Current Federal Tax Developments

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SECTION: 104
EXTENDED STATUTE ENACTED TO CLAIM REFUND RELATED TO NON-TAXABLE SEVERANCE PAYMENTS MADE TO VETERANS

Citation: Combat-Injured Veterans Tax Fairness Act of 2016, H.R. 5015, 12/16/16

It has taken awhile (twenty-four years to be exact), but Congress enacted a relief provision to deal with the fact that the Department of Defense had been withholding taxes on lump-sum severance payments to combat-injured veterans despite that income being found to be excludable from taxable income under IRC §104(b)(3). The bill, the "Combat-Injured Veterans Tax Fairness Act of 2016" H.R. 5015 was signed into law on December 16.

In the case of *St. Clair v. United States*, 778 F. Supp. 894 (E.D. Va 1991) these one-time lump sum severance payments were held to be excludable from taxable income. However, per a *Tax Analysts* news article describing the bill, the Defense Finance and Accounting Service said an error with its payment system caused taxes to be improperly withheld from 14,000 veterans receiving these payments.

If those veterans had filed their returns noting that these payments were not taxable there would have been no harm—their tax liability would have been properly computed and any excess withholding would have been refunded. However, Congress determined that many veterans were not aware of the proper tax treatment and rather assumed that the information return they received from the Department of Defense that showed the payments as taxable income represented the proper treatment.

The bill requires the Department of Defense within one year after December 16, 2016 to identify:

- The severance payments --
  - That the Department paid after January 17, 1991;
  - That the Department computed under section 1212 of title 10, United States Code;
  - That were not considered gross income pursuant to section 104(a)(4) of the Internal Revenue Code of 1986; and
  - From which the Department withheld amounts for tax purposes; and
- The individuals to whom such severance payments were made.

Once the DOD has the list of affected veterans, the Department is required to send to the affected veteran:

- Notice of --
  - The amount of severance payments which were improperly withheld for tax purposes; and
  - Such other information determined to be necessary by the IRS to carry out the purposes of this section; and
- Instructions for filing amended tax returns to recover the amounts improperly withheld for tax purposes.

Since the vast majority of the returns affected by this erroneous withholding are closed to the filing of claims for refunds, the law provides a temporary extension of the time to file a claim for refund related to this issue.

Section 3(b)(1) of the law provides:

> If a claim for credit or refund under section 6511(a) of the Internal Revenue Code of 1986 relates to a specified overpayment, the 3-year period of limitation prescribed by such subsection shall not expire before the date which is 1 year after the date the information return described in subsection (a)(2) is filed. The allowable amount of credit or refund of a specified overpayment shall be determined without regard to the amount of tax paid within the period provided in section 6511(b)(2).

Presumably the information the DOD sends to the veteran will provide that due date for filing a claim for refund.

The law also directs the DOD to act to ensure that taxes are no longer withheld from such payments.

SECTION: 263
RELIEF EXTENDED BY ONE YEAR TO MAKE CERTAIN ACCOUNTING METHOD CHANGE REQUESTS UNDER AUTOMATIC PROCEDURES TO COMPLY WITH TANGIBLE PROPERTY REGULATIONS

Citation: Notice 2017-6, 12/20/16

The IRS has extended a special eligibility rule for taxpayers making an automatic change of accounting method by one year in Notice 2017-6.

Taxpayers were required to make various changes in their accounting methods to comply with the revised tangible property regulations that took effect in 2014. However, some of these taxpayers have discovered they need to make additional changes to comply with those regulations they had not noticed previously.

Under the general rules for requesting an automatic accounting method change found in Revenue Procedure 2015-13 the taxpayers might discover they are blocked from obtaining automatic consent due to a rule limiting the ability to make a second request to change the method of accounting for an item within five years of an earlier automatic change.

Specifically the IRS notes:

> Section 5 of Rev. Proc. 2015-13 provides certain eligibility rules for a taxpayer that applies for the Commissioner's consent to make a change in method of accounting under the automatic change procedures. Section 5.01(1)(f) provides that the automatic change procedures may not be utilized if the taxpayer has made or requested a change for the same item during any of the five taxable years ending with the year of change. This rule generally precludes a taxpayer from using the automatic change procedures to change the treatment of the same item more than once within a five-year period.

The IRS had waived this rule for certain changes related to the tangible property regulations for any year beginning before January 1, 2016 (Revenue Procedure 2016-29). Thus, calendar year 2017 returns would no longer be covered by that rule—but taxpayers continue to discover issues.

