Office of Chief Counsel
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Memorandum

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to: Associate Area Counsel (Indianapolis)
Small Business/Self-Employed)

from: Senior Counsel, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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subject: Effect on Amounts At Risk for Guarantees of LLC Debt

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Bank =

M =

N =

T =

X =

Y =

State =

Date1 =

Date2 =

Year1 =

Year2 =

a =

ISSUES

1. Will a guarantor of debt of a limited liability company (LLC) treated as either a partnership or a disregarded entity for federal tax purposes be at risk (within the meaning of § 465 of the Internal Revenue Code) with respect to the guaranteed debt if the guarantor does not completely waive his rights of subrogation and reimbursement from the LLC with respect to that guaranteed debt?
2. To what extent will a guarantor of debt of an LLC treated as either a partnership or a disregarded entity for federal tax purposes be at risk with respect to the guaranteed debt when other persons (who may or may not be members of the LLC) co-guarantee that debt?

CONCLUSIONS

1. Yes, a guarantor of debt of an LLC treated as either a partnership or a disregarded entity for federal tax purposes may be at risk, for purposes of § 465, with respect to the guaranteed debt even if the guarantor does not completely waive his rights of subrogation and reimbursement from the LLC with respect to the guaranty, as long as the guaranty is bona fide and enforceable by the creditor against the guarantor under local law and the guarantor is not otherwise protected against loss within the meaning of § 465(b)(4).
2. When other persons co-guarantee debt of an LLC treated as either a partnership or a disregarded entity for federal tax purposes (regardless of whether those persons are members of the LLC), a guarantor will not be at risk, for purposes of § 465, with respect to the guaranty, except to the extent that the guarantor has no rights of contribution or reimbursement against the other guarantors under local law for any amounts that may be paid by the guarantor on the guaranty (or until such time as those rights may be exhausted or extinguished under local law).

FACTS

The taxpayer, T, an individual, is the sole owner of X, an LLC formed under the laws of State, which is disregarded as an entity separate from its owner for federal tax purposes. X is the sole owner of Y, an LLC formed under the laws of State, which is disregarded as an entity separate from its owner for federal tax purposes. On Date1, Bank loaned $a to Y and Y executed a promissory note to Bank for that amount. Y used the loan proceeds in its trade or business activity. The business loan agreement, also dated Date1, required four parties to guarantee the full amount of the loan: M, N, T and X. M and N are S corporations formed under the laws of State that are wholly-owned by T. M and N do not directly hold any ownership interests in Y.

T personally executed a commercial guaranty on Date1 (within the taxable year Year1) in favor of Bank for the full amount of the loan made to Y. The commercial guaranty provided that T absolutely and unconditionally guaranteed full repayment of the loan to Bank. However, T did not waive his rights of subrogation and reimbursement against Y or his rights of contribution from M, N and X as co-guarantors in the event that T was called upon by Bank to repay the loan made to Y under the commercial guaranty.

On Date2 (within the taxable year Year2), T, Bank and Y modified Y's promissory note to make T a co-maker on the note with Y. T, Bank and Y entered into a modification agreement, modifying the promissory note as follows: "That [T] shall be a co-borrower instead of a guarantor of said Promissory Note, and is hereby released as guarantor. All other terms and conditions of the promissory note remain in full force." Under State law, T is an accommodation party and as such is not liable to the accommodated party, Y, and has a right to indemnification against Y. To date, Y has made all of the required payments on the loan from Bank, T has not made any payments personally, and Bank has not called upon T (or any of the other guarantors) to make any payments under the commercial guaranty or the modified promissory note entered into by T.

LAW AND ANALYSIS

Section 465(a)(1)(A) (in conjunction with § 465(c)(3)(A)) provides that, in the case of an individual engaged in an activity of carrying on a trade or business or for the production of income, any loss from the activity for the taxable year is allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of § 465(b)) for such activity at the close of the taxable year.

Section 465(b)(1) provides that a taxpayer shall be considered at risk for an activity with respect to amounts including (A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and (B) amounts borrowed with respect to such activity (as determined under § 465(b)(2)).

Section 465(b)(2) provides that a taxpayer is at risk with respect to borrowed amounts used in an activity if the taxpayer is either (A) personally liable for repayment of those amounts or (B) the taxpayer has pledged property, other than property used in the

activity, as security for the borrowed amounts. No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in § 465(b)(1).

