

10-1-2008

Who's at Risk? Abbott and Costello Take on Section 465

Ajay Gupta

Follow this and additional works at: <http://repository.law.miami.edu/umblr>



Part of the [Taxation-Federal Commons](#)

Recommended Citation

Ajay Gupta, *Who's at Risk? Abbott and Costello Take on Section 465*, 17 U. Miami Bus. L. Rev. 47 (2008)

Available at: <http://repository.law.miami.edu/umblr/vol17/iss1/4>

**WHO'S AT RISK? ABBOTT AND COSTELLO
TAKE ON SECTION 465**

AJAY GUPTA*

PART I.	INTRODUCTION	48
PART II.	SECTION 465 AND SUBCHAPTER K	55
	A. <i>Loss Limitation in Partnerships</i>	56
	B. <i>LCL—A Partnership for What Purpose?</i>	60
	C. <i>Hubert's First Lesson</i>	66
	D. <i>LCL—An LLC to What End?</i>	67
	E. <i>Meanwhile, Back at the Ballgame</i>	70
PART III.	A TWO-PART FRAMEWORK	72
	A. <i>Set of Legal Structures</i>	74
	1. Adherence under Law	74
	2. Personal Exposure	80
	3. Constraints under the Set of Legal Structures	82
	B. <i>Set of Economic Consequences</i>	82
	C. <i>Applying and Misapplying the Framework</i>	83
PART IV.	THE SECTION 752 RULES WITHIN THE FRAMEWORK	88
	A. <i>The Right Place to Begin</i>	89
	B. <i>The Proper Place to End</i>	90
	C. <i>An Additional Layer</i>	90
PART V.	THE CONSTRUCTIVE LIQUIDATION PROCESS	92
	A. <i>The Functionality</i>	93
	B. <i>The Steps</i>	94
	C. <i>The Operations</i>	96
	D. <i>The Results</i>	99
	E. <i>The Limitations</i>	101
	F. <i>The CLP in Hubert</i>	105
	1. Proving a Tautology	105
	2. Instrument of Torture	107
	3. Recommended Use	112
PART VI.	CALIBRATING THE TOOLS TO THE TASK	113
PART VII.	PERSONAL LIABILITY BY OTHER MEANS	114

* Ajay Gupta, M.B.A. (Yale, 1990), J.D. (Harvard, 1993), A.M. (Stanford, 1997), a tax lawyer who struggles to reach first base, can himself be reached at goopster22@gmail.com.

A.	<i>Unconditional Guarantee</i>	115
B.	<i>Creditor Enforceable DRO</i>	117
C.	<i>Losses Follow Liabilities</i>	120
D.	<i>The CLP Revisited</i>	122
PART VIII.	LIQUIDATION SALE ANALYSIS	125
A.	<i>Why Conduct an LSA?</i>	125
B.	<i>Why Conduct an LSA?!</i>	130
PART IX.	APPLYING THE TWO-PART FRAMEWORK	133
A.	<i>Analyzing the Facts of Hubert</i>	133
B.	<i>Court Decisions Before Hubert</i>	136
1.	Personal Liability	137
2.	Protection Against Loss	139
C.	<i>Hubert in the Courts</i>	142
1.	<i>Hubert I</i>	143
2.	<i>Hubert on Appeal</i>	145
3.	<i>Hubert I is Dead; Long Live Hubert?</i>	147
D.	<i>Thinking Outside the Section 752 Box</i>	148
PART X.	CONCLUSION	151

PART I. INTRODUCTION

The Tax Court's twin decisions in *Hubert Enterprises Inc. v. Commissioner*, on either side of a Sixth Circuit opinion, both holding that a Wyoming limited liability company (LLC) members' deficit restoration obligations (DROs) did not render the members at risk under section 465 for the LLC's debt,¹ appear to be serving as the backdrop for an Albert and Costello routine on which, if any, LLC members are at risk for an LLC's debts.

In its first at-bat, the Tax Court struck out. In concluding that the LLC members were not at risk, the court relied solely on the fact that members' DROs remained as yet unenforced, and failed to consider whether a creditor could ever enforce them.² The court's failure to examine the DROs' enforceability, much like Abbott's failure to spell out the names of the

¹ *Hubert Enters., Inc. v. Comm'r*, 95 T.C.M. (CCH) 1194 (2008) [hereinafter *T.C. Memo*], supplementing *Hubert Enters., Inc. & Subs. v. Comm'r (Hubert I)*, 125 T.C. 72 (2005), *aff'd in part, vacated in part, and remanded by* 230 Fed. Appx. 526 (6th Cir. 2007). In addition to the LLC members' section 465 at-risk amounts in the LLC's debt, *Hubert I* involved other issues that did not implicate section 465. The Tax Court's decisions on these issues were upheld on appeal by the Sixth Circuit. This article focuses exclusively on the section 465 decisions in *Hubert I*, including the allowable aggregation of subject activities for purposes of loss limitation, discussed in Part II *infra*, and the analysis of the impact of the members' DROs on their at-risk amounts that is mentioned throughout most of the article and discussed in detail *infra* Part IX.C.

² *Hubert I*, 125 T.C. at 106. See also *infra* Part IX.C.

ballplayers on his team, prompted a debate, both within and outside the courtrooms, in which answers were construed as questions, solutions framed as problems and results used to proved assumptions.³

The litigants, adjudicators, experts and commentators, all examined what they had identified as the applicable statutory, administrative and common law.⁴ Upon encountering relevant, and often irrelevant, solution schemes, they interpreted them, instead, as points of reference for formulating

³ See, e.g., Final Brief for the Appellee, *Hubert Enters. Inc. v. Comm'r*, 230 Fed. Appx. 526 (6th Cir. 2007) [hereinafter *IRS Brief*] (seeking denial of section 465 at-risk treatment by pointing out the possibility of the LLC members to “walk away” with positive capital accounts despite a default on the LLC’s debt—a situation in which the members’ capital contributions would, by definition, exceed their allocated losses and, therefore, the at-risk rules would not apply); Brief for Petitioners-Appellants, *Hubert Enters., Inc. v. Comm'r*, 230 Fed. Appx. 526 (6th Cir. 2007) [hereinafter *Taxpayer Brief*] (equating the LLC members’ DROs, representing obligations to make additional capital contributions, as “assets” of the LLC—property that could only have been acquired by previously made capital contributions); Brief of Amici Curiae Real Estate Roundtable, Nat’l Ass’n of Real Estate Investment Trusts and Nat’l Ass’n of Realtors In Support of Reversal in Part, *Hubert Enters. Inc. v. Comm'r*, 230 Fed. Appx. 526 (6th Cir. 2007) [hereinafter *NAREIT Brief*] (justifying the use of DROs to satisfy the section 465 at-risk rules in a limited partnership because they “shift the risk of loss to the partners that may otherwise have limited liability” presumably from partners who do not have limited liability—in an LLC where all members had limited liability and there was no partner with a risk of loss that could be shifted away); Richard M. Lipton, *At-Risk Rules and DROs: Did the Tax Court Err in Hubert Enterprises?*, 103 J. TAX’N 325 (2005) (concluding a DRO-member to be at-risk for section 465 purposes because the “member liable for the DRO is ‘on the hook’ in the event of a precipitous decline in value [of the LLC’s assets] without regard to the likelihood that the liability [under the DRO] will be incurred”—in a case that turned on the question of the enforceability of the members’ DROs); Karen C. Burke, *Illusory DROs: At-Risk Lessons from Hubert*, TAX NOTES, Jan. 21, 2008, at 405 [hereinafter *Burke*] (conducting a hypothetical “liquidation sale” of an LLC’s assets to arrive at the proper method for allocating recourse deductions among LLC members—in an LLC where all capital and income items were shared in a constant proportion; and speculating on the lack of “foundational support” for such allocations after repayment of the debt—where the members’ DROs supporting the allocations would have survived such repayment); Susan Kalinka, *Hubert Enterprises: LLC Members, Partners, Deficit Restoration Obligations, and the At-Risk Rules*, TAX NOTES, July 10, 2006, at 137 [hereinafter *Kalinka*] (attempting to “derive” the extent of the LLC’s unlimited liabilities via a similar allocation exercise—and ending up with an aggregate amount that was less than the sum of its component parts); Blake D. Rubin et al., *The Effect of a “DRO” on a Partner’s At-Risk Amount and Share of Liabilities: Hubert Enterprises v. Commissioner*, TAX NOTES, May 29, 2006, at 1031 [hereinafter *Rubin et al.*] (seeking to establish a creditor’s “unlimited” right to repayment by conducting an exercise in allocating the LLC’s debt among its members—where the allocation exercise proceeded by assuming the creditor’s unlimited repayment rights). See also *infra* Part V.F for a detailed critique of Rubin et al., and Kalinka, and *infra* Part VIII for a detailed critique of Burke.

⁴ Though the statute that has been applied, nominally if not substantively, has been section 465, the regulatory inspiration appears to be largely derived from the section 752 liability sharing rules—explicitly in the case of commentators and implicitly in the case of the litigants and adjudicators. See *infra* Parts V.F. and VIII on the former, and *infra* Part IX.C on the latter. The body of case law that has been almost universally applied is the one dealing with limited partners’ section 465 at-risk claims in limited partnerships with at least one general partner. See generally *infra* Part IX.B.

enquiries.⁵ Imitating Costello, they persevered with investigations into the facts of the case, treated answers as non-responses, and delved deeper.

Who's at risk?

And with Abbott's straight face, and constrained by the proverbial straitjacket of the subject matter's vocabulary, the facts answered—concisely, but without clarity. Yes.

On appeal, the Sixth Circuit's opinion did nothing to clarify the pervasive semantic ambiguity. If anything, it confounded the resulting conceptual confusion by directing that legal structures governing the members' DROs be examined under the glare of economic reality.⁶

I'm asking YOU who's at risk.

That's the business's name.

That's who's name?

Yes.

Well go ahead and tell me.

That's it.

That's who?

Yes.

Wielding the bat again on remand, the Tax Court swung and finally connected. Exhibiting admirable restraint in resisting the Sixth Circuit's dugout calls, the Tax Court considered the members' DROs strictly for their legal implications and held them unenforceable.⁷ In doing so, the Tax Court vindicated its initial decision. It may have accomplished little else, however. Because the Tax Court ignored the approach directed by the Sixth Circuit, the saga of Hubert Enterprises, the petitioner-taxpayer, may yet go into extra innings. And because the Tax Court made no attempt to address, leave alone respond, to the latter-day Costellos of the tax world, their perplexed questions may yet persist. This article seeks to end the misery.

Hubert featured Leasing Co. LLC (LCL), a Wyoming LLC engaged in equipment leasing. Ninety-nine percent of the membership interests in

⁵ See *infra* Part V.F. (discussing the (mis)use of the "constructive liquidation process" for an examination into the "unlimited" nature of the LLC's liabilities and quantifying their amount) and *infra* Part VIII (discussing the (mis)use of the "liquidation sale approach" for obtaining the proper allocation of recourse deductions among the LLC's members).

⁶ *Hubert I*, 125 T.C. at 531. See also *infra* Part IX.C.

⁷ *T.C. Memo*, *supra* note 1. See also *infra* Part IX.C.

LCL were held by HBW Inc. (HBW), a wholly-owned subsidiary, first of Hubert Enterprises Inc. (HEI), and then of HEI's wholly-owned subsidiary, Hubert Holding Co. (HHC). The remaining 1 percent of LCL's membership interests were held by Hubert Commerce Center (HCC) that was also "connected" with HHC.⁸ The entire Hubert group of affiliated corporations (collectively, and each of its constituent corporations, individually and interchangeably, Hu) was ultimately owned and controlled by the Hubert Family Trust.⁹

Well, then, who's at risk?

Yes.

I mean the business's name.

Hu.

The corporation at risk.

Hu.

The member of the LLC that is at risk.

Hu.

The partner exposed—

Hu is at risk!

The LCL members claimed tax deductions for their distributive shares of LCL's equipment leasing losses.¹⁰ The members sought to use their

⁸ See generally *Hubert I*, 125 T.C. at 84. "LCL is a Wyoming limited liability company formed on April 30, 1998. LCL filed its initial Federal partnership return of income on the basis of a taxable year ended July 31, 1998 (LCL's 1998 taxable year). LCL's organizers were Thomas, in his capacity as managing member of Hubert Commerce Center, Inc. (HCC), and Ollinger, in his capacity as vice president of HBW. HCC was *connected* with both the HEI and HHC affiliated groups." *Id.* (emphasis added). The "connection" was established through Thomas who, though "unrelated by blood or marriage to any member of the Hubert family," was a "fixture" in most of the "financial ventures of the Hubert family and their companies" and served as a trustee of the Hubert Family Trust, HEI's president and as chief executive officer of the entire "Hubert enterprise." *Hubert I*, 125 T.C. at 93–94.

⁹ *Hubert I*, 125 T.C. at 74–75 ("HEI was organized by the Hubert Family Trust (HFT) on or about October 8, 1992. HEI's only share-holder has always been HFT. . . . For HEI's 1997, 1998, and 1999 taxable years, HEI was the parent corporation of an affiliated group of corporations that filed consolidated Federal corporate income tax returns [and included HBW but did not include HCC] In August 1999, HEI transferred the stock of its subsidiaries to HHC. For HHC's 2000 and 2001 taxable years, HHC was the parent corporation of an affiliated group of corporations that filed consolidated Federal corporate income tax returns [and included HBW but did not include HCC]").

¹⁰ The taxpayer whose section 465 at-risk claim was at issue in *Hubert* was neither HBW nor HCC but rather HHC, the successor in interest to HEI as the corporate parent of HBW. The IRS had challenged HHC's consolidated tax returns for its taxable years 2000 and 2001 in which HHC had claimed, on behalf of HBW, 99 percent of LCL's passthrough equipment leasing losses. See generally *Hubert I*, 125 T.C. 72 (2005), *aff'd in part, vacated in part, and remanded by* 230 Fed. Appx. 526 (6th Cir. 2007).

obligations to restore any deficits in their respective capital accounts upon the liquidation of their membership interests to establish section 465 at-risk bases in LCL's otherwise exculpatory liabilities.¹¹ The issue posed fairly, albeit not quite squarely, before the Tax Court was: Did the liquidation contingency in LCL members' DROs make the DROs unenforceable?¹²

HBW had owned a constant 99 percent of LCL's membership interests since LCL had been formed on April 30, 1998. HBW itself had been initially wholly owned by HEI and, after August 1999, wholly owned by HHC. HCC that had owned the remaining one percent of LCL's membership interests was not a subsidiary of either HEI or HHC and no part of its share of LCL's passthrough losses was claimed by HHC. *See id.*

HEI had presumably claimed LCL's passthrough losses attributable to HBW for HEI's taxable years 1998 and 1999. It is unclear whether the IRS had allowed any such claimed losses or if HHC, as HEI's successor in interest, had agreed to carry them forward to its tax returns for its taxable years 2000 or 2001, or both. *Hubert I* indicated a "deal" between the IRS and the taxpayer. "Following concessions by petitioners, we must decide . . . for HHC's 2000 and 2001 taxable years, whether HHC may deduct passthrough losses from [LCL's] leasing activities." *Id.* at 73 (emphasis added).

HHC had claimed only HBW's 99 percent share of LCL's passthrough losses. Presumably HCC would have claimed its one percent share of these losses on its own tax return. HCC was neither a party to the *Hubert* litigation nor was its one percent share of LCL's passthrough losses an issue in *Hubert*. *See generally id.*

¹¹ In the absence of such at-risk bases in LCL's debt, LCL members would have been unable to use most of LCL's equipment leasing losses. LCL had been initially capitalized with a minimal \$10,000 in cash. "LCL's ownership consisted of 100 membership units. [Upon its formation on April 30, 1998], HBW received 99 of those units in exchange for a \$9,900 capital contribution, and HCC received the last unit in exchange for a \$100 capital contribution." *Hubert I*, 125 T.C. at 84. Thus HBW's capital account in LCL would have opened with a \$9,900 balance while HCC's capital account would have had an opening balance of \$100. These balances would have been wiped out and the members' capital accounts rendered negative early in LCL's 1998 taxable year. LCL's equipment leasing results on an activity-by-activity basis were as follows:

From the "Capital Resources Atmel" equipment leasing activity in 1998, LCL reported tax losses for 1998, 1999, 2000, and 2001 in the amounts of \$3,104,552, \$3,698,023, \$1,507,506, and \$302,921, respectively. From the "ECM Blisk" equipment leasing activity in 1999, LCL reported [losses] for 1999, 2000, and 2001 in the amounts of \$348,416, \$455,132, and \$234,573, respectively. From its "28 Quarters" equipment leasing activity in 2000, LCL reported losses for 2000 and 2001 in the amounts of \$170,130, and \$192,740, respectively. From its "20 Quarters" equipment leasing activity in 2000, LCL reported losses in the amounts of \$2,041,477, and \$1,892,051, respectively. *IRS Brief, supra* note 3 (citations omitted).

During this time, LCL members did not make additional capital contributions. Therefore, if they were unable to include any of LCL's debt in their respective at-risk amounts, LCL members would have been denied almost all of these losses. *But see infra* note 39 (discussing the possibility that HBW may have received capital account credit for contributed leases).

¹² The IRS had presented two alternative arguments: (i) the fact that the LCL members' DROs were not liquidated in the years at issue; and (ii) that a creditor could not enforce these DROs. The Tax Court, finding the first argument dispositive, never reached the IRS' second "argument that the DROs, if operative, did not cause the taxpayers to be at risk . . . because [they] did not confer rights on third parties." *IRS Brief, supra* note 3, at 17.

The fact-specific question merited a fact-specific examination of Wyoming law, LCL's articles of organization and its operating agreement. Instead of examining these sources for the impact of the liquidation contingency on the DROs' enforceability, the Tax Court satisfied itself with the observed failure of the liquidation contingency to materialize. Each member was required to contribute additional capital to restore a deficit in its capital account—but not before a liquidation of its membership interest in LCL. Because neither member's interest was liquidated in the years at issue, the court ruled that the two members were not at risk with respect to LCL's borrowings.

The Tax Court's refusal to test the enforceability of the members' DROs cracked open a door for a Subchapter K analysis of the categorization of LCL's debt as a partnership recourse liability and its allocation among the members. Instead of closing this door on appeal, by highlighting the need for an economic reality check, the Sixth Circuit opened it wider still.¹³ Through this door, and onto the turf that it opens on, where the Tax Court very wisely chose not to tread on remand, have come rushing in, Subchapter K scholars of great eminence.

These scholars, from both the profession and the academy,¹⁴ have brought to bear their mastery of complex partnership structures to analyzing a case that is neither complex nor even a real partnership. Almost all of LCL's equipment leasing losses were sought to be used by HHC, the parent of one of LCL's two members.¹⁵ There was no attempt at shifting income,

¹³ See *infra* Part IX.C.2.

¹⁴ See, e.g., Lipton, *supra* note 3; Rubin *et al.*, *supra* note 3 (representing the profession); Kalinka, *supra* note 3; Burke, *supra* note 3 (representing the academy).

¹⁵ At least two commentators have this fact wrong. They have stated that both HW and HCC were wholly owned subsidiaries of HHC, or at least, of a common parent. The error appears to have spread from one commentator to the other. See Kalinka, *supra* note 3, at 138 ("The two members of LCL were HBW Inc. (HBW) and Hubert Commerce Center Inc. (HCC), *two wholly owned subsidiaries* in an affiliated group of corporations whose *common parent* was owned by a family trust.") (emphasis added); Burke, *supra* note 3, at 405 n.3 ("The two members of LCL were HBW Inc. (HBW) and Hubert Commerce Center Inc., *two wholly owned subsidiaries* in an affiliated group of corporations whose *common parent* was owned by a family trust.") (emphasis added). This replicated assertion is wrong.

Ownership interests in HCC do not appear to have been held by any corporation in "the HEI and HHC affiliated groups." See *Hubert I*, 125 T.C. at 74–75. If HCC was a wholly owned subsidiary of HEI, and subsequently of HHC, then HHC would have claimed all, and not just 99 percent of LCL's losses. *IRS Brief*, *supra* note 3, and *Hubert I* both document HHC claiming no more than 99 percent of LCL's losses.

Two observations follow from this erroneous assertion. First, it makes these commentators' failure to divine the real motivation of using the partnership form for LCL even more baffling. See discussion *infra* Part II.B; see also *infra* note 48. Second, it makes their use of Subchapter K tools in analyzing the LCL members' at-risk claims even more incongruous. See *infra* Part II.D; see also *infra* note 60.

loss or risk between LCL's members. Nor was the underlying economic relationship between these members disguised for tax purposes. Regardless, the Subchapter K scholars have persisted with analytic tools designed to reveal the true face of a partnership lurking behind any tax inspired cosmetics. The resulting investigations have been (mis)directed at distinguishing between real and apparent benefit and burden sharing in an arrangement that made no attempt at either. The investigators' questions keep echoing back as answers leaving nobody any wiser.

Look, you got LCL, a Wyoming LLC that does equipment leasing.

That's right.

And, you got members in this LLC?

Certainly.

Who's at risk for the equipment leasing losses?

That's right.

When you share income and losses at the end of the year, who is allocated the losses?

Every dollar of it.

All I'm trying to find out is the name of the corporation at risk.

Hu.

The business that gets—

That's it.

Who gets the losses—

It does, every dollar. In fact, its parent claims them on its behalf.

Whose parent?

Yes.

In this article, I respond to this self-induced exchange not by supplying answers to the questions but by showing the line of questioning itself to be irrelevant. Throughout this article, I use the case of *Hubert Enterprises* both for what it tells us and, more importantly, what it cannot tell us. Though *Hubert* anchors much of the discussion that follows, the article itself has a broader purpose.

I have three specific goals in mind. First, to show how to conduct an ideal inquiry of a partner's section 465 at-risk claim in partnership debt. I do this by developing a two-part framework of analysis in which one part examines the relevant legal structures while the other investigates the economic consequences. Second, to demonstrate where, when and how applicable Subchapter K provisions, specifically, the section 752 liability sharing rules, can further such an inquiry. I do this by incorporating some of the analytic constructs of the section 752 rules within the legal structures part of the two-part framework. And, finally, to identify the causes and effects of some typical errors in the developed common law analyzing a

partner's section 465 at-risk claim in partnership debt. I do this by applying the two-part framework to representative fact patterns, their judicial treatment and the theories underlying such treatment as revealed by appellate review.

I have organized the remainder of this article as follows. Part II discusses the loss limitation effects of the section 465 rules to partnerships, highlights a loophole that the taxpayer sought to exploit in *Hubert* and offers a simple fix. In Part III, I formulate a generalized framework for analyzing a taxpayer's section 465 at-risk claim in any borrowed amount. As mentioned above, this framework of analysis comprises two separate parts—a set of legal structures and a set of economic consequences. Part IV particularizes this framework to a partner's at-risk claim in partnership debt and outlines the proper place within the framework for the section 752 liability sharing rules. Informed by this discussion and conscious of the overall role of the section 752 rules in a section 465 at-risk inquiry, the next four parts examine specific tools employed by the section 752 rules and their specialized utility in furthering such an inquiry.

Part V looks at the constructive liquidation process (CLP) that the section 752 rules use for categorizing partnership debt as a partnership recourse liability and allocating it among partners. Part VI shows how this categorization and allocation can be made to ensure that the allocatee-partners bear personal liability, under section 465, for their section 752 allocated share of partnership recourse liabilities. Part VII extends these results to an independent verification of a partner's personal liability, under section 465, for partnership debt, conducted outside of the section 752 rules that these rules can, nonetheless, validate. Part VIII completes the survey of the section 752 tools by examining a device used for the proper allocation among partners of deductions financed by partnership recourse liabilities—the so-called “liquidation sale analysis” (LSA).

In Part IX, I review courts' analyses of partners' section 465 at-risk claims in their respective allocated shares of partnership debt from the perspective of the two-part framework. This review both explains the source of common judicial errors and predicts the consequences of such errors on the at-risk treatment of the allocated partnership debt. Part X presents my concluding remarks.

PART II. SECTION 465 AND SUBCHAPTER K

Section 465 serves to limit losses that certain taxpayers may claim from specified activities. Taxpayers covered by section 465 include individuals

and “closely held” C corporations.¹⁶ All activities that such a covered taxpayer engages in as part of a trade or business or for the production of income are subject to section 465’s loss-limitation rules. These rules apply on an activity-by-activity basis.¹⁷ A “loss” from each such activity for section 465 purposes is the excess of allowable deductions relating to the activity over any income resulting from the activity.¹⁸ The use of such excess allowable deductions by a covered taxpayer to offset taxable income from other sources is limited to the taxpayer’s amount at risk in the subject activity at the end of the taxable year. This amount at risk includes the following investments in the subject activity: (i) the adjusted basis of the taxpayer’s capital contributions; and (ii) any borrowed amounts for which the taxpayer either is personally liable or has pledged personal property,¹⁹ but each only to the extent not protected against loss.²⁰

A. Loss Limitation in Partnerships

In the case of a partnership, the partnership’s communal activities are subject to section 465’s activity-by-activity analysis but its loss limitation rules apply to each covered partner.²¹ Though a platform for collective

¹⁶ I.R.C. § 465(a)(1) (2005). Some commentators believe that section 641(b) extends the application of section 465 to cover trusts and estates. See generally BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 28.2.2 at n.7 (RIA 2008). Closely held C corporations, for purposes of section 465, are those where more than 50 percent in value of the corporation’s stock is held, directly or indirectly, by or for five or fewer individuals. *Id.*

¹⁷ Section 465 applies to the following five specific activities: (i) the holding, production, or distribution of motion picture films or video tapes; (ii) farm operations; (iii) equipment leasing; (iv) the exploration for, or exploitation of, oil and gas resources; and (v) the exploration for, or exploitation of, geothermal deposits; and, to the extent not described by any of the foregoing, “each other activity engaged in by the taxpayer in carrying on a trade or business or for the production of income.” I.R.C. § 465(c)(1) (2005). Certain activities of closely held C corporations, however, are exempt from section 465. See I.R.C. § 465(c)(4) (2005).

¹⁸ I.R.C. § 465(d) (2005). See also Prop. Treas. Reg. §§ 1.465-2(a), -11(a), 44 Fed. Reg. 32235 (June 5, 1979).

¹⁹ I.R.C. § 465(b)(1)–(2). The amount cannot be borrowed from a person who has an interest in the subject activity, other than an interest as a creditor, or from certain parties related to a person with such an interest. I.R.C. § 465(b)(3); Prop. Treas. Reg. § 1.465-8, 44 Fed. Reg. 32235 (June 5, 1979). In addition, the pledged property cannot be property that is used in the subject activity. I.R.C. § 465(b)(2); see also Prop. Treas. Reg. §§ 1.465-25(a)(1), (b)(1), (b)(3), 44 Fed. Reg. 32235 (June 5, 1979).

²⁰ See I.R.C. § 465(b)(4) (2005); see also *infra* note 64 (discussing the poor choice of words in section 465(b)(4) that appears to suggest, incorrectly, that negation of personal liability constitutes protection against loss).

²¹ I show below that a taxpayer’s amount at risk in a subject activity represents those investments in the subject activity where the taxpayer is exposed both under law and in an economic sense. See *infra* Part III (discussing a two-part framework for analyzing a taxpayer’s at-risk claim). The adjective

action, a partnership is also a vehicle for conduit taxation. Ascertaining any one partner's tax liability entails both tracing the partnership's pooled inputs and attributing its joint output to each individual partner. Various provisions of Subchapter K engage in different aspects of this disaggregation exercise. Built-in safeguards are designed to ensure that the resulting fragmented representations essayed for tax purposes are of a piece with the partnership's true picture of shared financial benefits and burdens.

Section 465 limits a covered partner's losses from a partnership activity to the partner's amount at risk in that activity. Thus, applying section 465 to any one partner also requires a deconstruction of the partnership's performance and position. Consequently, any section 465 application in a partnership context is also vulnerable to the same mischaracterizations of the partners' underlying financial arrangement that Subchapter K seeks to guard against.

Section 465 applies to each covered partner of a partnership but only after the application of section 704(d).²² Thus, a covered partner's distributive shares of partnership losses that exceed the partner's outside basis are

"economic" has been the source of considerable confusion in applying section 465 to partnerships. Throughout the text of this article, I employ it, deliberately and consciously, to refer to the quality or state of belonging to the practical world of business and commerce. Thus, when I use it in phrases such as "economic consequences," "economic impact," and "economic reality," I intend to convey a contrast with theoretical possibilities. In the text of the article, I limit the use of the word "economic" to describe the nature of the investigation into a covered taxpayer's protection against loss where such a real world investigation is clearly required as part of a section 465 at-risk inquiry. See *infra* Part III.B. The adjective "economic" is also used by several Subchapter K provisions independent of any section 465 connotations. Two of these have relevance for this article: (i) the section 704(b) "economic effect" safe harbor prescribed by Treas. Reg. § 1.704-1(b)(2)(ii); and (ii) the "economic risk of loss" (EROL) analysis of the section 752 liability sharing rules. The section 704(b) safe harbor for determining partners' distributive shares describes the resulting allocations as having "economic effect." Economic effect in this context is used to convey a contrast with tax impact. The safe harbor seeks to ensure that the tax picture represented by the partnership's allocation of the partnership items conforms to the partner's substantive underlying arrangement—but substantive only in a financial accounting or "book" sense. This is evident from the manner in which the safe harbor endeavors to achieve "economic effect"—through financial accounting or book entries rather than a realistic assessment or practical audit. In fact, the cornerstone of the safe harbor is the proper maintenance of book capital accounts and not a market valuation. Thus, in this context, "economic" is perhaps better replaced by "financial"—at least for purposes of this article. Moreover, "economic effect" could be easily confused with testing economic consequences, as required in a protection against loss investigation in a section 465 at-risk inquiry. Therefore, I refrain from its use altogether. I refer to the section 704(b) rules governing partners' distributive shares simply as the section 704(b) safe harbor. I describe the resulting allocations as those having "financial integrity." And I allude to the partners' underlying substantive arrangement as their financial arrangement. See, e.g., text accompanying *infra* notes 24, 25, 176, and 187.

For a discussion of the EROL label of the section 752 liability sharing rules, see *infra* Part IV.C and *infra* text between notes 99 and 103.

²² See generally *Loss Limitations*, KLEINROCK'S TAXEXPERT ANALYSIS AND EXPLANATION § 404.9.2.1 (2007).

subject to section 465's loss-limitation rules.²³ Even before any application of these rules and independent of them, the progression of a partnership item of loss or deduction to a partner's individual tax return has to go through several Subchapter K check-points that police against deviations from financial facts. A partner's DRO can play an important role at various stages of such procedures. To ensure that one partner's financial burden does not masquerade as another partner's distributive share of partnership losses, all allocations of partnership items of loss or deduction must comply with the rules of section 704(b) that mandate corresponding financial decrements to the allocatee-partners' respective partnership interests, as represented by their "book" capital accounts.²⁴ To impart "financial integrity" to any such allocations that create or increase a deficit in an allocatee-partner's capital account, these rules require a DRO.²⁵ In the absence of a DRO, such allocations would lack financial integrity and, thus, could no longer be made.

Even after a valid allocation, a partner may not claim an item of loss or deduction without sufficient outside basis. For a partner with insufficient capital contributions, partnership liabilities may provide additional outside basis. The liability sharing rules of section 752 prevent one partner's exposure, under law, to the loss of personal assets from supporting another partner's tax loss.²⁶ These rules employ the analytic tool of the CLP that envisages a constructive liquidation of the partnership to reveal the partnership's recourse liabilities and ensure that their allocation among individual partners follows losses.²⁷ Consequently, partners' allocated shares of the partnership's recourse liabilities reflect the manner in which the partners would share losses related to the assets financed by these liabilities.²⁸

²³ Assuming that the partnership conducts only one subject activity, a partner's section 465 at-risk amount in the partnership and, therefore, in the subject activity can be computed as follows: Begin with the partner's outside basis in the partnership, subtract from it the partner's share of partnership non-recourse debt as well as any debt at the partner level for which the partner is not personally liable that the partner has invested in the subject activity as its capital contributions to the partnership (e.g., debt secured by the partner's partnership interest); check the remainder for protection against loss. To the extent the remainder is unprotected against loss, it represents the partner's section 465 at-risk amount. *Id.*

²⁴ See *supra* note 21 (discussing the use of the word "financial" to denote the partners' substantive underlying arrangement).

²⁵ See Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3); see also *supra* note 21 (discussing the use of the phrase "financial integrity" to denote the defining characteristic of partner allocations that result from partners' distributive shares determined in compliance with the section 704(b) safe harbor).

²⁶ See *infra* Part IV.C (discussing this functionality of the section 752 rules that uses the EROL label but is more accurately described as a "theoretical risk of financial loss" analysis).

²⁷ See *infra* Part V.D including Example 13.

²⁸ See *infra* Part V (discussing the allocation among partners of losses from the deemed disposition of the partnership's assets in Step (6) of the CLP).

