

# TAX UPDATE

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## When Does a Loan Guarantee Provide Amounts at Risk



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In *Bordelon v. Commissioner*, the Tax Court addressed the circumstances under which an individual's personal guarantee of a loan to his single-member LLC established sufficient amounts at risk to enable him to claim more than \$1 million in losses.<sup>1</sup> The Tax Court also examined whether the individual's guarantee of a loan to a partnership increased his basis and established amounts at risk sufficient to enable him to claim a \$550,000 partnership loss that had been disallowed in a prior year.

The IRS disallowed losses claimed by Rock and Torie Bordelon for 2008 through 2011. In 2008, Bordelon used two entities in which he owned 100 percent of the interests to buy a hospital. Allegiance Health Management, Inc. (AHM), was a C corporation in 2008 and 2009, and an S corporation in 2010. In 2008, Bordelon formed Many LLC (Many), a single-member LLC that was disregarded for federal income tax purposes. Bordelon funded the purchase by taking out an agricultural development loan of \$9.9 million (the Many Loan), which he obtained from a bank. The bank granted the Many Loan under a

U.S. Department of Agriculture and Rural Development (USDARD) lending program. As a condition for the Many Loan, Bordelon was required to execute a personal guarantee for the full \$9.9 million loan amount. Bordelon listed AHM and Many as co-borrowers. The collateral was the hospital's facilities and equipment.

Under the Many Loan guarantee, Bordelon was liable for the full amount of the loan for as long as it was outstanding. In addition, the bank was not required to seek payment from any other source before demanding payment from Bordelon. Bordelon had no right of contribution from the USDARD; if the USDARD paid any amounts on the Many Loan, those amounts would become a federal debt owed by Bordelon.

Bordelon also owned a 90 percent interest in Kilgore LLC, which was taxed as partnership. Kilgore also owned and operated a hospital. Kilgore incurred substantial losses in 2008 and earned very little or no income in 2009 to 2011. Kilgore borrowed \$550,000 from a bank in 2011 (the Kilgore Loan). Bordelon executed the Kilgore Loan and note on Kilgore's behalf, securing the note with the Bordelon's home, Kilgore's account receivables, and a security interest in any deposits Kilgore had in the bank. Bordelon personally guaranteed the Kilgore Loan. His guarantee was an absolute and unconditional guarantee of performance under the loan, entitling the bank to enforce its rights against Bordelon without proceeding against any other obligor. Bordelon's liability under the guarantee was unlimited and his obligations continuing. There were no other guarantors to the Kilgore Loan, and no other member of Kilgore was personally liable for the debt.

In 2008, the Bordelons reported a loss from Many of about \$1.6 million and a loss from Kilgore of \$2.2 million. The IRS disallowed the Many loss on the grounds that Bordelon had not demonstrated that he was at risk, and disallowed the Kilgore loss on the grounds that Bordelon did not have sufficient basis in his Kilgore partnership interest and that he failed to establish amounts at risk.

The Tax Court concluded that Bordelon's guarantee of the Many Loan established sufficient amounts at risk to entitle him to deduct the Many losses for 2008. It further held that Bordelon's guarantee of the Kilgore Loan increased his basis in Kilgore and established amounts at risk sufficient to entitle him to deduct for 2011 his share of suspended losses disallowed for 2008 in the amount of the Kilgore Loan.

### **Did the guarantee of the Many Loan give Bordelon an amount at risk in Many?**

For individuals who are engaged in carrying on a trade or business or the production of income, Internal Revenue Code section 465 limits loss deductions to the amount for which the taxpayer is at risk. The amount at risk generally includes the amount of money and property contributed by the taxpayer, and amounts borrowed. Borrowed amounts are considered at risk to the extent that the taxpayer is personally liable for the repayment.<sup>2</sup> A taxpayer is not considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees and stop-loss agreements.<sup>3</sup>

To prevail in claiming the deductions, Bordelon had to show that he was personally liable for the loan and that he was not protected against loss.

