only if it does not exceed 18 percent of the gross proceeds of the offering.[6] Further, such fee may not exceed the normal rate for similar services in the locality where provided.[7] The acquisition fee paid to the sponsor is reduced to the extent that other real estate commissions, acquisition fees, or other fees or commissions are paid by any person in connection with the transaction.[8] Thus there is no maximum real estate commission paid by the program. However, third party commissions reduce the amount of any front-end commissions paid to the sponsor or his affiliate. Finally, the sum of the purchase price of the program's properties plus the acquisition fees may not exceed the appraised value of the properties.[9]

Historically, program managers and sponsors have been permitted a property management fee upon a showing that the fee is competitive with that charged for similar services by professional property managers.[10] The new rules carry forth the overall test of reasonableness and also provide explicit authority for the general partner to receive management fees where a program owns unimproved land or government subsidized projects. With respect to unimproved land, the general partner may be entitled to receive annual compensation not exceeding one-quarter of one percent of the costs of such unimproved land for operating the program until the land is sold or improved, up to a cumulative total of 2 percent of the original cost, regardless of

5. *Id.* §260.140.110.2(o).
6. *Id.* §260.140.113.3(b).
7. *Id.* §260.140.113.3(a).
8. *Id.* §260.140.113.3(b).
9. *Id.* §260.140.113.3(d).
10. *Id.* §260.140.111(a) and (c) (repealed).

the number of years held.[11] Where government subsidized projects are held, annual compensation cannot exceed one-half of one percent of the cost of such property during the entire time the property is held.[12]

Finally, strict limitations have been placed upon commissions to be received upon resale of the property of the program. These commissions may not exceed one-half of the standard commission and must be subordinated to a 100 percent return of the investors' capital plus the stated percentage return. The commissions must also be approved by a majority of the limited partners. No commissions may be paid to a syndicator in connection with the reinvestment of the proceeds from the resale, exchange, or refinancing of the syndicate property.[13] The new California Real Estate Rules permit reasonable promotional interests. The following interests are considered presumptively reasonable: (1) a 25 percent subordinated interest in the undistributed amounts after a 100 percent return to the investors of capital contribution; or (2) a subordinated interest equal to (a) 10 percent of the distributions from cash available for distribution, and (b) 15 percent of the distribution to investors from the proceeds on the sale or refinancing of the properties after payment to investors of 100 percent of their capital contribution, plus a 6 percent per annum cumulative return less the sum of prior distributions.[14]

Upon review of the entire compensation picture, it is apparent that the general test of reasonableness of the prior California law has been supplanted by more definite standards, with presumptively reasonable limits within which a sponsor can operate his program. Enactment of such standards should result in a uniform approach to regulation of real estate syndication offerings.

Suitability Standards

Since tax shelter is one of the primary goals of the investor, real estate syndications have generally attempted to maximize ultimate tax benefits. In a highly leveraged real estate syndication, the risk is increased because of the large mortgage carried. In addition, syndications have limited transferability of interest and limited investor democracy rights. The old suitability standard that the proposed investors must have a financial responsibility commensurate with the

11. *Id.* §260.140.113.4(a).
12. *Id.* §260.140.113.4(b).
13. *Id.* §260.140.113.6.
14. *Id.* §260.140.113.5(a) and (b).

proposed investment[15] had only limited success. The new rules seek to specify the *exact* kind of investor who is "suitable" for the particular program. Sponsors will be required to set forth in the prospectus the investment objectives of the syndicate, a description of the type of person who could benefit from the program, and the suitability standards to be applied in marketing it.[16] The application of the standards looks toward the amount of deductible tax losses during the year of the investment, realizing that such investments involve more than an ordinary risk. A substantial net worth would therefore be required to participate in such a program.