A DRO is one way a partner attracts a share of the partnership's recourse liabilities.²⁹ To do so, however, a DRO must survive the CLP. Therefore, the CLP necessarily tests each DRO, distinguishes illusory from real DROs and allocates recourse liabilities only to the latter.³⁰ Another construct, that of the LSA, completes the "cycle" of recourse allocations by determining the "proper" allocation of "recourse deductions"; that is, deductions relating to assets financed by recourse debt.³¹ A liquidation sale of these assets reveals recourse deductions and ensures that their allocations have financial integrity. It does so by "supplying" a DRO to each allocatee-partner who lacks one but is otherwise obligated for the partnership's recourse liabilities. Such financial integrity may, however, be transient if the partnership repays the recourse debt but retains the assets financed by it, causing the "supplied" DRO to disappear.³² In this case, the partner previously allocated recourse deductions supported by a disappearing DRO may require allocations of income or gain to restore any impermissible capital account deficit.

By the time section 465 is applied to a partner's distributive share of partnership losses, it has already been tested for financial integrity. In addition, the partner's share of any partnership recourse liabilities has been vetted for the partner's exposure, under law, to the loss of personal assets.³³ Section 465 would then allow the partner to use the resulting loss if it is no larger than the partner's amount at risk in the partnership activity that generated the partnership item of loss or deduction in the first instance. This inquiry would readily yield to an approach based on Subchapter K's analytics of dissecting a partnership's conduct and condition. The measurement and monitoring apparatus of Subchapter K would present itself for isolating and quantifying a partner's amount at risk. In assuming this approach and employing this apparatus, one should be mindful that both the methodology and methods of Subchapter K, as conceived and designed for their original purposes, assume a partnership in substance; that is, a structure

²⁹ See *infra* Part V.D (pointing out that any partnership debt previously classified as an "unlimited liability" based on an independent examination of the creditor's repayment rights is eventually categorized as partnership recourse liability by the CLP).

³⁰ But see *infra* Part V.E (pointing out that while the CLP reveals illusory DROs, it cannot test the enforceability of any DRO). Compare *infra* Example 14 (illusory DRO), with *infra* Example 15 (unenforceable DRO).

³¹ The "cycle" of recourse allocations consists of determining the partners who are obligated for repayment of the partnership's recourse liabilities; allocating all losses financed by such liabilities to the obligated partners in proportion to their respective repayment obligations which, in turn, ensures that the recourse liabilities themselves will be allocated in such proportion. See *infra* Part VII.C (discussing why liabilities follow losses and when losses should follow liabilities) and *infra* Part VIII.A (discussing how the LSA determined allocations of recourse deductions are "proper").

³² See *infra* Part VIII.A.

³³ See *infra* Part IV.C.

where at least two partners have non-trivial shares of the partnership's combined resources. A formalistic application that is insensitive to these considerations could very well cause the inquiry to generate its own results.³⁴

B. LCL—A Partnership for What Purpose?

LCL was a partnership for federal income tax purposes. A substantial amount of LCL's debt was labeled recourse.³⁵ Each of LCL's two members had entered into DROs. These symptoms, skin deep but prominent on the face of *Hubert*, appear to have prompted the diagnostic tools of constructive liquidation and liquidation sale, followed by the wizardry of illusory and disappearing DROs.³⁶

In the hurry to diagnose and dazzle, little thought was spared on the motivation for organizing LCL as a partnership in the first place. Implicit in their use of Subchapter K's measurement and monitoring apparatus, if not explicit in the commentators' commentary, has been the assumption of a more than marginal partnership. One with at least the potential for camouflaging economic reality by shifting losses and risk of losses.

Neither the structure nor the organization of LCL contemplated such a camouflage. To begin with, virtually all, or 99 percent, of LCL's equipment leasing losses were to be used by HHC—the corporate parent and sole shareholder of HBW—which in turn held 99 percent of the membership interests in LCL.³⁷ HCC, the holder of the remaining 1 percent interest in LCL was also “connected” with HHC.³⁸

In addition, for each of LCL's two members, there was complete correspondence between, on the one hand, its allocation of LCL's losses and, on the other, its investment in LCL—both the capital it had contributed and any obligations it had undertaken for further contributions. Both members

³⁴ See *infra* Part V.2 (discussing *Rubin et al.*, *supra* note 3, “inducing” partnership recourse liabilities by a mechanistic and perfunctory application of the CLP to a stylized but inaccurate reconstruction of the facts of *Hubert I*).

³⁵ LCL's payment for its “Capital Resources Atmel” equipment purchase in 1998 included two promissory notes that were “recourse” to LCL to the extent of \$4,750,000, and \$2,750,000, respectively. Curiously, both the *IRS Brief*, *supra* note 3, and the *Taxpayer Brief*, *supra* note 3, omit any mention of the second “recourse” note from the “Capital Resources Atmel” activity. Its payment for its equipment purchases in 2000 included two notes that were “recourse” to LCL to the extent of \$340,000 (for the “28 Quarters” equipment), and \$3,225,000 (for the “20 Quarters” equipment), respectively. See *Hubert I*, 125 T.C. 72 (2005), *aff'd in part, vacated in part, and remanded by* 230 Fed. Appx. 526 (6th Cir. 2007).

³⁶ See *infra* Part V.F (discussing the misapplication of the C.L.P. to determine or quantify LCL's “unlimited” liabilities) and *infra* Part VIII (discussing the redundancy of the LSA for determining or supporting allocations of recourse deductions among LCL members).

³⁷ See *supra* note 9.

³⁸ See *supra* note 8.

were allocated losses in strict accordance with their respective membership interests. These membership interests were acquired on the same day and for the same per-unit consideration.³⁹ The two members' remaining obligations towards LCL were limited to their DROs. These two DROs were identically worded.⁴⁰ Each required the respective member to restore any deficit in its capital account upon a liquidation of its interest in LCL. The members were not directly liable for any of LCL's debt either as a consequence of a guarantee or any other assumption of LCL's performance or obligations.⁴¹ Neither member could, then, have benefited from the other's amount at risk in LCL's equipment leasing activities.

Both members of LCL, if not siblings, were at least first cousins. To what end, this incest? Why, specifically, was a partnership contrived?

The answer lies in a partnership's preferential treatment in the application of section 465 to equipment leasing activities. Section 465(c)(2)(B)(i) aggregates, and designates as a single activity, partnership equipment leasing activities "with respect to [all] properties which (i) are leased or held for

³⁹ See *supra* note 8. The Tax Court states in *Hubert I* that upon formation of LCL, HBW had "as a contribution to LCL's capital [executed] an assignment in which HBW transferred to LCL all of HBW's rights, title, and interest in its leases, subject to existing loans." *Hubert I*, 125 T.C. at 84. While the *IRS Brief*, *supra* note 3, also reports an assignment of ongoing leases, the *Taxpayer Brief*, *supra* note 3, makes no mention of it. And neither *Hubert I* nor the *IRS Brief*, *supra* note 3, includes any such contributed leases in their detailed activity-by-activity discussion of LCL's equipment leasing activities. See *Hubert I*, 125 T.C. at 86-90. It is also unclear whether HBW received any capital account credit for such contributed leases. The *IRS Brief* reports that the "book value of HBW's leases at the time of the assignment was \$1,553,264" without clarifying whether this amount included, or was net of, any assumed indebtedness. *IRS Brief*, *supra* note 3, at 11. If this reported book value was inclusive of assumed indebtedness, then it is possible that the contributed leases had no positive net book value and that HBW received no capital account credit for this contribution. If, however, the contributed leases did have some positive net book value and, further, such leases were accorded capital treatment, then HBW would have received capital account credit for this contribution in the amount of such positive net book value. In this case, HBW's capital contributions to LCL would have exceeded 99 percent of LCL's total contributed capital. This would have implications for HBW's share of any LCL debt for which the members were considered personally liable as a result of their DROs. In particular, HBW's share would no longer be a straight 99 percent of such debt but would be given, at any one point in time, by employing the CLP. See *infra* note 170.

⁴⁰ The DROs were added to LCL's operating agreement by an amendment made on March 28, 2001, but written with retroactive effect to January 1, 2000. Section 7.7 of the amended and restated LCL operating agreement read as follows: 7.7 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 ninety days after the date such liquidation, for payment to creditors or distribution to Partners with positive capital account balances. See *Hubert I*, 125 T.C. at 85.

⁴¹ Section 4.2 of LCL's operating agreement, as amended and restated on March 28, 2001, to contain the members' DROs, stated that "no Member shall be liable as such for the liabilities of the Company." *Id.* at 84.

lease, and (ii) are placed in service in any taxable year of the partnership.” Individuals and closely held C corporations engaged in equipment leasing, who are denied this special aggregation rule, must treat leasing activities relating to any given piece of equipment, regardless of the taxable year in which the equipment is placed in service, as one separate section 465 activity. In other words, these taxpayers must compute their equipment leasing losses and at-risk amounts for section 465 purposes on an equipment-by-equipment basis. As a result, a loss from one piece of equipment is tested against the taxpayer’s amount at risk in that piece of equipment alone.

By comparison, a partnership engaged in equipment leasing computes a loss for section 465 purposes by aggregating the results of leasing activities relating to all pieces of equipment placed in service in any one taxable year. A partner’s distributive share of this loss, after applying section 704(d), is tested against the partner’s total amount at risk in all such pieces of equipment. This aggregation could make available to the partner a loss that section 465 would otherwise have disallowed because of an insufficient amount at risk. The partner could use such a loss from any one piece of partnership equipment to offset its allocated income from any other piece of partnership equipment placed in service in the same taxable year. Even if none of these pieces of equipment generates any income for the partner, one or more of them may yield the partner losses that would not have been limited by section 465 in the absence of aggregation.⁴² Any such piece of equipment would then have left the partner with an “unutilized” amount at risk. Aggregation, by combining the partner’s at-risk amounts in all pieces of partnership equipment placed in service in the same taxable year, ensures that no loss from any one piece of equipment is limited while there remains any unutilized amount at risk in any other piece.

If HBW that held 99 percent of LCL’s membership interests had also owned the remaining 1 percent, then LCL would have been a disregarded entity for federal income tax purposes. The results of LCL’s equipment leasing activities (along with any other items of income, gain, loss, deduction and credit) would have been attributed in their entirety to HBW. However, HBW, as a closely held C corporation,⁴³ would not have qualified for the aggregation privileges of section 465(c)(2)(B)(i). Hence, a partnership was contrived.

⁴² This would be the case if the loss in any such piece of equipment is smaller than the partner’s amount at risk in that piece of equipment, assuming such an at-risk amount can be computed. See *infra* note 45 and accompanying text (discussing the “administrative difficulty” of making such computations for each piece of equipment).

⁴³ HBW was a closely held C corporation for purposes of, and therefore subject to, section 465. See *supra* notes 9 and 16. See also *Kalinka, supra* note 3, at 139 n.16.

Why does section 465 allow partnerships to benefit from such aggregation? According to its legislative history, it does so to ease the administrative burden of allocating a partner's at-risk amount in the partnership to each piece of equipment.⁴⁴

In a partnership that engages in more than activity subject to section 465, a partner must determine its loss and amount at risk separately for each of those activities. If the partnership's leasing activities relating to each piece of equipment were to constitute a separate section 465 activity, then a partner would have to allocate its total amount at risk in the partnership to each such activity, and hence, to each piece of equipment. This involved procedure would be rendered even more difficult if partners' ownership and (profit and) loss sharing ratios varied across assets. The carry-over basis treatment of any contributed assets would introduce additional conceptual and computational complexities. In a partnership where more than one partner has a substantial ownership or profit sharing interest, and at least one of them contributes assets with substantial built-in gain, anomalous situations could arise with one partner's amount at risk in a contributed piece of equipment exceeding that asset's adjusted tax basis.⁴⁵ To reduce the resulting complications, section 465(c)(2)(B)(i) eliminates the need for performing this allocation between the various pieces of the partnership's equipment that are leased or held for lease and are placed in service in the same taxable year.⁴⁶

⁴⁴ See STAFF OF JOINT COMM. ON TAX'N, 95TH CONG., TAX REDUCTION AND REFORM PROPOSALS, PART 2: TAX SHELTERS AND MINIMUM TAX 8, 10 (Comm. Print 1978); STAFF OF JOINT COMM. ON TAX'N, 95TH CONG., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978 130 (Comm. Print 1979). See also Craig V. Witcher, Note and Comment, *Elliston v. Comm'r: Multi-Tiered Partnerships and the At-Risk Separate Activity Controversy*, 5 VA. TAX. REV. 161, at 173-75 (1985).

⁴⁵ Consider A, a general partnership, where A_1 and A_2 are both equal general partners. A_1 contributes cash of \$100. A_2 contributes E_1 , a piece of equipment for leasing out, with a net fair market value of \$1000, an adjusted tax basis of \$0 and a useful life of five years. A buys E_2 , another piece of equipment for leasing out, with a useful life of five years, for \$1,000 using its \$200 cash and a note for \$800. The note is a general obligation of the partnership; that is, no partner has been relieved of personal liability. A_2 's amount at risk in each of E_1 and E_2 is \$50 but E_1 has an adjusted tax basis of \$0. A_2 will have the following annual depreciation deductions for the next five years: \$100 (book) in each of E_1 and E_2 ; \$0 (tax) in E_1 as a consequence of the ceiling rule; and \$100 (tax) in E_2 . If A cannot aggregate E_1 and E_2 as a single activity, then A_2 's allowable losses will be limited to \$50, one-half of its tax depreciation deductions. Aggregation will allow A_2 to take all \$100 of its tax depreciation as a loss.

⁴⁶ The cost to the fisc of this aggregation "concession" granted to partnerships, in terms of lost tax revenue, will increase if aggregation is extended to cover equipment placed in service in different years. These pieces of equipment will be at different stages of their respective depreciation schedules. Aggregating across years will allow income from older equipment (with few or no depreciation deductions) to be sheltered against (the substantial) depreciation deductions from more recent equipment. For the four specific activities, other than equipment leasing, covered by section 465, however, partnerships are permitted to aggregate activities within each category regardless of the year

None of the factors that could contribute to or exacerbate the administrative difficulty associated with allocating a partner's amount at risk in the partnership to each piece of equipment was present in LCL's case. The ownership and (profit and) loss sharing ratios of LCL's two members were constant across all of LCL's assets. In fact, LCL had only one material partner—HBW, which had both contributed almost all of LCL's cash capital and was allocated almost all partnership items.⁴⁷ Allocating HBW's amount at risk in LCL to each piece of LCL's equipment that was leased or held for lease, regardless of the taxable year in which such equipment was placed in service, would have been straightforward.

Yet HBW, and through it, HHC, availed of the aggregation advantage conferred by section 465(c)(2)(B)(i).⁴⁸ Exploiting this advantage appears to be the real motivation of organizing LCL as a partnership. Remarkably, none of the commentators of *Hubert* has commented upon it. Certainly not because this motive was difficult to divine. In fact, HHC had sought an even more aggressive interpretation of section 465(c)(2)(B)(i) by claiming a right on HBW's behalf to aggregate leasing activities with respect to all pieces of equipment without regard to the taxable year in which they were placed in service.⁴⁹ The denial of this claim and a discussion of the proper

in which the activity originated or was placed in service. Presumably, the differences in depreciation deductions across the years with these activities are unlikely to be as marked as with equipment leasing. See Temp. Treas. Reg. § 1.465-1T (1983). See also I.R.S. Notice 89-39, 1989-1 C.B. 681.

⁴⁷ LCL itself appears to have acquired all of its equipment leasing assets none of which seems to have received carry-over basis treatment. See *Hubert I*, 125 T.C. at 86-90; But see *supra* note 39 (discussing the possibility that HBW may have contributed leases with positive net book value and may have received capital account credit for such contributions).

⁴⁸ If, as reported by two commentators, *supra* note 15, both members of LCL were indeed "wholly owned subsidiaries of a common parent" (HHC) that had claimed all of LCL's losses, along with all other partnership items of income, gain, loss, deduction and credit, LCL would have been functionally equivalent to a single member LLC where the sole member was a wholly owned subsidiary of HHC. In this case, treating LCL as a disregarded entity for federal income tax purposes would have been completely justified. Consequently, the aggregation benefits that section 465(c)(2)(B)(i) confers on partnerships would have been denied to LCL. See *infra* discussion. But see *Elliston v. Comm'r*, 82 T.C. 747 (1984), *aff'd* (5th Cir. 1985) (where the Tax Court declined to "look through" a nominal upper tier partnership and allowed it the aggregation benefits of section 465(C)(2)(B)(i)).

⁴⁹ *Hubert I*, 125 T.C. at 73. Assuming HBW could have included LCL's recourse debt in its at-risk amount, HBW would have had unused at-risk basis in LCL's "Capital Resources Atmel" equipment leasing activity for LCL's taxable years 1998 and 1999 and in LCL's "20 Quarters" equipment leasing activity for LCL's taxable year 2000. Other than the "Capital Resources Atmel" activity, LCL did not have any equipment leasing activities for its taxable year 1998. It began the "ECM Blisk" equipment leasing activity in 1999, for which it had reported a loss of \$348,416 in 1999 and \$455,132 in 2000, of which HBW's allocated shares were \$344,932, and \$440,672, respectively. See *id.* at 88; see also *supra* note 11. If the "ECM Blisk" activity of 1999 and the "Capital Resources Atmel" activity of 1998 were aggregated, some of HBW's allocated loss from the former in 1999 could have been applied against the

statutory construction of section 465(c)(2)(B)(i) occupies valuable real estate in the Tax Court's first *Hubert* opinion, just north of its discussion of LCL members' DROs and their implications for the members' at-risk amounts.⁵⁰ But the analysts seem to have missed it in their hurry to get to the promised Subchapter K land.⁵¹

The effectiveness of section 465 in limiting losses lies in its separate application to each subject activity. Any aggregation of a covered taxpayer's activities before applying section 465 reduces the scope of its loss limitation impact. At an extreme, if all activities of a covered taxpayer were aggregated and considered one single section 465 activity, then none of the taxpayer's losses would be limited and section 465 would be effectively nullified for this taxpayer. To the extent that a covered taxpayer can aggregate any of its activities subject to section 465, it can negate the resulting loss limitation. Thus, any aggregation privileges conferred by section 465 on partnerships constitute a congressionally permitted dilution of its loss limitation rules. As mentioned earlier, partnerships are permitted such aggregation to ease the administrative burden of allocating a partner's amount at risk in the partnership to each partnership activity. The use of the partnership form to secure this aggregation benefit even in the absence of any allocation difficulties is well known and was judicially approved in *Elliston v.*

unused at-risk basis available in the latter that year. Though HHC's 1999 tax return was not at issue in *Hubert I*, it is possible that the taxpayer had agreed to carry forward 1999 losses to its 2000 and 2001 returns. See *supra* note 10. And if the "ECM Blisk" activity of 1999 and the "20 Quarters" activity of 2000 were aggregated, some of HBW's allocated loss from the former in 2000 could have been applied against the unused at-risk basis available in the latter that year. See *id.*

⁵⁰ *Hubert I*, 125 T.C. at 102–05. The Tax Court states in *Hubert I* that the LCL members did not have deficit capital accounts in the years at issue; that is, taxable years 2000 and 2001. See *id.* at 85. Commentators have rightly found this observation difficult to reconcile with LCL's minimal \$10,000 initial cash capitalization on the one hand, and its considerably larger losses, on the other. See, e.g., Lipton, *supra* note 3, at 332; Rubin *et al.*, *supra* note 3. Moreover, as Lipton points out, positive book capital accounts would usually imply the inapplicability of the at-risk rules. It is possible that HBW had received capital account credit for its contributed leases. See *supra* note 39. Because the contributed leases would have originated before any of LCL's four other equipment leasing activities at issue in *Hubert I*, any at-risk basis in the former would have been unavailable for losses from the later. Such at-risk basis would have been reflected in HBW's book capital account and yet not prevented loss limitation under section 465. However, this would apply only to HBW and could not explain why "in 2000 and 2001, neither HBW nor HCC had a deficit in its capital account." *Hubert I*, 125 T.C. at 85. And even for HBW, any capital account credit from contributed leases would have been overwhelmed by its allocated losses as early as LCL's first taxable year (1998). See *supra* note 11.

⁵¹ Cf. Lipton, *supra* note 3, at 327–28 (commenting on the part of the Tax Court's opinion that denies the taxpayer's aggregation claim). But Lipton does not ascribe this attempted aggregation as a motive for using the partnership form for LCL's equipment leasing activities—an omission that may not be surprising in light of the fact that he was one of the principal drafters of the *NAREIT Brief*, *supra* note 3.

Commissioner as far back as 1984.⁵² *Hubert* demonstrates that this practice is alive and well today. This is, or at any rate, should be, the first lesson of *Hubert*.⁵³

C. Hubert's First Lesson

Hubert tells us that section 465's aggregation privileges should be reserved for partners in substantial partnerships created for legitimate business purposes and denied to a partner with an almost total share of a nominal partnership with one or more marginal partners who are related entities. The anti-abuse rule of reg. section 1.701-2, designed to check transactions representing abuse of entity treatment inconsistent with the intent of Subchapter K, may be invoked in some of these cases. However, any resulting impact would be limited to after-the-fact enforcement and the IRS' ability to demonstrate an actual reduction in the taxpayer's tax liability as a consequence of forming the partnership. On the other hand, a simple amendment to section 465(c) would have a prophylactic effect. Such an amendment should set a ceiling on each partner's loss allocation ratio whose violation would cause the partnership form to be ignored for section 465's aggregation privileges.⁵⁴ Any such ceiling would have to be arbitrary and

⁵² *Elliston v. Comm'r*, 82 T.C. 747 (1984). The Tax Court in *Elliston* permitted the aggregation of different equipment leasing activities despite a tiered partnership structure where each partner's at-risk amount in every equipment leasing activity was readily discernible. The taxpayer in *Elliston*, through its interest in an upper tier partnership, held partnership interests in five different lower tier partnerships, each conducting one separate equipment leasing activity. K-1's from the five lower tier partnerships would have revealed the upper tier partnership's at-risk amounts in each. The taxpayer's pro-rata share of these amounts would have yielded its own at-risk amounts in the five separate equipment leasing activities. Regardless, the Tax Court refrained from "looking through" the upper tier partnership. See *id.* at 754. A literal reading of the aggregation rules then allowed the taxpayer to apply section 465 to its distributive share from the upper-tier partnership that necessarily represented an aggregation of the results of the five separate equipment leasing activities.

⁵³ The taxpayer did not appeal that part of *Hubert I* where the Tax Court rejected the taxpayer's "aggressive" interpretation of the aggregation rule of section 465(c)(2)(B)(i) and limited aggregation to activities originating in the same year. Without an at-risk amount in any of LCL's debt, almost all losses would have been denied in any case, see *supra* note 11, and aggregation of activities in different years would have made no difference to the taxpayer's tax liability.

⁵⁴ For purposes of this "substantial partnership test," the loss allocation ratio must necessarily be applied to the amount of losses allowed after, rather than before, aggregation. Computation of losses allowed before aggregation would require determining each partner's at-risk amount in every equipment leasing activity and, therefore, defeat the very purpose of permitting aggregation. Making such a determination of each partner's at-risk amount in every activity should be reserved only for cases that fail the "substantial partnership test." As a result of aggregation, losses from one activity could be applied against another activity's "unutilized" at-risk amount; or offset by any income from another activity. The former, by itself, would increase total losses allowed after applying section 465. The latter, alone, would

would, at the margin, discriminate against some legitimate partnership arrangements by withholding section 465's aggregation privileges. However, conferring such benefits is motivated by administrative ease rather than any policy concerns. Consequently, denying them on an arbitrary basis would be eminently defensible.

Checking the misuse of the partnership form to exploit section 465's aggregation rules is the first Subchapter K lesson we can learn from *Hubert* on the proper application of the at-risk rules to partnerships. It is also the only lesson that this case can teach us in this area. The remaining lessons on the interplay between Subchapter K and section 465 that I discuss below are sourced not to the case itself but instead to the commentary surrounding it.

D. LCL—An LLC to What End?

The use of the partnership form for LCL does not appear to have served a legitimate business purpose. In contrast, the use of the LLC structure could only have been motivated by valid business reasons— to protect HBW's assets, other than those held through LCL, from LCL's creditors. LCL had financed the acquisition of a substantial part of its equipment leasing assets with debt. Most of this debt was true non-recourse debt; that is, state law nonrecourse debt secured by specific pieces of equipment. But a portion of the debt was recourse to LCL. For satisfaction of this debt, the creditors' remedies were not limited to any particular assets of LCL. Instead, the creditors could pursue all of LCL's assets not otherwise encumbered. However, LCL's limited liability shield would prevent the creditors from pursuing the assets of LCL's members that these members held outside of LCL. None of the terms of LCL's recourse debt made it recourse to either

lower the amount of losses subject to section 465 and, therefore, result in lower losses allowed after applying section 465. To reveal the full benefits of aggregation, any losses offset by income from another activity should be added back. This would be done at the activity level and not at the partner level and, therefore, would not raise the issues of "administrative difficulty" associated with computing each partner's at-risk amount in every activity that had justified aggregation in the first place. In fact, all partnerships compute financial results on an activity-by-activity basis regardless of any aggregation allowed. LCL itself had done so for each of its four separate equipment leasing activities. *See supra* note 11. Once any losses offset by income from another activity have been added back, the resulting figure should be allocated among the partners in accordance with the proportion that the partnership agreement provides for sharing such losses. If any one taxpayer-partner is allocated above a specified percentage, say 80 percent, of this figure, the partnership would fail the "substantial partnership test" and aggregation would not be allowed.

Consideration should also be given to applying such a "substantial partnership test" to the other four specified activities subject to section 465 in addition to equipment leasing. *See supra* notes 17 and 46.

of LCL's two members—HBW and HCC. Therefore, LCL's recourse debt constituted an exculpatory liability of LCL. Unless HBW affirmatively undertook any additional obligations, its liability for LCL's recourse debt was limited to its stake in LCL—the small amount of cash capital contribution that it had previously made.

HBW could not have been a thinly capitalized company with assets limited to its membership interests in LCL as one commentator has speculated.⁵⁵ If it were, then there would have been no need to restrict any equipment leasing related debt to LCL's level. HBW itself could have issued this debt. And all of it could have been with full recourse to HBW. HBW's corporate form would have provided the requisite limited liability shield. This would have safeguarded the non-equipment leasing assets of HBW's parent, HHC, and of HHC's ultimate owners, from the creditors who held HBW's equipment leasing related debt. HBW could then have included all of this debt, for which it would have been personally liable, as its amount at risk in LCL's equipment leasing activities. Instead, HBW interposed LCL between itself and the debt holders. LCL's limited liability shield must have been protecting HBW's assets that HBW held outside of LCL. There is nothing illegitimate or even abusive from a tax perspective about seeking and obtaining such protection from liability to creditors. But limited liability necessarily implies reduced risk. However, while hiding behind LCL's limited liability shield from LCL's creditors, HBW was unwilling to concede a reduction in its amount at risk in LCL to the IRS. Hence, the resort to a DRO.

HBW, through HHC, claimed that the DRO expanded HBW's amount at risk in LCL beyond HBW's small cash capital contribution to include HBW's pro-rata share of the debt that was recourse to LCL. Equating the DRO to "other assets of the company" that LCL's recourse creditors could reach, the taxpayer contended that as a consequence, HBW was obligated to make further capital contributions to the extent that LCL was otherwise unable to repay its recourse debt.⁵⁶

LCL represented a partnership where the two partners' partnership interests were not so much joint as adjoining. The two partners' relationships, with each other, with the partnership and with third parties, were perfectly symmetrical. HBW's 99 percent share and HCC's 1 percent share applied uniformly and consistently to all dimensions of ownership and operations—including capital contributions, claims on assets, profit and loss sharing and exposure (or lack thereof) to the loss of personal assets on

⁵⁵ *Kalinka*, *supra* note 3, at 150 ("If [HBW and HCC] were both thinly capitalized corporations, neither would be treated as bearing the economic loss for LCL's partially recourse liabilities").

⁵⁶ *See Taxpayer Brief*, *supra* note 3.

account of the partnership's debt. Neither partner was entitled to any preferential treatment in cash distributions or priority returns. Nor was either partner disproportionately burdened. LCL had received no partner (or related party) loans or any partner (or related party) guarantees of third party loans. Other than their identical DROs, the two partners had no further commitments to LCL. Neither partner was directly obligated, or had otherwise assumed any of LCL's obligations, to any creditors, suppliers or customers. As a result, the two partners' partnership interests could be easily, neatly and completely severed without altering any aspect of their substantive economic relationship. To see this, engage in the following thought experiment.

Assume that the amendment to the aggregation rules of section 465 proposed earlier⁵⁷ had actually been adopted and was in effect at all times relevant to this case. HBW would then have no reason to contrive a partnership by fabricating a marginal partner in the shape of HCC. However, HBW would still have every reason to minimize its non-equipment leasing assets from the creditors holding any of HBW's equipment leasing related debt. Consequently, HBW would still have structured its equipment leasing activities in a limited liability entity. And HBW would still be confronted with the problem of demonstrating an adequate amount at risk in this entity. Assume that HBW sought to accomplish the former with an LLC and the latter with a DRO.

Assume further that for some reason HBW wishes to own and lease only 99 percent, and insists on HCC owning and leasing the remaining 1 percent, of each piece of equipment that, in actuality, LCL had owned and leased.⁵⁸ HBW forms a single member LLC (call it HBW's LLC) that directly holds a 99 percent fractional interest in every one of these equipment leasing assets. The residual 1 percent fractional interest in all of these assets is owned by another single member LLC (call it HCC's LLC), all of whose membership interests are held by HCC. HBW capitalizes HBW's LLC with the same cash capital that it had contributed to LCL. Similarly, HCC pays the same consideration for the membership interests of HCC's LLC that it had paid for acquiring its share of LCL's membership interests. Compare and contrast this hypothetical construct of two single-member LLCs with the true facts of two-member LCL, as they had presented themselves in *Hubert*.

Debt, in the same amount and with the same security, could be replicated with the two single-member LLCs. LCL's true non-recourse debt could continue to be secured by the same identified assets except, instead of being

⁵⁷ See *supra* note 55 and accompanying text.

⁵⁸ Assume that each piece of equipment is jointly owned as a tenancy in common that does not constitute a partnership for tax purposes.

owned by LCL, each of these assets would be co-owned in a 99:1 proportion by HBW's LLC and HCC's LLC, respectively. LCL's recourse debt could be divided into two components. Ninety-nine percent of this debt would be recourse to HBW's LLC, without recourse to HBW and, therefore, an exculpatory liability of HBW's LLC. One percent of this debt would be recourse to HCC's LLC, without recourse to HCC and, thus, an exculpatory liability of HCC's LLC.

The DROs of LCL's two members could also be cloned, in wording and working, with two single-member LLCs. The respective member of each of the two single-member LLCs would enter into a DRO that would obligate it to restore a deficit in its capital account upon a liquidation of its interest. With LCL's assets directly owned in a 99:1 proportion by the two single-member LLCs, each of HBW's and HCC's rights to the equipment leasing assets and the resulting profits and losses would remain the same. Specifically, the financial and tax results of HBW's LLC would be identical to those reported by HHC on account of HBW's 99 percent ownership interest in, and pro-rata share of, LCL's equipment leasing activities.

With LCL's debt and its members' DROs reproduced in the two single-member LLCs, each of HBW's and HCC's obligations to creditors would remain unaltered. As with LCL, HBW could claim an amount at risk that exceeds its cash capital contribution to HBW's LLC only by using its DRO. Its contention would be that the DRO would require HBW to make additional capital contributions in the event that HBW's LLC was unable to repay its recourse debt. In verifying this claim in the context of a single member LLC, adopting the mechanics or adapting the mechanisms of any Subchapter K provisions would be entirely inappropriate.⁵⁹ Yet commentators of *Hubert* have chosen to do exactly that in examining an identical claim made under functionally equivalent economic circumstances. Fixating on the partnership façade, rather than focusing on the underlying economic substance, these commentators have sought both inspiration and insights from the section 752 liability sharing rules.

E. *Meanwhile, Back at the Ballgame*

These rules designed for peering through any obfuscating details of a partnership agreement to reveal the presence and extent of a partner's true obligations, under law, for repayment of a partnership's liabilities are redundant in the case of LCL where the partners' arrangements were completely transparent. Worse, their application to determine HBW's

⁵⁹ See discussion *supra* notes 15 and 48.

section 465 at-risk amount in LCL frames the wrong questions. The answers educed by these questions end up speaking past the facts of the case.

Whereas the case demanded to know whether HBW's DRO was enforceable, the inquiry could only reveal if the DRO was illusory; that is, if there would be a deficit for HBW to restore upon liquidation.⁶⁰ Whereas the facts asked whether as a result of their DROs, LCL's members were liable to LCL's recourse creditors, the inquiry could only answer whether the members' DROs caused one partner's exposure to loss to be disguised as another partner's allocated share of LCL's recourse debt. Whereas the issue at hand was whether HBW's DRO increased its amount at risk in LCL beyond its distributive shares of losses, the inquiry could only verify whether the DRO imparted financial integrity to these distributive shares.