That has lead to taxpayers filing requests for consents to non-automatic changes since IRS permission would now be required to change the method of accounting for any of these items if a prior change had been made within five years. Presumably the IRS has been receiving such requests and has now decided they will extend the special rule for one more year.

As the ruling holds:

> The Treasury Department and the IRS are aware that taxpayers continue to request consent to change their methods of accounting to utilize the final tangible property regulations and final depreciation and disposition regulations. To continue to ease taxpayers' transition to these final regulations and to reduce the administrative burden that would result from requiring taxpayers to apply for non-automatic changes of accounting methods for each of the changes specified above, this notice modifies the applicable sections of Rev. Proc. 2016-29 to extend the waiver of the eligibility rule under section 5.01(1)(f) of Rev. Proc. 2015-13 for one year to any taxable year beginning before January 1, 2017. The applicable sections are:
>
> > (1) Section 6.14, relating to a change from a permissible to another permissible method of accounting for depreciation of MACRS property under § 1.168(i)-1, § 1.168(i)-7, and § 1.168(i)-8, as applicable;
> >
> > (2) Section 6.15, relating to a change in method of accounting for dispositions of a building or structural component under § 1.168(i)-8;
> >
> > (3) Section 6.16, relating to a change in method of accounting for dispositions of tangible depreciable assets (other than a building or its structural components) under § 1.168(i)-8;

(4) Section 6.17, relating to a change in method of accounting for dispositions of tangible depreciable assets in a general asset account under § 1.168(i)-1; and

(5) Section 11.08, relating to changes in methods of accounting for tangible property under the final tangible property regulations.

The IRS also has provided a transition rule that will allow taxpayers that had filed for consent to a non-automatic change that would be covered by the extension of the relief noted above to make their change under the automatic procedures. Such a Form 3115 must have been pending with the National Office of the IRS on December 20, 2016.

SECTION: 501
ORGANIZATION WHERE 50% OF FUNDS RAISED TO BE USED TO BENEFIT SPECIFIC CANCER PATIENT DENIED EXEMPT STATUS

Citation: PLR 201651016, 12/16/16

Organizations that wish to qualify as a tax-exempt organization under IRC §501(c)(3) must serve a public rather than private interest pursuant to Reg. §1.501(c)(3)-1(d)(ii). That issue tripped the application of the organization that is the subject of PLR 201651016.

Reg. §1.501(c)(3)-1(d)(ii) specifically provides:

> An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Note that the regulation doesn't provide any exception that allows a targeted benefit organization is the individual in question is truly deserving—rather a designated individual organization simply cannot qualify for §501(c)(3) status.

In this case the organization looking to be granted §501(c)(3) status provided the following details on its purpose:

> You were originally formed to provide financial assistance solely to the N family. Your activities consist of raising funds to assist the family of M, a child diagnosed with cancer, with medical expenses related to cancer preventive treatments that are not covered by the family's medical insurance. Your board reviews the medical expenses and distributes funds to the medical provider administering care. One of your board members shares the same last name as the recipient, M. Although you indicated on Form 1023 that your officers or directors are related through family or business relationships, you did not provide an explanation of the relationships.

Very likely the family in question is both in need and deserving, but the regulation doesn't allow for such an organization to get §501(c)(3) status. The organization likely was made aware of that fact during its application process.

Therefore, it made a change to its purposes as follows:

> You revised your activities during the processing of your application by stating you will provide financial assistance to other families in the P area with children that have been diagnosed with cancer or other life threatening illnesses. You will provide financial support to several families annually to help defer medical expenses including hospital visits/stays not covered by medical insurance. Families must submit a request for assistance in writing and include the name and age of the dependent child, the nature of the child's medical condition, the treatments the child is undergoing at the time of the request, and proof of residence in the P area. The families must also provide proof that all qualified insurance claims have been exhausted and/or denied for coverage of medical expenses, treatments, or stays incurred in the

> treatment of the child. All medical expenses will be reviewed by your board and funds will only be distributed in the name of the medical provider administering care. You will advertise the availability of these funds during all of your fundraising events and on social media.
>
> …[Y]ou stated that up to 50% of your total funds raised will be made available to the N family for M and the other 50% will be available to other qualifying families who request assistance.

Unfortunately, reserving ½ of the funds for a specific beneficiary continued to provide the prohibited private benefit.