### **The First Prong of the At Risk Test: Did Bordelon have personal liability?**

The Tax Court observed that merely executing a guarantee is insufficient to establish personal liability. That is because in a typical guarantee, if the guarantor were required to pay on the underlying debt, the guarantor generally would be entitled to seek reimbursement from the primary obligor. However, “not all guarantees are created equal.” In *Abramson v. Commissioner*,<sup>4</sup> the court found that when a taxpayer is directly liable on a debt with no meaningful right to reimbursement, the guarantor’s liability would constitute personal liability for Code section 465 purposes. The test for whether a guarantor has personal liability is whether the guarantor has the ultimate liability for the debt. This is analyzed based on the “worst-case scenario” to identify the obligor of last result. In other words, “if there are not funds to repay the debt and all of the assets of the activity or business are worthless, to whom would the creditor look for repayment?”<sup>5</sup>

The Tax Court determined that the guarantee created a direct liability against Bordelon that would have permitted the bank to pursue him directly without any action against AHM or Many if either of them defaulted. The Tax Court rejected the IRS’s contention that a surety who pays the creditor is entitled to reimbursement from the obligor under Louisiana law. Using the worst-case scenario — which is that AHM and Many, as the primary obligors, would be worthless — led to the conclusion that Bordelon was liable. The Tax Court concluded that:

Moreover, even if we looked to Many LLC and AHM (whether or not deemed defunct or insolvent) as the obligors responsible *in form* for any such reimbursement, we

cannot ignore the fact that Mr. Bordelon, as the sole owner of Many LLC and AHM, would still bear the economic responsibility for such reimbursement *in substance*. See *Melvin v. Commissioner*, 88 T.C. at 75 (“the fact that the partnership or other partners remain in the ‘chain of liability’ should not detract from the at-risk amount of the parties who do have the ultimate liability”). In other words, any reimbursement to which Mr. Bordelon might theoretically be entitled would be due to him from his own 100%-owned entity. Mr. Bordelon would ultimately be paying the debt, and the fact that he might then be entitled to seek reimbursement from himself would not render him any less at risk.

(Emphasis in original).

The IRS’s final argument was that the Many Loan was substantially collateralized, which meant that it was unlikely that Bordelon would be required to pay. The Tax Court found that argument to be immaterial, noting that, in a worst-case scenario, the ultimate responsibility still fell to Bordelon to pay the Many Loan. Because he had no right to seek reimbursement from any other party (other than his 100 percent-owned entities), he was personally liable.

### **The Second Prong of the At Risk Test: Was Bordelon protected against loss?**

In its prior decisions, the Tax Court’s analysis for loss protection has been similar to its analysis for personal liability. A guarantor who had a right to reimbursement from a primary obligor is generally not considered to be at risk. In two prior cases,<sup>6</sup> the guarantor’s right to reimbursement limited the risk because the facts indicated a certainty as to the reimbursement, and therefore the right to reimbursement was meaningful. Conversely, when a guarantor’s right to reimbursement is against a primary obligor that has only limited liability, such as a corporation or an LLC, and there is no fixed recourse obligation for the underlying debt, the right to reimbursement is less meaningful, and there may be risk. When evaluating a guarantor’s loss protections, which include reimbursement from primary obligors:

[w]e look at the facts and circumstances to determine not only whether there is a right to the reimbursement but whether the substance of the right is meaningful. In other words, we must consider the “realistic possibility” that the guarantor would ultimately be subject to “economic loss” if called upon to make payments on account of the guarantee.

When an individual guarantees debts of his solely owned business, first the “worst-case scenario” is applied, which assumes that the primary obligor defaults, becomes worthless, and is unable to make payments of the debt, which would trigger payments from the guarantor. Second, the realistic possibility of economic loss analysis is applied.

The Tax Court observed that among the Courts of Appeals there has been a perceived split as to whether the analysis should be of the realistic possibility or the obligor of last result under a worst-case scenario.<sup>7</sup> However, in *Bordelon*, it found that both approaches would lead to the same result. In its determination that Bordelon was personally liable, the Tax Court’s analysis presumed that Many and AHM, the primary obligors, were worthless and unable to pay the amount owed under the Many Loan. The Tax Court found that it was clear that Bordelon would not be protected against loss because his right to reimbursement would be against the worthless entities that had no method to repay him for any amounts contributed.

The Tax Court’s conclusion as to the Many Loan was that it was persuaded that Bordelon was personally liable, not protected against loss, and at ultimately at risk during 2008. Therefore, Bordelon was able to deduct the losses related to Many that were claimed on the 2008 return.