Look, all I wanna know is when you allocate LCL's losses among its members and the taxpayer with losses files its tax return, how does this taxpayer sign its return?

Hu.

The business.

Hu.

How does it sign—

That's how it signs the return.

Who?

Yes.

The homophony of an “economic risk of loss” (EROL) analysis under section 752 with an “amount at risk” analysis for section 465 purposes is deceptive.⁶¹ Enticed by it, commentators of *Hubert* have embraced the section 752 rules ignoring both the specialized nature of the substantive investigation they conduct under the EROL label and the complete absence of need for such a scrutiny in LCL's case. As a result, the investigators extract responses that, while completely accurate are also entirely irrelevant to HBW's at-risk claims.

All I'm trying to find out is which partner is at risk.

No. Which partner has a DRO.

I'm not asking you who's got a DRO.

Hu's at risk.

One concept at a time!

Well, don't change the partners around.

⁶⁰ See *infra* Example 14 (discussing and demonstrating an illusory DRO).

⁶¹ See *infra* Part IV.C (discussing why the EROL label may be a misnomer in a section 465 at-risk inquiry).

I'm not changing nobody!

Take it easy, buddy.

I'm only asking you, who's the one at risk?

That's right.

OK.

All right.

PART III. A TWO-PART FRAMEWORK

The section 752's liability sharing rules were both unnecessary and misapplied for determining LCL members' section 465 amounts at risk. As a result of this misapplication and the accompanying commentary, however, *Hubert* has emerged as a case study on whether, when and how a section 752 analysis designed to allocate a partnership's liabilities among partners can further an inquiry into a partner's section 465 at-risk amount in such partnership liabilities.

As mentioned above, a taxpayer covered by section 465 may include in its amount at risk in a subject activity not just its capital contributions but also certain kinds of borrowings invested in the activity.⁶² I now present a simple two-part framework for analyzing and resolving whether any given borrowing is so includable. The first part of this framework deals with a set of legal relationships while the second relates to a set of economic consequences.

This framework is based on both the intent and substance of the section 465 at-risk rules. The intent is evident from section 465's legislative history and its successive amendments as well as the organization and over-all design of both the statute and the relevant regulations—final, temporary and proposed. The substance is revealed by the “solved” regulatory examples. Unfortunately, the statutory and regulatory expression is not always faithful to the underlying concepts. In critical places, the choice of words is poor and the use of terminology imprecise.⁶³ The “right” solutions of the solved

⁶² See *supra* Part II.A.

⁶³ See, e.g., I.R.C. § 465(b)(4) (2005) (“Notwithstanding any other provision of this section, 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.”) (emphasis added). See also Prop. Treas. Reg. § 1.465-6, 44 Fed. Reg. 32235 (June 5, 1979), Example 3 (characterizing a circumstance that removes the taxpayer's personal liability as “effective protection against loss). Nonrecourse financing, by definition, implies a lack of personal liability. Thus, a literal construction of section 465(b)(4) and the example cited above would yield the following inferences: A negation of personal liability results in protection against loss. Consequently, an absence of protection against loss must necessarily create personal liability. However, a broader reading of the statutes and regulations reveal these constructions to be inaccurate and, therefore, the inferences untenable. Personal liability and absence of protection against loss are clearly envisaged as two independent requirements. Several

examples often appear to be arrived at by the wrong (or no) method.⁶⁴

These solutions convey the substantive result—including or excluding a borrowed amount in a taxpayer's amount at risk. They are "right" in the sense that they conform to the outcomes required by the regulations. However, the accompanying analysis is not always illuminating and often tautological. As a result, a cursory reading may leave the reader uncertain about the determinative factor in concluding that a taxpayer is not at risk for a borrowed amount under a given set of circumstances. This failure to trace the causal chain for denying at-risk treatment for stylized borrowings can and has engendered confusion in real world applications as manifest in court opinions and published articles.⁶⁵ The inconsistent approaches and contradictory conclusions presented there have constituted the background noise surrounding, and often drowning out, the at-risk argument in *Hubert*.

Tuning out this discordance, I home in on the regulatory core of the section 465 at-risk rules' treatment of borrowings—the substantive result of inclusion or exclusion under different circumstances. To this core, I have attempted to provide a uniform and consistent textual, theoretical and paradigmatic covering. The two-part framework developed below thus seeks to synthesize the regulatory examples by supplying their results with both an explanatory overlay and a conceptual underpinning. When specific scenarios sketched in these regulatory examples are examined under this framework, the examination arrives at the right solutions by the right methods. These methods consist of the rules of decision for including or excluding a specific borrowing in a taxpayer's at-risk amount that follow from employing the framework to analyze these scenarios. They are "right" in the sense that when directly applied to scenarios not presented in the regulations but encountered in court cases and journal articles, they yield results that are consistent with the outcomes envisaged by the statute.

provisions demonstrate this. In particular "qualified nonrecourse financing" secured by real property constitutes an exception to the at-risk rules so long as "no person is liable for repayment." Treas. Reg. § 1.465-27(b)(1)(iii). Neither section 465(b)(6) creating this exception, nor Treas. Reg. § 1.465-27 implementing it, mentions protection against loss. In fact several regulatory examples, such as Treas. Reg. § 1.465-27(b)(6), and Examples 1, 2, and 3, and show taxpayers not protected against loss who are, nonetheless, eligible for the qualified nonrecourse financing exception. The implication is that absence of protection against loss does not create personal liability. If it did, then, in these examples one or more persons would have been personally liable for repayment and the qualified nonrecourse financing exception would not have been available. Conversely, no examples show taxpayers who are eligible for this exception by virtue of being protected against loss. The implication is that protection against loss, without an explicit negation of personal liability, is not eligible for this exception. Thus, personal liability and absence of protection against loss are independent conditions. See also *infra* note 89.

⁶⁴ See *infra* Part III.C.

⁶⁵ See *infra* Part IX.B for examples of confusion in court opinions. See also *infra* note 79 for examples of confusion in published articles.

By comparison, when confronted with these fact patterns, judges and academics have often formulated rules of decision that are at variance with these right methods. Such methods, wrong under the framework presented below, appear to both misconstrue the intent of the at-risk rules and misconstrue their substance. Applying these “alternative” methods can frequently, though not always, deliver the “wrong” results—suggesting the exclusion of a borrowed amount in situations equivalent to those where the statute contemplates inclusion.⁶⁶ The potential for such errors is greatest where, as in a partnership, the identity between the taxpayer and the borrower breaks down.

A. *Set of Legal Structures*

To be included in a taxpayer’s at-risk amount, a loan should satisfy two broad sets of constraints. The first set of constraints specifies requirements for the legal relationships created by the borrowing. I label this the set of legal structures. The second set of constraints specifies economic outcomes whose probability of occurrence should not have been negated by the conduct of the subject activity following the borrowing. I label this the set of economic consequences.

The set of legal structures applies to two discrete relationships created by the borrowing: (i) one between the taxpayer and the borrowing; and (ii) the second between the borrower and the creditor. The use of the taxpayer in the first relationship and the borrower in the second relationship is deliberate. As shown below, this difference must be consistently and carefully observed in the context of a loan made to a partnership where the partner allocated a share of this loan is the taxpayer covered by section 465 even though the partnership is the borrower.

The set of legal structures itself imposes two basic requirements: (i) the loan must “adhere” to the taxpayer under applicable law; and (ii) the taxpayer must be exposed, under law, to the loss of personal assets for its repayment.

1. ADHERENCE UNDER LAW

For the borrowing to adhere to the taxpayer, the applicable law governing the loan should recognize the taxpayer as the borrower. The applicable law may be the terms of a contract. Thus, the taxpayer may be the named borrower under the original loan instrument, as modified, or become

⁶⁶ See *infra* Examples 10–12 and accompanying text.

the named borrower pursuant to an assumption agreement. Without being the contractually named borrower, the taxpayer may nonetheless accede to the borrower by operation of commercial, bankruptcy, corporate or any other substantive body of law that applies. For example, the taxpayer as the guarantor may be required to assume the borrower's obligations upon a default on the loan. Similarly, a bankruptcy of, or merger with the borrower may cause the taxpayer to become a successor in interest to the borrower and its obligations.

Where the taxpayer is the contractually named borrower, the borrowing adheres to the taxpayer upon effectiveness of the contract. Where the taxpayer accedes to the borrower by operation of applicable law, the borrowing adheres to the taxpayer when the applicable law takes effect. Thus, a taxpayer's guarantee of a third party's debt does not cause the debt to adhere to the borrower until the third party defaults and the taxpayer is required to honor its guarantee.⁶⁷

The requirement that the borrowing adhere to the taxpayer under applicable law is purely a matter of legalistic form. It is concerned only with the loan's *de jure* status and is not affected by the taxpayer's *de facto* liability for its repayment. This requirement of adherence under law cannot be met by economic responsibility for a loan where applicable law recognizes, or could recognize, another taxpayer as the borrower. The adherence of a borrowing to a taxpayer, though it forms the first step in our section 465 at-risk inquiry, cannot be resolved by the at-risk rules. A decision can be reached only by appealing to a substantive body of law that governs the borrowing.

Support for requiring the borrowing to adhere to the taxpayer can be found in the so-called "guarantee rule" of prop. reg. section 1.465-6(d) under which a guarantee does not increase a taxpayer's at-risk amount until the taxpayer is required to make payments on the guaranteed debt.⁶⁸

Two taxpayers, whether or not covered by section 465, could not both be at risk, in an economic sense, for the same dollar of borrowing. Requiring the borrowing to adhere to the taxpayer under applicable law can, therefore, be justified as a means of preventing any one dollar of borrowing

⁶⁷ Similarly, the debt adheres under law to a successor in interest only upon a declaration of bankruptcy or a consummation of merger.

⁶⁸ See Prop. Treas. Reg. § 1.465-6(d), 44 Fed. Reg. 32238 (June 5, 1979). In addition, the taxpayer must not enjoy any recovery rights against the third party who was the "primary obligor." Such rights must be examined under the set of legal structures for their legal implications, and not under the glare of economic reality. See *id.* (requiring the taxpayer's amount at risk to be increased only "at such time as the taxpayer has no remaining legal rights against the primary obligor") (emphasis added). See also *infra* Part IV.C (discussing the perceived proper examination of recovery rights against other partners in a partnership and against third parties) and *infra* note 79 (discussing the perceived inconsistency of the guarantee rule with Prop. Treas. Reg. § 1.465-24(a), 44 Fed. Reg. 33242 (June 5, 1979)).

from being included in two different taxpayers' at-risk amounts.⁶⁹ Any one dollar of borrowings can adhere to at most one taxpayer, at a given moment in time.⁷⁰ Thus, where the borrower is another taxable entity, separate from and independent of the taxpayer covered by section 465 that is the focus of our analysis, the borrowing should not be deemed to adhere to this taxpayer so long as it can adhere to the borrowing taxable entity.

However, where the borrower is a non-taxable entity, a pass-through entity (a partnership) or a disregarded entity (a single member LLC), the borrowing can never adhere to the borrowing entity. But the borrowing may adhere to a covered taxpayer with an ownership interest in such a non-taxable borrowing entity. For this: (i) the non-taxable entity must be the contractually named borrower or have acceded to the original borrower; and (ii) the covered taxpayer must have been allocated the non-taxable entity's borrowing and such an allocation must be independently valid under applicable law. For a single member LLC, the allocation of all such borrowings to the sole member will be trivially valid. For a partnership, the allocation to a partner must comply with the section 752 liability sharing rules.

The requirement that a borrowing adhere to the taxpayer is merely a generalization of the basis limitation of losses that applies to capital assets. The following is a conclusive test to determine whether and when a borrowing adheres to a given covered taxpayer. Any one dollar of borrowings adheres to this taxpayer if and when the taxpayer could include that dollar in its basis for the subject activity assuming the subject activity constitutes a capital asset. Where the subject activity is conducted by a partnership, a partner's partnership interest is, in fact, a capital asset that includes or consists of the subject activity.⁷¹ A dollar of the partnership's debt adheres to a partner if and only if the partner could include that dollar

⁶⁹ See, e.g., Charles R. Levun, *The At-Risk Rules and Limited Liability Companies*, CCH PARTNERSHIP TAX PLANNING AND PRACTICE (No. 120) 11 (Aug. 26, 1998) ("Prop. [Treas. Reg. §] 1.465-6(d) should be interpreted as providing a rule that a liability cannot be counted twice.").

⁷⁰ The requirement of adherence under law is sufficient but not necessary for this result and, thus, might be over-inclusive in some situations. Where a covered taxpayer (individual or closely held C corporation) guarantees the debt of an uncovered taxpayer (widely held C corporation), only the former would have an at-risk amount and, therefore, the violation of the adherence under law requirement would not result in the same dollar of borrowings being included in two taxpayers' at-risk amounts. The exact implication of the adherence under law requirement is the following. It prevents any one dollar of borrowings from being included in two different taxpayers' respective bases for the subject activity if the subject activity were to constitute a capital asset. See *infra* Examples 1, 2, and 3 discussing this "basis test."

⁷¹ The partnership may conduct more than one activity, not all of which may be subject to section 465.

in its outside basis for its partnership interest. The following examples demonstrate this requirement.⁷²

Example 1. A buys Parcel 1, a parcel of farm-land, to engage in the activity of farming for a purchase price of \$10,000 by borrowing the entire amount from B on a full recourse basis. C, who farms on Parcel 2, an adjoining parcel of farm-land, guarantees repayment of A's \$10,000 loan in exchange for the right to use A's tractor on Parcel 2 for a specified number of hours.⁷³ A, B and C are unrelated to each other. A can include the \$10,000 loan in its basis for Parcel 1. Thus, if A's activity of farming consisted solely of holding Parcel 1 as a capital asset, A could have included the \$10,000 loan in its basis for the subject activity. Therefore, the \$10,000 loan adheres under law to A. C cannot include any part of the \$10,000 loan in its basis for Parcel 2. Thus, if C's activity of farming consisted solely of holding Parcel 2 as a capital asset, C could not have included the \$10,000 loan in its basis for the subject activity. Therefore, no part of the \$10,000 loan adheres under law to C.⁷⁴

Example 2. A and C organize an LLC to engage in the activity of farming. The LLC acquires Parcel 1 for \$10,000 by borrowing the entire amount from B. The loan is recourse to the LLC but not to either member. C guarantees repayment of the LLC's loan and contributes Parcel 2 that is valued at \$10,000 and free of debt. A contributes \$10,000 in cash. The section 752 liability sharing rules allocate all \$10,000 of the LLC's loan to C.⁷⁵ Each of A and C has an outside basis for its respective membership interest in the LLC. A's outside basis equals \$10,000 and consists of its cash contribution. C's outside basis equals \$20,000 and consists of its \$10,000 cash contribution and \$10,000 of the LLC's loan allocated to C. Thus, all \$10,000 of the LLC's loan adheres under law to C and no part of it adheres to A.⁷⁶

⁷² Unless otherwise indicated, all taxpayers featured in the examples of this article and denoted by letters of the alphabet, with or without numerical subscripts, are individuals covered by section 465.

⁷³ Thus, C furnishes the guarantee as part of its farming activity.

⁷⁴ The result would be the same if A's loan were a state law nonrecourse debt secured only by Parcel 1. All \$10,000 of the loan would adhere under law to A, but A would not be personally liable and, therefore, not at risk for it.

⁷⁵ The section 752 rules will recognize C's guarantee outside the CLP. See *infra* Example 14.

⁷⁶ The following variation on the facts of Example 2 would present a more difficult case. Example 2(a). A and C organize an LLC to engage in the activity of farming. A, who had had previously acquired Parcel 1 by borrowing \$10,000 from B on a full recourse basis, contributes it to the LLC subject to the debt, in addition to making a cash capital contribution of \$10,000. C guarantees the loan in addition to contributing Parcel 2 that is valued upon contribution at \$10,000 and free of debt. The LLC's operating agreement allocates all partnership items between the two members equally. If, upon contribution, B releases A from personal liability for the loan, viewing C's guarantee to be sufficient

Example 3. The facts are the same as in Example 1 except C is a general partnership comprised of C_1 and C_2 , both equal general partners who agree to share profits and losses equally. C is neither a named borrower nor has it acceded to A as the borrower. Under the terms of the loan, A is the named borrower. Therefore, all \$10,000 of the loan adheres under law to A and no part of it adheres to C.

Example 4. The facts are the same as in Example 1 except A declares personal bankruptcy and defaults on the loan. The creditor calls C on its guarantee and C is required to make payments on the loan. C accedes to A as the borrower and all \$10,000 of the loan adheres under law to C.

Example 5. The facts are the same as in Example 1 except C is a general partnership comprised of C_1 and C_2 , both equal general partners who agree to share profits and losses equally. Further, A declares personal bankruptcy and defaults on the loan. The creditor calls C on its guarantee and C is required to make payments on the loan. C accedes to A as the borrower and the section 752 liability sharing rules allocate the \$10,000 loan equally to C_1 and C_2 . Each of C_1 and C_2 has an outside basis for its respective general partnership interest that includes one-half or \$5,000 of the loan allocated to it. Thus, \$5,000 of the loan adheres under law to each of C_1 and C_2 .

There is nothing remarkable about requiring a borrowing to adhere to the taxpayer under applicable law before a taxpayer can include it in its at-risk amount. Nor does this requirement represent an additional substantive limit where the basis limitation rules apply. However, making this requirement explicit places in their proper contexts regulatory conclusions regarding the exclusions of certain borrowings from the respective taxpayer's at-risk amounts. In the absence of recognizing this requirement, such conclusions are narrowly construed and misinterpreted. The guarantee rule

security, then following contribution, the loan would be recourse to the LLC and, disregarding C's guarantee, without recourse to either member. In this case, the analysis would proceed as in Example 2 with all \$10,000 of the loan adhering under law to C. If, however, upon contribution, B does not release A from personal liability on the loan, then the section 752 liability sharing rules will recognize both A's personal liability and C's guarantee. See Treas. Reg. § 1.752-2(b)(3)(i)-(iii) (as amended in 2006). Neither A nor C is required to make additional capital contributions and, therefore, has a DRO. Each of A and C would be supplied with a DRO in the amount of \$10,000—the limit of its exposure to the loss of personal assets for repayment of the loan. See *infra* Part VII.A discussing a “supplied” DRO for a partner who lacks an actual DRO but is otherwise statutorily or contractually obligated for partnership debt. See also *infra* Part VIII discussing both the need and redundancy of the LSA in this context. The LSA would indeed be redundant in this case because A and C had made equal capital contributions, share losses equally and their repayment obligations are identical. Therefore, the section 752 rules will allocate \$5,000 of the loan to A and \$5,000 to C. Thus, \$5,000 of the loan would adhere under law to each of A and C. The CLP can validate this result. See *infra* Example 20.

mentioned earlier is properly seen as a manifestation of this requirement.⁷⁷ Instead, commentators have read the rule as a substantive regulatory provision that denies at-risk treatment to guarantees under section 465.⁷⁸ This narrow and erroneous construction contradicts the treatment, approved by the same regulations, of a partner's guarantee of partnership debt.⁷⁹ As Example 2 shows, such a partner guarantee serves to attract, and allocate to the guarantor-partner, for section 752 purposes, the amount of the partnership debt. Depending upon the satisfaction of other constraints that I discuss below, such an allocated amount of partnership debt may be includible in the partner's at-risk amount.⁸⁰

The inquiry should not merely focus on the fact that a guarantee was furnished. Instead, it should consider the broader question of whether, as a consequence of the guarantee, the borrowing has adhered to the taxpayer under applicable law. In Example 1, under the applicable contract and commercial law, the answer to that question is no. In Example 2, under the

⁷⁷ See *supra* note 68 and accompanying text.

⁷⁸ “[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.” Prop. Treas. Reg. § 1.465-6(d), 44 Fed. Reg. 32238 (June 5, 1979) (emphasis added). Commentators have read the word “person” to include a partnership and constructed the rule to imply that with the partnership as the primary obligor, no partner could include partnership debt in its at-risk amount. Hence, the perceived inconsistency with Prop. Treas. Reg. § 1.465-24(a), 44 Fed. Reg. 32242 (June 5, 1979), under which partners can receive at-risk treatment when the “partnership incurs a liability in the conduct of an activity and under state law [the partners are] held personally liable for repayment of the liability” for which a guarantee alone, without any payments on the guarantee, suffices. Reading the word “person” in Prop. Treas. Reg. § 1.465-6(d) to include a partnership and recognizing the partnership as the primary obligor is at odds with the look-through treatment that both the proposed and the final regulations accord to partnerships in this regard. *Id.* See, e.g., Treas. Reg. § 1.465-27(b)(4) 62 Fed. Reg. 43295 (Aug. 13, 1997) (“[T]he personal liability of any partnership for repayment of a financing is disregarded” for purposes of the qualified nonrecourse financing exception).

⁷⁹ See, e.g., 65-9 New York University Annual Institute on Federal Taxation 9.02 (6)(a) (“Prop. Treas. Reg. § 1.465-24(a)(2) is inconsistent with Prop. Treas. Reg. § 1.465-6(d) because under [the former], no payment need be made in order for a guarantee to increase a taxpayer's amount at-risk.”) and the sources cited therein, including Marvin S. Cash, *The Application of the At-Risk Rules to Limited Liability Companies*, 14 VA. TAX REV. 483, 497-501 (1994); Richard W. Harris & Louis H. Moran II, *Guaranteed LLC Debt: Does the Guarantor-Member Receive At-Risk Basis?*, 91 J. TAX'N 16 (1999); Larry E. Ribstein & Robert R. Keatinge, § 17.9. *Determination of Members' Basis in LLC and the LLC's Basis in Its Property*, 2 RIBSTEIN & KEATINGE ON LTD. LIAB. COS. §17:9 (1993). See also Lipton, *supra* note 3, at 330 (lamenting the “long-standing” conflict between the two proposed regulations). Cf. Levun, *supra* note 69 (“Prop. [Treas. Reg. §] 1.465-6(d) should not be interpreted to provide a per se rule that a guarantor does not receive an amount at-risk until the payment is made under his guarantee.”).

⁸⁰ See *infra* Part III.C.2 discussing the remaining constraints under the set of legal structures (requiring exposure to the loss of personal assets upon no other contingency except default on the debt) and *infra* Part III.B discussing the constraints imposed by the set of economic consequences (requiring an absence of protection against loss).

applicable law of partnerships and section 752, the answer is yes.

2. PERSONAL EXPOSURE

The second broad requirement imposed by the set of legal structures relates to the legal implications of a default on the loan. Specifically, it requires the taxpayer's exposure, under law, to a loss of personal assets for repayment of the loan. This exposure, at least for section 465 purposes, can itself be parsed into three separate conditions: (i) the availability of the covered taxpayer's personal assets to the creditor; (ii) for satisfaction of the debt; (iii) upon the occurrence of no other contingency except a failure to repay the loan. Each of these conditions encapsulates a ramification of one or more provisions of law that would ensue following a default but does not consider the probability of any actual default.

Support for requiring the taxpayer to be exposed, under law, to the loss of personal assets for repayment of the loan is found in the statute itself. The statute also endorses establishing this exposure by establishing the three conditions enumerated above. Though section 465(b)(2)(A) requires that a taxpayer be "personally liable for the repayment" of any borrowings that are included in the taxpayer's at-risk amount, section 465(2)(B) offers the taxpayer an alternative. Borrowings for whose repayment the taxpayer is not personally liable can, nonetheless, be included in the taxpayer's at-risk amount if the taxpayer "has pledged [personal] property, other than property used in [the subject] activity, as security for such borrowed amounts (to the extent of the net fair market value of the taxpayer's interest in such property)."⁸¹

Assuming personal liability, or being held personally liable for repayment of a loan, creates an exposure, by word, to the loss of personal assets upon a default. By comparison, securing a loan by a pledge of personal property not used in the subject activity effectively creates, by affirmative act, such an exposure to the loss of personal assets upon a default.

Personal liability may follow from the terms of the loan or a related contract; or background law; or a combination of the two. For example, a partner who is covered by section 465, may assume personal liability for repayment of the partnership's debt by furnishing a guarantee or may be held personally liable for the debt by virtue of being a general partner of the partnership. A taxpayer's personal liability may be unlimited or limited to a specific dollar amount. In contrast, a pledge of personal property not used in the subject activity necessarily limits, to the property's net fair market value, the taxpayer's exposure to the loss of personal assets.

⁸¹ I.R.C. § 465(b)(2)(B) (2005).

The equivalence under statute of a pledge of personal property with personal liability for repayment validates the three constituent conditions listed above of the taxpayer's exposure, under law, to the loss of personal assets upon a default. When a covered taxpayer secures debt financing for a subject activity by pledging personal property not used in the activity, such property, by definition, cannot be included in the taxpayer's capital contribution to the activity. Even so, the taxpayer stands to lose the pledged property if the activity's resources and returns are inadequate to satisfy the debt. The creditor can directly foreclose on the pledged property upon a default regardless of its cause or the presence or absence of any other circumstances. It follows that to be personally liable for a loan, the taxpayer must stand to lose its personal assets; that is, assets not used in the subject activity. Further, the creditor should be able to access such personal assets and apply them towards the outstanding loan if the subject activity is unable to make timely payments. Finally, the taxpayer's loss of its personal assets and their application towards repayment of the loan should not be predicated on any contingencies other than the default.

Each of these three conditions is necessary and, together, all three are sufficient to create the taxpayer's exposure, under law, to the loss of personal assets upon a default. To see this, reconsider Example 1 with two different variations on its facts, each shown below as an additional example.

In Example 1, A is personally liable for the \$10,000 loan because it is exposed to the loss of personal assets that it has not contributed to its farming activity on Parcel 1.⁸²

Example 6. The facts are the same as in Example 1 except A's loan is a state law nonrecourse debt secured only by Parcel 1. A is exposed to the loss of only Parcel 1 that is used in A's farming activity. Therefore, A is not personally liable for the loan.^{83, 84}

⁸² If Parcel 1 and any other assets used by A in its farming activity were insufficient to repay the loan, A would be required to make up the shortfall with personal assets. The "payor of the last resort test" under the worst case scenario discussed in Part IX.B.1 *infra* would validate A's personal liability. C is not considered in this test because the loan has not adhered under law to C.

⁸³ C's guarantee exposes him to the loss of personal assets not used by C in its farming activity on Parcel 2. However, the loan does not adhere under law to C until C is required to make payments on it. C is not considered an obligor or payor until then. See *supra* note 68 and the accompanying text discussing the guarantee rule.

⁸⁴ Similarly, in Example 4, C is personally liable for the \$10,000 loan because it is exposed to the loss of personal assets that it has not contributed to its farming activity on Parcel 2. Once A has declared personal bankruptcy and defaulted on the loan, A is no longer an obligor or payor to be considered in a payor of the last resort test. Conversely, once C is required to make payments on the loan, C becomes an obligor or payor; in fact, the only payor to be considered in a payor of the last resort test. If Parcel 2 and any other assets used by C in its farming activity were insufficient to repay the loan, C would be required to make up the shortfall with personal assets.

Example 7. The facts are the same as in Example 1 except A's loan is a state law nonrecourse debt secured only by Parcel 1. However, A has pledged Parcel 3, an adjoining parcel of land lying fallow that A does not use in its farming activity and that has a net fair market value of \$10,000. A is personally liable for the loan to the extent of \$10,000 since it is exposed to the loss of Parcel 3.⁸⁵

3. CONSTRAINTS UNDER THE SET OF LEGAL STRUCTURES

The two broad requirements of the set of legal structures—the borrowing's adherence under law to the taxpayer; and the taxpayer's exposure, under law, to the loss of personal assets for repayment, are independent of each other. The latter itself entails satisfying three discrete conditions: (i) the availability of the taxpayer's personal assets; (ii) the creditor's ability to access these assets; and (iii) the inapplicability of any contingency except default. When each of these is considered a separate restriction and added to the legal adherence requirement, four individual constraints comprise the set of legal structures. Of these, the borrowing's adherence under law to the taxpayer and the availability of the taxpayer's personal assets towards repayment define aspects of the taxpayer's relationship with the borrowing. The remaining two individual constraints, the creditor's access to the taxpayer's personal assets and the irrelevance of contingencies other than default, circumscribe the borrower's relationship with the creditor.

B. *Set of Economic Consequences*

The constraints in the set of legal structures ensure that, under applicable law, the borrowing adheres to the taxpayer who is exposed to the loss of personal assets for its repayment. Despite this exposure, however, the taxpayer may be protected against an actual loss of these assets. Hence, the need for a second set of constraints—the set of economic consequences.

⁸⁵ The requirement that the pledged property not be used in the subject activity applies even if another taxpayer makes the pledge. To see this, reconsider Example 4 with the following variation on the facts. C instead of guaranteeing A's loan pledges Parcel 2. C would not be personally liable for the loan because Parcel 2 was used in C's farming activity. Thus, even after A declares personal bankruptcy and defaults on the loan and B forecloses on Parcel 2, C cannot include any part of the loan in its at-risk amount. This is the correct result because the loss of Parcel 2 does not increase the amount that C has at risk in its farming activity. C would have already included Parcel 2 in its capital contribution to the subject activity.

Whereas the set of legal structures is concerned with legal relationships created by the borrowing, the set of economic consequences represents economic arrangements made or furthered by the subject activity following the borrowing. As does the set of legal structures, the set of economic consequences consists of two broad requirements. As shown above, the requirements of the set of legal structures relate to two legal relationships—one between the taxpayer and the borrowing and the other between the borrower and the creditor.⁸⁶ By comparison, each of the two requirements of the set of economic consequences governs the economic relationship of the taxpayer with the borrowing.

Both requirements relate to the manner in which the subject activity is conducted and together ensure that the taxpayer is not protected against a loss of personal assets following the borrowing. The first proscribes prospective protection—conducting the subject activity in a manner that eliminates the possibility of a default on the loan. The second disallows retroactive protection—economic arrangements made or furthered by the subject activity that reimburse the taxpayer for any loss of personal assets. A stop loss arrangement is an example of the former while a recovery right exercisable against a third party exemplifies the latter. Each type of protection against loss is shown below.

Example 8. A borrows \$10,000 from B on a full recourse basis to buy seed for planting corn on Parcel 1, a plot of farm-land that A owns. Before planting, A enters into a forward sale of all corn harvested from Parcel 1, regardless of its actual quantity, to C for \$10,000. A is protected against loss of the \$10,000 on a prospective basis.

Example 9. The facts are the same as in Example 8 except instead of entering into a forward sale, A obtains crop insurance from C who agrees to pay the amount, if any, by which the sale proceeds of the actual harvest of corn from Parcel 1 fall short of \$10,000.⁸⁷ A is protected against loss of the \$10,000 on a retroactive basis.

C. *Applying and Misapplying the Framework*

A covered taxpayer should be considered at risk for section 465 purposes for a borrowed amount only upon satisfaction of the requirements of both the set of legal structures and the set of economic consequences. Each set is independent of the other and the two should be applied separately and

⁸⁶ See *supra* Part III.A.

⁸⁷ Assume that this crop insurance covers all natural and economic causes and protects against both quantity and price risks. Thus, A is protected against a shortfall in the quantity of corn produced for any reason as well as a shortfall in the sale price per unit of corn, again for any reason.

sequentially, with the set of legal structures leading and the set of economic consequences following. This conceptual construct is firmly established in the architecture and functionality of the statute and regulations.⁸⁸ However, as mentioned earlier, the accompanying statutory and regulatory verbiage does not always conform to this design and detail and, at times, appears to conflate the two sets of constraints.

Regulatory discussions, supported by the statute, of the negation of personal liability for a taxpayer who has not pledged personal property for a loan characterize the resulting absence of exposure to the loss of personal assets as “effective protection against loss.”⁸⁹ Assume that this loan adheres to the taxpayer under applicable law. Since the taxpayer has not pledged personal property, the taxpayer should be personally liable to create an exposure to the loss of personal assets for repayment and satisfy the requirements of the set of legal structures. Despite this exposure, however, the taxpayer may be protected against an actual loss of personal assets.

A conclusion that this taxpayer who has not pledged any personal property is not at risk for a loan because it has no personal liability for its repayment says nothing about the taxpayer’s protection against loss. Lack of personal liability for this taxpayer does not, by itself, constitute protection against loss. Instead, it represents the failure to create an exposure, under law, to the loss of the taxpayer’s personal assets. This is a distinction with a difference.