Section 465(b)(4) provides that, notwithstanding any other provision of § 465, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

Succinctly, the two tests (aside from the pledged property rule of § 465(b)(2)(B)) 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". *Pritchett v. Commissioner*, 827 F.2d 644 (9th Cir. 1987), *rev'g and remanding* 85 T.C. 580 (1985); *Melvin v. Commissioner*, 88 T.C. 63 (1987), *aff'd*, 894 F.2d 1072 (9th Cir. 1990), and *Bennon v. Commissioner*, 88 T.C. 684 (1987). 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. *Waters v. Commissioner*, 978 F.2d 1310, 1317 (2d Cir. 1992), *cert. denied*, 507 U.S. 1018 (11th Cir. 1993); *Young v. Commissioner*, 926 F.2d 1083, 1088-1089 (11th Cir. 1991); *Moser v. Commissioner*, 914 F.2d 1040, 1048 (8th Cir. 1990).

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. In *Emershaw v. Commissioner*, 949 F.2d 841, 849 (6th Cir. 1991), the Sixth Circuit concluded that the limited partners were at risk in a circular sale-leaseback transaction and that, in order for § 465(b)(4) to apply to deny a taxpayer at risk treatment, the loss limitation arrangement must be contained in a collateral agreement protecting the taxpayer from loss after the loss has already occurred.

We conclude that the majority view, as expressed in *Waters, et al.*, 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, in *HGA Cinema Trust v. Commissioner*, 950 F.2d 1357, 1362 – 1363 (7th Cir. 1991), *aff'g* T.C. Memo 1989-370, the Seventh Circuit cited the "realistic possibility of loss" standard with approval.

Accordingly, if a taxpayer is insulated from loss with respect to a borrowed amount under an arrangement described in § 465(b)(4), based upon the facts and

circumstances existing at the end of the taxable year, the taxpayer is not at risk. However, if at some future time the taxpayer demonstrates that he cannot recover under the loss limitation arrangement, the taxpayer will become at risk at that time. *Waters*, 978 F.2d at 1317-18 (citing legislative history contained in S. Rep. No. 938 at 50, n.6). To determine whether such a loss limitation agreement exists, "the substance and commercial realities of the financing agreements presented … by each transaction" are taken into account. *Thornock v. Commissioner*, 94 T.C. 439, 449 (1990). To avoid the application of § 465(b)(4), there must be more than a "theoretical possibility that the taxpayer will suffer economic loss." *American Principals Leasing Corp. v. United States*, 904 F.2d 477, 483 (9th Cir. 1990). Interpreting § 465(b)(4) in this way, any part of a formal obligation, the risk of which is practically eliminated by some other arrangement, is disregarded when determining the amount at risk.

In applying the first test under § 465(b)(2) for determining whether T is at risk for the amounts borrowed by Y under the promissory note, we must determine whether T is ultimately liable for repayment as the payor of last resort in the worst case scenario. Under the worst case scenario, we assume that the promissory note becomes payable in full, Y fails to pay the liability, Bank cannot collect on the liability from Y because its assets are worthless, and Bank seeks payment in full from T under the guaranty. Under this test, T would be the payor of last resort in the worst case scenario and would be at risk under § 465(b)(2), assuming that the guaranty is bona fide and enforceable by Bank against T under local law.

Next, we must apply the second test of § 465(b)(4) to determine whether T is otherwise protected against loss through nonrecourse financing, guarantees, stop loss agreements or other similar arrangements with respect to the liability under the promissory note. In applying this test, consistent with the majority view, we must base our analysis on the economic realities present at the end of the taxable year at issue. You suggested in your analysis that, in the present case, the Service should take the position that T is not at risk at the end of Year1 because T has not waived his rights of subrogation and reimbursement from Y with respect to the guaranty prior to Date2 nor has he waived his rights to indemnification from Y after Date2 as a co-maker under the modified promissory note. 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 T's failure to waive these rights against Y, by itself, does not protect T 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 T may be entitled to subrogation, reimbursement, or indemnification from Y (and only Y) 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 Y holds assets with positive value at the end of the taxable year in question.

In addition, in the current case, M, N, and X are co-guarantors in the event that Bank calls upon T to repay the loan made to Y under the commercial guaranty prior to Date2. These co-guarantees must also be analyzed to determine whether T is protected from loss under the economic realities existing at the end of Year1 under § 465(b)(4). To the extent that T may be entitled to contribution or reimbursement from persons other than Y (irrespective of whether those other persons are members of Y), T 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 an 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.

Under the facts as presented, in Year1, T will be at risk with respect to the guaranteed amount, irrespective of whether T has completely waived his rights to subrogation and reimbursement from Y, as long as the guaranty is bona fide and enforceable by Bank against T under local law and T is not otherwise protected against loss within the meaning of § 465(b)(4). To the extent that T has a right of contribution or reimbursement for amounts from M, N and X if Bank demands payment from T under the guaranty, T will not be at risk for those amounts (subject to the analysis and conclusion provided in the preceding paragraph). In Year2, T will be at risk with respect to the guaranteed amount, as long as the guaranty is bona fide and enforceable by Bank against T under local law and T is not otherwise protected against loss within the meaning of § 465(b)(4).

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.

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Please call (202) 622-3060 if you have any further questions.

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