The burden of finding that a person fits the prescribed suitability standards is placed upon the syndicator and each person selling limited partnership interests on behalf of the syndicate.[17] The sponsor must ascertain whether or not a particular investor can benefit from the program by analyzing the nature of his employment experience, educational level, access to professional advice, and experience in prior investments.[18] The sponsor must further ascertain that the investor understands and appreciates the risks involved, as well as the consequences of his investment.[19]

Given this background, the new rules attempt again to establish presumptively reasonable standards for the suitability of an investor and for the minimum investment in a particular program. California now requires a $2,000 minimum initial cash purchase per investor on all offerings.[20] The Department will also employ the following presumptively reasonable suitability standards for participants in real estate syndications: either (1) a minimum annual gross income of $20,000 and a net worth of $20,000, or (2) a minimum net worth of $75,000. It should be noted that net worth shall be determined exclusive of home, furnishings, and automobiles. The California Real Estate Rules further specify that in high risk or principally tax oriented offerings, higher suitability standards may be required.[21]

Net Worth and Experience Requirements of the General Partner

In light of the general partner's unlimited liability under law on behalf of the partnership, the Department requires the general partner to have adequate financial ability to perform his obligations. The

15. *Id.* §260.140.114 (repealed).
16. *Id.* §260.140.112.1.
17. *Id.* §260.140.112.2.
18. *Id.* §260.140.112.2(b)(1).
19. *Id.* §260.140.112.2(b)(2).
20. *Id.* §260.140.112.4.
21. *Id.* §260.140.112.5.

new California Real Estate Rules provide a standard which is modeled after the safe-harbor rule followed by the Internal Revenue Service. At a minimum, the sponsor is required to have a financial net worth equal to the greater of either (1) $50,000, or (2) an amount at least equal to 5 percent of the offering sold within the prior twelve months, plus 5 percent of the gross amount of the current offering, to a maximum net worth of $1,000,000.[22] Additionally, he must present evidence of his ability to maintain the required net worth for a period of three years after consummation of the offering.

In the area of the experience requirements of management, setting a minimum standard as adequate experience poses a difficult problem. The California Real Estate Rules opted for an alternative standard by providing that the sponsor, general partner, or affiliate providing services to the program shall have not less than four years relevant experience in this particular service, or otherwise must demonstrate sufficient knowledge to perform the services or manage the type of properties to be acquired.[23]

It has been alleged that the principal reason for the failure of syndications was that the syndicator lacked the experience to successfully engage in selection or acquisition of properties and to structure them financially. Consequently, the prospectus or offering circular must disclose the business experience of the sponsor for the past ten years. Any lack of experience must be disclosed as a risk factor for the investor to consider in making his investment.[24] Thus the law still allows for discretion by the Commissioner where the four-year presumptively reasonable standard has not been met and mandates a disclosure requirement to apprise the investor of the significant risk he may be taking.

Conflicts of Interest

The new rules set forth many prohibitions and restrictions on transactions among promoters, affiliates, and syndicates. The sponsor may only sell or lease property to the syndicate upon the formation thereof and may make such sale or lease only upon terms fair to the syndicate and at a price not in excess of the property's appraised value. Should the promoter's cost be less than the price to be paid by the syndicate, the transaction will not be deemed fair regardless of the appraised value, unless the sponsor can show that there was a material factor or change which has occurred in the property which

22. *Id.* §260.140.111.2.
23. *Id.* §260.140.111.1.
24. *Id.* §260.140.117.3(d).

would increase the value since the date the sponsor purchased said property.[25] Of course, full disclosure of the transaction and the terms thereof must be made in the prospectus. While the new rules will not ordinarily permit the sale of property by the syndicate to the sponsor, flat-out prohibitions are made upon loans by the syndicate to the sponsor or an affiliate, or acquisitions of property from a program in which the sponsor has an interest.[26]

The new rules delineate numerous other areas which are deemed conflicts of interest between a program and a sponsor, including exclusive agreements between a sponsor and a program to sell the property for the program,[27] a commission or fee paid to a sponsor in connection with the investment of the proceeds of the resale, exchange, or refinancing of the property,[28] insurance brokerage fees received by the sponsor on any of its property,[29] or other rebates, kickbacks, or other reciprocal arrangements which would tend to circumvent these rules.[30]

Disclosures

Under prior law, the Commissioner required disclosure of all material information relating to the investment, compensation, profit to promoters, or assessments to the investors.[31] In theory, all "material information" could be broadly interpreted to mean anything within the discretion of the administrator. The new California Real Estate Rules, in exhaustive detail, list the information required to be included in the prospectus of the program.[32] The business experience, compensation to the general partners, assessments, and risk factors have already been mentioned. Additionally, the Department will require extensive explanations of the investment objectives and policies of the syndicate and an explanation of the past experience (the "track record" of the sponsor or its affiliates[33]) including a five-year history of the previous syndicate experience of the sponsor or other affiliate. Disclosures required include the location of syndicate property, the effective date of the offering, the total amount of the interest offered, the types of property acquired, the total dollar amounts of federal tax items which were deductible and passed on to the investor, the amount of cash distributions to the investor, the compensation to the sponsors, and a

