Will New CCA Put an End to IRS Challenges to Inclusion of Guaranteed LLC Debt In a Guarantor’s Amount At-risk?

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One of the vexing issues for tax professionals has been facing off with IRS agents who continue to erroneously treat an LLC member who guarantees LLC debt as not being at risk for his “share” of the amount of the guaranteed debt. On the other hand, perhaps some of these tax professionals welcome the challenge to do battle with IRS agents, because these tax professionals are able to generate substantial professional fees with respect to an issue that should have been clarified at the agent level years ago. Just kidding, of course!

This issue arises from two regulatory provisions contained in at-risk regulations that have been in proposed form since June 6, 1979, which could be construed as conflicting – although perhaps not, as explained in more detail below. Prop. Reg. §1.465-24(a)(2)(i) (the “24(a) regulation”) provides that “[w]hen a partnership incurs a liability in the conduct of an activity and under state law members of the partnership may be held personally liable for repayment of the liability, each partner’s amount at risk is increased to the extent the partner is not protected against loss.” On the other hand, Prop. Reg. §1.465-6(d) (the “6(d) regulation”) provides that “[i]f a taxpayer guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, the guarantee shall not increase the taxpayer’s amount at risk. 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.”

Field agents have seized on the 6(d) regulation to assert that the guarantee by an LLC member of an LLC debt does not provide the guarantor with an amount at risk, because the guarantor/member has a claim against the LLC (i.e., the primary obligor). Tax professionals have long believed that this position is in error, and that the 6(d) regulation merely is designed to prevent a limited partner from being at risk for a debt when there is a right of reimbursement from a general partner, which generally would be the case under state law, and that the regulation has absolutely no relevance in an LLC situation; in this latter situation, the concepts contained in the 24(a) regulation make the guaranteeing LLC member at risk.

Tax professionals initially had thought that the issue was put to bed by FSA 200025018, a field service advice that came close to addressing the issue head on and will be reprised below. However, these tax professionals were often in error, as IRS agents to this day continue to ignore the concepts contained in the FSA.

On February 22, 2013, the Office of the Associate Chief Counsel of the IRS issued CCA 201308028, which once again addresses the issue and more explicitly explains that the 6(d) regulation does not prevent an LLC member from being at risk for a guarantee of LLC debt. This month’s Partner’s Perspective will delve into the CCA.
**FSA 200025018 Reprise**

In FSA 200025018, the IRS addressed two situations under the at-risk rules. In the first situation, one of the members of a two-member LLC operating a restaurant guaranteed (referred to in the FSA as a stipulation) the outstanding balance of an unpaid account balance. In situation two, each member of a three-person LLC executed a joint and several guarantee of the LLC’s lease for its space.

In the first situation, the IRS concluded: “A partner who, through a contractual obligation, has ultimate responsibility for the debt is at-risk with respect to such amount. …Thus, the member who executed the stipulation in his individual capacity is at-risk with respect to the liability.” (Citations omitted.) And in situation two, the IRS concluded: “A guarantor of a partnership liability is not at-risk for purposes of section 465 to the extent there is a right of reimbursement against any partner. …Each member of T2 is at-risk for purposes of section 465, except to the extent the member has a right of reimbursement against the remaining two members and emphasis added.” (Citations omitted; emphasis added.)

While the IRS did not specifically refer to the 6(d) regulation in the ruling (but did refer to the 24(a) regulation), the import of the IRS’s analysis appears clear. The 6(d) regulation is designed to prevent double counting. That is, a general partner typically has a personal obligation under state law to indemnify a limited partner who satisfies a partnership guarantee, and when the regulations were proposed, LLCs were not in vogue (it may have been that only Wyoming had an LLC statute). To permit a limited partner to be at risk for a guarantee would potentially create a situation in which the limited partner would claim an amount at risk and the general partner would likewise claim the same amount at risk. Consequently, the 6(d) regulation should be interpreted as providing that a guaranteeing partner is not at risk where there is a right of reimbursement from another person (other than the partnership itself). However, the regulation should have no applicability where there is no right of reimbursement; in that case, the 24(a) regulation controls, making the guaranteeing partner at risk.

**CCA 201308028**

In the CCA the taxpayer wholly owned Holding LLC, which, in turn, wholly owned Operating LLC. (The facts do not indicate the reason for the tiered structure, but one might speculate that Holding LLC might have owned multiple single-member LLCs so as to avoid assets of one LLC from being subject to the liabilities of another LLC.) A bank lent money to Operating LLC, which was guaranteed by the taxpayer, Holding LLC and two S corporations that were wholly owned by the taxpayer. Critical to the analysis in the CCA is the following factual representation:

However, [the taxpayer] did not waive his rights of subrogation and reimbursement against [Operating LLC] or his rights of contribution from [the two S corporations and Holding LLC] as co-guarantors in the event that [taxpayer] was called upon by Bank to repay the loan made to [Operating LLC] under the commercial guaranty.