The IRS points out that in Rev. Rul. 67-367 the existence of preselected individuals to benefit from the organization barred exempt status:

> Revenue Ruling 67-367, 1967-2 C.B. 188 describes a nonprofit organization whose sole activity was the operation of a 'scholarship' plan for making payments to pre-selected, specifically named individuals. The organization did not qualify for exemption from federal income tax under section 501(c)(3) of the Code because it was serving private rather than public or charitable interests.

The IRS found that this organization, even with the ½ reserved for other parties, was still an organization of the sort described in that ruling:

> You are like the organization described in Revenue Ruling 67-367 because you were formed and are operated to benefit a preselected individual. You were formed to provide financial assistance to the N family for M's medical expenses. You expanded your activities to include providing assistance to other families whose children have been diagnosed with cancer or other life threatening illnesses. However, up to 50% of your funds raised will still be given to the N family for M, thereby resulting in substantial private benefit to the N family. Per Treas. Reg. Section 1.501(c)(3)-1(d)(1)(ii), you are not operated exclusively for an exempt purpose because you serve a private rather than a public interest.

The IRS also referred to a 1986 Tax Court decision denying exempt status for an organization where 30% of the benefits went to family members of the founder:

> In *Wendy L. Parker Rehabilitation Foundation, Inc. v. Commissioner*, T.C. Memo. 1986-348, the tax court upheld the Service's position that a foundation formed to aid coma victims, including a family member of the founders, was not entitled to recognition of exemption. Approximately 30% of the organization's net income was expected to be distributed to aid the family member of the founders who was a coma victim with medical and rehabilitative. The court found that the family coma victim was a substantial beneficiary of the foundation's activities.

The IRS found that this case was much like that one, noting:

> Similar to *Wendy L. Parker Rehabilitation Foundation, Inc., Petitioner v. Commissioner of Internal Revenue*, a substantial amount of your funds will be expended for the benefit of the N family for M. While the extent of your board's relationship to the N family and M is not clear, one of your board members does share the same last name as the N family and M and you clearly indicate that you were formed for the sole purpose of providing financial assistance to the N family for M.

For these reasons, the IRS denied the organization's request to be granted §501(c)(3) status.

SECTION: 642
STATE COURT MODIFICATION TO TRUST THAT DID NOT RESOLVE AMBIGUITY DID NOT CREATE TRANSFER TO CHARITY PURSUANT TO TERMS OF GOVERNING INSTRUMENT

Citation: Chief Counsel Advice 201651013, 12/16/16

Charitable contributions are complicated with regard to trusts. In Chief Counsel Advice 201651013 the question involved a modification of a trust that allowed the distribution of trust assets to a charity.

The advice describes the facts as follows:

> …[T]he trustees of Trust B filed an additional petition with the state court requesting certain modifications including (1) that Child 2's testamentary power of appointment be changed to an inter vivos power and (2) that he be allowed to immediately exercise such inter vivos power to appoint c% of the income and principal to Foundation 1 and d% to Foundation 2, thus causing Trust B to terminate. Foundation 1 and Foundation 2 are private foundations; Foundation 1 was preexisting, while Foundation 2 was newly created to receive funding at the termination of Trust B. On Date 4, the court approved the modification and termination, and the distribution of the trust assets to Foundation 1 and Foundation 2 was completed by the end of Year 2.

Initially no deduction was claimed by the trust for this deduction. But later the trust filed an amended return, arguing either for a charitable contribution deduction under IRC §642(c) as a charitable contribution or, failing that, as an income distribution deduction to the trust under IRC §661.

Under IRC §642(c) certain requirements must be met for a payment to a charity to qualify as a charitable contribution by a trust. The memo describes these provisions as follows:

> Section 642(c)(1) provides generally that in the case of an estate or trust (other than a trust meeting the specifications of subpart B [a "simple trust" described in §§ 651 and 652]), there shall be allowed as a deduction in computing its taxable income (in lieu of the deduction allowed by § 170(a)), relating to deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which **pursuant to the terms of the governing instrument** is, during the taxable year, paid for a purpose specified in § 170(c) (determined without regard to § 170(c)(2)(A)). [emphasis added]
>
> Section 642(c)(2) provides that in the case of an estate and in the case of certain trusts (in general, those created before 10/9/69), there shall also be allowed as a deduction in computing its taxable income any amount of the gross income, without limitation, which **pursuant to the terms of the governing instrument** is, during the taxable year,permanently set aside for a purpose specified in § 170(c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit. [emphasis added]

