August 23, 2000

What is "At Risk"
—Borrowing From a Person Having an Interest

By: Ronald A. Morris and David E. Kahen

The at risk rules under section 465 of the Internal Revenue Code limit the losses allowable to certain taxpayers with respect to an activity to the taxpayer's amount "at risk". In applying the at risk limitation, it is frequently assumed that any debt for which a taxpayer is personally liable ("recourse debt") will be includible in the taxpayer's amount at risk—but this is not always correct.

A recent Tax Court case illustrates one situation in which recourse debt may not be included in a taxpayer's amount at risk, namely, where the loan is taken from a person having an interest in the activity other than as a creditor. *Van Wyk v. Commissioner* (113 T.C. No. 29 (1999)).

Background

The at risk rules under Code section 465 bar the allowance of losses to an individual or closely held C corporation in excess of the taxpayer's amount at risk. A taxpayer's amount at risk is, in general, the sum of (i) the amounts contributed by the taxpayer to the activity and (ii) any amounts borrowed with respect to the activity for which the taxpayer has personal liability or has pledged property not used in the activity. (Nonrecourse debt may be includible in a taxpayer's amount at risk if it is secured by real property and meets several other requirements.)

Certain borrowed amounts, however, are not includible in a taxpayer's amount at risk even if the borrowing is recourse debt. In particular, if the activity is one of those enumerated in Code section 465(c)(1) (activities relating to film production or distribution, farming, the leasing of "section 1245 property," and exploring for or exploiting oil and gas resources or geothermal deposits), amounts borrowed with respect to the activity from a person having an interest in the activity other than as a creditor (e.g., a shareholder or partner), or from a person related to such person, are generally not includible in the taxpayer's amount at risk.

The purpose of the rule regarding borrowings from a person having an interest in the activity is to help ensure that debt included in the amount at risk is bona fide debt that will be enforced in the manner in which creditors typically enforce their rights. The statute authorizes the extension of this rule, by regulation, to activities other than those enumerated in Code section 465(c)(1), including the holding of real property, but no such regulation has been issued.

With regard to S corporations, the at risk rules as originally enacted applied at both the corporate and the shareholder levels. The statute was amended, however, before the years at issue in the *Van Wyk* case, to provide in substance that the at risk limitation applies in the context of an S corporation at the shareholder level only.

Van Wyk

Larry Van Wyk ("Van Wyk") and his brother-in-law Keith Roorda ("Roorda") each owned 50% of the stock of an S corporation engaged in farming.

On December 24, 1991, Van Wyk and his wife (the petitioners) borrowed $700,000 from Roorda and his wife, which amount was transferred by the petitioners to the corporation on the same day. Of the total amount, approximately $250,000 was used to repay debt owed by the petitioners to the corporation and the balance of approximately $450,000 was lent to the corporation.

The petitioners apparently claimed losses from the S corporation on their personal income tax returns for 1991, 1992, 1993, and for 1988 (presumably as a carryback from 1991), that would not have been allowable if the amount borrowed from the Roordas and then re-lent to the corporation was not includible in Van Wyk's amount at risk. The IRS disallowed losses attributable to the petitioners' 50% interest in the activity, apparently on the ground that Van Wyk was not at risk with respect to the $450,000, and imposed a substantial understatement penalty for each of the years 1991-1993. (The treatment of the $250,000 used to repay a debt owed to the corporation was not at issue before the court.)

The petitioners first argued that the amount in question had been contributed by Van Wyk to the activity, and therefore was includible in Van Wyk's amount at risk, regardless of the ultimate source of the funds. In support of this result, the petitioners cited the example in Proposed Regulation section 1.465-10(d) in which the sole shareholder of an S corporation contributed $50,000 in exchange for stock, and borrowed an additional $40,000 which was then lent to the corporation. In the example, all of the amounts contributed and lent to the corporation were held to be includible in the shareholder's amount at risk.

The court concluded, however, that the example did not contemplate a situation in which the funds were borrowed by the shareholder from someone having an interest in the activity. (In the example, it was the sole shareholder who borrowed the funds, suggesting that no other person had an interest in the corporation other than as a creditor.)

