THE PARTNER'S PERSPECTIVE by *Charles R. Levun, Esq.*

Charles R. Levun, JD, CPA, is a Partner in the Chicago-area law firm of Levun, Goodman & Cohen, Adjunct Professor of Law at the IIT Chicago-Kent Graduate Tax Program, Consultant to the **CCH** INCORPORATED's PARTNERSHIP TAX PLANNING and PRACTICE GUIDE *and Editor-in-Chief of the* JOURNAL OF PASSTHROUGH ENTITIES.

The Tax Court Finally Gets Hubert Right—Sort Of

The Partner's Perspective has chronicled the travels of the *Hubert* case over the last two plus years from its initial visit to the Tax Court [*Hubert v. Commissioner*, 125 TC 72 (2005), discussed in the July, 2006 Partner's Perspective at ¶9710] to its appellate remand by the Sixth Circuit [230 Fed. Appx. 526 (6th Cir. 2007), discussed in the May, 2007 Partner's Perspective at ¶9720].

While the case is somewhat factually complicated, its relevant facts boil down to a relatively simple issue. In *Hubert*, the operating agreement of an equipment leasing LLC was amended to add a deficit restoration obligation ("DRO"), which provided:

> Deficit Capital Account Restoration. If any Partner has a deficit Capital Account following the liquidation of his, her or its interest in the Partnership, then he, she or it shall restore the amount of such deficit balance to the Partnership by the end of such taxable year or, if later, within 90 days after the date of such liquidation, for payment to creditors or distribution to Partners with positive capital account balances.

On *Hubert's* initial sojourn, the apparent rationale of the Tax Court was that a DRO did not render a member at risk for LLC indebtedness under Code Sec. 465 until the member's interest was liquidated. While many, but not all, tax professionals believed that the Tax Court reached the right at-risk result, most tax professionals believed that the Tax Court's rationale for its decision completely missed the boat. The reason—the Tax Court ignored the well-established "obligor of last resort" doctrine, and seemed to suggest that a taxpayer could not be at risk for a partnership liability that was due in the future. The Sixth Circuit agreed that the Tax Court's rationale was flawed, and remanded the case with instructions to the Tax Court to apply the obligor of last resort doctrine.

This month's Partner's Perspective will discuss the result of *Hubert's* return visit to the Tax Court.

The Results of the Second Visit

On remand, the Tax Court applied the "obligor of last resort" doctrine (referred to in the opinion as the "payor of last resort" doctrine), as instructed by the Sixth Circuit, which it described as follows: "That test essentially asks in the setting of section 465(b) whether the taxpayer has a fixed and definite obligation to use personal funds to pay a debt in a worst case scenario." Applying this test, the Tax Court once again, for three primary reasons, found in favor of the IRS.

First, the Tax Court found that the DRO did not require an unconditional obligation to contribute additional capital to the LLC. Instead, the Tax Court noted that a member only had to contribute capital if (1) the member liquidated its membership interest and (2) had a deficit capital account balance at that time. In this regard, the Tax Court noted that the holder of the LLC's debt (which could be satisfied from all the LLC's assets and, consequently, was "recourse" with respect to the LLC itself, but was "nonrecourse" as far as the LLC members were concerned) had no legal right under state law to force a member to liquidate its LLC interest (i.e., a default on the debt did not give the creditor the right to compel a member to liquidate its membership interest). As a result, the member's "personal liability for repayment of [the LLC's] recourse debt is neither fixed nor definite but is generally contingent on [the member] voluntarily causing a liquidation of its interest in the LLC." While the Tax Court's conclusion as to the speculative nature of the DRO is correct, it is not clear that its observation that the creditor cannot compel a member to liquidate its membership interest isn't a matter of how many angels can dance on the head of a pin. After all, while it is true that creditors rights law does not permit an LLC creditor to require an LLC member to liquidate its interest in the LLC, that is often what practically occurs, if the creditor obtains a judgment against an LLC that does not have sufficient assets to satisfy the creditor's claim (i.e., the LLC winds up liquidating because it has no assets).