The issue addressed by the CCA is the extent to which the taxpayer is at risk for the guaranteed liability of Operating LLC. The IRS starts its analysis of the presented facts with what it regards as the two relevant Code sections to the analysis: (1) Code Sec. 465(b)(2)(A), which provides that a taxpayer is at risk for borrowed amounts if he is personally liable for repayment of such amounts, and (2) Code Sec. 465(b)(4), which provides that a taxpayer is not at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements. The IRS summarized these two tests as follows:
Succinctly, the two tests...for determining whether a taxpayer is at risk for borrowed amounts may be summarized as follows: (1) the taxpayer must be personally liable for the debt, and (2) the taxpayer is not otherwise protected from loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements. The first test — whether the taxpayer has personal liability — is generally determined by analyzing whether the taxpayer is ultimately liable for repayment of the borrowed amounts as the “payor of last resort in the worst case scenario.” With respect to the second test - whether the taxpayer is otherwise protected against loss — the majority view of the Circuit Courts of Appeals that have addressed the issue is that the question whether an arrangement protects the taxpayer from loss is analyzed based on the “economic realities” present at the end of the taxable year. (Citations omitted.)

The minority view among the Circuit Courts, as adopted by the Sixth Circuit, is that the “payor of last resort in a worst case scenario” analysis applies for both the first and the second tests...We conclude that the majority view...is supported by the legislative history for §465 and is the correct analysis with respect to arrangements described in §465(b)(4). The Seventh Circuit, wherein the present case arises, has not addressed the issue of the proper test to be applied in connection with §465(b)(4) loss limitation arrangements... However,...the Seventh Circuit cited the “realistic possibility of loss” standard with approval. (Citations omitted.)

In applying the first test, i.e., whether the taxpayer was at risk for the borrowed amounts, the IRS determined that the taxpayer would be “the payor of last resort in the worst case scenario and would be at risk.”

The IRS then proceeded to analyze whether the “stop loss” rules of Code Sec. 465(b)(4) would apply. The starting point in this analysis was a position taken by the agent who apparently submitted an inquiry to the National Office that prompted the CCA, which is the same position that many tax professionals are encountering in audits containing similar facts:

You suggested in your analysis that, in the present case, the Service should take the position that [the taxpayer] is not at risk at the end of Year1 because [the taxpayer] has not waived his rights of subrogation and reimbursement from [Operating LLC] with respect to the guaranty.... We disagree. Under the worst case scenario test, we assume that the primary obligor cannot and will not pay on the liability, thus putting the guaranteeing member at risk for ultimate payment. We believe it would be inappropriate to apply the economic realities test of §465(b)(4) to then assume that the guaranteeing member will nevertheless be able to successfully seek subrogation, reimbursement, or indemnification from the primary obligor after a default because the member has not waived his rights for such actions against the primary obligor. Accordingly, we conclude that [the taxpayer’s] failure to waive these rights against [Operating LLC], by itself, does not protect [the taxpayer] against loss.

Generally speaking, with respect to situations involving LLCs that are treated as either partnerships or disregarded entities for federal tax purposes, an LLC member that guarantees the debt of the LLC is positioned similarly to a general partner in a partnership with respect to claims on the entity's assets. To the extent that a general partner does not have a right of contribution or reimbursement under local law against any other partners for the debts of the partnership, the general partner will be at risk for such debts under §465(b)(2) regardless of whether the partnership itself possesses assets with positive value at the end of the taxable year. In such situations, we would not consider a general partner to be “protected against loss” within the meaning of §465(b)(4) merely because the partnership possesses assets with positive value at the end of the taxable year. It therefore would be incongruent to treat a guaranteeing member of an LLC different than a general partner under §465(b)(4) in these situations. Accordingly, we
conclude that the mere fact that [the taxpayer] may be entitled to subrogation, reimbursement, or indemnification from [Operating LLC] (and only [Operating LLC]) under local law when payment is made on the guaranty does not mean that the member is “protected against loss” within the meaning of §465(b)(4). We reach this conclusion irrespective of whether [the taxpayer] holds assets with positive value at the end of the taxable year in question.

In analyzing the impact under Code Sec. 465(b)(4) of the existence of the co-guarantors, the IRS concluded that the taxpayer would not be at risk to the extent it had a right of contribution from the two S corporations and Holding LLC. This latter part of the ruling is noteworthy from the standpoint of a couple of traps for the unwary. First, from the standpoint of the S corporations, note that they were wholly owned by the taxpayer, and many a taxpayer might think that the at-risk analysis should be a “right pocket, left pocket” analysis, i.e., that the taxpayer should be at risk because he wholly owns the S corporations. As made clear by the ruling, this is not the case, and losses funded by the portion of the debt for which each S corporation is considered liable (because of the taxpayer’s right of contribution against the S corporations) could very well be trapped at the S corporation level, because the taxpayer would not be able to include the debt of the S corporation in the basis for his S corporation stock. Consequently, in this type of situation, the taxpayer often would want to waive any right of contribution from the S corporations and also would want to indemnify the S corporations in the event they were called upon to satisfy the guaranty.