Personal liability implies that if there is a default on the loan, the taxpayer will bear the loss of personal assets. This potential loss of personal assets conditional upon a default originates in the specific contours of the legal relationships created by the borrowing. In contrast with personal liability, protection against loss arises from the economic posture of the subject activity with respect to the borrowed amount. If a taxpayer is

⁸⁸ Absence of protection against loss applies to not just borrowed amounts but also capital contributions where personal liability is irrelevant. See I.R.C. § 465(b)(4) (2005). Thus, the two—personal liability and absence of protection against loss—must necessarily be separate requirements. Where both apply—in borrowed amounts, protection against loss must be investigated independent of and after verifying personal liability. Treas. Reg. § 1.465-20(a) acknowledges the possibility of protection against loss of a borrowed amount despite personal liability (or a pledge of personal property). Prop. Treas. Reg. § 1.465-6(a) requires protection against loss to be tested in addition to and after verifying personal liability (or a pledge of personal property). Prop. Treas. Reg. § 1.465-24(a)(2) reiterates this for partnerships. “To the extent the partner is protected against loss . . . the liability shall be treated *in the same manner as* amounts borrowed for which the taxpayer has no personal liability and for which no security is pledged. *Id.* (emphasis added). There would be no need for assuming such equivalence if the two conditions—personal liability and absence of protection against loss—were identical. See also *supra* note 63.

⁸⁹ See, e.g., I.R.C. § 465(b)(4) (2005); Prop. Treas. Reg. § 1.465-6, 44 Fed. Reg. 33238 (June 5, 1979); see also Example 3 discussed *supra* note 63.

protected against loss, it means that the economic characteristics of the subject activity will either prevent a default, or if there is one, recompense the taxpayer for the loss of personal assets.

In deciding whether a taxpayer who has not pledged personal property is at risk for a loan, construing a factor that negates personal liability as one that protects against loss can confuse the analysis. But, so long as the taxpayer is also the borrower, the final result should remain unaffected. However, where the identity between the taxpayer and the borrower is no longer sustained, the muddled inquiry may well deliver a different result than the one derived from the two-part framework presented above. It can do so in at least two different ways. First, an aspect of the loan that pertains to the borrower and defines the borrower's relationship with the creditor may be incorrectly treated as applicable to the taxpayer. Further, and independent of such treatment, this aspect that rightly belongs to the set of legal structures may be considered under the set of economic consequences. Thus, whereas each such aspect should be examined strictly for its legal implications, it could instead be assessed for its economic consequences. The following examples demonstrate both types of errors.

Example 10. A borrows \$10,000 from B for planting corn on Parcel 1, a plot of farm-land that A owns. The loan is secured by, and B's right to repayment is limited to, the proceeds of all sales of corn that A makes during the year. A enters into a forward sale contract with C pursuant to which A promises to deliver 10,000 bushels of corn at \$1 a bushel.

Under the two-part framework, A is not personally liable and, therefore, not at risk for the loan. This follows from an examination under the set of legal structures of B's relationship with A, the borrower. B's right to repayment is limited to the proceeds of A's corn sales during the year. There could be a default on the loan if A produces and sells less than 10,000 bushels during the year and does not otherwise make up the shortfall in its forward sale obligation to C. Specifically, B cannot force A to make up this shortfall by making available personal assets that A has not yet contributed to its farming activity to buy corn from the market to deliver to C.

The "right" rule of decision that derives from this application of the two-part frameworks is the following. A is not personally liable where B, the creditor, cannot force A, the borrower, to make available personal assets not yet contributed to augment the activity's available assets to satisfy the debt. If, however, one concludes that A is not at risk because it is "effectively protected against loss," then a completely different rule of decision emerges. A could be deemed effectively protected against loss despite its obligation to C under the forward sale contract only because B cannot force the performance of this contract. The following "wrong" rule of decision arises. A is not at risk where B, the creditor, cannot directly

proceed against A, the taxpayer, to enforce an obligation of the latter. The contrasting effects of these two alternative rules of decision become evident where the borrower and the taxpayer are separate entities as in the following example.

Example 11. A, a limited partnership, in which A_G is the only general partner and A_L the only limited partner, borrows \$10,000 from B to plant corn on Parcel 1, a plot of farm-land with a net fair market value of \$10,000 that A_G has contributed to A. A_L has made no capital contributions but has entered into a DRO of \$10,000 for which it does not enjoy any recovery or reimbursement rights against A_G. The \$10,000 loan is a general obligation of the partnership; that is, no partner has been relieved of personal liability. A_G and A_L share all profits equally but all losses are allocated first to A_L to the extent of its DRO and then to A_G. A plans to sell all harvested corn on the open market and has not entered into any forward sale contracts or any other risk reduction or elimination arrangements.⁹⁰ Under the two-part framework, A_L is personally liable and, because of the absence of any protection against loss, at risk for the loan. An examination under the set of legal structures of the allocation of losses and A_L's DRO establishes A_L's personal liability for A's loan. This result does not violate the "right" rule of decision from Example 10. B, the creditor, can force A, the borrower, to make available personal assets not yet contributed to satisfy the debt. Since the loan is a general obligation of the borrower-partnership, B can proceed against it upon a default. A_G, as the general partner, would be obligated by operation of law to satisfy B's claim and would, therefore, enforce A_L's DRO.⁹¹ Thus, A_L stands to lose personal assets and B enjoys the right to access them upon no other contingency except default. Applying the wrong rule of decision generates the opposite result. Despite the facts that the loan is a general obligation of the borrower-partnership and that A_L has entered into a DRO, A_L is not at risk because B cannot proceed against A_L, the taxpayer.⁹²

⁹⁰ A has not obtained any crop insurance or otherwise hedged against quantity or price risk.

⁹¹ The section 752 rules assume all partners discharge their respective obligations without regard to their economic ability. See Treas. Reg. § 1.752-2(b)(6) (as amended in 2006). These rules, thus, remain restricted to the set of legal structures. See *infra* Part IV.C. Moreover, they can be made to deliver results that conform to the requirements of section 465. See *infra* Part VI.

⁹² See, e.g., *Pritchett v. Comm'r*, 85 T.C. 580, 590 (1985), *rev'd*, 827 F.2d 644 (9th Cir. 1987) (limited partners held not at risk for obligations to make additional contributions to the limited partnership that the general partner could enforce because the creditor could not proceed against the limited partners); *Abramson v. Comm'r*, 86 T.C. 360, 376 (1986) (distinguishing *Pritchett* and holding limited partners at risk for guaranteeing limited partnership's functionally nonrecourse debt because, unlike in *Pritchett*, "each partner's liability for the partnership debt . . . ran directly to the [creditor.]"). Cf. *Melvin v. Comm'r*, 88 T.C. 63 (1987), *aff'd per curiam*, 894 F.2d 1072, 1075-76 (9th Cir. 1990)

Example 12. The facts are the same as in Example 10 except A is a limited partnership in which A_G is the only general partner and A_L the only limited partner and A_L guarantees the performance of A's forward sale contract. Under the two-part framework, neither A_G nor A_L is personally liable and, therefore, at risk for the loan. Viewing A_L 's performance guarantee strictly as a legal relationship and examining it for its legal implications does not change the analysis of Example 10 and the applicability of the right rule of decision derived there. A_L 's performance guarantee represents an obligation of the taxpayer owing to C, a third party. It does not affect either of the two relationships of interest for purposes of an at-risk inquiry—that of A_L , the taxpayer with the loan and of B, the creditor, with A, the borrower.

If, however, one had concluded in Example 10 that A was “effectively protected against loss,” then A_L 's performance guarantee must necessarily be examined under the set of economic consequences. Specifically, one must consider the economic conditions that would cause A to fail to perform on its forward sale contract with C and the economic impact of this failure on the repayment status of the loan from B.

Depending upon the scenario sketched, a call by C on A_L to honor its performance guarantee may or may not be accompanied by a default by A on its loan from B. One could construct circumstances where A_L is required to surrender personal assets which are then used towards repayment of the loan. In such situations, A_L could be considered at risk for A's loan from B. Alternative circumstances could show A_L not obligated to lose personal assets despite a failure by A to repay the loan from B. Under these situations, A_L could not be considered at risk for A's loan from B.

For example, A might breach its forward sale contract with C if it produces less than 10,000 bushels of corn and the price for a bushel of corn in the open market exceeds the agreed upon forward price of \$1. In this case, A would also default on the loan from B. C would call A_L on its performance guarantee. If A_L then buys corn on the open market for delivery to C at the agreed upon forward price of \$1 a bushel, A_L would have

(appearing to abandon the ability of the creditor to proceed directly against the taxpayer-partner as a rule of decision for the latter's at-risk treatment with respect to the partnership's debt.). *But see* Henkind v. Comm'r, 62 T.C.M. (RIA) 555 (1992) (holding limited partners at risk for additional capital contributions because “the partnership agreement specifically provides that creditors of the partnership may proceed against the partners directly to collect partnership debts, a feature apparently not found in the *Pritchett* case partnership agreement”); Krause v. Comm'r, 92 T.C. 1003, 1023 (1989) (relying on applicable state law under which the partnership's creditors “would be regarded as intended third-party beneficiaries and would be entitled to enforce the debt obligations personally against the limited partners” to determine that the latter were at risk for the partnership's debt obligations). Both subsequent Tax Court cases have continued to stress the importance of this “wrong” rule of decision.

surrendered personal assets. B would apply the resulting proceeds of this sale received from C towards repayment of the debt. Therefore, A_L 's personal assets would be used towards satisfaction of the loan. Under this scenario, A_L could be considered at risk for A's loan from B.

On the other hand, A might default on the loan even though A_L is not called on its performance guarantee. This might happen where the market price for a bushel of corn is less than the agreed upon forward price of \$1 a bushel and C breaches the forward sale contract by refusing to take delivery. Even if A produces 10,000 bushels and sells them on the open market, the resulting proceeds would not be sufficient to repay the loan. Because a default would proceed without A_L being required to surrender personal assets, A_L could not be considered at risk for the loan.

Finally, A might breach its forward sale contract with C without defaulting on the loan from B. A might not deliver the contracted for 10,000 bushels of corn to C if A can get a higher price on the open market than the agreed upon forward price of \$1. In this case, A's proceeds from corn sales would exceed \$10,000 and there would be no default on the loan. Under this scenario, A_L 's performance guarantee could not cause A_L to be considered at risk for the loan because any loss of personal assets could not possibly be applied towards repayment of the loan.

Examining A_L 's performance guarantee that rightfully belongs to the set of legal structures under the set of economic consequences allows for reaching either substantive result- inclusion or exclusion of A's loan from B in A_L 's at-risk amount. The actual at-risk treatment is determined by the specific economic scenario envisaged.

PART IV. THE SECTION 752 RULES WITHIN THE FRAMEWORK

Where and how do the section 752 rules fit into the two-part framework presented above? In determining a partner's section 465 at-risk amount in the partner's share of partnership debt, how, if at all, can this framework use the results of a section 752 analysis? Section 752 has already been explicitly mentioned in connection with the first requirement of the set of legal structures- adherence of the borrowing to the taxpayer under applicable law. In resolving whether a partnership debt adheres to the partner, the section 752 rules constitute the applicable law and, therefore, supply the answer.⁹³ But these rules also conclusively respond to the second requirement of the set of legal structures—the taxpayer's exposure to the loss of personal assets

⁹³ Under the ordering rule for a partner's at-risk amount, section 465 applies after the basis limitation of section 704(d). See *supra* note 22 and accompanying text. The section 752 rules determine whether a given partnership debt forms part of the partner's outside basis for its partnership interest.

towards repayment.⁹⁴ When applied to any partnership debt, the section 752 rules categorize it as a recourse or nonrecourse liability of the partnership and then allocate it among the partners. Partnership debt that these rules allocate to a partner as a partnership recourse liability represents an exposure to the loss of the partner's personal assets towards repayment.

A. *The Right Place to Begin*

For a partner's share of partnership debt, the section 752 rules can replace most, but not all, of the analysis set forth under the set of legal structures above. These rules do not begin quite at the beginning of this required analysis. The section 752 rules take as their input a given amount of partnership liabilities. By itself, section 752 cannot ascertain whether a certain borrowing in fact constitutes a partnership liability and is, therefore, subject to its categorization and allocation rules. This fact must be established before resorting to the section 752 rules. Under the two-part framework presented above, the partnership must be, or must have become, the contractually named borrower or have acceded to the borrower, before the debt is deemed a partnership liability that can be categorized as either recourse or nonrecourse and allocated to the partners under the section 752 rules.

A failure to perform this additional step in the required analysis is the source of the perceived inconsistency in the application of the guarantee rule to partners and partnerships. Example 2 and its discussion highlight both the perception of this inconsistency and its proper resolution.⁹⁵

In categorizing and allocating partnership liabilities, the section 752 rules engage in analyses that look inside and outside the partnership, respectively. In determining whether a partnership liability is recourse or nonrecourse, these rules have to look outside the partnership. This involves testing the borrower-partnership's relationship with the creditor. The task of allocating partnership liabilities among partners uses an intra-partnership analysis—an examination of the taxpayer-partner's relationship with the borrowing.

⁹⁴ This response can be made to conform to the requirements of the section 465 at-risk rules. See *infra* Part VI.

⁹⁵ The perception of such an inconsistency by theorists and practitioners represents a more general failing—not always being cognizant whether the section 465 at-risk analysis is being conducted outside the partnership and requires examining the borrower-partnership's relationship with the creditor, or is being carried out inside the partnership and entails an examination of the taxpayer-partner's relationship with the borrowing. The guarantee rule relates to the former relationship. Construing it as a required element of the latter leads to results that contradict the regulatory language of the at-risk rules (Prop. Treas. Reg. § 1.465-24(a)(2005)) and of the liability sharing rules (Treas. Reg. § 1.752-2 (as amended in 2006)).

B. *The Proper Place to End*

In both instances, however, the section 752 rules examine the relevant legal relationships. In the two-part framework presented above, these rules thus remain limited to the set of legal structures. They do not even purport to test the taxpayer-partner's economic relationship with the loan and, therefore, should not be seen as venturing into the set of economic consequences. They may appear to do so, however, because in allocating a partnership's recourse liabilities, the rules examine a partner's right to recovery- but only from another partner and not from a third party. This represents, not a foray into the set of economic consequences, but merely an extension of the examination of the set of legal structures.

The section 752 liability sharing rules do not examine the probability of a default on partnership recourse liabilities and, therefore, the possibility that the partner allocated these liabilities would be actually required to lose its personal assets. Nor do these rules consider this partner's right to recover any such loss from a third party. Thus, in categorizing and allocating a partnership's recourse liabilities, the section 752 rules ignore both prospective and retroactive protection against loss. Using a partner's section 752 allocation of the partnership's recourse liabilities as this partner's section 465 at-risk amount can, thus, be over-inclusive.⁹⁶

C. *An Additional Layer*

Though a section 752 analysis is limited to the set of legal structures, when dealing with a partner's share of partnership debt, the presence of other partners introduces an additional layer of complexity. The two legal relationships of interest continue to be: (i) the one between the taxpayer and the borrowing; and (ii) that between the borrower and the creditor. But the

⁹⁶ To see this, reconsider Examples 8 and 9 with A as a general partnership. No part of any partnership debt that the section 752 rules allocate to the general partners in A as a partnership recourse liability could be included in such partners' respective at-risk amounts because all partners would be protected against loss. An entirely different reason can cause the amount allocated by the section 752 rules as a partnership recourse liability to be over-inclusive for section 465 purposes. This reason is the two regimes' inconsistent treatment of a partner who secures partnership debt by pledging personal property that the partner has already contributed to the partnership. So long as "substantially all" partnership items relating to the pledged property are allocated to the pledgor-partner, the section 752 rules will recognize this as an indirect pledge, categorize the debt as a partnership recourse liability to the extent of the pledged property's net fair market value and allocate it to the pledgor-partner. See Treas. Reg. § 1.752-2(h)(2) (as amended in 2006). However, because such pledged property would, by definition, be used in the subject activity, the debt cannot be used in the partner's section 465 at-risk amount.

legal relationship between the taxpayer-partner and the borrowing is itself a function of, among other factors, the respective legal relationships that the taxpayer-partner has with its other partners. Before deciding whether a given taxpayer-partner is exposed to the loss of personal assets towards repayment of the partnership debt, all obligations and entitlements between the partners must be scrutinized; and the section 752 rules do. In allocating a partnership's recourse liabilities to a given partner, these rules test whether any other partner may instead be the rightful allocatee. They do so by examining whether the given partner is legally entitled to recover its loss of personal assets—not from a third party but from another partner.⁹⁷

In applying these rules, one should eschew assessing the probable economic consequences upon an actual default on the debt. Clearly, no more than one partner should be considered exposed under law to the loss of personal assets towards repayment of the same dollar of debt. By considering a partner's rights to recover from, or obligations to reimburse other partners, the section 752 rules ensure that the partner allocated the partnership recourse liability is the one so exposed—but only under law. Therefore, the examination should be strictly limited to the formal structure of the legal relationships between the partners. The economic ability or inability of a partner to fulfill its obligations to another partner should be ignored. Support for this conclusion is provided in the rules themselves.

Under reg. section 1.752-2(b)(6), for purposes of determining which partner is exposed, under law, to the loss of its personal assets, "it is assumed that all partners . . . who have obligations actually perform those obligations, irrespective of their actual net worth."⁹⁸

The scope and purpose of the section 752 rules are limited to the set of legal structures. Ignoring this can lead to an assumption that these rules also examine any protection against loss under the set of economic consequences. This assumption is a source of potential confusion among judges called upon to apply section 465 to a partner's section 752 allocation of partnership debt and academics who have sought to streamline such applications by attempting to reconcile the section 465 at-risk rules with the section 752 liability sharing rules. This assumption appears to originate, and the attempt at reconciliation seems to gain inspiration, both understandably but incorrectly, from the EROL label that the section 752 rules have attached to the analysis required to discharge their categorization and allocation

⁹⁷ See Treas. Reg. § 1.752-2(b)(5) (as amended in 2006) ("A partner's . . . obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner . . .").

⁹⁸ Treas. Reg. § 1.752-2(b)(6) itself contains an anti-abuse exception where "the facts and circumstances indicate a plan to circumvent or avoid the obligation."

functions.

The first word in the EROL label—"economic"—induces false parallels with both the nature and results of the inquiry described under the set of economic consequences above. And the second word—"risk," lends further misplaced support to a notion that a section 752 EROL analysis also conclusively determines a section 465 at-risk amount.

When applying this framework in a section 465 at-risk inquiry, the adjective "economic" in the EROL label appears misplaced and, therefore, can be misleading. Though this adjective qualifies the noun "risk," it suggests a description of the very nature of the analysis—an analysis of *economic* risk may connote a consideration of economic consequences, which is clearly inaccurate. As shown above, a section 752 analysis does not subject the categorization and allocation of partnership debt to a scrutiny under the glare of economic reality. In fact, a section 752 analysis is a theoretical exercise in legal implications because all partnership liabilities are presumed to become due and payable and, therefore, must be allocated, regardless of the actual attendant economic circumstances.⁹⁹ Thus, if the noun "risk" must be qualified in order to suggest the nature of the analysis, the adjective of choice should be "theoretical" and not "economic." The word economic in the EROL label, as in other Subchapter K provisions, is intended to convey a contrast with tax impact and is better placed before the noun "loss" in order to qualify it.¹⁰⁰ And even there, it is best replaced by the adjective "financial," reflecting Subchapter K's penchant for using financial or "book" entries and accounts to capture the partners' underlying substantive arrangement.¹⁰¹ Once the EROL label is replaced by, or at least read to denote a "theoretical risk of financial loss," the proper role of the section 752 liability sharing rules in a section 465 at-risk inquiry becomes obvious.¹⁰²

PART V. THE CONSTRUCTIVE LIQUIDATION PROCESS

After any borrowing has been properly attributed to a partnership as a partnership liability, the section 752 liability sharing rules can take over and complete the analysis required under the set of legal structures. Partnership debt that these rules characterize as a partnership recourse liability and allocate to a partner covered by section 465 will adhere to the partner under

⁹⁹ See *infra* Part V discussing the CLP.

¹⁰⁰ See *supra* note 21.

¹⁰¹ See *id.*

¹⁰² Ironically, the section 465 at-risk rules do not use the term EROL or the phrase "risk of loss" or even "economic risk." They use the words "economic burden" or "economic loss"—clearly to convey a contrast with accounting burden or accounting loss.

applicable law. In addition, the partner will be exposed to the loss of personal assets for repayment of this debt. As shown above, this exposure for section 465 purposes can be created either by a pledge of personal property not used in the subject activity or by personal liability for repayment of the debt. Verifying a pledge of personal property is straightforward and the section 752 rules' categorization and allocation functions treat such a pledge in a straightforward manner. Partnership debt that is secured by a partner's pledge of personal property is categorized as a partnership recourse liability and allocated to the pledgor partner.¹⁰³

A. The Functionality

Verifying personal liability of individual partners for borrowings made by the partnership collective is more complex. In examining any one partner's personal liability for repayment of partnership debt, the section 752 rules discharge their categorization and allocation functions simultaneously. In effect, these rules define as a partnership recourse liability any partnership debt that is allocable to a partner because, under the CLP, the partner would be called upon to surrender its personal assets to satisfy the debt. Thus, the section 752 rules employ the CLP to establish personal liability, and through it, the debt's categorization and allocability. Specifically, for any partnership debt, these rules consider whether upon a constructive liquidation of the partnership, a partner would be obligated to make a payment to any person or a contribution to the partnership without an entitlement to reimbursement from another partner.¹⁰⁴ A partner so obligated would, by definition, be exposed to the loss of its personal assets and, therefore, personally liable for repayment of the debt. If the CLP reveals that a partner is obligated to make such a payment or additional capital contribution, then the partnership debt is categorized as a partnership recourse liability and allocated to the obligor-partner.

The CLP is a much misunderstood and even more misapplied tool.¹⁰⁵ Powers have been attributed to it that it could not possibly possess and tasks have been demanded of it that it was never designed to perform.¹⁰⁶ In this part, I dispel some of the myths surrounding the CLP and demystify the

¹⁰³ But see *supra* note 96 discussing the possibility of an indirect pledge under Treas. Reg. § 1.752-2(h)(2).

¹⁰⁴ A partner's right to recover such payments or contributions from partnership assets, whether now owned or hereafter acquired, is irrelevant for purposes of this exercise. See *infra* note 213.

¹⁰⁵ See, e.g., *infra* Part V.F discussing the misuse of the CLP in *Hubert I*.

¹⁰⁶ See *Rubin et al.*, *supra* note 3 (deploying the CLP to establish the extent of a creditor's repayment rights for partnership debt).

process. I begin by simply reciting the prescription for the CLP as laid out in the regulations. I follow this by identifying the ingredients for this prescription- the information needed for the CLP to proceed. I then repeat the prescribed steps of the CLP but rearranged in an order that tracks the sequence of operations that it performs, along with annotations that explain the effects of these operations on the partnership's balance sheet, as captured by a basic accounting identity. Finally, I summarize what the CLP accomplishes, highlight the limits of its scope and show where and how the commentators in *Hubert* went wrong with their use of it.

B. *The Steps*

Reg. section 1.752-2 lays out the following steps for the CLP.

Step (1): All of the partnership's liabilities become payable in full.

Step (2): All of the partnership's assets, including cash, have a value of zero.¹⁰⁷

Step (3): The partnership disposes of all of its property in a fully taxable transaction for no consideration, except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership. Gain or loss on the deemed disposition of the partnership's assets is computed, as applicable, under steps 4 and 5.

Step (4): If the creditor's right to repayment of a partnership liability is limited solely to one or more assets of the partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is extinguished by the deemed disposition and the book value of those assets.

Step (5): A loss is recognized equal to the remaining book value of all other partnership assets.

Step (6): All items of income, gain, loss, or deduction are allocated among the partners.

Step (7): The partnership liquidates.

To compute the gain (or loss) in Step (4), the partnership must identify: (i) all partnership liabilities where the creditor's right to repayment is limited solely to one or more assets of the partnership (limited liabilities or LL); and (ii) the partnership assets that the creditor can pursue (encumbered assets or EA).¹⁰⁸ The gain (or loss) in Step (4) equals the difference between the face

¹⁰⁷ The CLP excludes property contributed to secure a partnership debt (an indirect pledge under Treas. Reg. § 1.752-2(h)(2)). See Treas. Reg. § 1.752-2(b)(ii) (as amended in 2006). The section 752 rules handle both the indirectly pledged property and the debt secured by it outside the CLP. See *supra* note 96. By comparison, the section 465 at-risk rules do not allow any indirect pledges. See *id.*

¹⁰⁸ If the creditor's right to repayment is not "limited solely to one or more assets of the

value of the limited liability and the book value of the encumbered assets and is represented by the expression:

$$LL - EA \qquad (1)$$

Once all limited liabilities have been identified, the remaining partnership liabilities are those where the creditor's right to repayment is not "limited solely to one or more assets of the partnership" (unlimited liabilities or UL). Similarly, after all encumbered assets have been identified, the remaining partnership assets are those that are beyond the reach of a creditor seeking repayment of a limited liability (unencumbered assets or UA). Unencumbered assets are those partnership assets that have been financed by, and are available to satisfy, the partnership's unlimited liabilities.¹⁰⁹ The loss in Step (5) equals the book value of the unencumbered assets and is represented by the expression:

$$- (UA) \qquad (2)$$

In order to apply the CLP, all partnership liabilities must be segregated into limited and unlimited liabilities and all partnership assets must be separated into encumbered and unencumbered assets. The CLP cannot proceed before the partnership liabilities and assets have been thus divided. The CLP itself cannot perform this division. This is a required input for the CLP—it is entered into the CLP formula and could not possibly be an output from it. In particular, the CLP cannot determine whether a partnership debt is a limited liability and, if so, what assets of the partnership are available to the creditor. The CLP merely frames the question. The answer is supplied by the applicable law governing the debt—the terms of the loan agreement or partnership agreement, or provisions of the state law that apply to the partnership and the loan transaction.

The CLP is a device to allocate the partnership's unlimited liabilities to the proper partners. The proper partners are the ones who are personally liable for repayment of these unlimited liabilities and who would be

partnership" as contemplated by Treas. Reg. § 1.752-2, then, by definition, this right is not limited to all partnership assets and extends beyond them. This implies that the creditor can pursue the personal assets of at least one partner. The CLP reveals which partner is exposed to the loss of personal assets on account of a debt previously classified as an unlimited liability becoming due and payable. The section 752 rules then allocate unlimited liabilities to this partner to the extent of the partner's personal exposure. See *infra* Part V.D.

¹⁰⁹ Unencumbered assets would have been acquired by taking on unlimited liabilities and any capital contributions not used to acquire encumbered assets.

allocated losses relating to the partnership assets financed by them. To see this, retrace the steps of the CLP, but this time in the context of the partnership's basic accounting identity:

$$C + L = A \quad (3)$$

where

C represents the aggregate of the partners' capital contributions;

L represents the partnership liabilities and is given by the sum of limited and unlimited liabilities;¹¹⁰ that is:

$$L = LL + UL \quad (4)$$

and A represents the partnership assets and is given by the sum of encumbered and unencumbered assets;¹¹¹ that is:

$$A = EA + UA \quad (5)$$

The partnership's basic accounting identity, shown above as Equation (3), simply states that all assets of the partnership are financed by the sum of the partners' aggregate capital contributions and the total liabilities of the partnership. This holds true at all times regardless of the values of the respective variables. As a result, the partnership's balance sheet must always balance. Therefore, any change to one side of Equation (3) must be balanced by an equal change on the other side of the equation. A change in the total value of the partnership assets on the right hand side of Equation (3), for example, must be reflected in a change in the sum of the partners' capital contributions and total partnership liabilities, on the left hand side of the equation.

C. *The Operations*

I repeat the steps of the CLP below, rearranged in the order of the operations they perform. Alongside the narrative of each step, I show its effect on the partnership's basic accounting identity that I reproduce below as Equation (3-a).

¹¹⁰ "L" measures the aggregate face value of all partnership liabilities.

¹¹¹ "A" measures the book value of all partnership assets.

Step (4): If the creditor's right to repayment of a partnership liability is limited solely to one or more assets of the partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is extinguished by the deemed disposition and the book value of those assets.	This gain or loss is given by (1) above: $(LL - EA)$ (1)
Step (5): A loss is recognized equal to the remaining book value of all other partnership assets.	This loss is given by (2) above: $-(UA)$ (2)
Step (3): The partnership disposes of all of its property in a fully taxable transaction for no consideration, except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership. Gain or loss on the deemed disposition of the partnership's assets is computed, as applicable, under steps 4 and 5 above.	$C + L = A$ (3-a) Using (4) and (5) from above in (3-a) gives: $L = LL + UL$ (4) $A = EA + UA$ (5) $C + (LL + UL) = (EA + UA)$ (3-b)
Step (1): All of the partnership's liabilities become payable in full.	$C = (EA + UA) - (LL + UL)$ (3-c)
Step (2): All of the partnership's assets, including cash, have a value of zero. ¹¹²	$C - (EA + UA) = -(LL + UL)$ (3-d)
Step (6): All items of income, gain, loss, or deduction are allocated among the partners.	(3-c) can be rearranged to reflect (1) and (2): $C + (LL - EA) - (UA) = -(UL)$ (3-e)
Step (7): The partnership liquidates.	The amount of the partnership's outstanding liabilities are given by: $-(UL) = C + (LL - EA) - UA$ (3-f)

Equation (3-f) summarizes the cumulative net impact of the CLP on the partnership's basic accounting identity. It demonstrates that on an aggregate level for the partnership, the CLP merely represents a series of elementary algebraic operations that rearrange the terms of the identity to reveal the extent of the partnership's unlimited liabilities. However, as stated above,

¹¹² Any partnership property securing partnership debt (an indirect pledge under Treas. Reg. § 1.752-2(h)(2)) is excluded. See *supra* note 107.

an identification of the partnership's limited liabilities is a prerequisite for conducting the CLP. At an aggregate partnership level, the CLP then merely verifies the simple arithmetic of subtracting the partnership's limited liabilities from all partnership liabilities and labeling the remainder, comprising the partnership's unlimited liabilities, as partnership recourse liabilities.

But this does not even begin to justify the shelf-space that the CLP occupies in the Code of Federal Regulations.¹¹³ The CLP's benefits lie, and its effects are seen, not at the aggregate partnership level but at the individual partner level—in each partner's allocation of the partnership recourse liabilities. In making these allocations, the CLP ensures two things: (i) only the partners who are exposed to the loss of personal assets and, therefore, are personally liable for repayment of the partnership recourse liabilities are allocated these liabilities; and (ii) such allocations are made in the manner that these partners would share losses relating to assets financed by the these liabilities—the partnership's unencumbered assets. The following example demonstrates this.

Example 13. A_{G1} , A_{G2} , and A_L contribute \$150, \$75, and \$75, respectively to form a limited partnership with A_{G1} and A_{G2} as general partners and A_L as a limited partner. The partnership purchases property for \$900 using its \$300 cash and a \$600 note. The note is a general obligation of the partnership; that is, no partner has been relieved of personal liability. The three partners share all profits in the proportion of their capital contributions, that is, 2:1:1. Losses are also allocated in the same proportion between the three partners until A_L 's capital account has been exhausted after which all losses are allocated between A_{G1} and A_{G2} in a 2:1 proportion.

In a constructive liquidation, the \$600 note becomes due and payable. The property is deemed to be worthless and sold for a value of zero. On this hypothetical disposition, the partnership recognizes a loss of \$900 that is allocated among the partners in the manner that they have agreed to share all such losses. Capital accounts, after this allocation, are as follows.

	A_{G1}	A_{G2}	A_L
Initial contribution	\$150	\$75	\$75
Loss on hypothetical sale	(550)	(275)	(75)
	(\$400)	(\$200)	\$0

¹¹³ Treas. Reg. § 1.752-2(b)(1)-(6) devotes 744 words to describe the CLP. Five examples (Treas. Reg. § 1.752-2(f), Examples 1-5) demonstrating the CLP take up another 1,121 words.

A_{G1} and A_{G2} , as general partners, would be obligated by operation of law to make additional net contributions of \$400 and \$200, respectively. Therefore, the \$600 note is categorized as a partnership recourse liability and allocated \$400 to A_{G1} and \$200 to A_{G2} . A_L was not exposed to the loss of its personal assets and was, therefore, not personally liable for repayment of any amount of the note. Consequently, the CLP did not allocate any part of the note to A_L . Each of A_{G1} and A_{G2} , on the other hand, was exposed to the loss of its personal assets and was, therefore, personally liable for repayment of the note. In addition, A_{G1} and A_{G2} would have shared the losses relating to the assets financed by the note in a 2:1 proportion. Consequently, the section 752 rules allocate the \$600 note, categorized as a partnership recourse liability, in the same proportion between A_{G1} and A_{G2} .¹¹⁴

D. The Results

As stated above and shown in Example 13, to both categorize and allocate a partnership's recourse liabilities, the section 752 rules look to the payments or additional capital contributions that a partner is required to

¹¹⁴ In this example, the unlimited liability is allocated between A_{G1} and A_{G2} in the same proportion in which they shared losses financed by the note (the so-called "recourse deductions") because their respective capital accounts were exhausted simultaneously. This, in turn, was brought about by the fact that the proportion in which the two general partners had made capital contributions (2:1) was the same as the proportion in which they had shared losses financed by their capital contributions (also, 2:1). If these two proportions had been different, the two general partners' respective capital accounts would not have been exhausted simultaneously. As a result, the unlimited liability would have been allocated between the two general partners in a proportion different from the one in which they shared recourse deductions. To see this, consider the following example.