25. *Id.* §260.140.114.1(a).
26. *Id.* §260.140.114.1(b), (c) and (d).
27. *Id.* §260.140.114.3.
28. *Id.* §260.140.114.4.
29. *Id.* §260.140.114.5(a).
30. *Id.* §260.140.114.6(a).
31. *Id.* §260.140.115 (repealed).
32. *Id.* §260.140.117.3.
33. *Id.* §260.140.117(i), (k).

comparison between all projected and actual results.[34] The Commissioner has the discretion to require additional information to fairly present the track record of a syndicator.[35] In my opinion, this is a significant step forward in the area of required disclosures in the offering circulars of real estate syndications.

Taxation

The previous policy of the Department, requiring extensive discussion in the prospectus of the federal tax consequences of the offering in the form of an opinion of tax counsel, has been retained in the new rules.[36] The opinion of counsel should set forth the legal basis for the conclusion that the entity will be taxed as a "partnership" and not as an "association." Also, there should be adequate discussion of the "partnership characteristics" claimed for the entity for income tax purposes. Where no Internal Revenue Service ruling has been requested, it should be pointed out that the Internal Revenue Service may challenge the partnership classification upon audit. Additionally, appropriate disclosure should be made as to the adverse tax consequence of classifying the entity as an "association" taxable as a "corporation," rather than as a partnership.

Taxation and Investor Democracy Rights

The Internal Revenue Service views the "continuity of life" characteristic as an important element in the determination of whether the particular entity under review is an association or a partnership for tax purposes. Further, in the past few months the Internal Revenue Service has taken a position on "continuity of life" which operates to directly affect limited partnerships in California—that a limited partnership, which is subject to a statute corresponding to the Uniform Limited Partnership Act, lacks "continuity of life."[37] The problem arises in that, in the opinion of the Internal Revenue Service, the version of the Uniform Limited Partnership Act adopted in California does not so "correspond." Therefore, a partnership subject to the California statutory scheme for limited partnerships will indeed possess "continuity of life" and thus lose its partnership tax status, if its organizers elect to include, in the partnership agreement, a provision allowing for the continuation of the partnership by less than unanimous vote of all the limited partners upon the death, retirement, removal,

34. *Id.* §260.140.117.3(k)(2)(i)-(ix).
35. *Id.* §260.140.117.3(k)(2)(x).
36. *Id.* §260.140.117.3(o)(1)-(7), (v).
37. Treas. Reg. §301.701-2(b)(3) (1960).

or bankruptcy of the general partner. Such an agreement clause is permissible under California law.[38]

Recognizing the jeopardy to many limited partners created by the posture assumed by the Internal Revenue Service, the Commissioner has taken the interim position that it will be permissible for the partnership agreement to require a vote of 100 percent of the limited partners to continue the partnership upon the death, retirement, removal, or bankruptcy of the general partner. However, such an agreement must still provide for only a majority vote to remove the general partner and to approve termination of the partnership. Further, there should be a provision in the agreement that a majority of the limited partners may elect to continue the partnership if prior to the occurrence of a terminating event, such as death, retirement, or removal of the general partner, it has been established by either (a) a final appellate federal court decision or (b) a published revenue ruling by the Internal Revenue Service that, for income tax purposes, a continuation of the partnership by a vote of less than all of the limited partners will not cause the partnership to have the corporate characteristic of "continuity of life" for purposes of determining whether or not the partnership will be taxed as a partnership or as an association. The Department is continuing its efforts to persuade the Internal Revenue Service not to penalize limited partners in California simply because they claim for investors certain democratic rights given to them under California law.

Additions under Disclosure

The final innovative area of disclosure—the use of projections—is extensively covered in the California Real Estate Rules.[39] California has been applying liberal standards for projections, encouraging them when they are based on actual operating results. California has always required as a basis for the predictions that disclosure be made of the supporting assumptions and source of data. The new rules[40] provide that projections shall be permitted in the offering circular if they are for a period of at least ten years or equivalent to the anticipated holding period of the property, whichever is less. They must definitely project a resale. The projections must disclose the required occupancy rate in order to meet the debt service. All expenses and rental revenues must be predicted, based on occupancy rates below the break-even occupancy rate. The projections must also predict annual cash flow and give the assumed occupancy rates therefor.