### **Did Bordelon have sufficient basis in Kilgore?**

The IRS disallowed Bordelon’s 2008 Kilgore deduction. Bordelon conceded that in 2008 his basis in Kilgore was zero, and thus the IRS’s disallowance of the 2008 deduction was correct. However, Bordelon claimed that his basis in Kilgore increased for 2011 by \$550,000 as a result of his 2011 personal guarantee of the Kilgore Loan, and that this basis increase allowed him to deduct \$550,000 of the Kilgore losses disallowed for 2008 as carryforward losses. The IRS claimed that Bordelon’s basis did not increase in 2011 and/or that Bordelon did not establish that he was at risk at the end of 2011 for the Kilgore Loan.

Code section 704(d) generally limits a partner’s losses to an amount equal to adjusted basis in the partnership at the end of the year in which the loss occurred. Any excess would be carried forward until such time as the loss could be deducted. Basis is increased by a partner’s share of liabilities and decreased by a decrease in the partner’s share of liabilities.<sup>8</sup>

A partner's share of partnership liabilities depends on whether the liability is recourse or nonrecourse. A liability is "recourse" to a partner only to the extent that the partner bears the economic risk of loss for the liability.<sup>9</sup> The Treasury Regulations provide a "constructive liquidation" test for determining whether a liability is recourse.<sup>10</sup> Under that test, the following events are deemed to occur simultaneously: all partnership liabilities become payable in full; all assets become worthless; the partnership disposes of all of its property in a fully taxable transaction for no consideration other than satisfaction of nonrecourse liabilities secured by the property; the partnership allocates all tax items for its last taxable year as of the date of the constructive liquidation; and the partnership is liquidated. If a partner would be liable for a debt, then the liability is considered recourse.

In applying the constructive liquidation test, the Tax Court stated that it could not perceive any scenario in which Bordelon could not be considered economically at risk for the Kilgore Loan to the full extent of his guarantee. It based its decision on the following facts: there were no other partnership assets securing the Kilgore Loan; no other partner was liable for the Kilgore Loan; and if the Kilgore Loan were due in full, the bank would have sought payment from Bordelon. Consequently, as a result of Bordelon's being economically at risk, his guarantee caused the Kilgore Loan to become a recourse obligation, which increased Bordelon's Kilgore basis by the amount of the guarantee. As a result, Bordelon could deduct the carryforward 2008 losses up to the Kilgore Loan amount.

### **Was Bordelon at risk with respect to the Kilgore Loan?**

The Tax Court used its same analysis concerning basis to shoot down the IRS's claim that Bordelon was not at risk. The personal guarantee made him personally liable for the Kilgore Loan; there was no right for a contribution from another member of Kilgore; and there was no loss protection on the amount guaranteed. The Tax Court said, "We assume that there might be a scenario in which a partner's basis could increase on account of a guarantee but in which the guarantee would not result in his being considered at risk under section 465, but this is not such a case."

### **Takeaways**

The issue of whether a taxpayer who guarantees a loan is at risk with respect to the investment depends on the facts. In *Bordelon*, the facts were favorable for the taxpayer. In the first investment, under the terms of the guarantee: he was directly liable to the bank for the full amount if the obligors defaulted; there was no other guarantor on the debt; the bank could have pursued him directly without any action against the co-borrowers; Bordelon was the sole owner of the co-borrowers; and he was the only person with unlimited

liability for the loan. Those facts persuaded the Tax Court that he was personally liable, not protected against loss, and ultimately at risk. Had any one of the facts been different, Bordelon might not have prevailed.

The facts were similar with respect to the second investment, in which the issue also was based on whether Bordelon was at risk with respect to a guarantee. In that investment, he guaranteed a loan of a partnership in which he was a 90 percent member. There were no other partnership assets securing any of the debt; no other partner was liable for any portion of the debt; and if the debt were due in full, the bank “would certainly” have sought payment directly from Bordelon. As with the first investment, Bordelon’s complete liability under the guarantee persuaded the Tax Court that he was at risk.

