

TAX UPDATE

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Risky Business—LLC Debt Restoration Provision Fails to Provide At Risk Status
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What Constitutes “Payor of Last Resort” Status?

The Tax Court gave its decision in the case of *Hubert Enterprises, v. Commissioner* (TC Memo. 2008-46), a case that was sent back to the Court by the Sixth Circuit Court of Appeals (2007-1 USTC ¶150,494) to determine the effect of the LLC operating agreement’s debt restoration obligation under the test outlined by the 1991 Sixth Circuit decision in *Emershaw v. Commissioner* (949 F.2d. 841). That test required considering whether, in a worst case scenario, the taxpayer would become the payor of last resort for the creditor.

In the original *Hubert* case (125 TC 73) the Tax Court had decided that the operating agreement’s debt restoration obligation was ineffective in creating at risk status for recourse debt, since it applied only upon liquidation of a member’s interest. Since no liquidation had occurred in the years in question, the Tax Court held that the provision was ineffective in creating at risk status. The Sixth Circuit noted “the Tax Court’s opinion failed to address whether or not economic

circumstances beyond the control of LCL members might force liquidation of their interests, thus causing the DRO to operate in a manner that might cause LCL members to become liable for a portion of LCL's obligations.”

The Sixth Circuit test is easier for a taxpayer to clear than the test applicable in a number of other circuits, including the Ninth. In those Circuits, the test is whether the transaction has been structured to avoid a realistic possibility that the taxpayer would have to make payment, based on economic reality. CCH's *Tax Research Consultant* cites cases from the Ninth Circuit (*American Principals Leasing Corp. v US*, , 904 F2d 477, and *H.L. Casebeer v Commr*, 909 F2d 1360), Eighth Circuit (*W.L. Moser v Commr*, 914 F2d 1040), and Second Circuit (*J.J. Waters v Commr*, 978 F2d 1310, *cert. denied*, 507 US 1018), as well as a published Tax Court decision affirmed by the Eleventh Circuit (*F. Levien v Commr*, 103 TC 120, *aff'd, per curiam*, CA-11, 77 F3d 497, *cert. denied*, 116 S Ct 2501) as applying the “realistic possibility” test.

The Tax Court ends up holding that, even under the Sixth Circuit's more liberal standard, the DRO was still defective in terms of creating at risk amounts for the members, and its analysis is of interest in looking at the at risk provisions of §465 and the issues created by operating agreements. Clearly an agreement that won't past muster under the Sixth Circuit's test is likely to be in serious trouble elsewhere.

At Risk

At risk is governed by Section 465 of the Internal Revenue Code. Losses are restricted to amounts at risk by §465(a), with the determination of what is at risk governed by §465(b).

Amounts at risk are divided into two categories:

- the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, *and*
- amounts borrowed with respect to such activity that meet the requirements of §465(b)(2) [§465(b)(1)]

Borrowed funds generally have to fall into one of two categories to be qualified as “at risk” borrowings under §465:

- is personally liable for the repayment of such amounts, or
- has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property). [§465(b)(2)]

- As well, any debt for which a taxpayer is protected against loss by nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements is not considered at risk. [§465(b)(4)]

A number of modifications follow this provision that further restrict or expand the applicability of at risk amounts, including

- Borrowings from related parties (not considered amounts at risk) [§465(b)(3)(A)]
- Borrowings from parties with an interest in the activity (not generally considered at risk) [§465(b)(3)(A)]
- Borrowings to the extent used to allow for deduction of losses in prior years (not considered any longer at risk) [§465(b)(5)] (and consider the recapture of losses when at risk goes below zero under §465(e))
- Qualified nonrecourse financing (considered at risk) [§465(b)(6)]

One of the characteristics of limited liability companies is that, generally, the members of the LLC are not liable for the debts of the LLC, which creates an issue regarding at risk limitations since there is no personal liability for debts of the LLC. The question in the *Hubert Enterprises* case is whether modifications made to the operating agreement served to override this effect for recourse debts of the LLC.

Hubert Facts

The LLC in *Hubert* first had an operating agreement that state, in accordance with the laws of Wyoming under which it was formed, that “no Member shall be liable as such for the liabilities of the Company.”

It turns out that the members needed the debt to be “at risk” for purpose of deducting losses from the operations for the fiscal years ended July 31, 2000 and July 31, 2001. On March 28, 2001, apparently after discovering this fact (or, as well, issues under the provisions of the substantial economic effect regulations for capital account maintenance under §704) for the July 31, 2000 fiscal year, the operating agreement was retroactively revised, effective January 1, 2000, to provide that no member is required to make capital contributions, however the follow provision was also added:

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.

The revised agreement also contained a provision regarding third party creditors that stated “Nothing express or implied in this Agreement is intended or shall be construed to confer upon or to give any person or entity, other than the parties or their successors-in-interest in accordance with the provision of this Agreement, any rights or remedies hereunder or by reason hereof.”

Modifications to Agreement

The Tax Court quickly dealt with the first year under consideration by referring to §761(c). While partnership agreements (and, by extension, LLC operating agreements) can be modified after the tax year end, the effect of such modifications is governed by §761(c). That provides “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, or which are adopted in such other manner as may be provided by the partnership agreement.”