38. CAL. ADMIN. CODE tit. 10, §260.140.110(b); CAL. CORP. CODE §15507(b), (c).
39. *Id.* §260.140.117.4.
40. *Id.* §260.140.117.4(a)(4).

They must predict the annual depreciation and amortization, describing the methods used, together with annual income or loss and an explanation of the tax treatment of the results.[41] Projections are not allowed for unimproved land; however, a table of deferred payments specifying the various holding costs such as interest, taxes, and insurance must be included.[42] Additional disclosures may be required where the program intends to develop and sell the unimproved land.

Although only a few of the requirements of the projections have been touched upon, one can readily see that the new rules provide a comprehensive scheme for regulating the use of projections in the offering circular to provide more meaningful and nonmisleading disclosures to investors.

Subsidized Housing Syndicates

In general, the rules relating to real estate syndications also apply to subsidized housing syndicates. However, there are certain unique aspects of subsidized housing syndicates which may require differing standards of regulation. Most offerings of subsidized housing syndicates are exempted under the provisions of the California Corporate Securities Law;[43] and since there is limited activity in this area, many of the rules regarding subsidized housing syndicates are applied on a case-by-case basis. The investor benefits of a subsidized housing syndicate are different than in the normal tax-oriented real estate syndication. The motivating factor for investors is usually the accelerated depreciation offered over the life of the program and some regular, if minimal, cash flow every year. One factor which increases the risk in subsidized housing syndicates is the relatively slight prospect for profits on resale of the property. Therefore, the Department has generally imposed suitability standards of (a) a liquid net worth of at least $50,000, and (b) annual income, some of which is taxable in the 50 percent income tax bracket under the Internal Revenue Code.

Compensation Structure

In subsidized housing syndicates the syndicators usually seek large front-end compensation from the proceeds of the public offering because cash flow is usually limited, with few residual proceeds. The publicly offered subsidized housing syndicates usually consist of a

41. *Id.* §260.140.117.4(a)(2)(iv)-(viii).
42. *Id.* §260.140.117.4(b).
43. Cal. Corp. Code §25102(f); Cal. Admin. Code tit. 10, §260.140.102.2.

"two-tier" partnership arrangement. The "top-tier" partnership has the syndicator as a general partner and the public investors as limited partners. It is basically a blind pool of capital which the general partner will invest in a series of local "lower-tier" partnerships, each of which owns equity in a project. The developer is the general partner and the top-tier partnership is the sole limited partner in the lower-tier partnership. This arrangement presents serious questions as to what amount of compensation is reasonable and fair under the circumstances. The reasonable standard of former Section 260.140.111(a) has been used. Presumably, the Department will modify this in the future to conform more closely to the new Real Estate Rules.

The Department takes the position that the local developer is a "syndicator" for the purpose of application of the rules. Therefore, the price at which the local developer sells a project to the syndicate becomes important because a profit on the sale of property by the syndicator is not normally permitted.[44]

Experience Requirement of Management

The experience of management is a crucial factor in the success of the syndicate. Also, the quality and experience of the local developer and his financial capability are important considerations.

Investor Democracy Rights

In relation to the basic investor rights required by law,[45] the question arises whether, even if the "lower-tier" partnerships provide the same investor rights as are required by the "top-tier" partnership, can the public investors effectively exercise those rights without direct participation in the "lower-tier" partnership? Despite contrary determinations by the Federal Housing Administration, the Department takes the position that the California rules and law seem to require that investors have the ability to meaningfully assert their rights. Any significant inhibition upon the enforceability of these rights would run counter to the basic tenets of investor democracy.

Oil and Gas Programs

The tax shelter afforded to an investor in an oil and gas program depends on the kind of program in which he invests. The riskiness of an investment depends upon the activities of the program and its atti-

44. Cal. Admin. Code tit. 10, §260.140.111(c).
45. Cal. Corp. Code §15507(b), (c).

tude toward immediate income. An exploratory oil and gas program is one whose major activity is the search for new petroleum reserves. The oil and gas operator and investors join forces to conduct oil and gas exploration. Generally speaking, the operator supplies the knowledge and experience and the investor supplies the needed capital. The tax advantages of petroleum exploration programs are based on the fact that intangible drilling and completion costs are deductible for federal income tax purposes. To the extent that his oil and gas investment reflects expenditures for such items, an investor can offset his investment against his ordinary income received from other sources. Additionally, he is entitled to a deduction for depletion on the income derived from the production and sale of oil and gas and other minerals. There is a substantial probability that oil and gas properties may not be discovered in productive quantities and thus there is a high risk of loss of the total investment.