Example 13(a). The facts are the same as in Example 13 except losses are allocated equally between the three partners until A_L 's capital account has been reduced to zero after which all losses are allocated equally between A_{G1} and A_{G2} . After applying the CLP, the \$600 note will be categorized as a partnership recourse liability and allocated between A_{G1} and A_{G2} in the amounts of \$262.50, and \$337.50, respectively. Though A_{G1} and A_G share recourse deductions equally, A_{G1} 's additional \$75 capital contribution causes the CLP to allocate \$75 of the unlimited liability away from A_{G1} to A_{G2} . Thus, of the \$600 partnership recourse liabilities, less than half is allocated to A_{G1} while more than half is allocated to A_{G2} .

If in LCL's case, HBW had received capital account credit for contributed leases, *see supra* note 39, HBW's share of LCL's total capital would have been more than ninety-nine percent while HCC's share would have been less than one percent. Consequently, of any LCL debt that was classified as an unlimited liability, the CLP would allocate less than 99 percent to HBW and more than one percent to HCC. The actual amounts allocated to each member at any given point in time could only be determined by applying the CLP to LCL's book balance-sheet and member capital accounts, reflecting the book values of all assets, including the contributed leases, and the face values of all liabilities, at such time. The allocation of recourse deductions between the two members, however, would continue to follow the 99:1 proportion that applied to the sharing of all losses. *See infra* notes 182 and 185.

make upon a constructive liquidation of the partnership. Whether such a payment or additional capital contribution is necessitated depends upon the state of the individual partners' capital accounts following the CLP and the gains and losses that it allocates.

The allocation among the individual partners of the partnership's gains and losses in Step (6) of the CLP is made as follows. A partnership may recognize a gain or loss in Step (4) upon the deemed discharge of a limited liability depending on the book values of the corresponding encumbered assets. A gain represents a "net decrease in partnership minimum gain" and is charged back to the partners in the proportion that nonrecourse deductions were allocated among the partners.¹¹⁵ A loss represents one or more partners' positive equity in the encumbered assets and is allocated among the partners in the proportion that they have agreed to share losses relating to the encumbered assets.¹¹⁶ The loss recognized by the partnership in Step (5) of the CLP upon the deemed disposition of the unencumbered assets is allocated among the partners in the proportion that they have agreed to share losses relating to the unencumbered assets.

The balance in an individual partner's capital account following such allocations by the CLP is given by:

$$C_p + (LL - EA)_p - (UA)_p \quad (6)$$

Where the subscript refers to the partner's share of each respective partnership item and,

C_p : refers to the balance in the partner's capital account immediately prior to applying the CLP;

$(LL - EA)_p$: refers to the partner's allocated share of the gain (or loss) recognized by the partnership in Step (4) of the CLP upon the deemed discharge of the limited liability; and

$(UA)_p$: refers refers to the partner's allocated share of the loss recognized by the partnership in Step (5) of the CLP upon the deemed disposition of the unencumbered assets.

The section 752 rules ask whether, after the allocation of these gains and losses, a partner is obligated to make a payment to any person or an additional capital contribution to the partnership as a consequence of all the partnership's liabilities becoming due and payable in full. Such an obligation would attract an equal amount of the partnership's unlimited liabilities since they would survive the CLP and remain outstanding. This amount of the

¹¹⁵ See Treas. Reg. § 1.704-2(d)(1) (as amended in 2006).

¹¹⁶ See Treas. Reg. § 1.704-2(b)(2) (as amended in 2006).

partnership's unlimited liabilities would be allocated to the partner as a partnership recourse liability.

E. *The Limitations*

There are two important limitations of the CLP that must be kept in mind while applying it. First, an obligation that is invoked upon a constructive liquidation of the partnership is not necessary to establish one or more partners' personal liability for repayment of the partnership debt. And second, even where personal liability is established by such a method, the CLP cannot verify the enforceability of the obligation. It can merely test whether the obligation is "illusory"; that is, if it would be invoked whenever the partnership assets are insufficient to satisfy the debt.

A partner's unconditional guarantee of repayment of a partnership debt that is not contingent upon a negative balance in the partner's capital account upon a liquidation, whether constructive or actual, creates an exposure on the part of the guarantor-partner to the loss of its personal assets and, therefore, establishes its personal liability for repayment of the debt. The partnership debt subject to the guarantee may very well have otherwise constituted a state law nonrecourse debt or an LLC's exculpatory liabilities. However, as a consequence of the unconditional guarantee, the creditor's right to repayment, despite being initially limited to one or more assets of the partnership, extend to the guarantor-partner's personal assets held outside the partnership. Therefore, the debt that in the absence of the guarantee would have been classified a limited liability, is transformed into an unlimited liability as a result of the guarantee.¹¹⁷ The section 752 rules recognize the guarantee, categorize the debt as a partnership recourse liability and allocate it to the guarantor-partner—all outside the CLP.¹¹⁸

An unconditional obligation to repay a partnership debt thus creates personal liability independent of the CLP.¹¹⁹ But where the obligation to make a payment or an additional capital contribution is contingent upon a

¹¹⁷ The section 752 rules examine the guarantor-partner's right to obtain reimbursement or recover from other partners for payments made on the guarantee before recognizing the guarantor-partner's obligation and allocating the guaranteed debt to it. See Treas. Reg. § 1.752-2(b)(5) (as amended in 2006). See also *supra* Part IV.C. However, such reimbursement or recovery rights against other partners are irrelevant for classifying a partnership debt as an unlimited liability. Partnership debt is classified as an unlimited liability because one partner, whether the guarantor-partner or another general partner against whom the guarantor-partner enjoys recovery rights, is exposed to the loss of personal assets. The section 752 rules reveal the identity of the partner so exposed.

¹¹⁸ See Treas. Reg. § 1.752-2(j)(2) (as amended in 2006); see also Treas. Reg. § 1.752-2(b)(3)(i) (as amended in 2006).

¹¹⁹ The CLP can be made to validate the result. See *infra* Example 20.

deficit capital account, personal liability is established only if both the deficit and the obligation survive the CLP. In other words, the CLP must create a deficit in an individual partner's capital that then obligates the partner to make a payment or an additional capital contribution.

The CLP itself can only reveal a deficit capital account that will trigger the obligation. It cannot confirm whether this obligation will, in actual fact, be enforced. This enforceability can only be determined by the provisions of the law governing the obligation and must, therefore, be independently verified—outside the CLP.

A DRO is, by definition, a partner's obligation to make a payment or an additional capital contribution contingent upon a deficit capital account. A DRO will establish personal liability for partnership debt that has been classified as an unlimited liability but only if the DRO is both invocable and enforceable upon default. The CLP only tests the DRO's invocability; that is, if the DRO will be triggered when the partnership's assets are inadequate to repay the partnership debt. A DRO that fails this test is "illusory." The CLP cannot confirm whether a DRO that is not illusory will actually be enforced when invoked.¹²⁰

The following examples demonstrate both of these limitations of the CLP.

Example 14. A_1 and A_2 organize an LLC to which each contributes \$100 in cash. The LLC buys real property for \$1,000 using its \$200 cash and a note for \$800. The note is recourse to the LLC but not to either member and, therefore, an exculpatory liability of the LLC. A_1 unconditionally guarantees repayment of the note if the LLC's assets are insufficient for this purpose. Neither member has a DRO and the LLC's operating agreement allocates all profits and losses equally between A_1 and A_2 . The section 752 rules recognize A_1 's guarantee outside the CLP. The \$800 note is categorized as a partnership recourse liability and allocated entirely to A_1 .

Example 15. The facts are the same as in Example 14 except each of A_1 and A_2 has a DRO of \$1,000 and the LLC's operating agreement allocates: (i) profits equally between A_1 and A_2 ; and (ii) the first \$800 of losses to A_1 to reflect A_1 's unconditional guarantee obligation and then equally between A_1 and A_2 . The CLP reveals A_2 's DRO to be illusory. Capital accounts after applying the CLP are as follows.

¹²⁰ Note that this reliance on and use of a partner's DRO is qualitatively different from the impact that the taxpayer ascribed to it in *Hubert I*. There, LCL members' DROs were used to, in effect, seek conversion of an otherwise limited liability into an unlimited liability. See *infra* Part VII.B. In the discussion in Part V.E, the partnership debt is an unlimited liability to begin with, as a result of an obligation other than a partner's DRO. In Examples 14 and 15 *infra*, A_1 's unconditional guarantee causes the partnership debt to be classified as an unlimited liability. A_2 's DRO is tested only to see if it would attract a share of this unlimited liability. See *infra* note 122.

	A_{G1}	A_{G2}
Initial contribution	\$100	\$100
Loss on hypothetical sale	(900)	(100)
	<hr style="width: 50%; margin: auto;"/> (\$800)	<hr style="width: 50%; margin: auto;"/> (\$0)

The \$800 note is categorized as a partnership recourse liability and allocated entirely to A_1 despite A_2 's DRO.¹²¹

¹²¹ A partner's DRO that is triggered by a deficit capital account may not be enforceable for two separate reasons. First, where despite a deficit in the partner's capital account, the DRO does not become due and payable. This could happen where the DRO is contingent upon the satisfaction of a further prior condition, in addition to a deficit in the partner's capital account. And second, where despite the DRO becoming due and payable, no person enjoys enforcement rights or privileges. This could happen where the terms of the DRO exclude non-partners from enforcing it and no other partner has a positive capital account that would confer enforcement privileges. The CLP is not designed to handle either case. In the first case, when the DRO is subject to an additional capital contingency beyond a deficit capital account, the proper treatment of the contingency for purposes of the CLP must be determined by examining the relevant section 752 rules independent of the CLP. Where the additional contingency is a liquidation of the partner's partnership interest, these rules necessarily ignore the contingency because the CLP is premised on a liquidation of the partnership and, therefore, of all partnership interests. This does not mean, however, that a liquidation contingency in a partner's DRO is irrelevant in establishing the partner's personal liability for the partnership debt. In fact, the liquidation contingency in LCL members' DROs was at the center of the debate in *Hubert I* about the members' personal liability for LCL's debt. The taxpayer had claimed that the liquidation contingent DROs rendered the members personally liable for LCL's debt. As shown in Part VII.B *infra*, this amounts to claiming that the DROs converted an otherwise limited liability into an unlimited liability. In contrast, the discussion in this Part V.E considers establishing a DRO partner's personal liability for partnership debt that has already been classified as an unlimited liability, as a result of an obligation other than the partner's DRO.

All contingencies other than a liquidation contingency should be reviewed under the standard of Treas. Reg. § 1.752-2(b)(4) that would require the DRO to be "disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged." Note that this review must be conducted before proceeding with the CLP. If, after this review, the DRO is disregarded as a consequence of its contingency, then the CLP assumes that the DRO does not exist. See *id.* The following variation on the facts of Example 15 demonstrates this.

Example 15(a). The facts are the same as in Example 15 except the LLC's operating agreement allocates all losses equally between A_1 and A_2 despite A_1 's unconditional guarantee and A_2 's DRO is contingent and only obligates A_2 to restore such deficit in its capital account as arises from the allocation of any loss of the real property's value caused by improper maintenance on the part of the LLC. "There are no facts that establish with reasonable certainty the existence of any [obligation] on the part of [A_2 for losses] resulting from the LLC's failure properly to maintain" the real property. Therefore, the section 752 rules disregard A_2 's DRO. In applying the CLP, A_1 's unconditional guarantee is the only partner obligation with respect to the repayment of the note that is recognized. Capital accounts after applying the CLP are as follows.

Example 16. The facts are the same as in Example 15 except the LLC's operating agreement allocates all losses equally between A_1 and A_2 despite A_1 's unconditional guarantee. Capital accounts after applying the CLP are as follows.

	A_{G1}	A_{G2}
Initial contribution	\$100	\$100
Loss on hypothetical sale	(500)	(500)
	(\$400)	(\$400)

The CLP cannot take the analysis beyond this stage and actually resolve the allocation of the \$800 note between A_1 and A_2 . This allocation would turn on the enforceability of A_2 's DRO—a question that the CLP cannot answer.¹²² Assume that the members' DROs are not enforceable by a creditor or any other non-member. Thus, only A_1 could possibly enforce A_2 's DRO. Whether A_1 can in fact do so, would depend upon the capital account treatment of A_1 's guarantee. If A_1 gets a capital account credit for payment on the guarantee, then A_1 will have a positive capital account after such payment and be in a position to enforce A_2 's DRO. If A_1 does not get such capital account credit, then A_2 's DRO is unenforceable. If A_1 can enforce A_2 's DRO, then the \$800 note is categorized as a partnership recourse liability and allocated \$400 each to A_1 and A_2 . If A_2 's DRO is not enforceable, then the \$800 note is categorized as a partnership recourse liability and allocated entirely to A_1 .¹²³

	A_1	A_2
Initial contribution	\$100	\$100
Loss on hypothetical sale	(900)	(100)
	(\$800)	\$0

The \$800 note is categorized as a partnership recourse liability and allocated entirely to A_1 despite A_2 's DRO. However, A_2 's DRO will probably be recognized for purposes of the section 704(b) safe harbor. See *infra* note 159.

The second case of an unenforceable DRO, where no person enjoys the rights or privileges of enforcing it is exemplified in Example 16 *infra*.

¹²² The enforceability of A_1 's DRO is not an issue because A_1 has furnished an unconditional guarantee. The partner nonrecourse debt rules of Treas. Reg. § 1.704-2(d)(2)(i), if applicable, would allocate all of the debt to A_1 . However, these rules only apply if the guaranteed debt is a state law nonrecourse debt. See *infra* note 159.

¹²³ Ignoring this limitation of the CLP, when combined with a failure to realize that classification of a partnership debt as an unlimited liability is a pre-requisite for proceeding with the CLP, results in a perception of "circularity" in the steps and operations of the CLP. See, e.g., *Burke*, *supra* note 3, at 412 ("On a constructive liquidation, there is a certain circularity: The amount realized on the deemed

Which partner is at risk?

*Which partner has a DRO?
When it isn't illusory.*

Illusory?

A creditor cannot enforce it.

Who can enforce it?

Hu's at risk.

F. *The CLP in Hubert*

In *Hubert*, one commentary has deployed the CLP to quantify LCL's recourse liabilities. Another used it to resolve whether and when LCL members' DROs could cause LCL's exculpatory liabilities to become recourse liabilities.¹²⁴ The first is completely unnecessary while the second represents an impossibility.

Which partner is at risk?

No. Which partner has a DRO.

I'm not asking you who's got a DRO.

Hu's at risk.

The CLP will reveal.

That's personal liability, we're not talking about it.

Now, how did I get to personal liability?

Why, you mentioned it.

If I mentioned personal liability, who did I say is exposed to the loss of personal assets?

No. Hu's at risk

1. PROVING A TAUTOLOGY

As shown above, the CLP merely allocates the partnership's unlimited liabilities to individual partners in the manner that the partners would share losses financed by them.¹²⁵ These unlimited liabilities, thus allocated by the CLP, follow losses. In order to apply the CLP, all partnership liabilities have to be classified as limited or unlimited. For this, the applicable law governing the liability, and not the CLP, provides the rule of decision. After applying the CLP, all partnership liabilities classified as unlimited liabilities

disposition depends on the amount of the LLC's limited liabilities, which in turn depends on whether the members' DROs [can be enforced].").

¹²⁴ See *Kalinka*, *supra* note 3, at 150–52, discussed in Part V.F.1 *infra*; *Rubin et al.*, *supra* note 3, discussed in Part V.F.2 *infra*.

¹²⁵ Unlimited liabilities include otherwise functionally nonrecourse debt backed by an unconditional guarantee. See *infra* Part VII.

are categorized as partnership recourse liabilities. Using the CLP to “derive” the partnership’s total recourse liabilities is, therefore, equivalent to proving a tautology. But this is exactly what one commentator has sought to do with LCL’s debt—without success.¹²⁶

Caught up with the complexity of making allocations of minimum gain from the deemed discharge of unlimited liabilities in Step (4) of the CLP,¹²⁷ our commentator seems to have missed the most basic feature about the basic accounting identity—that the two sides must always balance.¹²⁸ The

¹²⁶ See *Kalinka*, *supra* note 3, at 150–52.

¹²⁷ See *id.* at 152. *Kalinka* begins by postulating that a certain amount of LCL’s debt (\$7,500,000) allowed the creditor to reach beyond LCL’s assets and pursue its members’ personal assets. Consequently, this part of LCL’s debt comprises an unlimited liability. She then applies the CLP to LCL and its members’ capital accounts and ends up with an allocation of partnership recourse liabilities that aggregate less than the amount of the unlimited liabilities that she began with (\$4,829,696 for HBW; and \$48,785 for HCC; for a total of \$4,878,481; that is, \$2,621,519 less than the initially assumed \$7,500,000 of LCL’s “true” recourse debt).

¹²⁸ Equation (3-f) reproduced below shows the cumulative net impact of the CLP on the partnership’s basic accounting identity.

$$-(UL) = C + (LL - EA) - UA \quad (3-f)$$

The right hand side of Equation (3-f) captures the effect of the CLP on the partners’ capital accounts at an aggregate level. This effect at an individual partner level, on a given partner’s capital account, is given by (6) that can be particularized to the two LCL members, HBW and HCC, as follows:

$$C_{HBW} + (LL - EA)_{HBW} - (UA)_{HBW} \quad (6-a)$$

$$C_{HCC} + (LL - EA)_{HCC} - (UA)_{HCC} \quad (6-b)$$

with (6-a) relating to HBW’s capital account and (6-b) relating to HCC’s capital account. The subscripts HBW in (6-a) refers to HBW’s share of the respective partnership item. Similarly, the subscript HCC in (6-b) refers to HCC’s share of each partnership item. In LCL’s case, a 99:1 proportion between HBW and HCC applied uniformly and consistently to all partnership items of income, gain, loss and deduction as well as to the members’ respective capital contributions. Consequently, (6-a) and (6-b) can be restated as follows:

$$C_{.99} + (LL - EA)_{.99} - (UA)_{.99} \quad (6-c)$$

$$C_{.01} + (LL - EA)_{.01} - (UA)_{.01} \quad (6-d)$$

with the subscripts referring to the member’s percentage share of the respective partnership item.

An item-by-item addition of (6-c) and (6-d) yields the right hand side of Equation (3-f). This would be identical to Equation (3-f)’s left hand side since the two sides of LCL’s basic accounting identity must always balance. It follows that the respective deficits in HBW’s and HCC’s capital accounts after applying the CLP would always aggregate to LCL’s total unlimited liabilities. This final result cannot be affected by a gain (or loss) in the deemed discharge of limited liabilities—its total amount recognized by LCL in Step (4) of the CLP or its allocation among the members in Step (6). All such allocations become redundant when the two members’ capital accounts are aggregated.

Classifying a dollar of LCL’s debt as a limited liability instead of an unlimited liability, *ceteris paribus*, will have the following effect. If there was a gain in Step (4) of the CLP upon the deemed discharge of the limited liabilities and the deemed disposition of the encumbered assets, this gain would be smaller by a dollar. If instead there were a loss earlier in Step (4), this loss would be larger by a dollar. In either case, upon allocation of this smaller gain or larger loss, the aggregate of the respective balances in the two members’ capital accounts would be smaller by a dollar. Consequently, when the loss

imbalance in the commentator's computation of the two sides of LCL's basic accounting identity stems from assuming a certain amount of unlimited liabilities without a corresponding amount of unencumbered assets.¹²⁹

Applying the CLP and allocating gains and losses from the deemed discharge of liabilities and deemed disposition of assets to LCL members' capital accounts in order to arrive at LCL's recourse liabilities is "overkill," or at least attempted overkill—using a neutron bomb to kill a mosquito. But then to miss the target, as this commentator has done, can only be described as a "failure to execute."

2. INSTRUMENT OF TORTURE

Another set of commentators have wielded the CLP, not so much as an instrumentality of doom but as an instrument of torture—to extract from LCL the details about its members' personal liability.¹³⁰

Which partner is at risk?

Which partner has a DRO.

The CLP will reveal.

That's personal liability.

There I go, back on personal liability again!

These commentators have propounded that as a consequence of LCL members' DROs, the CLP could allocate to these members, shares of LCL's exculpatory liabilities that would then be categorized as partnership recourse liabilities. With a partnership where the liabilities are secured by all partnership assets, all liabilities are limited and all assets encumbered. In such a partnership, our commentators claim that the CLP would create a deficit in a partner's capital account only if all the partners had positive capital accounts to begin with and, further, that such a deficit would attract

recognized from the deemed disposition of the unencumbered assets in Step (5) is allocated among both members, the aggregate of the respective resulting deficits in the two members' capital accounts would be larger by a dollar. Thus, the two members' capital accounts, combined, would attract an additional dollar of LCL's unlimited liabilities as partnership recourse liabilities.

¹²⁹ Any liability must finance an asset of equal amount. Thus, a dollar of LCL's unlimited liabilities, on the left hand side of Equation (3-b) must be reflected in a dollar of unencumbered assets on the equation's right hand side. All unencumbered assets are deemed to become worthless and disposed of and their losses allocated to LCL members in Step (6) of the CLP. Thus, this dollar of loss must be allocated to and subtracted from the two members' respective capital accounts. This should cause the combined deficit of the two capital accounts, represented by the right hand side of Equation (3-f), to be larger by a dollar.

¹³⁰ See Rubin et al., *supra* note 3, at Part III.

an equal amount of the partnership's liabilities. The first could be true under some circumstances that did not, however, apply in LCL's case, while the second could never be true under any circumstances.

In a partnership where all the liabilities are limited and all assets encumbered, the CLP can create a deficit in any one partner's capital account only if the respective balances in the partners' capital accounts are positive at the time of applying the CLP. The aggregate of these positive capital account balances represents the partnership's positive equity in the encumbered assets.¹³¹ This is a necessary but not a sufficient condition for the CLP to create a deficit in any one partner's capital account. For such a deficit, losses relating to the encumbered assets must also be allocated among the partners in a manner disproportionate to their respective capital contributions.

The partnership's positive equity in the encumbered assets would "belong" to, or be claimed by, the partners in proportion to their respective capital contributions.¹³² Each partner's positive capital account balance, before the CLP, would consist of its individual share of the partnership's positive equity in the encumbered assets. The deemed discharge of the limited liabilities and the deemed disposition of the encumbered assets in Step (4) of the CLP would cause the partnership to recognize a loss in the amount of its positive equity in the encumbered assets. This loss would be allocated to the individual partners. So long as this allocation is made in the same proportion as the partner's respective capital contribution, it would exactly offset each partner's positive capital account balance that existed at the time of applying the CLP. Each individual capital account would be left with a zero balance and none would show a deficit. The following example demonstrates this.

Example 17. A_{L1} and A_{L2} are both limited partners in a limited partnership with no other limited partners. Each partner has a DRO.¹³³ A_{L1} and A_{L2} share capital contributions and all partnership items in a 99:1 proportion. The book balance sheet of the partnership is as follows.

¹³¹ Where the partnership has negative equity in the encumbered assets, the deemed discharge of limited liabilities and the deemed disposition of encumbered assets in Step (4) of the CLP and the minimum gain chargeback allocations in Step (6) will leave each individual capital account with a non-negative balance. There can be no discretion in how the minimum gain chargeback allocations are made among the partners. Each partner's minimum gain chargeback allocation will equal the amount of the nonrecourse deductions that it had been previously allocated. A partner's capital account balance, before applying the CLP, could have been negative only as a consequence of the allocation of such nonrecourse deductions. Consequently, after the CLP has made all minimum gain chargeback allocations, a deficit in any partner's capital account would have been completely restored.

¹³² The creditor can pursue all assets of the LLC which are, therefore, encumbered.

¹³³ Assume, as in *Hubert I*, that each DRO is contingent upon a liquidation of the respective member's membership interest in the LLC.

Assets		Liabilities and Capital	
Property	\$120.00	Debt	\$100.00
		Capital	
		A _{L1}	\$19.80
		A _{L2}	\$0.20
	<u>\$120.00</u>		<u>\$120.00</u>

The debt is secured by all assets of the partnership but is without recourse to either partner. Capital accounts after applying the CLP are as follows:

	A _{L1}	A _{L2}
Initial contribution	\$19.80	\$0.20
Loss on hypothetical sale	(19.80)	(0.20)
	<u>\$0</u>	<u>\$0</u>

The only way to create a deficit in any one partner's capital account is by allocating to that partner a share of the loss from the deemed disposition of the encumbered assets that is disproportionate to the partner's capital contributions. Either member's capital account will show a deficit only if it is allocated a loss that exceeds its pro-rata share of the combined positive equity in the encumbered assets. The aggregate of the two members' capital account balances will, as before, be zero reflecting the partnership's complete loss of its positive equity in the encumbered assets. But with a disproportionate allocation of this loss, one member's capital account will have a positive balance while the other's will show a deficit. The following example demonstrates this.

Example 18. The facts are the same as in Example 17 except that the partnership agreement requires that A_{L2} be allocated all losses until its capital account reaches (\$10). Capital accounts after applying the CLP are as follows:

	A _{L1}	A _{L2}
Opening balance	\$19.80	\$0.20
Loss on hypothetical sale	(9.80)	(10.20)
	<u>\$10.00</u>	<u>\$10.00</u>

It follows from Example 18 above that with a two-member LLC, where the debt is recourse only to the LLC and not to the members, the CLP could create a deficit in either member's capital account only if the encumbered assets are allocated among the two members in a manner disproportionate

to the members' capital contributions.¹³⁴ This deficit in one member's capital account would be created by, in effect, shifting losses from the other member and leaving the latter with a positive capital account. This was clearly not the case with LCL where all partnership items, whether flow (income, gain, loss and deduction) or stock (capital and debt) were allocated among the two members in the same 99:1 proportion.¹³⁵

Thus, causing the CLP to create a deficit in the capital account of either of LCL's two members requires taking liberties with the facts. But even with such liberties, the exercise remains futile. The objective in applying the CLP is not to see if it would create a deficit in an individual capital account but whether this deficit would attract an equal amount of the partnership's liabilities that are deemed to become due and payable and have survived the CLP. For this, the deficit must invoke an enforceable obligation to make a payment or additional capital contribution, not for distribution to the partner with a positive capital account balance or to bolster the partnership's cash reserves, but to meet a partnership liability that is deemed to become due and payable. Where the partnership has only limited liabilities, all the liabilities would be deemed to be discharged in Step (4) of the CLP. In fact, this deemed discharge by the deemed disposition of the encumbered assets and the recognition and allocation of the resulting loss would have allowed for contriving a deficit in the first place. In the absence of any liabilities that remain to be satisfied, there would be nothing for the deficit to attract.

The CLP is a prescription for establishing a partner's personal liability for a partnership debt that has been classified as an unlimited liability. It is not a license for speculating on the consequences that would befall a partner with a DRO if all partnership assets suddenly became worthless. The CLP recognizes personal liability for a partner who, upon a constructive liquidation, is obligated to restore a deficit in its capital account but only if the obligation arises because of a partnership liability that is assumed to become due and payable. Thus, a partner's DRO is meaningful for the CLP only if it would be "activated" by a partnership liability. While the deficit may owe its existence to the deemed disposition of partnership assets,¹³⁶ the

¹³⁴ This member's capital account should have a positive balance before applying the CLP. If the capital account's balance before applying the CLP is negative, then the minimum gain charge allocation will restore the entire deficit. See *supra* note 131.

¹³⁵ Capital contributions were made in the same 99:1 proportion. All allocations of partnership items of loss or deductions, representing depletions of the capital accounts were also allocated in this 99:1 proportion. Therefore, the capital account balances at any point in time would reflect the 99:1 proportion. But see sources cited *supra* note 39, discussing the possibility that HBW may have received capital account credit for contributed leases, thus upsetting the strict 99:1 proportion.

¹³⁶ See *supra* Part V.C discussing Step (3) of the CLP ("The partnership disposes of all of its property in a fully taxable transaction for no consideration, except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership.").

obligation to restore the deficit must be necessitated by the deemed repayment of a partnership liability.

An LCL member's capital account deficit, no matter how artfully contrived, and the member's obligation to restore it, no matter how persistently enforceable, would be meaningless for the CLP's purposes if there are no liabilities to discharge. The commentary that deploys the CLP to extract from LCL the "true facts" about its members' personal liability salvages the fanciful contrivance of the deficit by contending that the CLP's hypothesized destruction of a partnership's assets extends beyond a foreclosure.¹³⁷ The commentators argue that since these assets, if seized by a creditor, continue to be worthless, the creditor's claim and, therefore, LCL's liabilities would survive the CLP, their exculpatory nature notwithstanding.¹³⁸ An obligation to restore a deficit created by the CLP would, thus, be necessarily caused by these limited liabilities, albeit previously deemed discharged, becoming due and payable.

There is nothing in this argument that limits its application to an LLC's exculpatory liabilities. By this logic, even a state law nonrecourse debt could trigger a partner's DRO and be categorized as a partnership recourse liability. The following example demonstrates this.

Example 19. A_1 and A_2 are the members of a two-member LLC. Each member has a DRO. A_1 and A_2 share capital contributions and all partnership profits in a 99:1 proportion. The LLC's operating agreement requires that A_2 be allocated all losses until its capital account reaches (\$10). The book balance sheet of the LLC is as follows.

Assets		Liabilities and Capital	
Property	\$120.00	Debt	\$100.00
		Capital	
		A_1	\$19.80
		A_2	\$0.20
	<u>\$120.00</u>		<u>\$120.00</u>

¹³⁷ See *Rubin et al.*, *supra* note 3, at Part III, Example 3.

¹³⁸ Compare *Rubin et al.*, *supra* note 3 ("Note that under the language of the constructive liquidation test of the section 752 regulations, the assumption that all assets of the LLC are worth zero applies with respect to assets that are presumed transferred to the creditor on account of the debt. Thus, because the creditor's rights are *not extinguished*, in applying the constructive liquidation test the creditor should be presumed to pursue the [debt].") (emphasis added), with Treas. Reg. § 1.752-2(b)(2)(i) (2008) ("If the creditor's right to repayment of a partnership liability is limited solely to one or more assets of the partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is *extinguished* by the deemed disposition and [book value] in those assets.") (emphasis added).

The LLC's only debt is a state law nonrecourse debt secured by the only asset of the LLC—real property with a book value of \$120. Capital accounts after applying the CLP are as follows.

	A ₁	A ₂
Initial contribution	\$19.80	\$0.20
Loss on hypothetical sale	(9.80)	(10.20)
	\$10.00	(\$10.00)

If, as the commentators contend, “the creditor’s rights are *not extinguished* in applying the [CLP],” then “the creditors should be presumed to pursue the \$10” deficit in A₂’s capital account.¹³⁹ Therefore, A₂’s DRO should attract \$10 of the LLC’s state law nonrecourse debt. The absurdity of this result demonstrates the fallacy in the commentator’s analysis and contention.

Would you just stay on personal liability and don’t go off it.

All right, what do you want to know?

Now who’s personally liable for LCL’s debt?

Why do you insist on making Hu personally liable for LCL’s debt?

Which partner am I making personally liable for LCL’s debt.

No. Which partner has a DRO.

You don’t want who to be personally liable for LCL’s debt?

Hu is at risk.

The CLP will reveal.

Personal Liability!

3. RECOMMENDED USE

The correct way to handle a partnership debt that has been previously identified as a limited liability while applying the CLP is the following. The liability is deemed to be discharged in Step (4) of the CLP by transferring the corresponding encumbered assets to the creditor. The partnership recognizes gain or loss in the amount of the difference between the face value of the liability and the book value of the transferred assets. This gain

¹³⁹ *Rubin et al., supra* note 3, at Part III, Example 3 (emphasis added). In fact, the creditor has no right to this \$10 deficit so long as the debt is functionally nonrecourse, whether or not it is a state law nonrecourse debt. As Example 18 demonstrates, this \$10 deficit represents A₁’s positive equity in the real property. If anybody should be able to pursue it, it should only be A₁. The creditor has been made whole, and then some, assuming value equals basis, by obtaining real property worth \$120 in exchange for debt with a face value of \$100.

or loss is allocated among the partners in the applicable proportion.¹⁴⁰ The deemed discharge of liability and transfer of assets satisfies the debt in full and extinguishes all claims of the creditor.¹⁴¹ Any obligation on the part of a partner to make a payment or additional capital contribution cannot be attributed to or made on account of this discharged liability.