The July 31, 2000 Form 1065 was due on November 15, 2000. Although the modification had a stated retroactive effective date back to January 1, 2000, the Tax Court held:

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.

Thus, for the first year in question, the Tax Court held that the original agreement governed the first year under question, and that agreement clearly provided for no amounts to be at risk.

But clearly the revision was made well before the November 15, 2001 due date of the July 31, 2001 return, so now the issue was whether, once it became effective, did these provisions create at risk status for the debt by making the members into the payors of last resort.

Payor of Last Resort

The Tax Court looked at the impact of the provisions in question, applying state law in its analysis of whether or not the members of the LLC would be payors of last resort.

The taxpayers argued that Wyoming state law (the law of the state under which the LLC was formed), after adoption of the revised operating agreement, made them liable.

Petitioner asserts that Wyo. Stat. Ann. sec. 17-15-121(a) and (c) allows a member of a limited liability company to promise to contribute additional capital to the company and permits a creditor of the company to enforce that promise in order to receive payment on a debt owed to the creditor by the company.

The taxpayers claim that the changes to their agreement would have allowed a creditor to force a member to pay the debt in question should the LLC default.

The Court, in looking at the provision, notes that there are two requirements that must be met to force a member to make a payment to the LLC:

- The member must liquidate its interest in the LLC *and*
- The member must have a deficit in its capital account after such liquidation

The Court in a footnote, indicates a fundamental assumption that the taxpayers are making that the Court believes is erroneous after analyzing state law, an assumption that once removed causes major problems in arriving at a finding that the taxpayer is at risk.

Petitioner apparently assumes that in a worst case scenario HBW will liquidate its interest in LCL and then have a deficit capital account thus triggering the DRO. We disagree with the assumption. As stated herein, HBW's liquidation of its interest in LCL is left up to HBW, and we do not assume that HBW on its own would liquidate its interest in LCL if it was detrimental for HBW to do so. In other words, as discussed below, LCL could not be made to liquidate by a creditor in any circumstance, not even by a creditor that forced LCL into receivership or bankruptcy..

The Court gives the following "worst case" scenario analysis:

Here, in a worst case scenario, HBW is not a payor of last resort as to LCL's recourse debt. In such a scenario, LCL defaults on the debt without any assets to repay any of the debt. LCL's default, however, does not mean that the recourse creditor can simply turn to HBW to collect any part of the debt. HBW's obligation under the DRO requires in part that HBW liquidate its interest in LCL, and LCL's default on its payment of its recourse debt does not trigger a

liquidation of HBW's interest in LCL (or of LCL itself).⁶ Nor in a worst case scenario could LCL's recourse creditor recover directly from HBW or compel a dissolution of LCL so as to force a liquidation of HBW's interest in LCL. The revised operating agreement states that LCL shall be liquidated upon its "dissolution" and that dissolution occurs "only as provided by the Wyoming LLC Act." Under that act, the dissolution of a limited liability company occurs only upon the happening of one of three events, none of which is the company's default on the payment of a debt. See Wyo. Stat. Ann. sec. 17-15-123(a). Thus, LCL's default on its obligation to repay the recourse notes would not entitle LCL's recourse creditor to compel the dissolution of LCL. The DRO also would not apply to HBW if LCL defaulted on its debt and HBW had a positive capital account following a liquidation of HBW's interest in LCL. Given that the DRO requires additional capital contributions only when a member "has a deficit Capital Account following the liquidation of * * * its interest" in LCL and that no creditor of LCL could compel a liquidation of HBW's interest in LCL, we conclude that HBW is not a payor of last resort because HBW is not "personally liable for the repayment" of any of LCL's recourse debt within the meaning of section 465(b)(2)(A). In other words, we conclude that HBW is not personally liable for the repayment of any of LCL's recourse debt because HBW's obligation to contribute additional funds to LCL is not unavoidable in that HBW can avoid contributing additional capital under the DRO simply by not liquidating. See *Callahan v. Commissioner*, 98 T.C. at 283.

The Wyoming statute for dissolution provides for it to occur when one of three events takes place:

- When the period fixed for the duration of the limited liability company shall expire;
- By the unanimous written agreement of all members; or
- Upon the death, retirement, resignation, expulsion, bankruptcy, dissolution of a member or occurrence of any other event which terminates the continued membership of a member in the limited liability company, *unless the business of the limited liability company is continued by the consent of all the remaining members under a right to do so stated in the articles of organization of the limited liability company.*

The Court notes that the revised operating agreement does provide for the right to continue the entity in the third event. The Court found no Wyoming provision

that would have allowed a creditor to force a dissolution of the LLC for a debt of the LLC (though it did find such a provision for a debt of a member—however, as the court noted, that's not relevant here).

Without a method to force a dissolution, the creditor can't get to the provision that would require a restoration of a negative capital account balance. And, the Court notes, it seems unlikely a member would voluntarily consent to such a dissolution in that circumstance where doing so would subject them to having to make a contribution that otherwise is not required.

The Court also expressed concern that the provision was not directly linked to the debt. Thus, even if the DRO is triggered, the agreement does not limit the use of the funds contributed to paying the debts in question—it is allowed to be used to pay members with positive capital accounts (a provision clearly in the agreement to deal with the §704 regulations).

In fact, the Court notes the routine use of DROs for §704 purposes and indicates:

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.