Developmental programs in oil and gas have, as their principal activity, the development of existing petroleum reserves, rather than the search for new reserves. In general, semi-proven and proven prospects are successful in 50 to 75 percent of all cases. Although the risk is less, the value paid for the leases in proven and semi-proven areas is always higher. Other kinds of programs involve balanced arrangements providing for both exploration and development.

Oil and gas programs, with their varied methods of compensation structure, are of particular interest to the regulators, including California. The basic set of guidelines is Title 10, California Administrative Code, Section 260.140.120 *et seq.* These rules, however, have not kept pace with newly emerging programs, and therefore, as of this writing, the Commissioner has recently appointed a blue ribbon committee of distinguished oil and gas attorneys from California, Texas, and Oklahoma to assist the Department in drafting a more modern system of regulating these programs. Promoter's compensation, suitability standards of investors, management experience, and disclosure are the key areas under scrutiny.

Promoter's Compensation and Expenses

In most instances, the manager or promoter generally gets paid more as his performance improves. There are many different forms of compensation structures, such as front-end interest, overriding royalties, net profit interests, working interest after pay out, functional allocation, etc. In any event, the total amount of compensation, of all kinds, to promoters should be reasonable in light of the nature of the

exploration and development proposed and the identity of the investors.[46] Additionally, promoters may be reimbursed out of the proceeds of the sale of the program interests for actual and necessary expenses paid by the promoters for the purpose of exploration and development. These expenses may include the acquisition and maintenance of leaseholds, except when a "functional allocation" method of compensation is used.[47] Under a functional allocation method of compensation, tangible or capital costs are paid by the promoters and intangible or noncapital costs are paid by the investors, with revenues being shared at specific percentages. In situations where a functional allocation program method is used, the Department takes the position that if the aggregate percentage of revenues payable to a promoter does not exceed by more than 15 percent the aggregate cost borne by the promoters, then such a promotional interest is presumptively reasonable. The cost should be computed on the basis of the total program and not on a well-by-well or drilling block basis. A reasonable overriding royalty or net profit interest which entitles the promoter to an immediate share of production may be paid to the promoter only in those instances where no other compensation, except commissions and management fees or direct reimbursement for actual exploration and development expenses, is paid to the promoter.[48]

An overriding royalty is basically a percentage of the gross income of the program. The principal difference between a net profit interest and an overriding royalty is that an overriding royalty is a percentage of gross income, while a net profit interest is a percentage of net income. An overriding royalty or net profit interest which does not exceed 3/32nds of the syndicate's share of production is deemed presumptively reasonable under California law.[49] Alternatively, a promoter may take a promotional interest in the form of a subordinated percentage of the working interest or a subordinated net profit royalty interest which does not exceed 33 1/3 percent of the working interest. A subordinated interest should provide for a 100 percent return of the investor's invested capital before the promoter receives subordinated working or net profit royalty interest.[50] Syndicators will not be permitted, in defining "pay-out," to exclude certain amounts of the investor's contributions, such as amounts which go to pay selling expenses.

46. CAL. ADMIN. CODE tit. 10, §260.140.120(a).
47. *Id.* §260.140.120(d).
48. *Id.* §260.140.120(b), (c), (d).
49. *Id.* §260.140.120(b).
50. *Id.* §260.140.120(c).

Section 260.140.120 creates an anomalous situation. It requires the promoter to elect between a subordinated working interest, which does not participate in production until a 100 percent return has been achieved on invested capital by the investor, and an overriding royalty or net profit interest which entitles the promoter to a front-end, immediate share of production. From the viewpoint of most experts, the net participation of the promoter under either alternative is substantially the same because an overriding royalty percentage may be worth about three or four times as much as the corresponding working interest. In sum, a promoter may receive organizational expenses and management fees of 10 percent of the invested capital and either a promotional interest in the form of a 33 1/3 percent working interest subordinated to a 100 percent return to the investors of their initial capital, or an overriding royalty or net profit interest of 3/32nds, or under a functional allocation method a 15 percent promotional interest. Promoters may be reimbursed out of the proceeds of the sale of the program interests for exploration and development expenses if they do not elect the functional allocation method of compensation.