This method is straightforward and easy to follow where the limited liability nature of the debt is clear—from the provisions of the loan agreement or the partnership's organic documents or background law. Confusion arises, however, in the case of supplementary obligations undertaken by a partner that run directly to the creditor or to other partners and that relate to, or could relate to the loan. These obligations could cause a loan that otherwise on its own terms would be a limited liability of the partnership to be classified as an unlimited liability under the section 752 rules. How does one make this determination? More importantly, can this determination be calibrated with the requirements of personal liability under section 465? If so, then once partnership debt has been classified as an unlimited liability under the section 752 rules, the debt's allocation pursuant to the CLP will ensure the allocatee-partner's personal liability for its repayment under section 465. In the next part, I show that this calibration is indeed feasible and should be the norm for classifying partnership debt as an unlimited liability under the section 752 rules in any section 465 at-risk inquiry.

PART VI. CALIBRATING THE TOOLS TO THE TASK

In this part, I derive the necessary and sufficient conditions for a partnership debt classified as an unlimited liability under the section 752 liability sharing rules to yield personal liability under the section 465 at-risk rules. Any partnership debt that is classified as an unlimited liability under the section 752 rules will eventually be allocated by the CLP to one or more partners as a partnership recourse liability. What conditions must be met for the allocatee-partner to be considered personally liable under section 465 for repayment of this debt? If these conditions are met, then, a partnership debt that is classified as an unlimited liability under the section 752 rules will, upon allocation, also establish the allocate partner's personal liability under section 465.

¹⁴⁰ A gain is allocated as a minimum gain chargeback in the proportion that nonrecourse deductions were previously allocated. A loss is allocated in the proportion agreed upon for sharing losses relating to the encumbered asset. See *supra* text accompanying notes 115–16.

¹⁴¹ See *supra* note 138.

We saw earlier that a taxpayer's personal liability for repayment of a debt, for section 465 purposes, is comprised of three discrete conditions: (i) the availability of the taxpayer's personal assets; (ii) to the creditor; (iii) upon no other contingency except default.¹⁴² Of these three conditions, the first relates to the taxpayer's relationship with the borrowing while the last two define the creditor's relationship with the borrower. In order to establish a partner's personal liability under section 465, a partnership's unlimited liability that is allocated to the partner must also satisfy these three conditions. Until an unlimited liability is allocated, the individual taxpayer-partners who are personally liable for its repayment cannot be identified. Thus, the first condition, defining the taxpayer-partner's relationship with the borrowing, could only be satisfied by the allocation function of the section 752 rules. The last two conditions, describing the creditor's relationship with the partnership must be satisfied by the unlimited liability itself. It follows that for an unlimited liability under the section 752 rules to establish personal liability under section 465: the creditor should be able to access one or more partners' personal assets; and this access should not depend upon any contingency except default on the debt.

Each of these two conditions is a necessary condition for a partnership debt classified as an unlimited liability under the section 752 rules to establish personal liability under section 465. Moreover, satisfaction of both conditions is sufficient for this purpose. A partnership debt that satisfies the two conditions would also be classified as an unlimited liability under the section 752 rules. Where a creditor can access one or more partners' personal assets upon no other contingency except default, the creditor's right to repayment is not limited to one or more assets of the partnership. But this is exactly how the section 752 rules define an unlimited liability.¹⁴³ Thus, the classification of an unlimited liability under the section 752 rules can be made in a manner that delivers personal liability under section 465. In the remainder of this article, I refer to a partnership liability, thus classified, as having been properly classified as an unlimited liability.

PART VII. PERSONAL LIABILITY BY OTHER MEANS

Where a partnership debt is otherwise functionally nonrecourse, supplementary obligations could cause it to be properly classified as an unlimited liability under the section 752 rules and, upon allocation, establish the allocatee-partner's personal liability for its repayment under section 465.

¹⁴² See *supra* Part III.A.3.

¹⁴³ See Treas. Reg. § 1.752-2(b)(2)(i) (2008) (stating that "creditor's right to repayment of a partnership liability is [not] limited solely to one or more assets of the partnership").

For this, as shown above, the test is whether the supplementary obligations enable the creditor to access one or more partners' personal assets upon no other contingency except default.

A. *Unconditional Guarantee*

Because all partnership liabilities must be segregated between limited and unlimited liabilities for the CLP to proceed, this test must be conducted independent of and before applying the CLP. The CLP itself cannot be used or made a part of this test.¹⁴⁴ A partner's unconditional guarantee to repay a partnership debt will satisfy this test.¹⁴⁵ The unconditional guarantee will obligate the partner to apply its personal assets held outside the partnership to satisfy the debt. And by invoking the guarantee, the creditor will be able to access these assets upon no other contingency except a default on the debt. The debt should therefore be classified as an unlimited liability for purposes of the CLP. As mentioned earlier, the section 752 rules recognize both the guarantee and the guarantor-partner's obligation outside the CLP. Even so, the CLP can be made to validate the result. For this, all losses financed by the guaranteed debt should be allocated to the guarantor-partner. In applying the CLP, any assets that under the original terms of the loan secured the guaranteed debt should no longer be considered encumbered assets but be treated as unencumbered assets.¹⁴⁶ In Step (5) of the CLP, the partnership should recognize a loss in the amount of the book value of these assets and any other remaining proceeds of the guaranteed debt. The entire amount of this loss should be allocated to the guarantor-partner in Step (6).¹⁴⁷ As a result, the CLP will leave a deficit in the guarantor-partner's capital amount that equals the face value of the guaranteed debt. To support the allocation of losses financed by the guaranteed debt and sustain the resulting deficit in its capital account, the guarantor-partner should have a DRO.¹⁴⁸ If the guarantor-partner lacks an

¹⁴⁴ See *supra* Part V.B.

¹⁴⁵ The guarantee should not be contingent upon a deficit in the partner's capital account. See *supra* Example 14. See also *supra* note 120 and accompanying text.

¹⁴⁶ This would include any security for the debt under the original terms of the agreement as memorialized in the principal loan document, under the partnership agreement, or in background law, such as the state's LLC act.

¹⁴⁷ These losses are recourse deductions because the assets they relate to are now considered unencumbered assets.

¹⁴⁸ This would ensure compliance with the section 704(b) safe harbor. See *supra* note 25.

actual DRO,¹⁴⁹ then it will be “supplied” one in the amount of the guarantee.¹⁵⁰

The DRO, whether actual or supplied, in the amount of the face value of the guaranteed debt, will attract an equal amount of the partnership’s unlimited liabilities. Because these unlimited liabilities will include the guaranteed debt, the guarantor-partner will be allocated this debt. The section 752 rules will, therefore, categorize the guaranteed debt as a partnership recourse liability. In doing so, these rules will establish the guarantor-partner’s personal liability for its repayment. The following example demonstrates this.

Example 14 reproduced below as Example 20 shows the use of a partner’s unconditional guarantee to establish personal liability for repayment of partnership debt that is otherwise functionally nonrecourse.

Example 20. A₁ and A₂ organize an LLC to which each contributes \$100 in cash. The LLC buys real property for \$1,000 using its \$200 cash and a note for \$800. The note is recourse to the LLC but not to either member and, therefore, an exculpatory liability of the LLC. A₁ unconditionally guarantees repayment of the note if the LLC’s assets are insufficient for this purpose. Neither member has a DRO and the LLC’s operating agreement allocates all profits and losses equally between A₁ and A₂, subject to the requirements of the section 704(b) safe harbor.¹⁵¹ The section 752 rules recognize A₁’s guarantee outside the CLP. The \$800 note is categorized as a partnership recourse liability and allocated entirely to A₁.

The CLP can validate this result. In applying the CLP, the following should be observed: (i) as a consequence of A₁’s unconditional guarantee, the \$800 note is properly classified as an unlimited liability; (ii) the first \$800 of losses are allocated to A₁ to reflect A₁’s unconditional guarantee obligation¹⁵² and then equally between A₁ and A₂; and (iii) to support these allocations, A₁’s unconditional guarantee supplies it with a DRO in the amount of its guarantee obligation. Capital accounts after applying the CLP are as follows.

¹⁴⁹ An “actual” DRO is one that the partner has contracted for, and is typically contained in the partnership agreement. See *supra* note 40 (setting forth the LCL members’ actual DROs that were contained in LCL’s amended and restated operating agreement).

¹⁵⁰ See Christine Rucinski Strong & Susan Pace Hamill, *Allocations Attributable to Partner Nonrecourse Liabilities: Issues Revealed by LLCs and LLPs*, 51 ALA. L. REV. 603, 634 n.127 (2000); Treas. Reg. § 1.704-1(b)(2)(ii)(c) (2008). See also Part VIII (discussing the LSA and “supplied” DROs).

¹⁵¹ The LLC would meet the so-called “alternate test” of the section 704(b) safe harbor prescribed by Treas. Reg. § 1.704-1(b)(2)(ii)(d) (2008). This would allocate away from A₂, who has neither an actual nor a supplied DRO, or any losses that would cause or increase a deficit in A₂’s capital account.

¹⁵² See *id.*

	A ₁	A ₂
Initial contribution	\$100	\$100
Loss on hypothetical sale	(900)	(100)
	(\$800)	\$0

A₁'s \$800 capital account deficit and the accompanying obligation to restore it, represented by A₁'s "supplied" DRO, attract an equal amount of the partnership's unlimited liabilities. Therefore, the \$800 note is categorized as a partnership recourse liability and allocated entirely to A₁.

The CLP thus validates a guarantor-partner's personal liability for an unconditional guarantee to repay a partnership debt that is otherwise structured and documented as a limited liability—a state law nonrecourse debt or an LLC's exculpatory liabilities. Though the CLP does so by means of the guarantor-partner's DRO, the guarantee itself supplies a DRO to a guarantor-partner who has not contracted for one. Therefore, an unconditional guarantee by itself, in the absence of an actual DRO, is sufficient to categorize the guaranteed debt as a partnership recourse liability and establish the guarantor-partner's personal liability for its repayment. This begs the question: Could an actual DRO alone, without an explicit guarantee, suffice for this purpose? In other words, can a partner, without explicitly guaranteeing repayment of a partnership's otherwise functionally nonrecourse debt, establish personal liability for its repayment by merely entering into a DRO?

B. *Creditor Enforceable DRO*

For this, the DRO itself must cause the debt to meet the test of an unlimited liability. A DRO represents a partner's obligation to make additional capital contributions to restore a deficit in its capital account. However, unlimited liabilities are defined in terms of the creditor's right rather than the partner's obligation.

For the debt to be properly classified as an unlimited liability, the creditor should be able to access the DRO-partner's personal assets not yet contributed to the partnership upon no other contingency except default. The only personal assets of the DRO-partner that could become available are the additional capital contributions that the partner makes to restore a deficit in its capital account. A creditor can access them only if the debt allows the creditor to pursue all assets of the partnership—even those that are acquired

after the debt is incurred.¹⁵³ It follows that the debt must be with full recourse to all assets of the partnership; that is, a state law recourse debt.

The creditor's right to these assets upon default should be real rather than constructive. If the DRO-partner is obligated to make additional capital contributions only upon a liquidation of the partnership, the creditor's right exists only within the world of the CLP. Until the partnership is liquidated, the DRO-partner is not obligated to make additional capital contributions and the creditor cannot access them. Thus, the creditor should be able to enforce the DRO upon default, or alternatively, force a liquidation upon default.¹⁵⁴

Finally, the creditor's access cannot be subject to any other contingency except default. However, a DRO, by definition, is contingent upon a deficit capital account. Therefore, any default should be accompanied by a deficit in the DRO-partner's capital account. This deficit should be no less than the shortfall in the partnership's assets to repay the debt. This condition will be satisfied so long as all losses financed by the debt are allocated to the DRO-partner. Such an allocation will ensure against an illusory DRO.¹⁵⁵

As a result of this allocation, the CLP will leave the DRO-partner's capital account with a deficit in the amount of the debt.¹⁵⁶ This deficit and

¹⁵³ The standard security agreement granting such a right covers all assets of the partnership whether now owned or hereafter acquired.

¹⁵⁴ Creditor enforceability does not contradict the analysis in Part III.C where the creditor's ability to proceed against the taxpayer was shown to be irrelevant to a section 465 at-risk inquiry. See *supra* Example 11. Affixing personal liability of a taxpayer for partnership debt requires the debt's proper classification as an unlimited liability and its allocation under the section 752 rules to the taxpayer-partner. It is the creditor's ability to access these assets, irrespective of whether or not it can proceed against the taxpayer-partner, that matters. In Example 11, under the terms of the debt the creditor did not have to proceed against the taxpayer-partner to access these assets. However, where the terms of the debt and applicable background law deny the creditor access to assets not yet contributed to the subject activity (as with a state law nonrecourse debt or an LLC's exculpatory liabilities), an affirmative obligation on the part of the taxpayer alone could grant such access. This affirmative obligation, an unconditional guarantee or creditor enforceable DRO, necessarily enables the creditor to proceed against the taxpayer. Therefore, in Example 20 *supra*, the creditor's right to proceed against the taxpayer-partner was an integral part of its access to the taxpayer-partner's assets.

¹⁵⁵ Where the terms of the debt or the applicable background law allow the creditor to access one or more taxpayer-partners' personal assets upon no other contingency except default, the debt is properly classified as an unlimited liability. The CLP serves to "reveal" the specific taxpayer-partners who are so exposed by "following" losses. However, where the creditor's access results from supplemental obligations affirmatively undertaken by one or more taxpayer-partners, the identity of these taxpayers is revealed by the very obligations that cause the debt to be classified as an unlimited liability. In this case, there is nothing left to reveal. The CLP can only confirm what is already known—but only if losses follow liabilities.

¹⁵⁶ Any positive equity in the encumbered assets is zeroed out by loss recognition in Step (4) of the CLP. See *supra* Part V.C. Any deficit in the DRO-partner's capital account will be restored by allocations of minimum gain chargeback in Step (6) of the CLP. See *supra* Part V.F.1.

the partner's creditor enforceable DRO will attract an equal amount of the partnership's unlimited liabilities. The partnership's total unlimited liabilities will be larger by the amount of the partnership debt that, though otherwise functionally nonrecourse, has been classified as an unlimited liability because of the creditor enforceable DRO. Consequently, the DRO-partner will be allocated this partnership debt that the section 752 rules will then categorize as a partnership recourse liability. This will establish the DRO-partner's personal liability for repayment of the debt.¹⁵⁷

The result arrived at by the CLP comports with economic reality. The allocation of all losses financed by the otherwise functionally nonrecourse debt to the DRO-partner ensures that the DRO-partner will have a capital account deficit whenever the partnership assets are insufficient to repay the debt. Because the partner's DRO is enforceable by the creditor upon default, the creditor can then satisfy the debt by forcing the partner to make additional capital contributions.¹⁵⁸ Consequently, the partner is exposed to

¹⁵⁷ Compare this situation with Example 19 *supra*. In that example, the DRO was not enforceable by the creditor. Partnership debt that was classified as a limited liability, though once discharged, became "alive" again. In the situation described here, the debt is "properly classified" as a limited liability to begin with. The difference between Example 19 and the situation here is not limited to semantics. Creditor enforceability of the DRO defines the creditor's repayment right and extends it beyond the partnership's assets. This enforceability is verified before applying the CLP and causes the debt to be "properly classified" as an unlimited liability for purposes of the CLP. As a consequence of this classification, the CLP will "derive" the correct result. But, more importantly, this result also comports with economic reality. See the immediately following discussion.

¹⁵⁸ Because the debt is a state law recourse debt, the creditor can access these additional capital contributions. The DRO is not, and is not treated as, an asset that the creditor can seize. It is not included in the DRO-partner's capital account. If it were an asset, there could never be a loss in Step (4) of the CLP. The partnership debt constituting a limited liability would be satisfied by an equal amount of partnership assets (including the DRO). Similarly, under the two-part framework, if the DRO were an asset, the DRO-partner could never be considered personally liable. The DRO-partner would not be exposed to the loss of personal assets not yet contributed because the DRO would be considered already contributed to the partnership. Compare this situation with the *Taxpayer Brief, supra* note 3, which claimed LCL members' DROs were LCL's assets that the creditor could seize. See also *Burke, supra* note 3, at 415 (arguing that contribution of a "nonnegotiable promissory note" to an LLC would create personal liability for the contributing partner for repayment of the LLC's exculpatory liabilities in the amount of the note). A nonnegotiable note would, by definition, not be readily tradable on an established securities exchange and, therefore, would not be includable in the contributing partner's capital contributions. See Treas. Reg. § 1.704-1(b)(2)(iv)(d)(2) (2008). Thus, the note would represent the partner's personal assets not yet contributed to the partnership. But, under the two-part framework, the creditor should be able to access such assets upon no other contingency except default. For this, the note should be freely transferable without requiring the maker's consent. A nonnegotiable promissory note could not be so transferred and would not, therefore, create personal liability for the contributing partner. However, a transferable note, where the maker waives any prior consent requirements for transfer and is not tradable on an established securities exchange, would suffice to create personal liability for the contributing partner.

the loss of the personal assets that it has not yet contributed to the partnership and that are not reflected in its capital account balance. Thus, the DRO-partner is personally liable for repayment of the debt.

C. Losses Follow Liabilities

With both unconditional guarantees and creditor enforceable DROs, the requirement that all losses financed by the debt be allocated to the obligated partner is critical. This ensures that the respective obligation to make a payment or additional capital contributions is triggered whenever the partnership's assets are insufficient to repay the debt. It also achieves the correspondence between liabilities and losses that the section 752 rules mandate. With debt that on its own terms is an unlimited liability, losses lead and liabilities follow.¹⁵⁹ Where a partner's unconditional guarantee

¹⁵⁹ Neither the section 704(b) safe harbor nor the CLP checks DROs for their enforceability. As a result, an unenforceable DRO can serve two "abusive" motives for a partner who is not exposed to the loss of personal assets for repayment of partnership debt. First, it can support allocations of partnership losses financed by this debt to the partner. Second, it can cause this debt to be allocated to the partner as a partnership recourse liability. In most situations, the LSA and the partner nonrecourse debt rules of Treas. Reg. § 1.704-2(i) check against the former and the CLP then prevents the latter. See *infra* Part VIII.A for a discussion on the LSA. See also *infra* notes 160 and 172. See Strong & Hamill, *supra* note 150, at 661-66, for a discussion on how and when the partner nonrecourse debt rules can prevent unenforceable DROs from supporting allocations of distributive shares of debt financed losses. The potential for abuse remains where an LLC's debt that, without being state law nonrecourse, is nonetheless functionally nonrecourse. As a result, it is an exculpatory liability, in which neither the LSA nor the partner nonrecourse debt rules apply. This illustrates the need to independently ensure that losses follow liabilities.

For partnership debt that is properly classified as an unlimited liability on its own terms and applicable background law (a "true" recourse debt), if the partners' obligations for repayment of the debt arise on account of their DROs, these DROs are likely to be enforceable. One or more partners, (usually general partners in a limited partnership) will enjoy both the rights and privileges of enforcing such DROs. With true recourse debt, where the obligated partner lacks a DRO, the LSA will police against an unenforceable DRO from serving the former abusive purpose. And the CLP, if it follows the LSA mandated allocation of losses, will deny the latter abusive purpose. The partner nonrecourse debt rules achieve the same results for state law nonrecourse debt that is converted into an unlimited liability as a result of a partner's unconditional guarantee or creditor enforceable DRO. Now, consider an LLC's state law recourse debt that is otherwise an exculpatory liability, but subject to a partner guarantee or creditor enforceable DRO. The LSA is inapplicable because the debt on its own terms and applicable background law is not an unlimited liability. See *infra* notes 160 and 172. And the partner nonrecourse debt rules do not apply because the debt is not a state law nonrecourse debt. See Strong & Hamill, *supra* note 150, at 661-66. The requirement that losses follow liabilities can then be seen, alternatively and equivalently, as extending the LSA or the partner nonrecourse debt rules to an LLC's exculpatory liabilities. See *id.* for a detailed discussion on this issue. If losses do not follow liabilities, then a "functionally non-obligated" partner's nominal but unenforceable DRO can support allocations of the debt financed losses. Where the obligated partner has furnished a guarantee, the obligation will be

or creditor enforceable DRO is used to convert a functionally nonrecourse debt into an unlimited liability, the liability leads and losses must follow. The obligated partner should be the one who is allocated the debt. This partner, instead of any other partner, is obligated to make a payment or additional capital contribution and, therefore, personally liable for its repayment. Consequently, all losses financed by this debt must also be allocated to the obligated partner.¹⁶⁰

In the preceding discussion, I have assumed that a partner seeks to establish personal liability for repayment of the entire amount of a functionally nonrecourse debt by means of an unconditional guarantee or

recognized outside the CLP and still be allocated correctly to the guarantor-partner. See *supra* Example 15. The situation is more complex where the obligated partner's obligations arise from a creditor enforceable DRO. There, the debt financed losses would have been allocated to the functionally non-obligated partner with the unenforceable DRO. The CLP will then reveal the obligated partner's DRO, though enforceable, to be illusory because this partner was not allocated any of the debt financed losses. On the other hand, the partner who was allocated the debt financed losses and consequently has a deficit capital account would have a DRO that could not be enforced. Consequently, the debt could not be allocated to either partner. This would call into question its proper classification as an unlimited liability. The following variation on the facts of Example 15 demonstrates this.

Example 15(b). The facts are the same as in Example 15, except for the following: instead of furnishing an unconditional guarantee, A₁ enters into a DRO that the creditor who holds the \$800 note can enforce, A₂ enters into a DRO that a non-member cannot enforce, and the LLC's operating agreement allocates all losses equally between A₁ and A₂ until A₁'s capital account is reduced to zero and then to A₂ despite A₁'s creditor enforceable DRO. Because the section 704(b) rules will not test either DRO for enforceability, the members' agreed upon loss allocation will be honored. Capital accounts after applying the CLP are as follows.

	A ₁	A ₂
Initial contribution	\$100	\$100
Loss on hypothetical sale	<u>(100)</u>	<u>(900)</u>
	\$0	(\$800)

Allocating the debt to A₂ would require an independent assessment, independent of and outside the CLP, of the enforceability of A₂'s DRO. The terms of the DRO deny enforcement rights to a creditor and only A₁ could possibly enforce it. But in this case, because A₁ does not have a positive capital account, it too will be unable to enforce A₂'s DRO. Requiring losses to follow liabilities will prevent this anomalous result.

¹⁶⁰ This requirement is already embodied in existing law for most situations except for an LLC's state law recourse debt that, in the absence any affirmative obligations by the LLC's members – such as unconditional guarantees or creditor enforceable DROs—would constitute the LLC's exculpatory liabilities. The partner nonrecourse debt rules of Treas. Reg. §1.704-2(i) (2008) achieve this correspondence, but only for state law nonrecourse debt that is properly classified as an unlimited liability. An LLC's state law recourse debt would not be covered by these rules. See Strong & Hamill, *supra* note 150, at 661–66. The LSA, as contained in Rev. Rul. 97-38, 1997-2 C.B. 69, applies only to state law recourse debt where the partners who are obligated under state law for repayment of the debt lack actual DROs. See *infra* note 172. Because members of an LLC could never have state law repayment obligations for the LLC's debt, they would not appear to be covered by Rev. Rul. 97-38. See also *supra* note 159.

creditor enforceable DRO. Thus, the extent of a partner's respective obligation has covered all of the outstanding debt. Losses financed by the entire amount of the debt are, therefore, allocated to the obligated partner. Where the partner's unconditional guarantee or creditor enforceable DRO is limited to a dollar amount, the obligated partner's personal liability for repayment of the debt is similarly limited—to the amount of its obligation.¹⁶¹ Losses financed by only this amount of the total outstanding debt are then allocated to the obligated partner.¹⁶²

Where more than one partner furnishes an unconditional guarantee or creditor enforceable DRO, personal liability for repayment of the otherwise functionally nonrecourse debt is allocated among these partners in the proportion of their respective obligations. Therefore, losses financed by this debt should also be allocated among the partners in the same proportion.

D. *The CLP Revisited*

The CLP's utility lies not at the aggregate partnership level—in quantifying the partnership's recourse liabilities but at the individual partner level—in revealing the existence and extent of each partner's personal liability for repayment of the partnership debt. However, even here, the CLP's elaborate machinery is largely redundant if the partnership structure is transparent. In fact, the CLP can be dispensed with in ascertaining each partner's personal liability for repayment of any part of the partnership debt where the same proportion applies uniformly and consistently to the partners' capital contributions and allocations of all gains and losses and the partners have identical obligations with respect to all partnership debt. These obligations, as well as the applicable contractual and statutory provisions relating to the debt and the partnership, will serve to properly classify any partnership debt as a limited or unlimited liability. Once a partnership debt has been so classified, the extent of an individual partner's personal liability for its repayment can be directly determined without using the CLP, by applying the partner's pro-rata share of all partnership items to the amount of the debt.¹⁶³

Whether or not it is actually used in practice, the CLP is a tool designed for the specific task of determining a partner's personal liability for

¹⁶¹ If no other partner is obligated, then the remaining debt is treated as a limited liability.

¹⁶² If no other partner is obligated, then the remaining losses are nonrecourse deductions. These losses are allocated in accordance with the "partners' interest in partnership" or the nonrecourse deductions safe harbor of Treas. Reg. §1.704-2(e)(2) (2008), and are reversed as allocations of minimum gain chargeback.

¹⁶³ Limited liabilities will be allocated under the three-tier allocation regime prescribed by the nonrecourse debt rules of Treas. Reg. § 1.752-3 (2008).

repayment of a partnership debt and for no other purpose. This means that in the two-part framework developed earlier for conducting a section 465 at-risk inquiry, the CLP's role remains limited to the set of legal structures. The CLP is not engineered for, and cannot further an investigation into, the set of economic consequences. Specifically, the CLP cannot assess whether the partnership's activity is being conducted in such a manner that eliminates the probability of default or entitles a partner to recover from a third party, the loss of any personal assets that it suffers upon an actual default.¹⁶⁴ The following examples demonstrate this.

Example 21. A_1 and A_2 organize an LLC to which each contributes \$100 in cash. The LLC buys property for \$800 with a note in the same amount. The note is recourse to the LLC but not to either member and, therefore, an exculpatory liability of the LLC. However, each of A_1 and A_2 furnishes an unconditional guarantee for repayment of \$400 of the note. Each member also enters into a DRO for \$400.¹⁶⁵ The LLC uses its cash of \$200 to purchase an option to sell the property to B for \$800. In applying the CLP, the \$800 note is assumed to become due and payable. However, all of the LLC's assets including the property and the option to sell it to B are deemed worthless. Capital accounts after applying the CLP are as follows.

	A_1	A_2
Initial contribution	\$100	\$100
Loss on hypothetical sale of property ¹⁶⁶	(400)	(400)
Loss on hypothetical sale of option to sell property to B ¹⁶⁷	(100)	(100)
	<u>(\$400)</u>	<u>(\$400)</u>

Thus, the note is categorized as a partnership recourse liability and allocated \$400 to A_1 and \$400 to A_2 . This allocation represents the allocatee-member's respective exposure to the loss of personal assets if the LLC defaults on the note and the member is called on its guarantee. However, in actuality, there

¹⁶⁴ A third party is an individual that is not another partner in the same partnership.

¹⁶⁵ The contractual DROs contained in the LLC's operating agreement are redundant for purposes of the CLP and the section 704(b) safe harbor requirement because each member's guarantee will supply it with a DRO in the amount of its respective guarantee. See *supra* note 150.

¹⁶⁶ The total allocated loss represents the book value of the property at the time of applying the CLP.

¹⁶⁷ Assume that the option is carried at cost on the LLC's books as a contingent asset. Whether or not it is actually included in the LLC's balance sheet prepared for financial accounting purposes, the CLP would assume the "destruction" of its value (assumed equal to cost) and allocate the resulting loss between A_1 and A_2 .

could never be a default and neither member would be called on its guarantee because the LLC would always be able to exercise its option to sell the property for the face value of the note. In deeming the sell option to be worthless, the CLP disregards the LLC's ability to ensure against a default on the note.

Example 22. The facts are the same as in Example 21, except in exchange for the \$200 in cash, B appraises and "underwrites" the property's resale value at \$800 and agrees to make up the difference if the property fetches less than that amount in a sale. After applying the CLP, the note would be categorized as a partnership recourse liability and allocated \$400 to A₁ and \$400 to A₂ for the same reasons as in Example 21. Here, unlike in Example 21, the LLC could default on the note and the members could be called on their respective guarantees. However, even if A₁ and A₂ are required to surrender personal assets, B will reimburse them for the loss. The CLP ignores this recovery right by disregarding the worth of B's underwritten appraisal as an asset of the LLC.¹⁶⁸

I have shown above how commentators have misapplied the CLP to the facts of *Hubert*. In fact, the CLP is completely unnecessary to an examination of LCL members' personal liability for repayment of LCL's debt. As stated above, the segregation of this debt between unlimited and limited liabilities would have to be made independent of the CLP. Once the debt has been so segregated, it could be allocated among LCL's members without resort to the CLP. The constant 99:1 proportion that applied to all aspects of the members' respective interests in LCL and their identical obligations with respect to LCL's debt would obviate the need for using the CLP in allocating any part of this debt that has been properly classified as an unlimited liability.¹⁶⁹ For repayment of such part of this debt, HBW and HCC would be personally liable in a 99:1 proportion.¹⁷⁰ The remaining

¹⁶⁸ This underwritten appraisal will probably appear in a footnote to the LLC's financial accounting balance sheet as a contingent asset. Even so, the CLP would assume the "destruction" of its value (assumed equal to cost) and allocate the resulting loss between A₁ and A₂.

¹⁶⁹ The members' contributions were made in a 99:1 proportion. Losses causing depletion of these capital contributions were made in the same 99:1 proportion. Therefore, the respective balances in their capital accounts at any time, whether positive or negative, would also reflect the same proportion. The members' DROs were identical. See *supra* note 40. Consequently, their repayment obligations would also be identical. This would not be the case, however, if HBW had received capital account credit for contributed leases. See *supra* note 38 (discussing this possibility); *infra* note 170 (discussing the implications for the allocation between HBW and HCC of LCL's debt that has been properly classified as an unlimited liability).

¹⁷⁰ But see *supra* note 39, discussing the possibility that HBW may have received capital account credit for contributed leases, thus upsetting the constant 99:1 proportion. In this case, the CLP would have to be employed to determine the limits of LCL members' respective repayment obligations. The members' DROs could render the members personally liable only for debt that was recourse to the LCL.

debt, constituting LCL's limited liability, would be allocated among HBW and HCC pursuant to section 752's three-tier allocation regime for nonrecourse debt that does not use the CLP.¹⁷¹

PART VIII. LIQUIDATION SALE ANALYSIS

The CLP is not the only Subchapter K tool that commentators have employed to analyze the taxpayer's at-risk claims in *Hubert* without regard to its applicability or utility. One commentator has used the LSA to determine LCL members' allocable shares of deductions financed by LCL's otherwise exculpatory liabilities in the event that the members were considered personally liable for their repayment.

A. *Why Conduct an LSA?*

The LSA facilitates proper allocation of a partnership's recourse deductions where the debt financing these deductions is validly categorized as a partnership recourse liability as a consequence of one or more partners' statutory or contractual repayment obligations that do not, however, include DROs.¹⁷² An example would be an otherwise functionally nonrecourse partnership debt whose repayment is unconditionally guaranteed by one or more partners who lack DROs.¹⁷³ This guaranteed debt would be validly

See supra Part VII.B. The CLP would reveal the appropriate allocation of this debt among the obligated members and, therefore, the extent of their respective personal liability at any given point in time. *See supra* note 114 (containing Example 13(a)).

¹⁷¹ *See* Treas. Reg. §1.752-3 (2008). This allocation should also follow the 99:1 proportion since neither member appears to have contributed section 704(c) property. *See supra* note 39, discussing the possibility that HBW may have contributed leases and received capital account credit for them. However, neither *Hubert I* nor the IRS Brief mentions that any such contributed leases had built-in gains or losses and, therefore, constituted section 704(c) property.

¹⁷² Statutory obligations would be those arising under applicable state law, such as a general partner's liability for a partnership debt that is "a general obligation of the partnership where no partner has been relieved of personal liability." Contractual obligations would consist of an unconditional guarantee or a creditor enforceable DRO. *See supra* Part VII. The LSA, in the form of regulatory guidance, was provided by Rev. Rul. 97-38, 1997-2 C.B. 69. As contained therein, the LSA remains restricted to statutory repayment obligations and, therefore to "true" recourse debt. This debt, on its own terms and applicable background law, is properly classified as an unlimited liability. Rev. Rul. 97-38 focuses on state law recourse debt where the partners who are obligated under state law for repayment of the debt lack actual DROs. *See generally* Michael A. Oberst, *The Disappearing Limited Deficit Restoration Obligation*, 56 TAX LAW. 485, 486 (2003) ("Revenue Ruling 1997-38 deals with the determination of the extent to which state law would cause a general partner to be treated as having a [DRO.]). *See also supra* notes 159-60. However, the principles of the LSA could be extended to cover contractual repayment obligations such as unconditional guarantees or creditor enforceable DROs. *See supra* Part VII.