The IRS, after analyzing a number of cases, decided that the modification should not be considered as a transfer "pursuant to the trust instrument" for these purposes:

> In the current case, the taxpayer makes a summary argument that the payments qualify under § 642(c) because they are pursuant to the governing instrument, citing to Old Colony. They do not address the authorities concerning deductions under modified trust instruments. Here there was no conflict with respect to Trust B subsequent to the division of Parent Trust. The trust terms were unambiguous. The purpose of the court order was not to resolve a conflict in Trust B but to obtain the economic benefits which the parties believe they will receive from the modification of the Parent Trust. Neither Rev. Rul. 59-15 nor *Emanuelson* hold that a modification to a governing instrument will be construed to be the governing instrument in situations where the modification does not stem from a conflict of some sort. Additionally, both Crown and Brownstone have a narrow interpretation of what qualifies as pursuant to a governing instrument. Therefore, any payments to Foundation 1 and Foundation 2 after the modification of Trust B would not be considered to be made pursuant to the governing instrument, and Trust B is not entitled to a deduction for such payments under § 642(c).

Basically, the IRS found that a revision to change a trust, other than to resolve an ambiguity that existed in the trust, will not serve to make a transfer "pursuant to the trust instrument." The fact that a state court approved the modification doesn't change the result, since there were no adverse interests disputing an interpretation of the trust document, nor any clear issue with the language of the trust.

The memorandum next considered the trust's fallback argument—that the transfer, if not a charitable contribution deductible under IRC §642(c), was nevertheless qualified as an income distribution deduction under IRC §661.

The memorandum notes that the regulations under IRC §661 provide that a charitable contribution is not a distribution but rather governed generally by IRC §642(c):

> Section 1.663(a)-2 provides that any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in § 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under § 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under § 662. **Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in § 642(c).** For purposes of this section, the deduction provided in § 642(c) is computed without regard to the provisions of §§ 508(d), 681, or 4948(c)(4). [emphasis added]

Reg. §1.663(a)-2 specifically provides that a distribution deduction is not available, but rather the requirements of §642(c) must be met. The regulation provides:

> Any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under section 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under section 662. Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c). For purposes of this section, the deduction provided in section 642(c) is computed without regard to the provisions of section 508(d), section 681, or section 4948(c)(4) (concerning unrelated business income and private foundations).

SECTION: 701
PARTNER MUST PAY TAX ON FULL AMOUNT OF FLOW THROUGH INCOME EVEN IF THE RESULT IS UNFAIR

Citation: Walter S. Mack Jr. et ux. v. Commissioner, T.C. Memo. 2016-229, 12/19/16

The tax law may be "unfair and unjust" but that doesn't allow a taxpayer to ignore the law to arrive at what he may believe is a more just result. That's the key lesson the case of *Walter S. Mack Jr. et ux. v. Commissioner*, T.C. Memo. 2016-229 provides.

Mr. Mack was a partner in a law firm. He received K-1s from two law firm related partnerships for 2011 that showed total income of $479,473. However, he only reported income of $75,000 from the partnerships on his Form 1040 for that year.

Mr. Mack did not claim that the amounts on the K-1 did not reflect his share of the reported income on the partnership returns. Rather, he claimed that he should only have to report a lesser amount of income for the following reasons as reported by the Tax Court:

> However, Mr. Mack alleges that, in the wake of the 2008 recession, other partners at DRKM could not cover their shares of the firm's expenses and that, as a result, the firm had gone into "significant negative capital". Mr. Mack felt that it was his fiduciary obligation under New York partnership law to cover other partners' partnership expenses. Mr. Mack claims that his DRKM "capital account bore no relationship to the financial condition of the partnership, and what little money was available to * * * [Mr. Mack] was used to absorb expense [sic] that normally would have been expenses of the firm." Mr. Mack does not allege that any partnership expenses were omitted from the partnership's returns and Schedules K-1.

That is, Mr. Mack's income was not paid out to him by the partnership, but rather was apparently held in the partnership and used to pay other expenses. Mr. Mack, feeling it would be unfair for him to have to pay taxes on the income he did not receive in cash, sought the advice of the firm's accountants and tax return preparers.