Second, insofar as the guaranty of Holding LLC is concerned, the IRS conclusion may be significant. It makes the following statement:

To the extent that [the taxpayer] may be entitled to contribution or reimbursement from persons other than [Operating LLC] (irrespective of whether those other persons are members of [Operating LLC]), [the taxpayer] will not be at risk. For this purpose, an entity that is disregarded as an entity separate from its owner for federal tax purposes but which provides limited liability protection to its owner under local law may be treated as [a stop loss] arrangement described in §465(b)(4). Accordingly, whether the owner of a disregarded entity will be at risk for amounts guaranteed by the disregarded entity will depend on the facts and circumstances of each case.

The IRS finding that the taxpayer was not at risk to the extent of the right of contribution from Holding LLC indicates that the “wrapper” of a single-member LLC is taken into account to determine a taxpayer’s amount at risk. Unfortunately, how this “facts and circumstances” analysis is done is not explained by the IRS. It may be that the amount at risk of the owner of the LLC that counts as an amount at risk for the relevant partnership (Operating LLC in the above discussion) would be limited to the fair market value of the assets of the LLC at some measuring date, applying the concepts of Reg. §1.752-2(k). This regulation generally provides that a partnership debt guaranteed by a single-member LLC partner is considered a recourse liability to the extent of the net value of the single-member LLC, generally determined as of the date that the partnership first is required to determine the liability-sharing ratios of the partners. It would not appear to be appropriate to totally exclude the portion of the guaranteed debt in the CCA that is allocable to the disregarded LLC from the taxpayer’s amount at risk in the Operating LLC, given that the taxpayer is deemed to own all the assets to which the guarantee by the disregarded entity would be subject. It just may be that the wrapper is taken into account to limit the amount of the liability that can be taken into account. In any event, as with the case of the S corporations discussed above, it probably would make sense for a similarly situated taxpayer to waive any right of contribution from the disregarded entity and also to indemnify the disregarded entity in the event it was called upon to satisfy the guaranty.
Distinguishing the 6(d) Regulation

As noted at the outset of this column, the 2000 FSA did not specifically mention the 6(d) regulation. Perhaps the failure to mention the regulation is one of the reasons that IRS agents continue to cite the regulation on audit to deny an LLC member an amount at risk for the guarantee of LLC indebtedness. Fortunately, the CCA meets the 6(d) regulation head on. While the main text of the CCA does not mention the regulation, it is mentioned in detail at the end of the ruling in the section entitled “CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS.” In this section, the IRS makes the following statement:

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.

Finally, tax professionals have an explicit statement from the IRS that confirms what they have been asserting to IRS agents all along – a taxpayer is at risk for a partnership liability to the extent there is no right of reimbursement from any other person (not counting the LLC, itself). In the case of a limited partnership, there generally is a state law right of reimbursement from a general partner; however, if this right is waived, the guaranteeing limited partner should be considered to be at risk. In the case of an LLC, there generally is no state law right to reimbursement from any other LLC member and the guaranteeing LLC member likewise should be considered at risk.
Hopefully, IRS agents will now “get it,” and taxpayers will avoid having to pay unnecessary professional fees contesting IRS assertions that a guarantee of a partnership liability (without any right of reimbursement) does not provide taxpayers with an amount at risk. (It would be helpful for the IRS to send a special bulletin to its agents making them aware of the CCA or, even better, for the IRS to issue a public ruling mirroring the CCA.) A taxpayer, however, still needs to demonstrate the portion of a guaranteed liability for which he is the obligor of last resort, where there are multiple guarantors.

Lastly, note that in the CCA, the taxpayer restructured the debt after the end of year one to make the taxpayer a co-guarantor to avoid the at-risk “slippage,” which occurred in year one as a result of the lack of waiver by the taxpayer of a right of reimbursement against the co-guarantors and the lack of an indemnity of the co-guarantors by the taxpayer. These failures, no doubt, were an oversight.

However, there may have been another way for the taxpayer to be considered as being 100% at risk for the amount of the guaranteed debt. While the at-risk rules generally apply on an activity-by-activity basis, Code Sec. 465(c)(3)(B) provides that the “non-listed” Code Sec. 465 activities can be aggregated where the activities constitute a trade or business and (1) the taxpayer actively participates in the management of the trade or business or (2) if the trade or business is conducted by a partnership or S corporation, 65% or more of the losses for the taxable year are allocable to persons who actively participate in the management of the trade or business.

There is no apparent case law or public ruling on this subject, and the IRS has issued only one private letter ruling addressing Code Sec. 465(c)(3)(B) – TAM 9035005, which provides that a taxpayer who was a partner in an oil and gas partnership could not aggregate that activity with an interest in a restaurant partnership. The interesting aspect of this TAM is that its clear import (although not explicitly stated) is that the effect of Code Sec. 465(c)(3)(B) is to allow losses from an activity for which a taxpayer is protected against risk to be supported by an “extra” amount at risk in another activity, if the two activities constitute a single trade or business. However, the TAM does make clear that “these aggregation provisions allow aggregation only within a SINGLE trade or business. There is no provision in section 465 that would permit aggregation of activities between two or more trades or businesses.” In the CCA, there are not enough facts to discern whether the Code Sec. 465(c)(3)(B) standards would have been satisfied.