Suitability Standards

The exploration and development of oil and gas properties involves a highly speculative investment undertaking. Generally, investments should be limited to those classes of investors who are sophisticated and experienced and will be able to avail themselves of the advantages and benefits of this type of investment. Whether a particular investor is suitable for an oil and gas investment depends on the kind of program, his investment objectives, and his individual situation, both in terms of income tax bracket and net worth. An investor in oil and gas programs should have a minimum annual income and net worth which is suitable for the proposed investment.[51] He should also be in a tax bracket which will permit him to realize a reasonable income tax benefit from the proposed investment, regardless of the success of the venture.[52] The Department has been applying the following suitability standards: (1) a $50,000 net worth during the previous tax year, or an estimate that the investor will have a $50,000 net worth during the current tax year and a current annual income which places him in the 50 percent federal income tax bracket, or (2) net worth of at least $200,000. Additionally, the investor should have the requisite investment experience and availability of independent advice to evaluate the inherent risks of the proposed investment.

51. *Id.* §260.140.2.
52. *Id.* §260.140.2.

Where the securities are being sold by brokers registered under the Securities Exchange Act of 1934, there will be no prior independent review of an investor's qualifications. Where the securities are being sold by persons other than brokers registered under the Act, an application for qualification must present information satisfactory to the Department to qualify each investor under the prescribed standards. In oil and gas programs which are organized for the purpose of investing substantially all of their assets in *oil producing properties* and which are prohibited from engaging in exploratory operations, in light of the lower risk ordinarily a lower suitability standard for the investor will be deemed presumptively reasonable: (1) a net worth of $35,000 and an annual income of $20,000, or (2) a net worth of $100,000.

As in real estate syndications, a minimum purchase is required in oil and gas exploratory programs. Ordinarily an investor must make a minimum investment of $5,000, but variances in certain circumstances may be made. Nevertheless, suitability standards for investment in an oil and gas syndicate are the most stringent placed on any security offered to the public.

Management's Experience and Net Worth

Although there are no explicit rules setting forth the requirement of management's experience and net worth for oil and gas syndicates, the Department takes the position that management must have the requisite experience to carry out the proposed plan of operations of the program. This is part of the overall determination that the offering complies with Section 25140 of the Corporations Code which requires that the Commissioner find the offering "fair, just and equitable." Normally, no net worth requirement is imposed on the general partner in oil and gas programs.

Investor Democracy Rights

The Department has recently altered its policy—oil and gas partnerships are now required to provide the same investor rights as those imposed upon real estate syndications.[53] Where the investor democracy rights jeopardize the taxable status of the partnership, similar concessions are made for oil and gas syndicates as for real estate syndications. With reference to the tax aspects of syndicates for oil and gas properties, it is customary to require an opinion of counsel or a ruling from the Internal Revenue Service that the syndi-

53. *Id.* §§260.140.110, 260.140.112(c).

cate will not be regarded as an association taxable as a corporation under the Internal Revenue Code. The opinion of counsel should explain the legal basis for the express conclusion that the syndicate will be taxed as a partnership by explaining the lack of corporate characteristics as set forth in the Internal Revenue regulations. The form of this opinion can be substantially the same as that required for real estate syndications.

The partnership agreement, as under the allocation of profit and loss, should be explained to disclose to the limited partners the tax consequences of gains and losses of the partnership. Each special feature of the oil and gas program which is claimed to be deductible by the partnership should be individually discussed. Some items in this area are intangible drilling costs, depletion, depreciation, lease acquisition costs, and geophysical costs. The other tax consequence items, such as gain or loss on the sale of partnership units and effect upon dissolution of the partnership, should also be comprehensively discussed in the tax consequences section of the prospectus.

CATTLE PROGRAMS

In recent years, there has been a dramatic increase in the number of publicly offered limited partnerships engaged in cattle-feeding programs. Although there are many other types of cattle programs which are securities (cattle-breeding programs, combination breeding and feeding programs, and investment contracts in cattle), we are mainly concerned here with the use of the limited partnership vehicle as a tax shelter in cattle-feeding programs. The Midwest Securities Commissioners Association has adopted rules for the registration and regulation of publicly offered cattle-feeding programs. California applies most of these rules.

