discharge[24] request an explanation for the separation of a co-worker.[25] Whether the explanation is requested or volunteered, a defamed employee will still have the opportunity to recover damages if the privilege is abused.[26]

Purdue University GEORGE E. STEVENS

THE RECENT LARSON OPINIONS CONCERNING IRS ATTEMPTS TO CLASSIFY LIMITED PARTNERSNIPS AS CORPORATIONS
PHILLIP G. LARSON v. COMMISSIONER, 66 T.C. 159 (1976).

The Tax Court, on April 27, 1976, held that a syndicate, organized as a limited partnership, had corporate characteristics of centralized management and free transferability of interest, but lacked continuity of life and limited liability.[1] Because corporate

[24] Obviously, the interest of the employees should be more than idle curiosity. *See* Caruso, *supra* note 3, at 335.

[25] In some circumstances a conditional privilege has attached to the discussion of a former employee only when the information was requested and not volunteered. *See, e.g.*, Draper v. Hellman Commercial Trust & Savings Bank, 203 Cal. 26, 263 P. 240 (1928) (communication from one employer to another). But in Michigan and in many other jurisdictions a variety of volunteered statements have been protected when the defamer was found to have a legal or moral duty to communicate with the recipient. *See* Jones, *Interest and Duty in Relation to Qualified Privilege*, 22 MICH. L. REV. 437, 444-45 (1924). The employer's legal duty to communicate with employees in cases similar to *Haddad* may be questionable, but it could be argued that a moral duty does exist.

[26] *See* text accompanying notes 8-11, 21 *supra*.

[1] Phillip G. Larson v. Commissioner, 66 T.C. 159 (1976). Petitioners in this consolidated case owned limited partnership interests in two real estate syndications organized under the California Uniform Limited Partnership Act. The sole general partner in each partnership was a corporation, independent of the limited partners, organized for the purpose of promoting and managing such syndications. Under state law, the partnership would be dissolved by the bankruptcy of the general partner. The general partner invested no funds in the partnerships and its interests were subordinated to those of the limited partners. The limited partners had the right to vote to remove the general partner. Limited partners' income rights were transferable with the consent of the general partner, which consent could not be unreasonably withheld. A transferee of a limited partner's capital interest, if the transfer was at fair market value, had the right to become a substituted limited partner without the consent of any member. The partnerships incurred losses and

characteristics did not outweigh noncorporate characteristics, the entity was held to be a partnership.[2]

The Tax Court had earlier declared, with six judges concurring, that the syndicate was an association taxable as a corporation.[3] The Court denied a motion for reconsideration by the full court, referring it to the trial judge as a motion for his reconsideration.[4] The trial judge granted the motion on November 7, 1975, and on that same date the original opinion was withdrawn.[5]

The original opinion was never officially published by the Court. Nevertheless, it created considerable interest among the members of the tax bar and accounting profession when it was filed. Taxing of limited partnerships as corporations would disallow the pass-through of entity income and losses to the individual partners.

Internal Revenue Regulations set forth the major characteristics of associations taxed as corporations.[6] These characteristics consist of (1) associates, (2) joined together to carry on a business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) limited liability, and (6) transferability of interests. After eliminating those characteristics that are common to partnerships and corporations, the regulations leave for consideration continuity of life, centralization of management, transferability of interest, and limited liability. The Tax Court was not called upon to decide the validity of the regulations, as both parties relied upon those regulations to sustain their opposing positions.[7]

Continuity of Life

The general partner is the only entity liable for the debts of the limited partnership. In the case of bankruptcy of the general partner, there is no one left to whom the creditors can look for

petitioners deducted their distributive shares of such losses on their individual tax returns. The Commissioner disallowed those deductions on the ground that the partnerships were associations taxable as corporations and not partnerships.

[2] *Id.*

[3] Phillip G. Larson, 65 T.C.M. (P-H) 63 (1975).

[4] *Id.*

[5] *Id.*

[6] Treas. Reg. § 301.7701-2, T.D. 6797.

[7] 66 T.C. at 172.

satisfaction of their claims. Unless some provision is made for the substitution of a new general partner, bankruptcy of the general partner by necessity brings about a dissolution of the enterprise.

The original opinion maintained that the general partner was relegated to the role of an elective trustee or "manager" and could be replaced by a bare majority of the limited partnership interests. Therefore, the court held, the bankruptcy of the general partner would not necessarily bring about a termination of the partnership; continuity of life was held to exist.

In the reconsideration, the court came to the opposite conclusion on this issue, declaring that the partnerships involved did not satisfy the continuity-of-life test of the regulations. The opinion reads as follows:

> We recognize that our application of respondent's existing regulations to the event of bankruptcy results in a situation where it is unlikely that a limited partnership will ever satisfy the "continuity of life" requirement of those regulations. But the fact that the regulations are so clearly keyed to "dissolution" (a term encompassing the legal relationship between the partners) rather than "termination of the business" (a phrase capable of more pragmatic interpretation encompassing the life of the business enterprise) leaves us with no viable alternative.[8]

Centralization of Management

The regulations announce that "limited partnerships subject to a statute corresponding to the Uniform Limited Partnership Act, generally do not have centralized management, but centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners."[9]

Centralization of management was found to exist on four facts: (1) management of the venture was vested solely and completely in the general partner, (2) the general partner made no measurable capital contribution to the partnership, (3) the general partner acted in a representative capacity subject to removal by the vote of the limited partners, and (4) the general partner was limited by a quasi-fiduciary restriction in its dealing with the partnership property.

