

Member Guarantee Provides Code Sec. 465 At-Risk Basis



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By Betsy G. Hastings, CPA

For partnership tax experts, general tax practitioners, and LLC members alike, the argument of whether or not an LLC member is at risk under Code Section 465 when the member guarantees debt has been a debate that has raged for many years. On February 22, 2013, the widely-debated topic was laid to rest in Chief Counsel Advice (CCA) 201308028.

The Code Section 465 at-risk rules are designed to ensure that a taxpayer deducts losses only to the extent he is economically or actually at risk for the investment. A taxpayer's amount at risk includes cumulative cash contributions, the cumulative adjusted basis of property contributed to the LLC, and certain amounts borrowed with respect to the activity for which the taxpayer is personally liable for repayment or for which the taxpayer has pledged property, other than property used in the activity, as security for the borrowed amounts. While cash contributions and the adjusted basis of property contributed to the LLC are seldom questioned for at-risk purposes, the notion of a member guarantee providing at-risk basis has been a point of contention between the IRS, tax practitioners and LLC members for years.

In the above referenced CCA, the IRS has determined that an LLC member is at risk under Code Section 465 when the member guarantees LLC debt, provided that the member is (1) the obligor of last resort, (2) the guarantee is bona fide and enforceable by the lender, and (3) the member is not otherwise protected against loss by some person or entity, other than the LLC itself. The IRS further concluded that the LLC member may be at risk under Code Section 465 with respect to the guaranteed debt even if he doesn't waive his rights to subrogation and reimbursement from the LLC. However, the guarantor is not considered at risk provided that others co-guarantee the LLC debt, except to the extent that the guarantor has no rights of contribution or reimbursement against the other guarantors.

Two tests are applied in determining whether a taxpayer is considered to be at risk for borrowed amounts. First, the taxpayer must be personally liable for the debt. This test can generally be determined by analyzing whether a taxpayer is ultimately liable as the

"payor of last resort in the worst case scenario." Second, the taxpayer must not be otherwise protected against the loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements. In determining the second test, the most widely used approach analyzes the presence of a protective arrangement based on the "economic realities" present at the end of the tax year. A less used approach follows the 'payor of last resort' analysis used in the first test.

In determining if an LLC loss is deductible, a taxpayer must first determine if he has sufficient outside tax basis in his LLC interest, then determine if the losses are deductible under the at-risk limitation, and finally determine if the losses are deductible under the passive activity loss limitation rules. The rules that govern a taxpayers' ability to deduct a loss are complex and fact-specific. Understanding the at-risk limitations and identifying if a taxpayer is subject to the at-risk rules are vital to ensuring the taxpayer is deducting the full economic loss allowable. As such, it is important to consider member guarantees, as they can have a positive impact on a taxpayer's at-risk basis by allowing a loss that may otherwise be disallowed.

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