The Court opinion notes that Mr. Mack related their response to his position as follows:

> When I sought the advice of the firms' accountants and tax preparers, I was in essence told that the tax law was unfair and unjust under these circumstances, and my options were to dissolve the firm, take all the capital in the firm to pay my taxes and move on, and let my partners fend for themselves, and the employees go on unemployment. When I discussed [m]y obligations under New York State Partnership Law to act as a fiduciary to my partners, I was told to be prepared to face the consequence of that decision as I am now, that the Respondent would likely be deaf to the financial realities of the firm and not respect the state law fiduciary partnership duties.

Mr. Mack did not follow this advice. Rather, he decided to report what was "fair" and, in his words, "face the consequence."

The consequence was that Mr. Mack found himself facing the IRS demanding additional tax, interest and penalties and a Tax Court that found in favor of the IRS.

The Court notes, first, that a partner is obligated under the law to report his/her share of partnership income regardless of whether that income is distributed to him/her. As the Court noted:

> If Mr. Mack did in effect plow his share of the 2011 income back into the firm (because he thought that State law required him to do so), then that amount presumably constituted a contribution to the firm's capital and would increase his own capital account at the firm, see 26 C.F.R. sec. 1.704-1(b)(2)(iv)(b) and (c), Income Tax Regs., but such a capital contribution is not deductible, see sec. 721 (providing nonrecognition treatment for contributions to partnerships by partners); *Lopo v. Commissioner*, T.C. Memo. 1961-126, 20 T.C.M. (CCH) 620, 624 (1961) (holding that capital contributions to joint ventures are not deductible business expenses).
>
> As a partner in DRKM, Mr. Mack was obliged to report his share of the firm's income, whether or not it was distributed to him, and whether or not that money was thereafter used to pay firm expenses.

But, argued Mr. Mack, given how little of the income he felt he could take out of the partnership without violating his duty under state law, how was he to pay the income tax? The Tax Court noted that this was not a relevant consideration at this point—rather, the question of ability to pay could only be raised as part of a later collection action.

The opinion continues:

> A taxpayer's assertion that he has no money to pay an income tax liability might be relevant in a "collection due process" ("CDP") case brought pursuant to section 6330(d); and in a deficiency case the assertion might be relevant to an argument that he should not be held liable for an addition to tax for failure to timely pay, pursuant to section 6651(a)(2) (which the IRS did not determine in this case). But where, as here, the issue is the unreported amount of the liability, the Macks' argument misses the mark.
>
> A taxpayer's ability to pay the tax he owes has no bearing on the amount of his or her tax liability. The Macks may in the future raise issues of collectibility at a CDP hearing before IRS Appeals under section 6320 or 6330, and the judicial appeal of an IRS determination in such a hearing would lie in this Court. However, in the instant case, a deficiency case arising under section 6213(a), the Macks' argument about their inability to pay is not relevant to our ultimate issue -- the amount of their tax liability.

With regard to the accuracy related penalty under IRC §6662(a), the Tax Court found that Mr. Mack had no defense to that penalty in this case. In this case, since the tax in question would exceed the greater of 10% of the tax due on the return or $5,000, the burden shifted to the taxpayer to show the penalty would not apply.

The penalty could be lifted if Mr. Mack could show his position either had substantial authority or was adequately disclosed and had a reasonable basis—but the Court found Mr. Mack did not make a showing that would bring in either of these provisions.

That left the exception found at IRC §6664(c)(1) which provides the penalty will not apply if the taxpayer has reasonable cause for the understatement and acted in good faith. But the Court found that Mr. Mack could not show that he reasonable cause or had acted in good faith.

As the opinion concludes:

> If the Macks contend that their failure to include the proper amounts was for reasonable cause or in good faith, then the contention fails. Mr. Mack admits that tax professionals explained to him that the tax law required him (albeit "unfair[ly]", they said) to report his share of the partnership income (and advised him to dissolve the firm in order to stay in compliance with his own tax obligations), and that he disregarded their advice and affirmatively decided not to do so but instead to "face the consequence". The accuracy-related penalty is now part of that consequence.

SECTION: 752
PARTNER DID NOT PRODUCE CALCULATION OF HER SHARE OF PARTNERSHIP DEBT, THUS FOUND TO LACK BASIS TO CLAIM A LOSS

Citation: Hargis v. Commissioner, TC Memo 2016-232, 12/21/16

Merely being a guarantor of a rather large outstanding partnership debt was not sufficient to allow a deduction for losses flowing through from a partnership in the case of *Hargis v. Commissioner*, TC Memo 2016-232.