[8] *Id.* at 175.

[9] Treas. Reg. § 301.7701-2(c)(4), T.D. 6797.

Upon reconsideration, the court paid particular attention to the right of the limited partners to remove the general partner. "Thus, [the general partner's] right to participate in future growth and profits was wholly contingent on satisfactory performance of its management role, and not at all analogous to the independent proprietary interest of a typical general partner."[10]

Limited Liability

The main concern of the court in the original opinion on the limited-liability question was the regulation requirement that "if a corporation is a general partner, personal liability exists with respect to such general partner when the corporation has substantial assets (other than its interest in the partnership) which could be reached by a creditor of the organization . . . ."[11] The court was unable to find the "substantial assets" which could be reached by a creditor of the limited partnership. Whatever assets the corporate general partner had over those on its balance sheet were more in the nature of future expectations. Thus limited liability was found to exist.

In the reconsideration, however, the court went beyond the "substantial asset" test to a conjunctive test, under which a general partner is considered not to have personal liability only "when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization *and* when he is merely a 'dummy' acting as the agent of the limited partners."[12] In other words, personal liability exists if the general partner either has substantial assets *or* is not a dummy for the limited partners.

The court concluded that personal liability existed with respect to the general partner, because the general partner was the moving force in the enterprise and not a rubber stamp of the limited partners. "With a minor exception, the persons controlling the general partner were independent of and unrelated to the limited partners."[13]

[10] 66 T.C. at 178.
[11] Treas. Reg. § 301.7701-2(d)(2), T.D. 6797.
[12] *Id.* (emphasis added).
[13] 66 T.C. at 181.

TRANSFERABILITY OF INTERESTS

The court in both opinions concluded that the requisite transferability of interests existed, although a member of the organization must offer his interest to the other members at its fair market value before selling to an outsider. Any restrictions or conditions that the limited partnership had placed on such transfers were procedural rather than substantive.

The court, in the withdrawn opinion, had found that the limited partnerships in question qualified as taxable associations. It was held that the partnerships possessed corporate characteristics on each of the four relevant major characteristics. The court had further announced that "in the light most favorable to petitioners; the question would be at best a 'standoff.' "

The withdrawn opinion had proclaimed:

> When we look to the manner in which the limited partnerships were organized and their "shares" sold, the purpose for which organized, the relationship between the general partner and the limited partners, the relationship of the limited partners to each other, the separability of the association from its limited partner members, and the limitation of liability enjoyed by the limited partners, it is clear that the limited partnerships are in fact more closely akin to a corporation than to a partnership.

With the new opinion, the court found that the organizations should be classified as partnerships. It stated:

> The regulations provide that an entity will be taxed as a corporation if it more closely resembles a corporation than any other form of organization. They further state that such a resemblance does not exist unless the entity possesses *more* corporate than noncorporate characteristics. If every characteristic bears equal weight, then Mai-Kai and Somis are partnerships for tax purposes. We have found that they possess only two of the four major corporate characteristics and that none of the other characteristics cited by the parties upsets the balance.[14]

The court asserted, however, that if it were permitted to weigh each factor according to its degree of corporate similarity, it would be inclined to find that the entities would be taxable as corporations. But the court could find no warrant in the regula-

[14] *Id.* at 185.

tions or in cases which have considered them for such refined balancing.[15]

Limited partnerships passed this most recent test. But the *Larson* decision had 6 dissenters and 2 nonparticipants among the 16 judges. Furthermore, cases lost by the IRS have involved limited partnerships that met the technical requirements of the regulations—regulations the IRS itself had written. Judges in several cases in the limited partnership area have emphasized that the IRS has the power to change the regulations.

Texas A&M University JAMES R. HASSELBACK

THE CIVIL LIABILITY OF ACCOUNTS ENGAGED IN AUDITS OF COMPUTER-BASED INFORMATION SYSTEMS ADAMS V. STANDARD KNITTING MILLS

Although the courts have generally been willing to comment on the legal relationship that exists between accountants and third party financial statement users, the judiciary has seldom been willing to advance opinions concerning the auditor's responsibilities with respect to specific aspects of the audit function. In *Adams v. Standard Knitting Mills, Inc.*,[1] the federal court broke with this tradition by outlining the basic duties of public accountants engaged in audits of computer-based information systems. Such a shift in judicial perspective, when viewed in light of other recent developments in the area of auditors' liability, may serve as a precursor of future trends in the legal environment of public accounting.

BASIC FACTS OF THE LITIGATION

In 1969, Chadbourn, Inc. engaged Peat, Marwick, Mitchell &

[15] *Id.*

[1] Adams v. Standard Knitting Mills, Inc., [1976] FED. SEC. L. REP. (CCH) ¶ 95,683 (E.D. Tenn. May 19, 1976).