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Legal Update

Risky Business: Loan Guarantees Provide Basis and At Risk in *Bordelon*

By Mark Leeds and Christian Choi[1]

Perhaps the best line penned for Tom Cruise's character in the 1983 break-out hit, *Risky Business* was, "It seems to me that if there were any logic to our language, trust would be a four-letter word." In other words, "trust me" to repay a debt is seldom sufficient. In *Bordelon v. Commissioner*, T.C. Memo, 2020-26, a taxpayer was able to use the government's reluctance to rely on an ostensible borrower to repay a debt, and instead require a loan guarantee, to deduct operating losses from a health care business that otherwise would have been suspended or disallowed altogether.

Facts

Between 2008 to 2011, Rock Bordelon (the "Taxpayer") owned two companies in the health care business. One of the companies was a health care management services company taxable as a C corporation, Allegiance Health Management, Inc. ("AHM"). The other was a limited liability company taxable as a disregarded entity, Many LLC. The Taxpayer formed Many LLC in 2008 to purchase a hospital in Many, Louisiana.

In order to enable Many LLC to finance the hospital purchase, AHM and Many LLC (together, the "Borrowers") borrowed $9.9 million from a Bank under a US Department of Agriculture and Rural Development ("USDARD") lending program ("Loan 1"). The USDARD loan program required the Taxpayer to execute a personal guarantee for Loan 1. The terms of the guarantee provided the bank with a cut-through to the Taxpayer, that is, the Bank was not required to seek repayment from the Borrowers prior to seeking payment from the Taxpayer, USDARD was not a co-guarantor on Loan 1 and if USDARD paid any amounts on Loan 1 to the Bank, these amounts would become a Federal debt owed by Taxpayer. Although the guarantee was ominous on its face, the Taxpayer was comforted by the fact that the Borrowers had substantial assets which could be used to repay the debt.

During the Years at Issue, Taxpayer also owned a 90.2 percent interest in Kilgore LLC, which owned and operated a hospital in Kilgore, Texas. Kilgore LLC was not profitable during the years at issue: it incurred substantial losses in 2008, earned less than $16,000 in 2009, and earned nothing in 2010 and 2011. In 2011, Kilgore LLC borrowed $550,000 ("Loan 2") from Home Federal Bank in Louisiana. The Taxpayer personally guaranteed Loan 2. Taxpayer's personal guarantee of Loan 2 was an absolute and unconditional guarantee of performance under the loan. There were no other guarantors to Loan 2.

The Internal Revenue Service (the "IRS") disallowed approximately $1 million of Taxpayer's $1.6 million claimed loss deductions in 2008 relating to Many LLC on the ground that Taxpayer had not demonstrated that he was "at risk" to the extent of the reported loss. The IRS also disallowed the deductions related to Kilgore LLC for 2008 on the ground that Taxpayer did not have a sufficient adjusted basis in Kilgore LLC to claim the deduction and was not "at risk" with respect to the Home Federal Bank loan. To add insult to injury, the IRS asserted over $1 million in penalties attributable to the fact that the Taxpayer claimed these losses. Thus, the Taxpayer was left little choice but to litigate and the case went to trial. Happily, the Taxpayer sustained that he was entitled to the losses. Accordingly, the penalties were abated.

Taxpayer Was "At Risk" to the Extent of Disallowed Deductions

For individuals and certain closely held corporations engaged in a trade or business, Section 465 of the Internal Revenue Code of 1986, as amended (the "Code"), generally limits the ability to claim loss deductions to the amount for which the taxpayer is considered "at risk."[2] A taxpayer's amount at risk generally includes: (1) the amount of money and the adjusted basis of other property contributed to the activity and (2) amounts borrowed with respect to such activity.[3] Amounts borrowed are considered to be at risk only to the extent that the taxpayer: (a) is personally liable; or (b) has pledged other property as security.[4] Further, a taxpayer is not considered to be at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements or other similar arrangements.[5]

The IRS argued that the Taxpayer's personal guarantee of Loan 1 did not actually put him "at risk." The Taxpayer was not the borrower; he was a guarantor. In a 1983 case, the Tax Court held that merely executing a guarantee is insufficient to establish personal liability if there is a person (other than the debtor itself) from whom the guarantor can seek reimbursement.[6] The Tax Court's approach provides an amount "at risk" only if the guarantor has the "ultimate liability" for the debt. This is a two-step inquiry. First, the Tax Court assumes that the debtor has no assets to repay the debt. Then, it asks whether there is any other person from whom the guarantor could seek reimbursement.[7] If the answer is "no," then the taxpayer is "at risk."