Interestingly, neither the Tax Court, in its opinion, nor the IRS, in its briefs, noted what would occur from a capital account balance standpoint, if the debt holder were to foreclose on its debt without being paid in full. As discussed in the Partner's Perspectives at ¶9710 and ¶9720, such a foreclosure likely would create sufficient gain to eliminate the members' negative capital accounts (because any unpaid debt would be considered additional sale proceeds). However, the Tax Court seemed "to get it," given that it noted that the capital contribution obligation <u>only arose</u> if there were a negative capital account at the time of a voluntary liquidation of the member's interest. In other words, even if liquidation of a member's interest were to occur, it is speculative as to whether the member would have a negative capital account balance at that time, thereby likewise making the DRO a speculative obligation (which is not sufficient to meet the obligor of last resort doctrine).

The Tax Court's next approach—

> Second, even if both conditions are met [i.e., voluntary liquidation of the member's interest at a time the member had a negative capital account balance], the DRO does not impose on [the member] an obligation to contribute funds in the amount necessary to satisfy its proportionate share of any unpaid debt owed by [the LLC]; the DRO simply requires that [the member] contribute funds equal to the amount of the deficit in [the member's] capital account, which may or may not be the same as the amount of [the member's] proportionate share of [the LLC's] debt.

This argument is somewhat a corollary of the first argument, that the member may or may not have a deficit capital account balance at the time of any voluntary liquidation of its interest.

The third approach of the Tax Court:

> Third, even if [the member] actually makes an additional contribution to [the LLC's] capital under the DRO, the DRO does not require that any of the additional contribution be paid to one or more of [the LLC's creditors]. The DRO states specifically that [the LLC] may transfer the additional contribution to its members with positive capital accounts.

The Strange Code Sec. 704(b) Observation

As discussed above, the Tax Court asserted several theories as to why the LLC's members were not at risk by reason of the DRO. However, the Tax Court also felt the need to throw the kitchen sink into its opinion, and made the following statement:

> We also note the illogic of petitioner's argument that the DRO in and of itself makes [the taxpayer] at risk for the repayment of [the LLC's] recourse debt. As we have stated, a DRO is routinely inserted into a partnership agreement to meet the substantial economic effect requirements of section 704(b). If a member of a limited liability company is automatically "at risk" for repayment of the company's recourse debt simply by inserting a DRO in the operating agreement in order to meet the requirements of section 704(b), then the at-risk rules of section 465 have little purpose in that seemingly every member of a limited liability company is at risk for the repayment of the company's recourse debt.

It is unclear how the Tax Court arrived at the conclusion that DRO provisions are commonly contained in partnership agreements – that is not this author's experience. Although, as noted above, DROs may not operate in a manner to make a partner the obligor of last resort with respect to a third party obligation of the partnership (or may be manipulated to produce this result), under certain circumstances DROs can operate to require a partner to contribute additional funds to a partnership and are not commonly used in partnership transactions. The requirements of the Code Sec. 704(b) regulations more commonly are satisfied by the partnership agreement containing a qualified income offset (Reg. §1.704-1(b)(2)(ii)(d)), in which, for instance, a partner with a negative capital account caused by the allocation of recourse deductions must be allocated partnership gross receipts to bring the partner's capital account back up to zero.

Nevertheless, despite the Tax Court's erroneous observation, there is sufficient other rationale contained in its opinion to justify the result it reached.

The Code Sec. 761(c) Issue

There were two tax years at issue in *Hubert*, the LLC's tax year ending July 31, 2000 and its tax year ending July 31, 2001. Technically, the Tax Court's at-risk decision only applied to the tax year ending in 2001, although its rationale equally could have applied to the tax year ending in 2000. The basis for finding the taxpayers not at risk for the tax year ending in 2000 was different.

The DRO was added to the LLC's operating agreement by an amendment made on March 28, 2001, which had a stated effective date of January 1, 2000. The impact of the timing of this amendment was not discussed in the initial Tax Court opinion, because the issue was not relevant once there was a holding that the taxpayers were not at risk. However, on remand, the Tax Court decided to focus on the impact of this retroactive amendment.