The petitioners' argument regarding contributed funds was undercut by the statement in section 1.465-22(a) of the proposed regulations that the amount at risk includes "personal" funds contributed by a taxpayer to an activity.

The court concluded that the proposed regulations were consistent in this respect with the legislative intent, as reflected in a footnote in the General Explanation of the Tax Reform Act of 1976 by the staff of the Joint Committee on Taxation (commonly referred to as the "Bluebook"), that where funds contributed by the taxpayer to an activity are borrowed from someone else, such funds are included in the taxpayer's amount at risk only to the extent permitted under the detailed rules pertaining to borrowed amounts; and that interpreting the borrowed funds rule as not applicable in this context would be inconsistent with other rules of Code section 465(b) as to borrowed funds. It would imply, for example, that even funds borrowed by a taxpayer on a nonrecourse basis, secured only by an interest in the activity, would be includible in the taxpayer's amount at risk as long as the funds were then contributed to the activity.

The court therefore concluded that the petitioners failed to provide "any meaningful support" for their argument that the funds should be includible in Van Wyk's amount at risk as contributed funds without regard to the borrowed funds restrictions.

The petitioners' second argument was based on an exception to the rule which generally excludes from amounts at risk funds borrowed from a person having an interest in the activity other than as a creditor. The exception, not artfully drafted, provides that, "[i]n the case of amounts borrowed by a corporation from a shareholder," the rule that excludes from a taxpayer's amount at risk borrowings from a person having an interest in the activity "shall not apply to an interest as a shareholder."

On a close reading of the statute, however, the court agreed with the Commissioner that this exception was intended to apply only where the person claiming an amount at risk is a corporation—as would be the case if the borrower were a closely held C corporation to which Code section 465 applied. Since an S corporation is not itself subject to the at risk rules, the court concluded that no protection was intended to be afforded under this provision with respect to amounts lent to an S corporation by one of its shareholders.

This reading appears to be supported by the discussion of the shareholder exception in the House committee report relating to the legislation that added this exception (as cited in the opinion), and seems a sensible interpretation of the statutory regime in light of the resolution of the first issue. If an amount borrowed by one shareholder from another and then contributed by the borrower to the corporation as a contribution to capital is not to be included in the borrower's amount at risk, a loan of such funds by the borrowing shareholder to the corporation should not increase the borrowing shareholder's amount at risk either.

Finally, the court's conclusion that the substantial understatement penalty under Code section 6662 was not properly imposed showed some sympathy for the petitioners' situation. The court did not conclude that the petitioners' position was based on substantial authority, or that there was a reasonable basis for the reported tax treatment and adequate disclosure of the facts relating to the issue on their tax returns—the principal defenses established by the Code to the imposition of the substantial understatement penalty.

Rather, the court refused to sustain the penalty because it found that the petitioners acted in good faith and with reasonable cause, and therefore that the penalty abatement criteria of section 6664 were met in this case. The opinion refers, specifically, to "the complexity of section 465, and the lack of express guidance in the regulations," as leading the petitioners to an "honest mistake" of law.

Taking into account that the circumstances described in the opinion suggest that the loan transactions were structured largely to attempt to increase the petitioners' amount at risk at an opportune time, the court's conclusion on this point may be generous. If, however, the Treasury Department had clarified its interpretation of the law by issuing final regulations before the years at issue, the petitioners might not have taken this position, or, if they had, the penalty issue would more likely have been resolved in favor of the Commissioner.

Other Observations

The petitioners have filed an appeal from the Tax Court's decision. In the view of the authors, however, the Tax Court's decision appears to be based on reasonable interpretations of Code section 465, and is likely to be sustained.

The case underscores the importance of interpreting the language of the Code in the context of the overall purpose and structure of the Code sections. An interpretation of a clause or paragraph that, in isolation, seems very plausible, often becomes difficult to defend persuasively once the overall purpose and operation of the provision are considered.

The decision also suggests that the Tax Court continues to struggle with the weight to be given longstanding proposed regulations. The opinion repeats the oft-stated observation that "proposed regulations are given no greater weight than a position advanced by the Commissioner on brief." The opinion also states, however, that "proposed regulations can be useful as guidelines where they closely follow the legislative history of the act"—as the court apparently felt was true in this case.