There are significant areas of concern for administrators in cattle programs. As in real estate syndications, there is a large potential for conflict of interest among promoters, sponsors, and affiliates who perform various services in the process of preparing a steer for market both on the feed lot and in the marketing process. Each program is scrutinized on a case-by-case basis to insure compliance with the adopted guidelines. Cattle feeding essentially consists of purchasing calves or yearlings, fattening them on ranches or in feed lots, and selling them for slaughter. The general partner arranges loans to the partnership to purchase the cattle and operates the feed lots. This produces a highly leveraged investment with a partner receiving high proportionate gain or loss on his investment.

Compensation Structure

All expenses for organization of the partnership and selling of the partnership interests to the public must be borne solely by the sponsor if the sponsor is to receive the allowable 12 1/2 percent of the gross cash receipts as a management fee for the first year of operation.[54] For each additional year, the sponsor is permitted a 5/8 percent per month interest on the net assets of the program. The sponsor must pay all of its administrative and overhead expenses, and all other expenses of the limited partnership are required to be billed and paid by the program.[55] There are other areas where the sponsor or its affiliate will receive additional front-end compensation. Mark-ups on feed costs sold to the partnership and mark-ups on purchase of cattle are generally permissible when the actual cost to the partnership does not exceed that price paid by nonaffiliated customers in the same locale at the time of purchase.

Conflicts of Interest

Most cattle programs have serious potential conflicts of interest between the sponsors and their affiliates, who are usually the feed lot operators and managers. Since the feed lot affiliate cannot charge management fees or overhead fees which would be deemed additional compensation not provided for in the rules, it has been suggested that the affiliates often may find other ways to profit from the relationship. As rear-end compensation, the general partner or sponsor is permitted a 25 percent subordinated interest in the program's profits after a return of 100 percent to the public investors of their investment.[56]

Of course, the syndications least likely to have a serious conflict of interest are those that are not selling their own cattle to the partnership, nor feeding the partnership cattle at their own or affiliated feed lots, nor marketing said cattle to their own affiliate. The only attack the Department can make on conflicts is through the disclosure tool. The prospectus must fully describe all conflicts of interest between public investors and the sponsor and its affiliates.[57] No fees or commissions or other remuneration of any kind may be received by the sponsor or its affiliates, either directly or indirectly in connection with the venture,

54. Midwest Securities Commissioners Association Guidelines for Registration of Publicly Offered Cattle-Feeding Programs §I(C)(1) and (2) [hereinafter cited as Midwest Rules].

These rules are promulgated by the Midwest Securities Commissioners Association as a statement of association policy for guidance of individual state administrators. The rules are given effect only by adoption under state securities regulations.

55. Midwest Rules §I(C)(2).

56. Midwest Rules §I(C)(2).

57. Midwest Rules §I(L)(1).

which are not set out and fully disclosed in the prospectus. Additional prohibitions are placed upon the sale of partnership cattle to an affiliate of the sponsor. No fee may be charged upon such a sale,[58] and the program's cattle may not be sold to the sponsor or its affiliates except under limited circumstances where it is established that this was the same price paid by a packer for consistent quality cattle from other owners.

Suitability Standards

The Department applies the same basic test with regard to standards of suitable investors in cattle programs that it does in oil and gas syndicates. Depending on the amount of leveraging used in the purchase of the cattle and the financing of the feeding thereof, additional tax benefits are made available to the investor. The investor is suitable when he is in a tax bracket which will permit him to realize a reasonable income tax benefit from the proposed investment in the program, whether or not the program is successful. It is significant to note that the Midwest Rules do not explicitly provide for a net income or net worth requirement for investor participation. California follows the same unwritten procedure. The Department realizes that all cattle programs are different; and therefore, the suitability standards of net worth and net income requirements will vary accordingly. In general, it can be said that for cattle-breeding programs which are even more highly speculative than cattle-feeding programs, higher suitability standards are imposed. With regard to the minimum investment by a public investor, the Midwest guidelines provide for a $5,000 minimum, all of which must have been paid at the date the venture commences.[59] California does not take this approach. Again, the Department realizes that the minimum investment standard should vary accordingly with the risks of each particular investment. Thus California takes a flexible approach to application of both prongs of the suitability tests: net worth and net income standards and the minimum investment requirement.