¹⁷³ *See, e.g., supra* Example 20.

categorized as a partnership recourse liability and deductions financed by it will constitute recourse deductions despite the absence of partner DROs. The LSA guides the allocations of these deductions among the partners. These allocations are proper in two respects: they are proportionate to the allocatee-partner's debt repayment obligations;¹⁷⁴ and they comply with the "financial integrity" requirements of the section 704(b) safe harbor.¹⁷⁵

The LSA is based upon a hypothetical liquidation sale of all partnership assets- a deemed sale of these assets at their respective book values. This sale identifies the deductions financed by the partnership's otherwise functionally nonrecourse debt for whose repayment one or more partners are statutorily or contractually obligated. The LSA then allocates these recourse deductions to the obligated partners in proportion to their debt repayment obligations. To support these allocations and ensure that they have financial integrity, the LSA supplies the allocatee-partners with DROs in the amounts of their respective debt repayment obligations.¹⁷⁶

The LSA is a tool designed for partnerships where the partners assume personal liability for a partnership's otherwise functionally nonrecourse debt in amounts disproportionate to the allocation of partnership items of gains and losses.¹⁷⁷ In such a partnership, a liquidation sale of the partnership's assets segregates the portion of the assets' bases attributable to this debt from the portion attributable to the partners' capital contributions. This

¹⁷⁴ In this respect, the LSA can be seen as an embodiment of the requirement that losses follow liabilities. See *supra* note 160.

¹⁷⁵ See *supra* note 21 (discussing the use of the phrase "financial integrity" to denote the defining characteristic of partner allocations that result from partners' distributive shares determined in compliance with the section 704(b) safe harbor).

¹⁷⁶ The total amount of the partnership debt that the partner is obligated to repay represents the limits of its supplied DRO, regardless of the actual amount of any existing deficit. Assume that the partnership's only debt is a state law nonrecourse debt secured by all assets of the partnership, and all partners guarantee repayment of this debt in the proportion that they had made capital contributions. Additionally, assume that the same proportion also governs the allocation of all partnership items of gains and losses. Any recourse deductions will accrue only after the positive equity in the partnership's assets has been wiped out and their allocations will create deficits in the partners' respective capital accounts. Once all recourse deductions have been allocated, these deficits will equal the limits of the partners' supplied DROs. *Burke, supra* note 3, at 413-14, equates the actual deficit in a guarantor-partner's capital account, caused by allocation of realized losses, with the limit of the guarantor-partner's supplied DRO. This results in the bizarre conclusion, clearly incorrect, that a partner's at-risk basis in a depreciable asset "increases" as the asset is depreciated. See *infra* note 191 and accompanying text.

¹⁷⁷ If a single proportion governs the allocation of all partnership items of gains and losses, then the LSA will be required to determine the allocation of recourse deductions between the partners only if the partners' respective repayment obligations are both: (i) fixed; and (ii) fixed in a proportion that is different from the one in which they share all partnership items of gains and losses. Compare Example 23 *infra*, with Examples 23(a) and 23(b) *infra* note 182.

segregation is a pre-requisite for the accurate measurement of the deductions financed by this debt.¹⁷⁸ The following example demonstrates this.

Example 23. A_1 , A_2 , and A_3 organize an LLC to which they contribute \$150, \$75 and \$75 in cash, respectively. The LLC purchases depreciable property for \$900 using its \$300 cash and a note for \$600. The note is recourse to the LLC but not to any of the three members and, therefore, an exculpatory liability of the LLC. Each of A_1 and A_2 furnishes an unconditional guarantee for repayment of \$300 of the note. No member of the LLC has a DRO and the LLC's operating agreement provides for allocation of all profits and losses between the three members in the proportion of their respective capital contributions, subject to the requirements of the section 704(b) safe harbor.¹⁷⁹ The LLC's book balance sheet is as follows.

Assets		Liabilities and Capital	
Depreciable Property	\$900	Note	\$600
		Capital	
		A_1	\$150
		A_2	\$75
		A_3	\$75
	<hr/>		<hr/>
	\$900		\$900

Assume that the property is depreciated on a straight line basis over nine years. In a liquidation sale, the property will be deemed sold for its book basis. The first \$600 of this basis would be attributable to the note and any remaining amount would be attributable to the members' capital contributions. Thus, whereas the depreciation deductions in each of the first three years of the property's useful life would be financed by capital contributions, these deductions in each of the last six years of the property's useful life would be financed by the note and constitute recourse deductions. Therefore, for the first three years, each of A_1 , A_2 , and A_3 will be allocated annual deductions of \$50, \$25, and \$25, respectively. In the last

¹⁷⁸ Unless one or more partners' DRO, whether actual or supplied, is limited to a dollar amount, recourse deductions will be allocated among the partners in the same proportion in which they share all partnership items of gains and losses. See *supra* note 177; *infra* notes 182, 185.

¹⁷⁹ The LLC would meet the so-called "alternate test" of the section 704(b) safe harbor prescribed Treas. Reg. §1.704-1(b)(2)(ii)(d) (2008). This would allocate away from A_3 , who has neither an actual nor a supplied DRO, any losses that would cause or increase a deficit in A_3 's capital account.

six years, only A_1 and A_2 will be allocated the recourse deductions, each in an annual amount of \$50.¹⁸⁰

Consequently, over the property's nine-year useful life, A_1 , A_2 , and A_3 share the deductions financed by the \$300 of their collective capital contributions in the proportion of their respective capital contributions. The \$600 of deductions financed by the guaranteed but otherwise functionally nonrecourse debt is allocated only to the guarantor-members A_1 and A_2 in the proportion of their respective guarantee obligations. To support these allocations and ensure that they have financial integrity under the section 704(b) rules, each of A_1 and A_2 is also supplied a DRO in the amount of its respective guarantee obligations.¹⁸¹

In Example 23, a hypothetical liquidation sale was required to detect and measure recourse deductions because the members' guarantees were disproportionate to the manner in which they shared partnership items of gains and losses. Only two of the three members had furnished guarantees that were themselves equal whereas all three members shared partnership gains and losses in a 2:1:1 proportion. By comparison with Example 23, in a partnership where the same proportion applies both to partnership items of gains and losses and to debt repayment obligations, the allocation of the recourse deductions will also follow this proportion and hypothesizing a

¹⁸⁰ Each of the three members' respective capital account will be reduced to zero at the end of the third year of the property's useful life. In years four through nine, the members' respective repayment obligations for the \$600 note would govern the allocation of the deductions financed by the note (the so-called "recourse deductions"). Because A_1 and A_2 are each obligated for one-half of the total amount of the note, the recourse deductions will also be allocated equally between the two of them. Thus, of the total \$600 in recourse deductions, \$300 will be allocated to A_1 and \$300 to A_2 . Consistent with this, the \$600 note will be categorized as a partnership recourse liability and be allocated \$300 to A_1 and \$300 to A_2 . The CLP can validate this result. Compare Example 20, with Example 13 (showing that as a general obligation of a limited partnership, the \$600 note would be allocated to the general partners in the proportion of their respective statutory repayment obligations).

¹⁸¹ In Example 23 *supra*, the two obligated members' respective repayment obligations were fixed, definite, and given by the limits of their respective guarantees: \$300 each. The \$600 note would be allocated in the same amounts to the two obligated members. If the obligated members had instead established personal liability by means of actual DROs enforceable by the creditor, then the CLP would have to be employed to determine the limits of their respective repayment obligations. The DROs could render the members personally liable only for debt that was recourse to the LLC. See *supra* Part VII.B. The CLP would reveal the appropriate allocation of this debt among the obligated members and, therefore, the extent of their respective personal liability at any given point in time.

liquidation sale of the partnership assets is unnecessary.¹⁸² LCL embodied such a partnership.¹⁸³

¹⁸² In a partnership where a single proportion governs the allocation of all partnership items of gains and losses, the LSA will be required to determine the allocation of recourse deductions only if the partners' respective repayment obligations are both: (i) fixed; and (ii) fixed in a proportion that is different from the one in which they share all partnership items of gains and losses. To see this, consider the following two variations on the facts of Example 24 *supra*, in each of which the allocation of recourse deductions can be determined without resorting to the LSA.

Example 23(a). The partners' repayment obligations are fixed, but fixed in the same proportion that governs the allocation of all partnership items of gains and losses. The facts are the same as Example 23, except that the LLC's three members furnish guarantees for repayment of the \$600 note in the same proportion in which they share all partnership items of gains and losses—that is, 2:1:1. As a result, A₁, A₂, and A₃ unconditionally guarantee repayment of \$300, \$150, and \$150, respectively, of the \$600 note. In this case, A₁, A₂, and A₃ will be allocated annual depreciation deductions of \$50, \$25, and \$25, respectively, for all nine years of the property's useful life. The allocated depreciation deductions in the last six of these nine years would constitute recourse deductions. Thus, of the total \$600 in recourse deductions, \$300 will be allocated to A₁, \$150 to A₂, and \$150 to A₃. This allocation can be obtained by directly applying the 2:1:1 proportion to the amount of the unlimited liability, represented by the \$600 note, without resorting to the LSA. Consistent with this allocation of recourse deductions, the \$600 note will be categorized as a partnership recourse liability and be allocated \$300 to A₁, \$150 to A₂, and \$150 to A₃ as a consequence of the members' respective guarantees—outside and independent of the CLP.

Example 23(b). The partners' repayment obligations are not fixed. The facts are the same as in Example 23, except instead of A₁ and A₂ furnishing guarantees, all three members of the LLC enter into unlimited creditor enforceable DROs. In this case, as in Example 23(a), the total recourse deductions will be allocated among the three members in the same 2:1:1 proportion in which they share all partnership items of gains and losses. This allocation of recourse deductions will continue to apply where the partners' repayment obligations are statutory instead of contractual. Thus, if instead of being members of an LLC, A₁, A₂, and A₃ were general partners of a general partnership where they shared all partnership items of gains and losses in a 2:1:1 proportion, all recourse deductions would be allocated in the same proportion.

The general result from Examples 23(a) and 23(b) is the following: As long as none of the statutorily or contractually obligated partners has a DRO limited to a dollar amount that is less than the partnership's total unlimited liabilities, the obligated partners will share recourse deductions in the same proportion in which they share all partnership items of gains and losses. Even where this proportion is different from the one in which the obligated partners had made capital contributions, it will continue to determine the allocation of recourse deductions between them. See *supra* note 114 containing Example 13(a). Allocation of the unlimited liabilities between these obligated partners, however, will require employing the CLP. See *id.*

Therefore, in LCL's case, even if HBW had received capital account credit for contributed leases, see *supra* note 39, the allocation of recourse deductions between HBW and HCC would continue to follow the 99:1 proportion that applied to the sharing of all partnership items of gains and losses. See *infra* notes 184–85.

¹⁸³ See *infra* note 185.

B. *Why Conduct an LSA?!*

The LCL members could be personally liable for LCL's otherwise exculpatory liabilities, not because of any guarantees, but as a consequence of their DROs. In particular, if a creditor could enforce these DROs upon a default on the debt without being subject to any other contingency, then the members would be personally liable for LCL's otherwise exculpatory liabilities in the same 99:1 proportion that applied to all aspects of their membership interests in LCL. The two members had made capital contributions and shared all gains and losses in this proportion and their DROs were identical. Therefore, any deficits in their capital accounts and their resulting repayment obligations would reflect this 99:1 proportion.¹⁸⁴ As shown above, this proportion would also apply to allocations of deductions financed by LCL's otherwise exculpatory liabilities for whose repayment the two members would be held personally liable.¹⁸⁵ Each member's allocable share of these deductions could thus be directly obtained at any time without resorting to a liquidation book value sale of LCL's assets. Moreover, these allocations would always have "financial integrity" under the section 704(b) rules.¹⁸⁶ The members' actual DROs would eliminate the need for any LSA supplied DROs.

Thus, the LSA could serve no purpose in LCL's case. LCL members could be personally liable for LCL's otherwise exculpatory liabilities only because of their actual DROs rather than LSA supplied ones. Ignoring the only path that could lead to personal liability for LCL members, the commentary applying the LSA to LCL goes off on two separate tangents.¹⁸⁷ Slighting actual DROs for LSA supplied ones, this commentary discusses the consequences of LCL members' personal liability for LCL's debt. The first

¹⁸⁴ *But see supra* note 39 (discussing the possibility that HBW may have received capital account credit for contributed leases thus upsetting the strict 99:1 proportion). However, even in this case, the LSA would continue to be redundant for allocating recourse deductions among LCL members. *See infra* note 185.

¹⁸⁵ *But see supra* note 170 (discussing the possible need for employing the CLP to determine the respective limits of LCL members' repayment obligations and, therefore, the extent of their personal liability at any given point in time for LCL's debt). However, even in this case, the LSA would continue to be redundant for allocating recourse deductions among LCL members. Neither member's DRO was limited to a dollar amount. Consequently, all recourse deductions would be shared between the two members in the same 99:1 proportion that applied to all distributive shares of partnership gains and losses. *See supra* note 182.

¹⁸⁶ *See supra* note 21 (discussing the use of the phrase "financial integrity" to denote the defining characteristic of partner allocations that result from partners' distributive shares determined in compliance with the section 704(b) safe harbor).

¹⁸⁷ *See Burke, supra* note 3, at 413–16.

discussion, though accurate, is not applicable. The second is both inaccurate and inapplicable.

A partnership's timely repayment of an otherwise functionally nonrecourse debt would have consequences for a partner who lacks an actual DRO but was statutorily or contractually obligated to repay the debt if the partnership had failed to do so. Because the partnership had in fact repaid the debt, the partner's personal repayment obligation, along with its LSA supplied DRO, would disappear. This disappearance would eliminate the foundational support of any deficit in the partner's capital account created by allocations of deductions financed by the now repaid debt.¹⁸⁸ A capital account deficit that lacks foundational support after the debt has been repaid would have implications, not for section 465 at-risk purposes, but for section 704(b)'s "financial integrity" requirements. While concern for maintaining compliance with the section 704(b) rules is laudable and befits a Subchapter K scholar, it is also unwarranted in LCL's case where the members' DROs had roots in the firm ground of the partnership agreement rather than the shifting sands of the LSA.¹⁸⁹

The commentary next considers the situation where LCL, instead of repaying the debt that would otherwise constitute exculpatory liabilities, maintains it at the original level even as it depreciates the assets financed by it. Depreciation deductions financed by this debt, when allocated to LCL members, would leave deficits in their capital accounts. The amount of such a deficit in a member's capital account, at any point in time, and the accompanying obligation to restore it, would reflect the loss of personal assets that the member has already suffered towards repayment of the debt.¹⁹⁰

¹⁸⁸ Unlike the LSA, the partner nonrecourse debt rules of Treas. Reg. § 1.704-2(i) (2008) ensure continued foundational support for capital account deficits caused by allocations of debt financed losses upon repayment of the debt by means of the partner minimum gain chargeback. Compare Oberst, *supra* note 172, at 486-89, with Strong & Hamill, *supra* note 150, at 647.

¹⁸⁹ The LCL members' DROs were added to LCL's operating agreement by an amendment made on March 28, 2001, but written with retroactive effect to January 1, 2000. See *supra* note 40. See also *infra* note 195.

Wyoming law would have allowed the LCL members to rescind these DROs by another amendment. See WYO. STAT. ANN. § 17-15-121(c) (2008). Nothing in LCL's operating agreement would have prevented such a rescission or cancellation of the DROs. See generally *IRS Brief*, *supra* note 3. Only if the DROs were rescinded or cancelled would any deficits in LCL members' capital accounts lack "foundational support."

¹⁹⁰ LCL members' obligations arose from actual DROs and not guarantees. If the members' DROs were in fact enforceable by creditors, HBW's repayment obligation would amount to 99 percent of LCL's state law recourse debt. But see *supra* note 39 (discussing the possibility that HBW may have received capital account credit for contributed leases thus upsetting the strict 99:1 proportion). In this case, the extent of HBW's repayment obligation, at any one point in time, could be determined by the CLP. See *supra* note 170.

Conflating losses suffered with exposure for losses, this commentary posits the actual deficit in a member's capital account, at any point in time, as the member's personal liability for LCL's debt under an LSA analysis. The commentary then claims that this personal liability would equal the member's personal liability arising under the section 752 rules when assets financed by this debt have been fully depreciated.

Both the supposition and the claim are incorrect. A partner's personal liability for repayment of partnership debt represents exposure to the loss of personal assets and remains unchanged so long as the level of debt remains constant regardless of any depreciation of the assets financed by this debt. This axiom is unaffected by the source of the partner's personal liability—whether it arises from actual DROs, as it only could, if at all it would, in LCL's case, or from LSA supplied ones.

A failure to distinguish an obligation to restore an actual deficit from the potential extent of a DRO leads to the bizarre conclusion that depreciating a debt financed asset increases a taxpayer's at-risk basis in it; that is, the portion of the asset's basis attributable to debt for which the taxpayer is personally liable and, assuming an absence of protection against loss, is at risk for section 465 purposes.¹⁹¹

Look, you got assets in this partnership?

Sure.

Their bases financed by debt?

The LSA will say.

I just thought I'd ask you.

Well, I just thought I'd tell ya.

Then tell me who's allocated the recourse deductions.

Hu's at risk.

I'm not—stay out of section 465! I want to know which partner is allocated the recourse deductions.

No. Which partner has a DRO.

I'm not asking you who's got a DRO.

Hu's at risk!

The CLP will reveal.

PERSONAL LIABILITY!

¹⁹¹ *Burke, supra* note 3, at 461 ("Once the property is fully depreciated, the sharing of I.R.C. § 465 at-risk basis and I.R.C. § 752 recourse liabilities would converge, ensuring that only those partners with ultimate responsibility for member-recourse liabilities receive the corresponding at-risk amounts.").

PART IX. APPLYING THE TWO-PART FRAMEWORK

I now apply the two-part framework presented above for analyzing the at-risk amount in any borrowings invested in the subject activity, in sequence, to: the taxpayer's claims in *Hubert*; the judicial review of such claims leading up to *Hubert*; and the three *Hubert* opinions—two by the Tax Court and one by the Sixth Circuit. I follow this by discussing the use of the two-part framework in situations where the section 752 rules are entirely inapplicable.

A. Analyzing the Facts of *Hubert*

The examination under the set of legal structures begins with the adherence under law of LCL's debt to its two members. All of LCL's debt, whether state law nonrecourse debt or its exculpatory liabilities, would clearly adhere under law to the two members in the amounts of their respective allocations under section 752. LCL was the named borrower or had acceded to the borrower for all such debt. Therefore, once allocated among LCL members pursuant to the applicable provisions of LCL's liability sharing rules, the allocated debt would adhere under law to the allocatee-members.

The second part of the analysis under the set of legal structures entails establishing personal liability. Establishing personal liability for any part of LCL's debt would require the debt to be properly classified as an unlimited liability under the section 752 rules. As shown above, if any of this debt was so classified, HBW and HCC would be personally liable for its repayment under section 465 in a 99:1 proportion.¹⁹²

Is any of LCL's debt properly classified as an unlimited liability? It would only be so classified if the creditor could access LCL members' personal assets upon no other contingency except default. As demonstrated earlier, this test can be met by an unconditional guarantee or a creditor enforceable DRO.¹⁹³ Neither member had guaranteed LCL's debt. Both had entered into identical DROs. Again, as detailed above, in the absence of an unconditional guarantee, a DRO can convert partnership debt that is

¹⁹² See *supra* Part VIII.C and text accompanying notes 161–64. But see *supra* note 39 (discussing the possibility that HBW may have received capital account credit for contributed leases, thus upsetting the strict 99:1 proportion). In this case, see *supra* note 170 to determine the members' respective personal liability at any one point in time by employing the CLP. The remaining debt constituting LCL's limited liabilities would be allocated under the three-tier allocation regime prescribed by the nonrecourse debt rules of Treas. Reg. §1.752-3 (2008). Assuming no section 704(c) built-in gains or losses, this would also be allocated among HBW and HCC in a 99:1 proportion. See *supra* note 171.

¹⁹³ See *supra* Part VII.

otherwise functionally nonrecourse into an unlimited liability under the section 752 rules only if the creditor can enforce the DRO upon a default without waiting for any other contingency to materialize. In addition, the losses financed by such debt should be allocated among the DRO partners in proportion to their personal repayment obligations for the debt. LCL satisfied the latter requirement since all partnership items were allocated among the LCL members in a constant 99:1 proportion. Thus, each member's capital account would show a deficit whenever LCL's assets were insufficient to repay the debt.¹⁹⁴ Consequently, the members' DROs were certainly invocable.

But these DROs were not enforceable— not by a creditor, at least. LCL's operating agreement explicitly denied any creditors enforcement rights to the members' DROs.¹⁹⁵ Further, each DRO was contingent upon a liquidation of the respective member's membership interests in LCL.¹⁹⁶ A creditor could not force such a liquidation even upon default.¹⁹⁷ Thus, the members could resist the DROs and maintain deficit capital accounts by simply retaining their membership interests, despite any intervening default on debt. Consequently, LCL could default on any or all of its debt without obligating the members to restore the deficits in their capital accounts. Finally, the members could choose to rescind these DROs at any time without any creditor consent.¹⁹⁸ Thus, the DROs did not confer on a creditor any repayment rights to the members' personal assets not yet contributed to LCL. Nor did a creditor enjoy any such statutory rights with respect to any part of LCL's debt. No provision of Wyoming law preempted the terms of the DROs or any other clause of LCL's operating agreement or otherwise allowed a creditor to pursue LCL members' personal assets.¹⁹⁹

Based on these facts and assuming that there were no other superseding agreements or commitments on the part of LCL members, their DROs were not enforceable by a creditor and, therefore, could not justify classifying any part of LCL's debt as an unlimited liability. Consequently, neither member

¹⁹⁴ See *supra* text accompanying note 184. See also *infra* note 242.

¹⁹⁵ Section 20.9 of LCL's operating agreement as amended and restated on March 28, 2001, to contain the members' DROs stated that, "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." See *T.C. Memo, supra* note 1, at 7.

¹⁹⁶ See *supra* note 40.

¹⁹⁷ See WYO. STAT. ANN. § 17-15-123(a) (2008). Cf. WYO. STAT. ANN. §17-15-145 (2008) (stating that the creditor of an LLC member may force liquidation of the LLC upon default of the LLC member's personal debt owed to the creditor).

¹⁹⁸ See *supra* note 189. Thus, each member's DRO appeared to grant the member an option, rather than constituting an obligation, to restore a deficit in its capital account.

¹⁹⁹ See WYO. STAT. ANN. §17-15-101, -47. See also *T.C. Memo, supra* note 1, at 17 n.8.

could be considered personally liable for its repayment.

If, however, the facts were different and LCL members' DROs could be enforced by a creditor upon default, and such enforcement was not subject to any other contingencies, then each member would be considered personally liable for repayment of LCL's debt in the amount of its pro-rata share of such debt.^{200, 201} This would conclude the examination under the set of legal structures. Only if the members were considered personally liable for repayment of LCL's debt would any investigation into the set of economic consequences be required.

The set of economic consequences would then consider whether LCL's conduct of its equipment leasing activities protected its members against risk of loss—either by eliminating the likelihood of a default or ensuring a right to recover from a third party, any additional capital contributions required in the event of an actual default. The nature of LCL's equipment leasing activities suggests a mode of doing business that substantially diminished, if not completely eliminated, a possibility of default on the debt.

The activity of equipment leasing is eminently amenable to being conducted in a manner that, while using debt financing, affords prospective protection against loss by eliminating the possibility of a default on this debt.²⁰² Example 21 involves debt financed property where an option to sell the property for a price exceeding the face value of the debt removes all possibility of default and affords complete prospective protection against loss.²⁰³ Where the property consists of equipment acquired to be leased out, instead of relying on an option to sell, the lessor can obtain prospective protection against loss from the lease payments. This would require both the lease term to extend over the debt horizon and the periodic lease payments to cover all debt repayment obligations. Further, because protection against loss belongs to the set of economic consequences, the ability of the lease payments to meet the debt repayment obligations should be assessed with respect to the attendant economic conditions—including the lessee's credit worthiness and ability to pay.

²⁰⁰ Alternatively, the members could have furnished unconditional guarantees.

²⁰¹ If only some creditors could enforce the DROs, then only debts owed to such creditors would be classified as unlimited liabilities. See *Hubert I*, 125 T.C. 72 (2005), *aff'd in part, vacated in part, and remanded by* 230 Fed. Appx. 526 (6th Cir. 2007).

²⁰² Whether protection against loss requires elimination of all possibility, even a "mere theoretical possibility," of default is unclear. The Circuit Courts of Appeals are divided on the applicable standard. The Sixth Circuit applies a "payor of last resort test" under a worst case scenario. Other circuits use a "reasonable possibility" standard. See *infra* Part IX.B.

²⁰³ This constitutes prospective protection against loss. See *supra* Example 22 (demonstrating retroactive protection against loss).

It is unclear from the facts of *Hubert* whether the lease payments due from the lessees covered all of LCL's repayment obligations on its debt.²⁰⁴ If LCL was assured of receiving sufficient lease payments to meet its debt repayment obligations and there was no possibility of a default on the debt, then LCL's members would be deemed to be prospectively protected against loss.²⁰⁵ This debt could, consequently, not be included in the members' section 465 at-risk amounts.²⁰⁶

If, however, a default was possible, then neither member could be considered protected against loss on a prospective basis. However, to examine retroactive protection against loss, LCL members' recovery rights for the loss of any personal assets upon a default would have to be considered. No evidence of any such rights was presented and neither member appears to have been protected against loss on a retroactive basis.

B. *Court Decisions before Hubert*

The set of legal structures is formulaic and the section 752 rules can supply most of the needed formulas. If appropriately used, these formulas can complete substantially all, if not all, of the examination required under the set of legal structures. However, any investigation into the set of economic consequences must proceed without these formulas. Such an investigation can only be based upon facts and circumstances. Therefore, its standards cannot be administratively enforced and must necessarily be developed by case law.²⁰⁷ Courts, in reviewing a partner's section 465 at-risk claim in partnership borrowings, have adopted a primitive and inexact version of the two-part framework presented above. An examination under the set of legal structures has often been limited to a verification of the partners' personal liability for repayment of the partnership debt. An investigation of the partners' protection against loss has also been made but

²⁰⁴ See generally *Hubert I*, 125 T.C. at 86–90.

²⁰⁵ Indemnification against lessee's failure to make lease payments is one of the factors courts consider when investigating retroactive protection against loss. See, e.g., *Wag-a-Bag, Inc. v. Comm'r*, 64 T.C.M. (CCH) 948 (1992).

²⁰⁶ If only a portion of debt was covered by all lease payments, the members would be considered protected against loss on only that portion and, therefore, could not be deemed at risk for it. See I.R.C. § 465(b) (2005).

²⁰⁷ The straddle rules of section 1092 attempt such administrative enforcement but only for "personal property that is actively traded" where the available market pricing information yields ready and verifiable detection of "protection against loss." Strangely, section 465 itself has been held inapplicable to a section 1092 straddle that constitutes the quintessential protection against loss transaction. See *Laureys v. Comm'r* 92 T.C. 101 (1989), *action on dec.*, 1990–20 (June 4, 1990) (Congress addressed problems of tax straddles separately in section 1092 and did not intend for 465(b)(4) to apply to them).

not always under the set of economic consequences. Thus, despite a formal separation in their section 465 at-risk inquiry between a verification of personal liability, on the one hand, and protection against loss on the other, courts have tended to conflate the two—importing aspects of one into the other. This has been the result of using the same test, or at least a test with the same name, “payor of last resort test,” for both purposes—albeit under different standards.

1. PERSONAL LIABILITY

Most courts have generally applied the payor of the last resort test under the worst case standard for verifying personal liability.²⁰⁸ A worst case standard or scenario assumes “funds from the partnership’s business and investments are not available” to satisfy the partnership debt. In such an eventuality, the payor of the last resort test asks whether the “partner has the ultimate liability to repay the debt obligation of the partnership.”²⁰⁹ The scenario and the test match the CLP and the section 752 liability sharing rules, respectively. The worst case scenario qualitatively sketches what the CLP rigorously delineates. And the payor of the last resort test in this worst case scenario accomplishes with approximation what the section 752 rules determine with precision.

Whereas the worst case scenario posits that partnership assets are insufficient to repay the partnership debt, the CLP assumes that all partnership assets are worthless and allocates the resulting losses among the partners. While the payor of the last resort test traces ultimate liability for repayment of the partnership debt, the section 752 rules allocate a partnership’s unlimited liabilities based upon the partners’ obligations to the partnership and creditors and categorize the resulting allocations as partnership recourse liabilities.

This correspondence suggests that a partner who is allocated partnership debt categorized as a partnership recourse liability by the section 752 rules should also be the payor of the last resort as revealed by a worst case analysis conducted for verifying personal liability in a section 465 at-risk inquiry. However, in such a verification, courts have tended to consider the partner’s right to reimbursement not just from other partners, as the section 752 rules

²⁰⁸ See, e.g., *Melvin v. Comm’r*, 88 T.C. 63, 75 (1987), *aff’d per curiam*, 894 F.2d 1072 (9th Cir. 1990). (“The scenario that controls is the worst-case scenario, not the best case. . . . The critical inquiry should be who is the obligor of last resort.”). See also, Bruce A. McGovern, *Liabilities of the Firm, Member Guaranties, and the At Risk Rules: Some Practical and Policy Considerations*, 7 J. SMALL & EMERGING BUS. L. 63, 87 n.129 (Spring 2003).

²⁰⁹ *Melvin*, 88 T.C. at 75.

do, but from all sources—including third parties.²¹⁰ As a result, these courts' examination of personal liability extends beyond the set of legal structures and into the set of economic consequences and encompasses all retroactive protection against loss. This could negate personal liability for a partner who, though unconditionally obligated to repay the partnership debt, has a right to recover the loss of any personal assets from a source other than a partner in the partnership. The section 752 rules, by comparison, would classify the partnership debt in the amount of the partner's unconditional obligation as an unlimited liability, allocate it to the obligated partner, and then categorize the resulting allocation as a partnership recourse liability.

If the retroactive protection against loss were recognized in an examination under the set of economic consequences, the partnership debt would be excluded from the partner's section 465 at-risk amount even under an exact application of the two-part framework discussed above. In such a case, the inclusion of retroactive protection against loss in a personal liability verification does not affect the substantive outcome of inclusion or exclusion of the partnership debt in the partner's at-risk amount. It does, nevertheless, cut across the line demarcating the set of legal structures from the set of economic consequences. However, in many cases, cutting across this line can influence whether an arrangement that arguably constitutes retroactive protection against loss will be recognized as such and, thus, affect the substantive outcome of inclusion or exclusion.

Personal liability belongs to the set of legal structures and all aspects relating to it should be examined for their legal implications without regard to economic reality. Therefore, a partner's right to recover the loss of any personal assets from another partner is recognized without taking into account the latter's financial ability to meet its obligation.²¹¹ Retroactive protection against loss, on the other hand, is a constituent of the set of economic consequences and should be recognized only after considering the economic viability of any recovery rights. If the worst case standard is merely shorthand description, albeit not always accurate, for ignoring economic reality and strictly following legal implications, it comports with an examination under the set of legal structures.²¹² This justifies applying such a standard to a partner's right to reimbursement from another partner. However, subjecting nominal recovery rights against other sources to this

²¹⁰ See, e.g., *Abramson v. Comm'r*, 86 T.C. 360, 381 (1986) (Swift, J., concurring). See discussion *infra* note 213.

²¹¹ See *supra* Part IV.C.

²¹² If, under the "worst case standard," a partner's economic ability to meet its reimbursement obligations is disregarded, as Treas. Reg. § 1.752-2(b)(6) requires, see *supra* Part IV.C, while the posited outcome may be the "worst case" for the obligated partner, it is the "best case" for the partner who enjoys the reimbursement right. See Treas. Reg. § 1.752-2(b)(6) (2006).

standard could cause these rights to be recognized as retroactive protection against loss even when they lack economic substance. This would exclude from a partner's section 465 at-risk amount, partnership debt that an exact application of the two-part framework would have included.