Code Sec. 761(c) provides that "a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners…." (Emphasis added.) It is not uncommon for an operating agreement to be amended after year-end (but before the filing date, without extensions, for the prior year's tax return) to change certain provisions that may impact the allocations made to the partners for the prior year. Some tax professionals have wondered whether such a retroactive amendment to change responsibility for partnership debt is effective for basis and at-risk purposes, given that during such prior year the changed responsibility for the debt was not in effect, and therefore unenforceable in such year.

We now know what the Tax Court thinks. The Tax Court held that the amendment did not have retroactive effect for two reasons. First, the obvious—the amendment was not executed before the LLC's unextended due date of its July 31, 2000 tax return (which would have been November 15, 2000, instead of the March 28, 2001 execution date). Second, and more importantly, the Tax Court appears to have held in the alternative (although arguably in dicta) that a taxpayer's amount at risk cannot be changed retroactively by a Code Sec. 761(c) amendment because the taxpayer was not really at risk at the relevant date of determination:

> In addition, in the context of section 465, section 465(a)(1) requires that the amount for which a taxpayer is at risk with respect to an activity for a taxable year be determined at the close of that year. The amendment's purported retroactive effect to the earlier year also does not comport with the annual accounting system of Federal income taxation. Under that system, the amount of income tax payable for a taxable year is generally determined on the basis of those events happening or circumstances present during that year….Accord Daine v. Commissioner, 168 F.2d 449, 451-452 (2nd Cir. 1948) (and cases cited thereat) (retroactive order of State court not taken into account in the setting of Federal income tax), affg 9TC 47 (1947). [Certain citations omitted.]

While the breadth of the applicability of retroactive partnership agreement amendments under Code Sec. 761(c) was not discussed in depth, it appears that such amendments may be isolated to such matters as altering the partners' profit-sharing arrangements, and does not extend to retroactive changes that attempt to change a partner's amount at risk or basis for his partnership interest.

Final Observations–Simple Revenue Ruling to Resolve the At-Risk Guarantee Issue

The Tax Court reached the right decision, and its rationale is a vast improvement over its first decision. While one can take issue with some of the rationale, there is little question that many DROs (particularly the type in *Hubert*, which appears to have been designed to create the appearance of the taxpayer being at risk without "really" being at risk) do not make a taxpayer at risk for an LLC's liabilities. On the other hand, as discussed in the Partner's Perspectives at ¶9710 and ¶9720, a properly drafted provision whereby a member guarantees an LLC's debt or commits to contribute additional capital if necessary to satisfy unpaid LLC obligations generally should make such member at risk to the extent such member does not have a right of reimbursement from another member of the LLC, notwithstanding that the member may never be required to satisfy the obligation or contribute the capital (because the debt is satisfied by the LLC). The Tax Court in *Hubert* in so many words confirmed this conclusion when it stated: "The mere fact that a debt of a partnership (or similar entity) is payable in a later year by the partner does not necessarily mean that the partner must exclude the amount of that debt from the computation of the partner's at-risk amount with respect to the partnership." The IRS also confirmed this conclusion in its *Hubert* briefs.

Nevertheless, IRS field agents continue to assert that a guarantee of debt, without any right of reimbursement, does not make a taxpayer at risk. Now that we have some resolution of the DRO issue (and there has been virtually no doubt as to the guarantee/capital contribution obligation issue), it is time for the IRS to re-issue its Proposed Regulations under Code Sec. 465 (which remain in proposed form from June 5, 1979) and clearly delineate the manner in which guarantees can increase a partner's/member's amount at risk. In the interim, the IRS also should consider the issuance of a Revenue Ruling which could simply read as follows:

> A and B are each 50% members of the AB limited liability company ("LLC"). The LLC enters into a loan agreement ("Loan") with an unrelated third party lender ("Bank"). A and B execute guarantees of the loan providing the Bank with the right to enforce 50% of the Loan against each of A and B in the event that the LLC defaults on the Loan. The Loan is not currently in default. A and B have a right of reimbursement against the other, but only to the extent that A or B satisfies <u>more than 50%</u> of the Loan. Each of A and B are currently at risk for 50% of the amount of the Loan.

F:\DOCS\CL\15001\02\Columns of 2008\3-08.doc