In *Bordelon*, the Tax Court held that Taxpayer bore the "ultimate liability" and was not protected against loss with respect to Loan 1 because: (i) Taxpayer personally guaranteed the full amount of the loan; (ii) there were no other guarantors to the loan; (iii) the Bank could have pursued Taxpayer directly without any action against the Borrowers; and (iv) if USDARD paid any amounts of Loan 1, Taxpayer would be liable to USDARD as a Federal debt obligation. The IRS argued that Taxpayer could seek reimbursement from the Borrowers. The Tax Court swatted down this argument because the "at risk" analysis assumes that the primary debtor is insolvent. Furthermore, the IRS held that even if this was true, and the Taxpayer could pursue the original debtors, Taxpayer would essentially be seeking reimbursement from himself because he was the sole owner of the Borrowers. This latter argument was confusing at best.

Taxpayer Had Sufficient Basis in Kilgore LLC for 2011

Code § 704(d) generally limits a partner's loss deduction to an amount equal to his adjusted basis in the partnership at the end of the partnership year in which the loss occurred. Any excess that he could not deduct in that year is carried forward until such time as the partner has sufficient basis to claim the loss. A partner's basis is increased by an increase in a partner's share of partnership liabilities. A partner is entitled to share in certain partnership liabilities if the partner bears the economic risk of loss for the liability.[8]

The Taxpayer argued that his basis in Kilgore LLC increased for 2011 by $550,000 due to his personal guarantee of Loan 2 and that his basis increase would allow him to deduct $550,000 of the losses incurred in 2008 that carried forward to 2011. The IRS disagreed and argued, in the alternative, that Taxpayer did not establish that he was "at risk" for Loan 2. The Tax Court held that Taxpayer was entitled to basis for the loan and that he was economically at risk for Loan 2 to the full extent of the guarantee because: (i) there were no other partnership assets securing any of the debt; (ii) no other partner was liable for any portion of the debt; and (iii) if the debt was due in full, the Home Federal Bank would have sought payment directly from Taxpayer. Therefore, when Taxpayer guaranteed Loan 2 in 2011, the Tax Court held that Taxpayer increased his basis in Kilgore LLC by $550,000, which allowed him to deduct the same amount in Kilgore LLC losses carried forward from 2008.

Takeaway

Guarantees are risky business in the best of circumstances. Guarantees with cut-throughs are riskier still. Nonetheless, the brunt of the obligation can be mitigated by the ability to claim business losses for federal income tax purposes. And guarantees of obligations issued by credit-worthy borrowers present substantially less risk than guarantees that can be expected to be called upon. Taxpayers should not assume that personally guaranteeing a loan for an activity related to carrying a trade or business will provide them with an amount "at risk" and enable them to deduct losses under Code § 465. Following the Tax Court's decision in *Bordelon v. Commissioner*, taxpayers should ensure that they are "ultimately liable" before attempting to deduct losses based on the conclusion that a guarantee will provide them with an amount "at risk." Then at the very least, they should be able to enjoy some tax benefit from their risky business.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

Mark H. Leeds
+1 212 506 2499
mleeds@mayerbrown.com

Christian Choi
+1 212 506 2505
mchoi@mayerbrown.com

Endnotes

[1] The authors are both tax lawyers in the New York office of Mayer Brown.

[2] IRC sec. 465(a), (c)(3)(A).

[3] IRC sec. 465(b).

[4] IRC sec. 465(b)(2).

[5] IRC sec. 465(b)(4).

[6] *See Brand v. Commissioner*, 81 T.C. 821, 828 (1983).

[7] *See Melvin v. Commissioner*, 88 T.C. 63, 75 (1987), *aff'd* 894 F.2d 1072 (9th Cir. 1990).

[8] IRC sec. 752(a); Treas. Reg. sec. 1.752-1(a)(1).