In actual practice, courts have gone beyond just considering nominal recovery rights against existing "legitimate" third parties and have "invented" such rights to negate personal liability. Several courts have claimed that a partner's right to recover from the partnership itself is sufficient grounds to deny personal liability for partnership debt.²¹³ This paradoxical application of the worst case standard assumes the "best case" outcome by "resuscitating" partnership assets that, in order to verify a partner's personal liability, must necessarily be deemed insufficient to repay the partnership debt.²¹⁴

2. PROTECTION AGAINST LOSS

Because courts usually include retroactive protection in a personal liability verification, only prospective protection remains to be checked in a protection against loss investigation. For this purpose, courts have again adopted a payor of the last resort test. Though the test, or its name, remains

²¹³ See, e.g., *Brand v. Comm'r*, 81 T.C. 821 (1983) (limited partners who had guaranteed limited partnership's recourse debt held not personally liable because they enjoyed the right to seek recovery from "primary obligor" a phrase that the court did not clarify but probably referred to the partnership); *Bjerke v. United States*, 677 F. Supp. 633 (D.N.D. 1987) (same; except the court explicitly referred to the partnership as the "primary obligor"); *Peters v. Comm'r*, 89 T.C. 423, 443 (1987) (limited partners who had guaranteed limited partnership's nonrecourse debt held not personally liable because of "subrogation rights against [the partnership]" that, due to the debt's nonrecourse nature, could not have extended beyond the debt's security). Cf. *Abramson*, 86 T.C. at 381 (1986) (Swift, J., concurring) (limited partners who had guaranteed limited partnership's functionally nonrecourse debt were personally liable because they had "no other person or partner to whom to look for reimbursement should they be required to make payments under the guarantee agreements") (emphasis added). Under the two-part framework, the only recovery right that should be considered in verifying a partner's personal liability for partnership debt is a right against other partners. Any right to recover from a partnership's currently existing assets is irrelevant since personal liability for partnership debt can only arise if these assets are insufficient to repay it. A right to recover against future assets of the partnership is also not relevant because such recovery would be accompanied by corresponding deductions in the partner's capital accounts. This would reduce the partner's remaining claim on the partnership assets as well as the partner's at-risk amount in the partnership. To the extent Judge Swift's concurrence in *Abramson* argues against considering partnership assets, it is consistent with this application of the two-part framework. To the extent the opinion suggests considering recovery rights against third parties outside the partnership, it cuts across the line demarcating the set of legal structures from the set of economic consequences.

²¹⁴ The assertion that a partner can recover payments made on account of partnership debt from partnership assets can be seen as the "mirror image" of the contention of *Rubin et al.*, *supra* note 3, who in applying the CLP had "resuscitated" limited liabilities and "destroyed" even encumbered assets. See *supra* Part V.F.2.

the same, the question posed and, therefore, the answer sought, is different.

For testing prospective protection against loss, the courts have, in effect, asked whether taking into account all facts and circumstances, under the applicable standard, the partnership will default on the debt and the partner will be called upon to surrender its personal assets. The query's response and, therefore, the test's result depend upon the facts and circumstances that are considered and the standard under which they are considered.

Courts, except the Sixth Circuit, have applied this test under a realistic possibility standard.²¹⁵ The Sixth Circuit, however, has persisted with the worst case standard even for verifying prospective protection against loss.²¹⁶ Differing standards are only natural in a facts and circumstances based inquiry and not, in themselves, alarming or even disruptive for either tax planning or adjudicative purposes so long as they are transparently applied to the relevant facts and circumstances.²¹⁷ However, the standards for testing prospective protection against loss and the test itself appear motivated by and pliant to the substantive outcome that the court is inclined to reach—the inclusion or exclusion of the partnership debt in the partner's at-risk amount. For courts favorably disposed towards exclusion, the realistic possibility standard for testing prospective protection against loss opens up another avenue to deny at-risk treatment that can backstop the personal liability test. In such courts, the IRS has sought to exploit the realistic possibility standard by positing even the mere existence of substantial partnership assets as removing all realistic possibility of default on the debt.²¹⁸ The realistic possibility standard affords these courts the opportunity to take back under a prospective protection against loss investigation

²¹⁵ See, e.g., *American Principals Leasing Corp. v. U.S.*, 904 F.2d 477, 482 (9th Cir. 1990) (worst case standard is improper in investigating protection against loss in circular lease payment arrangement when the arrangement is structured to remove any realistic possibility of economic loss; theoretical possibility of loss such as insolvency of a party to the transaction should be disregarded).

²¹⁶ See, e.g., *Emershaw v. Comm'r*, 949 F.2d 841, 845–50 (6th Cir. 1991) (circular lease payment arrangement does not constitute protection against loss because the purchaser-lessor would be the obligor of last resort under the worst case scenario of the bankruptcy of the seller-lessee).

²¹⁷ A difference in standards may even represent an evolution towards the optimal standard.

²¹⁸ See, e.g., Memorandum from Marlene Gross, Director, Tax Litigation Division, available at 1988 LGM LEXIS 108, 33 n.3 (Oct. 11, 1988) (“partnership assets . . . unreasonably inflated beyond . . . business purposes” afford protection against loss to limited partners who are obligated for the limited partnership's debt). The IRS has met with mixed success with such arguments. Some courts have accepted them in whole or part. See, e.g., *Tepper v. Comm'r*, 62 T.C.M. (CCH) 505 (1991) (availability of partnership assets afforded protection against loss to limited partner who had guaranteed partnership liability); *Bennion v. Comm'r*, 88 T.C. 684, 692–93 (1997) (same). See also *Pritchett v. Comm'r*, 85 T.C. 580 (1985), *rev'd*, 827 F.2d 644 (9th Cir. 1987) (obligation of limited partners to make additional capital contributions contingent because partnership liabilities might be satisfied from partnership revenues). Other courts have rejected such arguments. See, e.g., *Krause v. Comm'r*, 92 T.C. 1003, 1024 (1989); *Ockels v. Comm'r*, 56 T.C.M. (P-H) P 87,507, 2745 (1987).

what they were required to concede in a personal liability examination where, in a worst case scenario, all partnership assets were deemed insufficient to repay the debt.²¹⁹

The taxpayer friendly Sixth Circuit represents the opposite extreme. The worst case standard gives it license to completely ignore the economic impact of any arrangement of partnership assets that offer prospective protection against loss—even where such protection renders a default on the debt an economic impossibility. Establishing personal liability then virtually ensures the inclusion of the partnership debt in the partner's at-risk amount.²²⁰

These anomalous results arise not because of two different standards but because they are applied to the wrong facts and circumstances. Both standards can be accommodated in the two-part framework developed above. The relevant facts and circumstances that can afford prospective protection against loss and, therefore, the ones that should be taken into account in a payor of the last resort test conducted to detect such protection, relate to the conduct of the partnership activity, including, necessarily, the arrangements governing the partnership assets. Thus, the adopted standard should be applied to the conduct of the partnership activity, including all arrangements made with respect to the partnership assets. And all such conduct and each such activity should be assessed for its economic consequences.

A realistic possibility standard then suggests that these facts and circumstances must allow for a realistic possibility of default on the debt. Conduct of the partnership activity, including the arrangements relating to

²¹⁹ By comparison, the proposed section 465 regulations characterize even recovery rights against other partners as retroactive protection against loss. They do not, however, clarify whether as a result of such characterization, these rights should no longer be considered in verifying personal liability. See, e.g., Prop. Treas. Reg. § 1.465-6(b), 44 Fed. Reg. 32238 (June 5, 1979) (“A partner shall not be at risk with respect to any partnership liability to the extent the partner would be entitled to contributions from other partners . . . because to that extent the partner is *protected against loss*.”) (emphasis added); Prop. Treas. Reg. § 1.465-24(a)(2), 44 Fed. Reg. 32238 (June 5, 1979) (“To the extent the partner is *protected against loss* (such as through a right of contribution), the liability shall” not be included in the partner's at-risk amount) and the example provided therein (characterizing each of two partners who enjoys a recovery right against the other as “protected against loss”) (emphasis added). If the verification of personal liability under the section 752 rules is not disturbed, then the characterization of recovery right against other partners as protection against loss would not affect the substantive result of inclusion or exclusion arrived at by applying the two-part framework. Under the section 752 rules, a partner would be personally liable only if it enjoys no recovery rights against any other partner. Any such recovery rights, howsoever nominal and lacking in economic substance, would negate personal liability and exclude the debt from the partner's at-risk amount. Re-examining such rights under a protection against loss investigation, whatever the applicable standard, could not be more restrictive than this.

²²⁰ See, e.g., *Emershaw*, 949 F.2d at 841.

the partnership assets, that leaves a theoretical possibility, which does not rise to a realistic possibility of default, would constitute an impermissible prospective protection against loss. Just the existence of partnership assets, no matter how substantial, without anything more, could not meet the standard. But an arrangement with respect to such assets that limits the partnership's potential loss on them, such as a stop-loss agreement, depending upon any residual exposure, may constitute prospective protection against loss under this standard.²²¹

A worst case standard, on the other hand, would require a complete elimination of all, even a theoretical, possibility of default before recognizing a prospective protection against loss. Thus a stop-loss arrangement on the partnership's assets that leaves the partnership exposed, under some circumstances, to a loss of some or all of these assets so that they no longer cover all the outstanding debt, would not constitute prospective protection against loss.²²² But an option to sell the partnership assets for an amount in excess of the outstanding amount of partnership debt would represent such protection.²²³

C. Hubert in the Courts

Both the Tax Court, in its first *Hubert* opinion, and the Sixth Circuit, on appeal, made short work of the taxpayer's at-risk claims.²²⁴ The Tax Court limited its at-risk examination to LCL members' personal liability for LCL's debt. Having concluded that the members were not personally liable, the court apparently saw no reason to investigate any possible protection against loss. On appeal, the Sixth Circuit's review was necessarily limited to the Tax Court's findings. Thus, the issue of circular lease payments and their possible loss protection effects was not adjudicated.²²⁵

²²¹ This conclusion could only be arrived at by examining each applicable contingency, its respective possibilities of occurring and the dollar amount of the exposure under it.

²²² If in any one contingency, the partnership is left with insufficient assets to repay the debt, the partners could not be considered protected against loss on a prospective basis.

²²³ Assume that the option can be exercised at will without being subject to any other contingencies.

²²⁴ *Hubert I* devoted 448 words in an opinion comprising 12,603 words to discussing and deciding the taxpayer's at-risk claims. See *Hubert I*, 125 T.C. at 105-06. The Sixth Circuit spared 593 out of a total of 2,943 words in its opinion to a review of the Tax Court's at-risk decision. See *id.*

²²⁵ The IRS had argued that LCL's substantial assets cannot be reasonably presumed to suddenly become worthless. See generally *IRS Brief, supra* note 3.

1. HUBERT I

In initially deciding that LCL members had not established personal liability for LCL's debt, the Tax Court focused exclusively on the liquidation contingency in their DROs. Because this contingency did not materialize in the years at issue, the Court reasoned that the members were not personally liable for repayment of any part of LCL's debt. This line of reasoning²²⁶ sent alarm bells ringing among the DRO faithfuls in the business and legal community.²²⁷

Businesses electing to be taxed as partnerships and their counsel advising them in such elections and the resulting tax liability routinely use liquidation contingent DROs to comply with various Subchapter K provisions. And such liquidation contingencies routinely fail to materialize. The surviving unenforced DROs, however, continue to maintain compliance with the relevant Subchapter K provision. The section 704(b) safe harbor allows a DRO to remain outstanding until the later of: (i) the end of such taxable year in which the taxpayer's interest is liquidated; and (ii) 90 days after the date of such liquidation.²²⁸ The fact that this liquidation does not occur in any one taxable year and a partner is not required to satisfy its DRO during that year does not invalidate the allocations of the partner's distributive shares of partnership items of gains and losses supported by its DRO during that year.

A liquidation contingent DRO also suffices to attract the partnership's unlimited liabilities during the CLP.²²⁹ The CLP, by definition, proceeds on the assumption of a liquidation of the partnership and, therefore, of all partnership interests. This does not imply, however, that the CLP's allocations of the partnership liabilities and their resulting categorization as partnership recourse liabilities are no longer valid if the assumed liquidation is not translated into reality.

The nonoccurrence of a liquidation contingency does not violate the allocations of a partner's distributive shares of partnership items or of the partnership's liabilities that the liquidation contingent DRO had supported in the first instance. However, where, as in LCL, the liquidation contingent DRO does not just support allocations but also seeks to convert the classification of an otherwise functionally nonrecourse debt from a limited

²²⁶ This reasoning literally comprised one line in the Tax Court's first Hubert opinion. "Neither HBW nor HCC liquidated its interest in LCL during the relevant years." See *Hubert I*, 125 T.C. at 106.

²²⁷ See, e.g., Lipton, *supra* note 3; NAREIT Brief, *supra* note 3.

²²⁸ See Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (2008).

²²⁹ The CLP assumes a liquidation of the partnership and, therefore, of all partnership interests. See generally I.R.C. § 752 (as amended in 1986).

to an unlimited liability under the section 752 rules, the liquidation contingency merits close attention.

If the liquidation contingency constitutes an obstacle to a creditor's ability to enforce the DRO upon a default, then the debt cannot be properly classified as an unlimited liability under the section 752 rules. Thus, the Tax Court was certainly on the right track in focusing on the presence of the liquidation contingency in LCL members' DROs. But it faced the wrong direction in inquiring whether the contingency had materialized. In relying on a failure of the liquidation contingency to materialize, the court seems to have equated a lack of realized losses with an absence of liability for losses. Personal liability demands a prospective view and not an after the fact review.

If LCL members' membership interests had indeed been liquidated during the relevant years, there would have been no issue for the Tax Court to consider or decide. Upon such a liquidation, the members' DROs would have become due and payable. Any deficit in the members' capital accounts during these years would have represented the inadequacy of LCL's assets to repay the debt. If the members had made additional capital contributions to restore these deficits in their capital accounts, they would have, in effect, funded the losses allocated to them. Those losses would then have been financed by their additional capital contributions and would have been allowed.²³⁰ If, on the other hand, the members had repudiated their DROs, then the members would have declined to fund their allocated losses which would consequently have been disallowed.

The two members may very well have had deficits in their capital accounts during the relevant years.²³¹ As mentioned earlier, such deficits would have reflected the insufficiency of LCL's assets to repay its debt.²³² But there is nothing in the facts as presented to the Tax Court that indicates that LCL had defaulted on its debt and that a creditor had sought to enforce the members' DROs. An unenforced DRO does not necessarily mean an unenforceable DRO. Instead of holding the lack of an actual DRO to be dispositive, the court should have asked whether making such a liquidation

²³⁰ Assuming the members had no right to reimbursement for such additional capital contributions and were therefore, not protected against loss.

²³¹ Any deficit in the members' capital accounts during these years would have represented the inadequacy of LCL's assets to repay the debt if these assets' combined value equaled the aggregate of their respective book bases. Each member received a pro-rata share of all partnership items based upon its respective membership interest. If there were no deficits in the members' capital accounts, all losses would have been financed by capital contributions. Therefore, all losses would have been allowed.

²³² Assuming value equaled basis, LCL would not have been able to repay the debt and the creditor could not have been made whole. A liquidation would have determined whether the members would fund their DROs and, thus, enable LCL to repay the debt.

a pre-requisite to the satisfaction of the DROs prevented a creditor from enforcing them upon a default.

In fact, the DROs, by their own terms, were not enforceable by a creditor at any time.²³³ Therefore, the liquidation contingency could add nothing to the DROs' enforceability—or more accurately, subtract nothing from the creditor's inability to enforce them. If anything, it could have opened up a back door for a creditor to enforce the DROs if the creditor enjoyed the right, statutory or contractual, to force a liquidation of the members' membership interests upon a default. But nothing in Wyoming law or LCL's operating agreement conferred such a right on a creditor.²³⁴ Thus, LCL members were not personally liable for any part of LCL's debt despite their liquidation contingent DROs. Not because their membership interests remained un-liquidated and their DROs remained unenforced, but because a creditor could neither enforce their DROs nor force a liquidation of their interests.

2. HUBERT ON APPEAL

If the Tax Court was on the right track but in the wrong direction, the Sixth Circuit on appeal appears to have jumped tracks. The Sixth Circuit faulted the Tax Court for not applying the payor of the last resort test under the worst case scenario in order to examine the members' personal liability for LCL's debt. As mentioned earlier, such a test approximates the results of the section 752 liability sharing rules.²³⁵ Under these rules, to the extent any of LCL's debt was properly classified as an unlimited liability, its allocation to LCL members and the resulting categorization as a partnership recourse liability would establish the members' personal liability for its repayment. These rules limit themselves to the contours of legal relationships and ignore economic reality. This conforms to the two-part framework developed above where personal liability belongs to the set of legal structures and should not be examined under the set of economic consequences. The payor of the last resort test under the worst case scenario conducted for verifying personal liability should similarly restrict itself to examining legal relationships and refrain from assessing economic consequences. But, in its opinion, the Sixth Circuit directs the Tax Court to go down this forbidden path.

In specifying the payor of the last resort test under the worst case scenario, the Sixth Circuit is asking for an assessment of the economic

²³³ See *supra* note 195.

²³⁴ See *supra* note 199.

²³⁵ It does not, however, test for prospective protection against loss. See *supra* Part IX.B.2.

conditions that would precipitate the liquidation contingency and force the LCL members to satisfy their DROs. The Sixth Circuit instructs the Tax Court 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 [debt].”²³⁶ The relevant question, instead, for the Tax Court to consider should be whether or not LCL members can prevent a liquidation of their membership interests despite a default on LCL’s debt and deficits in their capital accounts. And the answer should be supplied not by economic circumstances but by applicable law—LCL’s operating agreement and Wyoming’s LLC Act.

We saw earlier how cutting across the line separating the set of legal structures from the set of economic consequences can allow a court to reach the desired substantive result of inclusion or exclusion of the partnership debt in the partner’s at-risk amount regardless of the facts of the case.²³⁷ Courts that seek exclusion have examined legal relationships for their economic consequences. They have turned the spotlight of economic impact on the mere existence of partnership assets, termed their presence as prospective protection against loss and denied at-risk treatment to a partner who is personally liable for repayment of the partnership debt.²³⁸ Conversely, the taxpayer friendly Sixth Circuit, favorably disposed towards inclusion, has previously examined prospective protection against loss as, in effect, a legal relationship, by ignoring economic reality and, thus, nullifying, this constraint.²³⁹ In *Hubert*, the Sixth Circuit has sought to use the set of economic consequences offensively—to undermine a contingency that obstructs a creditor’s ability to access a partner’s personal assets upon a default on the partnership debt.

In remanding the case in order “to develop the factual record more fully,” the Sixth Circuit signaled for a parade of the economic horrors that would eviscerate the viability of the liquidation contingency and, therefore, the LCL members’ right to thwart a creditor. Constructing economic circumstances against whose backdrop, this right, validly conferred by LCL’s operating agreement, would appear unviable and, thus, un-exercisable, would facilitate establishing LCL members’ personal liability for repayment of LCL’s debt.

²³⁶ *Hubert*, 230 Fed. Appx. at 531.

²³⁷ See *supra* Part IX.B.

²³⁸ See *supra* note 219 and accompanying text.

²³⁹ See *supra* note 215 and accompanying text.

3. HUBERT I IS DEAD; LONG LIVE HUBERT?

To its great credit, the Tax Court ignored the Sixth Circuit's signals and no parade marched up or down the directed path. On remand, the Tax Court remained on track and focused on the liquidation contingency.²⁴⁰ However, it turned face, and the perspective of viewing this contingency, ninety degrees. Completely ignoring both the failure of the contingency to materialize as well as its own initial fixation on it, the court asked the questions that it should have posed the first time around: Could LCL default on its debt without causing a liquidation of its members' membership interests? Could a creditor force this liquidation and, thus, obligate the members to restore the deficits in their capital accounts?²⁴¹

And in its search for answers, the Tax Court restricted itself to the applicable law, notwithstanding the Sixth Circuit's reference to economic circumstances. An examination of LCL's operating agreement and Wyoming law answered the first question in the affirmative and the second in the negative. Therefore, the Tax Court concluded that LCL members DROs did not make them personally liable for LCL's debt.²⁴²

²⁴⁰ The Tax Court disregarded the members' DROs for the taxable year 2000 because the DROs were not added to LCL's operating agreement until it was amended and restated on March 28, 2001. Although the amendment was written retroactively as effective January 1, 2000, the court held that such retroactive effect for Federal income tax purposes was not permissible. Disregarding the DROs for the taxable year 2000 alone could not be dispositive of the taxpayer's claim, however, because, by itself, it would merely suspend the claimed losses for that year and bring them forward to the taxable year 2001. A resolution of the taxpayer's claim ultimately required a decision on whether the members' DROs rendered them personally liable for LCL's debt that the Tax Court then proceeded to provide. See *T.C. Memo, supra* note 1, at 4.

²⁴¹ See *T.C. Memo, supra* note 1, at 4.

²⁴² The Tax Court based its decision on two additional grounds: (i) the members' DROs may be "illusory"; that is, a default may not necessarily be accompanied by deficits in the members' capital accounts, thus rendering the DROs inapplicable; and (ii) even if a deficit existed at default and a member, pursuant to its DRO, was required to restore it, a creditor might not be able to access the additional capital contributions. *T.C. Memo, supra* note 1, at 17, 21-22. Neither ground should apply in LCL's case so long as the debt is a state law recourse debt and the creditor's repayment right extends to all assets of LCL whether now owned or hereafter acquired. If the existing assets are insufficient to repay the debt, assuming value equals basis, either or both members' capital accounts would show deficits. The two capital accounts, combined, would show a net total deficit in the amount by which the aggregate book value of the assets falls short of the face value of the debt. If the two members had made capital contributions in the same 99:1 proportion in which they shared all partnership items of gains and losses, then their respective capital accounts would also show deficits in this proportion. The two members would thus be personally liable for the debt in the same proportion. If HBW had received capital account credit for contributed leases, the CLP could be employed to determine these deficits and reveal the limits of the members' respective repayment obligations. See *supra* note 170. The second

By concentrating on the enforceability of the DROs and refraining from considering economic circumstances, the Tax Court has both redeemed itself and validated the theory presented in this article. Whether it has also finally resolved *Hubert Enterprises*' fate remains uncertain, however. Since the Tax Court ignored the approach outlined by the Sixth Circuit of analyzing the liquidation contingency in the context of economic circumstances that may precipitate it, there could very well be another appeal.

D. *Thinking Outside the Section 752 Box*

By disguising economic reality, the partnership form can mislead a section 465 scrutiny of a partner's claimed at-risk amount. The discussion in this article thus far has been concerned with a partner's at-risk claim in the partnership's borrowings—for good reason. The dichotomy between the taxpayer and borrower that results from a partnership's borrowings often trips up an application of section 465 to taxpayer-partners. The section 752 liability sharing rules offer tools that, if properly applied, can simplify this application in some of these cases. In others, such as *Hubert*, the transparency of the partnership structure makes the use of these tools redundant. However, there remain several cases where the partnership form obfuscates the underlying economic arrangement but none of the tools of section 752, or for that matter, any Subchapter K provisions, can help a section 465 inquiry. I highlight two such situations below.

Both situations involve a partner's capital contributions to a subject activity conducted by a partnership. In the first case, these capital contributions are sourced from borrowings while in the second, they represent the partner's previously earned and taxed income. Despite the inapplicability of any Subchapter K tool, one or both parts of the two-part framework developed above can continue to guide a section 465 inquiry to the right conclusion.

A partner who contributes capital to a partnership may itself have borrowed this amount from another source. This creates an identity between the taxpayer and borrower and removes both the need for, and the applicability of, the section 752 liability sharing rules. The following example demonstrates this.

Example 24. A_1 and A_2 organize an LLC to engage in farming. Each of A_1 and A_2 contributes \$500 in cash to the LLC. A_1 has borrowed its \$500

ground advanced by the Tax Court would also not apply because the creditor's right to repayment would include all assets acquired in the future, including the proceeds of any additional capital contributions as soon as they are made. See *T.C. Memo*, *supra* note 1.

cash contribution from B while A_2 uses its savings.²⁴³ The LLC buys Parcel 1, a plot of farm-land for \$1,000 using all of its cash.

Because the partnership has no debt, the section 752 rules would be completely inapplicable to analyzing the partner's at-risk claim. But the partner itself has borrowed the entire amount of its capital contributions to the partnership. However, the two-part framework developed earlier applies to a taxpayer's at-risk claim in any borrowed amount invested in the subject activity. Therefore, this framework can be used just as fruitfully in this case as it was earlier where the borrowings were made at the partnership level. In utilizing this framework, the set of legal structures must be applied at the taxpayer-partner level to verify the debt's adherence under law to the taxpayer-partner and the taxpayer-partner's personal liability for its repayment. And, as before, the partnership's conduct of the subject activity must be investigated under the set of economic consequences for detecting the taxpayer-partner's protection against loss.

Though the previous example featured a partner's capital contributions, these contributions themselves were financed by debt. Therefore, section 465's provisions relating to at-risk amounts in borrowings continued to apply. However, section 465 also applies to a covered taxpayer's own after-tax dollars that it contributes as capital to a subject activity. To receive at-risk treatment for such contributions and to be able to deduct losses financed by them, such amounts must not be protected against loss. To scrutinize such protection against loss, the set of economic consequences, with suitable modifications, can be applied to a taxpayer's "true" capital contributions—not obtained from borrowings but sourced from the taxpayer's own after-tax income.

In checking capital contributions for protection against loss, as it did with borrowings, the set of economic consequences would continue to focus on the conduct of the subject activity.²⁴⁴ This focus would seek to assess the likelihood and consequences of a loss of the investment in the subject activity. However, with capital contributions, the loss of interest would be that of the taxpayer's after-tax dollars invested as capital in the subject activity. Specifically, the taxpayer would be considered protected against loss of its capital contribution if the conduct of the subject activity ensures the taxpayer recovery of this contribution—either from the returns of the

²⁴³ If A_1 's loan from B is secured only by A_1 's membership interests in the LLC, the loan is nonrecourse and A_1 cannot be considered personally liable for it. See generally I.R.C. § 465(b)(6)(B)(i) (2005).

²⁴⁴ This would entail examining the use made of the claimed at-risk amount, whether comprised of borrowings or capital contributions.

subject activity or as a consequence of reimbursement from a third party, or both.²⁴⁵

This investigation, just as into borrowings, can be hindered by a partnership form. With borrowings, as shown above, the partnership form can be used to make difficult, detection and verification of personal liability.²⁴⁶ Also, as discussed earlier, the CLP can play a role in this function.²⁴⁷ By comparison, with capital contributions, the partnership form can make difficult, detection and verification of protection against loss. However, no section 752 or any other Subchapter K tools are designed to ferret out such protection.²⁴⁸

In fact, a Subchapter K device—the DRO, which was sought to be used in *Hubert* to establish the DRO-partner's personal liability for repayment of partnership debt—can also be used to protect against loss the capital contributions of another partner, one without a DRO. The following example demonstrates this.

Example 25. A_1 and A_2 organize an LLC to engage in farming. A_1 uses its savings to make a \$1,000 cash contribution to the LLC. A_2 does not make any capital contribution but enters into a DRO for \$1,000. The LLC's operating agreement provides for equal allocation of all profits between A_1 and A_2 but all losses are to be allocated to A_2 until A_2 's capital account reaches (\$1,000) after which all losses are to be allocated to A_1 .²⁴⁹ The LLC uses its cash of \$1,000 to rent Parcel 1, a plot of farm-land, and to buy seed and plants corn. A_1 's capital contribution to the LLC that the LLC, in turn, has applied for planting corn, is protected against loss as a consequence of the LLC's loss allocation schedule and A_2 's DRO. If the LLC were to lose its entire crop as a result of severe flooding, for example, all \$1,000 of the LLC's resulting losses would be allocated to A_2 supported by A_2 's DRO.²⁵⁰ A_2 's DRO would require A_2 to make capital contributions that will become available for distribution to A_1 .²⁵¹ Thus, A_1 is protected against a loss of the

²⁴⁵ An absence of protection against loss implies the possibility (whether reasonable or theoretical) of a loss in an "economic" sense and not simply an accounting loss in the subject activity.

²⁴⁶ See *supra* Part IV.

²⁴⁷ See *supra* Part V.

²⁴⁸ This is additional evidence that Subchapter K provisions cannot help with an investigation into the set of economic consequences as part of a section 465 at-risk inquiry. See *generally* I.R.C. §465 (2005).

²⁴⁹ Assume that the LLC meets all other requirements of the "alternate test" of the section 704(b) safe harbor. See Treas. Reg. § 1.704-1(b)(2)(ii)(d) (2008).

²⁵⁰ Such an allocation of losses represents a loan of A_1 's capital from A_1 to A_2 .

²⁵¹ A_2 would be required to make these additional capital contributions by the later of: (i) the end of such taxable year in which its membership interest is liquidated; and (ii) 90 days after the date of such liquidation. See Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (2008).

capital that it has contributed to the LLC. However, A₁ can still include all of this \$1,000 cash capital contribution in its section 465 at-risk amount in the LLC's farming activity.²⁵²

This retroactive protection against loss clearly violates section 465(b)(4).²⁵³ However, there does not appear to be a single case where one partner was denied section 465 at-risk treatment for its capital contributions because of another partner's DRO. This may reflect the conventional image of a DRO as a means of establishing personal liability for repayment of the partnership debt on the part of the DRO-partner rather than offering protection against loss to another partner, who lacks a DRO, for the latter's capital contributions. This image results from viewing any partnership situation for section 465 purposes through Subchapter K lenses. The example above suggests that these lenses could become blinders and should, then, be discarded. A complete section 465 at-risk inquiry into a taxpayer's protection against loss should take a good hard look at, and assess the economic consequences of, every arrangement that affects the taxpayer—both within and outside the partnership.

The partnership form, by masking the true distribution of risk among partners, can confuse the analysis of a taxpayer-partner's section 465 at-risk claims. Where the at-risk amount is claimed in the partnership debt, a proper application of the section 752 rules could clean up some of the obscurity and clear up some of the confusion. But where the source of the obfuscation lies, not in the partnership form, but the partner's opaque claims, a mechanical application of the section 752 rules can only serve to intensify the confusion.

PART X. CONCLUSION

In analyzing court cases dealing with partners' claims of at-risk amounts in partnership debt, professors and professionals have sought to reconcile the section 465 at-risk rules with the section 752 liability sharing rules—an exercise inspired by a perception of inconsistencies between the two

²⁵² The purpose of claiming and establishing a section 465 at-risk amount is to make losses in the subject activity available for use. A₂ does not have any amount at risk and, therefore, will not be able to use the \$1,000 in losses allocated to it if it is covered by section 465. But A₂ could be a taxpayer not subject to section 465, a widely held C corporation, for example. Alternatively, A₁ might have suspended losses from prior years as a result of inadequate section 465 at-risk amounts in such years. The addition of the \$1,000 of its cash capital contribution to the LLC to its at-risk amounts could make available to A₁ previously suspended losses in the same amount. See *generally* I.R.C. § 465 (2005).

²⁵³ See I.R.C. § 465(b)(4) (2005). See also S. REP. NO. 94-938, pt. I, at 45 (1976).

regulatory regimes.²⁵⁴ In this article, I have sought to demonstrate that this perception may arise from a failure to appreciate the specialized functions of the section 752 rules, realize the limits of their scope and locate their proper place in a section 465 at-risk inquiry. Misled by the EROL label that the section 752 rules have given to their liability sharing functionality and the resulting homophony with the purpose of a section 465 at-risk inquiry, academics and analysts have tended to believe that both sets of rules cover the same ground and, therefore, are superposable;²⁵⁵ hence, the urge to render them coincident by removing apparent incongruities. The inexact language of section 465 and the incomplete regulatory guidance have only served to strengthen this cause.

In this article, I have shown that the section 752 liability rules complement rather than compete with the section 465 at-risk rules. They do so by providing tools that can be deployed in a section 465 at-risk inquiry of a covered partner's at-risk claims in partnership debt. In the two-part framework that this article has developed for analyzing these claims, these tools can be used in most, if not all, of the required examination under the set of legal structures, where they can be calibrated to the precise configuration of legal relationships prescribed by the section 465 at-risk rules. Specifically, the classification of a partnership debt as an unlimited liability under the section 752 rules can be made to deliver results that correspond with the requirements for personal liability under the section 465 rules. Such correspondence between the results required by the section 465 at-risk rules and the assessment performed by the section 752 liability sharing rules harmonizes the two regimes. It is this harmonization, rather than the synthesis that commentators have attempted to force, that should be the end-goal of an integration of the two sets of rules.

Tinkering with the section 752 rules may not be the best way to convey this message, the EROL label attached to these rules notwithstanding. This would needlessly disrupt the application of these rules to the task for which they were designed—liability sharing, where they seem to perform adequately. Instead, completing the section 465 regulatory project may provide the perfect opportunity and ideal platform for distilling the exact shade of meaning to the section 752 rules' EROL label in a section 465 at-risk application. Regulatory examples such as those developed in this article showing both the proper and improper uses of the section 752 rules in conducting a section 465 at-risk inquiry could accomplish this.

²⁵⁴ See, e.g., *supra* note 79 and accompanying text.

²⁵⁵ See, e.g., *Burke, supra* note 3; *Rubin et al., supra* note 3.

For most situations, the section 752 rules can be made to deliver results that conform to the specifications of the section 465 rules. Where they may appear to fail, as in *Hubert*, or where they actually fail, as in Example 25, the fault lies not in the inadequacy of the section 752 rules, but in persevering with them despite their redundancy in a section 465 at-risk inquiry. The remedy should, therefore, be found not in revising the section 752 rules but in discarding their application when and where they are no longer needed.

Who's at risk?

Never mind. It's moot now.

Oh! That's the Tax Court's first Hubert decision.