## Endnotes

- 1 T.C. Memo. 2020-26 (Feb. 20, 2020).
- 2 IRC § 465(b)(2).
- 3 IRC § 456(b)(4).
- 4 86 T.C. 376(1986).
- 5 *Melvin v. Comm’r*, 88 T.C. 63, *aff’d*, 894 F.2d 1072 (9th Cir. 1990).
- 6 See *Brand v. Comm’r*, 81 TC 821, and *Melvin*, *supra* note 5.
- 7 The Tax Court cites the following cases applying the “realistic possibility” test: *Waters v. Comm’r*, 978 F.2d 1310, 1316 (2d Cir. 1992), *aff’g* T.C. Memo. 1991-462; *Young v. Comm’r*, 926 F.2d 1083, 1089 (11th Cir. 1991), *aff’g* T.C. Memo. 1988-440 and T.C. Memo. 1988-525; *Moser v. Comm’r*, 914 F.2d 1040, 1048-1049 (8th Cir. 1990), *aff’g* T.C. Memo. 1989-142; *Am. Principals Leasing Corp. v. United States*, 904 F.2d 477, 483 (9th Cir. 1990), and the following case applying the “obligor of last resort” under the worst-case scenario test: *Emershaw v. Comm’r*, 949 F.2d 841, 845 (6th Cir. 1991), *aff’g* T.C. Memo. 1990-246.
- 8 IRC § 752(a).
- 9 Treas. Regs. §1.752-1(a)(1).
- 10 Treas. Regs §1.752-2(b)-(k).

## Private Equity Benefits From Bonus Depreciation on Partnership Purchases



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Following the passage of the Tax Cuts and Jobs Act in 2017, an unlimited amount of business property could be depreciated immediately. This creates significant incentive for private equity funds to structure acquisitions to allow for readjusting asset basis to reflect purchase price, known as a step-up in basis.

In the case of an acquisition of a partnership interest, a purchaser may benefit from a step-up in basis of the assets of the partnership if the partnership makes what is known as a “754 Election.” Final Treasury Regulations confirm that immediate depreciation is applicable to partnership basis adjustments after September 28, 2017.

Below is an example of how a private equity firm can structure acquisitions to benefit from the new rules.

### **Explanation of the Partnership Basis Step-Up**

Assume that in 2013, two founding individuals, A and B, each contributed \$100,000 to AB Partnership in return for a 50 percent interest. AB Partnership used the \$200,000 of cash contributions to acquire depreciable equipment, such as office computers. In 2018, private equity fund C acquired B's interest in AB Partnership for \$200,000. Assume that the equipment is worth \$50,000, but AB Partnership's basis in it is zero — the result of depreciation deductions.

Absent a 754 Election, B would recognize a \$100,000 gain. C would take a \$200,000 basis in its interest in AB Partnership, but AB Partnership's basis in its assets would remain zero.

On the other hand, if AB Partnership made a 754 Election — either before or in connection with C's acquiring its interest, C's share of AB Partnership's asset bases would be increased (or stepped-up) to C's \$200,000 purchase price. A and B would not be treated any differently as a result of the 754 Election. The \$200,000 basis adjustment would be allocated among AB Partnership's assets based on the amount of income or gain that would be allocated to the transferee (here, C) from a hypothetical sale of the assets.

As the equipment had a \$50,000 value, \$25,000 (C's 50 percent share of the value of the equipment) of the basis step-up would be allocated to the equipment, and \$175,000 of the basis step-up presumably would be allocated to other asset categories — goodwill or going concern value. Regulations applicable to intangible amortization clarify that the \$175,000 basis adjustment allocable to goodwill and going concern value could be amortized over 15 years.

### **Bonus Depreciation After Tax Reform**

Under the tax reform provisions enacted in 2017, a taxpayer generally may immediately depreciate 100 percent of the cost of tangible personal property having a useful life of 20 years or less. In the tax law, property eligible for immediate depreciation was expanded to cover used property. The new bonus depreciation rules apply for property acquired and placed in service after September 28, 2017 and before January 1, 2023, with a phase-down of the percentage of the bonus depreciation for property placed in service after December 31, 2022 and before January 1, 2027.

### **Anti-Churning Rules**

Used property is eligible for the 100 percent depreciation only if the taxpayer acquired the property in a taxable transaction from an unrelated party and did not use the property before acquiring it. The basis adjustments permitted because of a 754 Election result solely because of an election permitted by Section 754, and not as a result of an actual sale of partnership property. The party using the property (the partnership) does not change. This raises the question of whether the property should be considered to have been used by the taxpayer before it acquired the property, and thus be ineligible for immediate depreciation.

The final regulations (effective retroactively to property placed in service after September 27, 2017) provide that, with respect to 754 Elections, the anti-churning rules are determined at the partner level, with each partner being treated as having owned and used a proportionate share of the partnership assets. As long as the taxpayer acquires the partnership interest in a taxable transaction from an unrelated party, and the taxpayer did not use the property (e.g., it did not lease the property from the partnership), immediate depreciation is allowed.

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