RECENT TAX COURT CASE SHOWS NEED FOR SECTION 465 GUIDANCE

In [Bordelon](https://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=12173), the Tax Court addressed two principal issues inexplicably raIsed by the IRS relating to amounts at risk under section 465 and tax basis under section 704(d) in order to deduct losses from both a single member disregarded entity owned by the taxpayer and by a partnership where the taxpayer was a 90 percent partner. The years at issue were 2008-2011. At issue were two loans that the taxpayer had guaranteed and where, under the terms of guarantee document, the taxpayer was personally liable for any deficiency, could be sued directly for nonpayment and where there was no realistic possibility of reimbursement if the taxpayer paid on the guarantee.

Despite a long line of authority, cited in the case, that applies a “worst case analysis” to testing for at risk basis, the IRS persisted in arguing that the taxpayer was not at risk under section 465 based on the likelihood, given the collateral supporting the loan, that the taxpayer would never pay on the guarantee. The IRS also challenged allowing tax basis under section 752 for a guarantee apparently based on its perception that there was no proof that the loan was outstanding in the record for the case. The Tax Court held, in a memorandum opinion, that the taxpayer was at risk under the “worst case scenario” test and that the taxpayer obtained recourse debt basis for guaranteeing the partnership debt, again based on what would occur if the debt became due and payable and the partnership had insufficient assets to repay the debt.

All of the issues raised in the case are seemingly clear based on the relevant authorities and it is very curious and odd that the IRS litigated this case in the first place.

In T.D. 9877, the IRS had this to say about providing guidance on section 465:

A commenter recommended guidance in determining a partner's amount at risk under section 465 for deficit restoration obligations. This commenter noted that under Hubert Enterprises, Inc. v. Commissioner, T.C. Memo. 2008-46, a deficit restoration obligation was not treated as giving a partner at risk basis because the obligation was contingent (because it was dependent upon the partner liquidating his interest) and the amount was uncertain (the deficit restoration obligation covered only the deficit in the partner's capital account at the time of liquidation and did not cover the entire debt obligation at issue). *The commenter also recommended providing guidance under section 465 similar to that provided in these final regulations regarding when guarantees will be recognized. Providing guidance concerning section 465 is beyond the scope of these regulations.* The Treasury Department and the IRS request comments, however, concerning whether guidance is needed to address issues under section 465. (emphasis added).

There is in fact very limited guidance on gu1arantees under section 465. Proposed regulations from 1979 that remain in proposed form today provide at proposed regulation §1.465-6(d) that a taxpayer does not obtain at risk basis for a guarantee unless the taxpayer ends up paying on the guarantee and has no remaining legal rights against the primary obligor.

Despite this proposed regulation and without either withdrawing or replacing the regulation, the IRS has on three separate occasions disregarded this proposed regulation.

First, in ILM 201308028 (Nov. 14, 2012) the IRS allowed at risk basis for a guarantee following the approach set forth in the Tax Court case addressed here, stating:

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

 It should be noted that the conclusions contained within this advice may be viewed as contrary to Prop. Treas. Reg. §1.465-6(d) (1979), which provides that if a taxpayer guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, the guaranty shall not increase the taxpayer's amount at risk. Prop. §1.465-6(d) further provides that if the taxpayer repays to the creditor the amount borrowed by the primary obligor, the taxpayer's amount at risk shall be increased at such time as the taxpayer has no remaining legal rights against the primary obligor. However, Prop. §1.465-6(d) was promulgated before the development of LLCs under various state laws, and at a time when entities treated as partnerships for federal tax purposes were usually state law general partnerships and limited partnerships.

Generally, with respect to limited partnerships, a limited partner that guarantees the debt of the partnership will not be considered at risk with respect to a guaranty because the limited partner would have the legal right to seek reimbursement from the partnership or the general partner if called upon to pay under the guaranty. Accordingly, a guaranty by a limited partner is generally not sufficient to cause the limited partner to be at risk for the amount of the guaranty until such time that the limited partner has no remaining rights against the partnership or the general partner. Given that an LLC that is treated as a partnership or disregarded entity for federal tax purposes has no members with unlimited liability with respect to the debts of the LLC, an LLC member that guarantees the debt of an LLC (in cases where no other persons co-guarantee the debt) is in a position similar to a sole general partner with respect to the guaranteed debt (i.e., the guaranteeing member's only recourse with respect to repayment of guaranteed debt is against the assets of the entity, if any remain).

Accordingly, we conclude that an LLC member is at risk with respect to LLC debt guaranteed by the member (where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes), but only to the extent that the member has no right of contribution or reimbursement from other guarantors and is not otherwise protected against loss within the meaning of §465(b)(4) with respect to the guaranteed amounts. Therefore, we conclude that Prop. §1.465-6(d) is generally not applicable to situations involving bona fide guarantees of LLC debt by one or more members of the LLC that is enforceable by creditors of the LLC under local law, where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes.

The second instance where the proposed regulation has been ignored was by AM 2014-003 (Aug. 27, 2013) where it was stated:

We further advise that, in the case of an LLC treated as a partnership or disregarded entity for federal tax purposes, Prop. §1.465-6(d) does not apply in cases where an LLC member guarantees LLC debt, the member has no rights of contribution or reimbursement, the guarantee is bona fide and enforceable by creditors of the LLC under local law, and the member is not otherwise protected against loss.

Finally, in LGM TL-37 (Oct. 11, 1988), issued under the original section 752 regulations pre-dating the temporary regulations issued in 1988, the IRS set forth its position on guarantees and section 465, once again disregarding the proposed regulation relating to guarantees.

Why was this case litigated? I think that failure to include up to date regulations under section 465 is the culprit. When guidance is issued via regulations that are either temporary or final, the IRS field agents pay a lot more attention to them. As such, the 1979 proposed regulations under section 465 should be updated and re-issued as soon as possible. Despite this gap in regulatory coverage, how in the world did this case reach the litigation phase? Doesn’t the IRS have better uses for its limited resources?