The case involved a question of proving basis both in S corporations in which the husband was a shareholder and basis in LLCs taxed as partnerships in which the wife was a partner. The S corporation issue was fairly simple—the debts did not flow directly from the husband to the S corporation, so there was no basis provided by the debt.

But the partnership situation is different—a key difference between partnerships and S corporations is that a partner considers as part of his/her basis calculation the partner's allocable share of partnership debt. How that debt is allocated to a partner depends on whether the debt is recourse (at least one partner has an economic risk of loss on the debt as provided for in Reg §1.752-2) or nonrecourse (where no partner has an economic risk of loss).

In this case, there were two partnerships, each with its own debts. The first partnership debt was described as follows in the opinion:

> Brenda Hargis was a member of Melbourne Properties, LLC (Melbourne Properties), which received a loan of $2 million from Liberty Bank of Arkansas (Liberty Bank) in December 2005. Brenda Hargis, petitioner, and four other individuals signed guaranty agreements as security for the Liberty Bank loan.

The second partnership and debt were described as follows:

> Brenda Hargis was also a member of Clay County, LLC (Clay County), which was one of seven coborrowers on a loan from Bank of Oklahoma in August 2009. The Bank of Oklahoma loan proceeds were for the purchase of the Corning nursing home property by Clay County and for the construction of a new facility on that property. The agreement did not state whether or how responsibility for the indebtedness was to be apportioned among the seven entities listed as coborrowers. Brenda Hargis, petitioner, and two other individuals signed as guarantors of the Bank of Oklahoma loan.

Neither debt specifically provided that the debts were to be recourse against the individuals. As well, the Bank of Oklahoma loan's remedies in the case of nonpayment of the debt did not include actions against individual members of the LLC.

The K-1s that Brenda received from each partnership had no entries on the lines for her allocation of debt. Brenda argued, though, that since she was a guarantor on the debt of the first partnership and a co-borrower on the debt of the second, she clearly had enough basis to claim the flow through losses. After all, the bank could

pursue any of the guarantors or any of the co-borrowers for the entire balance of the loan should the partnership fail to pay its debts.

Unfortunately for Brenda, the regulations aren't quite that simple. It wasn't clear that these were truly recourse debts at the partnership level though it seems likely they would so qualify. But even if the lender might look outside the partnership for payment and even take assets from Brenda to pay off the debt in the case of default, that doesn't mean Brenda would necessarily be allocated any of the debt.

Reg. §1.752-2(a) defines a partner's share of a recourse debt. Generally, it provides:

> A partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss.

The definition of "economic risk of loss" is found in Reg. §1.752-2(b)(1) which initially provides that:

> …[A] partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

The second clause is where Brenda runs into trouble—if she can seek reimbursement from other members of the LLC for some (or perhaps even all) of any amounts the bank could force her to pay, then that portion of the debt will not be considered as part of her basis calculation.

The basic calculation of her portion of the debt is calculated via a constructive liquidation calculation. As Reg. §1.752-2(b)(1) continues:

> Upon a constructive liquidation, all of the following events are deemed to occur simultaneously:
>
> > (i) All of the partnership's liabilities become payable in full;
> >
> > (ii) With the exception of property contributed to secure a partnership liability (see § 1.752-2(h)(2)), all of the partnership's assets, including cash, have a value of zero;
> >
> > (iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditors's right to repayment is limited solely to one or more assets of the partnership);
> >
> > (iv) All items of income, gain, loss, or deduction are allocated among the partners; and
> >
> > (v) The partnership liquidates.

To determine which partner is required to make a payment, Reg. §1.752-2(b)(3) provides that a determination is based on the facts and circumstances at the time of the determination and goes on to note:

> All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying this section, including:
>
> > (i) Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;
> >
> > (ii) Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and
> >
> > (iii) Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute.

Normally until a partner fails to fulfill his/her obligation, it is assumed that all partners will fulfill his/her obligations under those various agreements and under applicable law.

The fact that Brenda did not have a calculation of a deemed liquidation, nor evidence of how the various agreements and state law rules noted above would have impacted the amount she was deemed to be ultimately liable for in the worst-case liquidation scenario meant that Brenda could not show that any of the debt would have been allocated to her. Thus, the Tax Court sustained the IRS's position that since Brenda had not shown any basis in her interest no loss deduction was allowed for the year in question.