Management's Experience and Net Worth

Significant experience is required by the general partner or a manager who will be hired by the partnership to supervise the buying, breeding, or feeding of the cattle purchased by the partnership. According to the Midwest guidelines, such experience must be of at least

58. Midwest Rules §I(L)(3).
59. Midwest Rules §II(A).

five years duration, with three years in feed lot operations exceeding 1,000 head of cattle capacity within recent date of the pending public offering.[60] California takes the position, as it does in oil and gas programs, that the experience of management is one of the factors which is included in the finding of fairness under the "fair, just and equitable test" of Corporations Code Section 25140. Although no precise guidelines are set, significant experience is required to satisfy this standard. According to the Midwest Rules on cattle-feeding programs, the sponsor must purchase for cash a minimum of $100,000 in participation interests in any entity which offers its cattle-feeding interests to the public or, where the aggregate offering is less than $1,000,000, the sponsor is required to purchase only 10 percent of the offering, less underwriting discounts and commissions.[61] The sponsor's participation may also be reduced by 10 percent for each $35,000 in tangible net equity possessed by the sponsor. Thus the extent of the sponsor's participation will vary depending upon the aggregate amount of the offering.

Investor Democracy Rights

The same requirements as in real estate syndications or in oil and gas limited partnerships are required for cattle programs.

Tax Aspects

As in other partnerships, a counsel's opinion or an Internal Revenue Service Ruling confirming the tax treatment of the partnership as a partnership, rather than an association taxable as a corporation, is required. Special items such as prepaid feed expenses, absent an Internal Revenue Service Ruling, should be explained. Additionally, the tax counsel's opinion should address itself to the unsettled question in the Internal Revenue law—whether such items will be deductible in the year of prepayment. The depreciation recapture provisions of Section 1245 of the Internal Revenue Code apply to livestock. Therefore, the depreciation aspects should be discussed along with a treatment of Section 1251 property, which includes the disposition of property used in farming.

Disclosure

There are certain areas in cattle programs which require explicit treatment in the prospectus. A history of operations of the general

60. Midwest Rules §I(A).
61. Midwest Rules §I(B)(3).

partner or sponsor should be disclosed which includes all fees and remunerations received by the sponsor or affiliate from any publicly owned program for the past three years or for such shorter period as the sponsor has been engaged in cattle programs.[62] Disclosure is required of the average purchase weight of feed or cattle, average cost per head, commissions paid for buying, average gain per pound, average cost of feed, interest rate on borrowed operating capital, other management or selling charges, average sales weight by sex, average profit or loss per head by sex, and average equity investment per head by sex. With these required disclosures, a realistic evaluation of the past operating history of the promoter can be made. For any data which are estimated, the assumptions underlying such estimations and the basis therefore should be disclosed.

Crop Syndications

The most common crop syndications are formed for the purpose of growing pistachios, walnuts, citrus, fruit, grapes, and peaches. Significant risk exists when syndicators plant new crops in areas where they have never grown before. The risk of natural disaster by flood, frost, or wind may also be present. Since the crops may take anywhere from one to seven years to become productive, there can be an extended wait before the success of the venture can be measured. Only limited tax benefits are available to crop syndication as compared to real estate, oil and gas, or cattle programs. In fact, most are income-producing oriented. Rules and guidelines for crop syndications are currently being drafted. It may safely be assumed that they will reflect the principles applied to the regulation of other types of syndication in the areas of compensation, suitability standards (which will generally be higher because of the higher risks involved), conflicts of interest, management experience and net worth, and tax aspects.

In addition, the Department requires as to citrus and almond groves that there be an explanation that the expenses incurred during the first four years are nondeductible under Internal Revenue Code Section 278.

Projections

The Department permits projections based on actual experience for one year after the start-up period or until the first crop is grown.

62. Midwest Rules §III(B).

CONCLUSION

The capital raised by syndicators and promoters of tax shelter programs is important to our economic well being. At the same time, the last few years have seen such a demand for tax shelter vehicles that many inexperienced promoters have gotten into the market to help satisfy this demand. When insufficient talent exists to place and manage the public's money in the amounts the public wants to commit to this type of investment, the chances for failure rise markedly. By an effective and judicious administration of the rules discussed above, the Department is confident it can minimize the risk of loss to the public through unfair dealing or ill-conceived programs.