TaxNewsFlash

United States

No. 2023-216
June 21, 2023

U.S. Tax Court: Passthrough net operating loss carryovers disallowed due to insufficient basis

The U.S. Tax Court yesterday released a memorandum opinion holding that the taxpayer was not entitled to deduct net operating loss (NOL) carryovers in 2010, 2011, and 2012, attributable to passthrough losses claimed in 2007, 2008, and 2009, because the taxpayer failed to substantiate that he had sufficient basis in his interest and was at risk so as to be allowed to deduct the losses.

The case is: *Bryan v. Commissioner,* T.C. Memo 2023-74 (June 20, 2023). Read the Tax Court's opinion [PDF 203 KB]

Summary

The taxpayer owned a 99% membership interest in a limited liability company (LLC 1), and his wife owned the remaining 1% interest in LLC 1. LLC 1's operating agreement did not require its members to contribute capital in excess of the "maximum capital contribution" listed in the operating agreement, which for the taxpayer was $166,667. Under the operating agreement, the LLC 1 members must make their maximum capital contribution upon receipt of a notice of request from a "majority in interest" of LLC 1's members. There was no evidence the taxpayer ever made that contribution.

The taxpayer gave LLC 1 a purported promissory note dated September 30, 2007, stating that he would pay $2.7 million to LLC 1 on or before December 31, 2030, with interest accruing at an annual rate of 4.75%. The note was neither secured nor collateralized and did not include a repayment schedule but did allow repayment to be extended without notice. No payments were ever made on the note. LLC 1's operating agreement did not state that its members were liable for LLC 1's debts, and it did not provide for mandatory cash calls by or to its managers or members. LLC 1's operating agreement also did not provide for a capital deficit restoration obligation.

LLC 1 acquired a 20% interest in a lower-tier LLC (LLC 2) in exchange for a purported $2.7 promissory note with precisely the same terms as the note the taxpayer gave LLC 1. LLC 1 never made any

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payments to LLC 2 under the note. The operating agreement of LLC 2 stated that its members were not personally liable for any judgment, decree, or court order against LLC 2 or for the debts, obligations, liabilities, or contracts of LLC 2. In addition, the operating agreement did not provide for mandatory cash calls to its members (other than the managing member which LLC 1 was not) and provided that its members had no capital deficit restoration obligation.

LLC 2 secured third-party financing, but neither LLC 1 nor the taxpayer or his wife were personally liable for the debt, were a guarantor of the debt, or pledged any of their assets as collateral or security for the debt. In addition, neither the taxpayer's note to LLC 1 nor LLC 1's note to LLC 2 were pledged as collateral or security for the third-party debt.

The taxpayer also owned an interest in another LLC (LLC 3) which he acquired in exchange for a $1 million purported promissory note, payable with interest at 2.75%. Neither the taxpayer nor his wife ever made any payments to LLC 3 under the note. LLC 3's operating agreement stated that its members were not personally liable for any judgment, decree, or court order against LLC 3 or for the debts, obligations, liabilities, or contracts of LLC 3. In addition, the operating agreement did not provide for mandatory cash calls to its members (other than the managing member which the taxpayer was not) and provided that its members had no capital deficit restoration obligation (with certain limited irrelevant exceptions).

LLC 3 also secured third-party financing, but neither the taxpayer nor his wife were personally liable for the debt, were a guarantor of the debt, or pledged any of their assets as collateral or security for the debt. In addition, the taxpayer's note to LLC 3 was not pledged as collateral or security for the third-party debt.

The taxpayer claimed deductions for NOL carryovers of $3,501,337, $3,389,314, and $3,240,711 in 2010, 2011, and 2012, respectively. The NOLs result from passthrough losses that the taxpayer deducted on his 2007, 2008, and 2009 returns, the excesses of which were carried forward as NOLs. The IRS disallowed those deductions, determining in notices of deficiency that the taxpayer (1) failed to substantiate the existence or amounts of the claimed NOLs; (2) failed to substantiate he had a sufficient basis to deduct the claimed NOLs; (3) did not substantiate he was at risk so as to be allowed to deduct the claimed NOLs; and (4) did not substantiate that he materially participated in the activity or activities generating the losses so as to be allowed to deduct the claimed NOLs (although the IRS subsequently conceded that issue).

Tax Court decision

The Tax Court agreed with the IRS, finding that neither the taxpayer nor his wife acquired any basis during the subject years in LLC 1, LLC 2, or LLC 3, on account of the purported promissory notes, the third-party debt of LLC 2 or LLC 3, or otherwise. The court also found that the taxpayer failed to establish that he was at risk with respect to the business activities of LLC 2.

In that regard, the court found that the taxpayer's purported $2.7 million note to LLC 1 was not bona fide indebtedness because the taxpayer never intended to repay the note. The court referenced the various factors relevant to the determination of whether a loan is true indebtedness and then concluded there was no intention to repay the debt based on the facts that (1) there was no payment schedule other than an obligation to pay the note in full in almost 25 years, (2) the debt was unsecured and uncollateralized, (3) there were no payments made under the note, (4) there was no evidence the taxpayer had the wherewithal to pay any significant portion of the note, and (5) the partnership tax return did not list the note as an asset.

The court also found that while LLC 1's operating agreement provided for "maximum capital contributions" from its members, which could be required upon demand by a majority in interest of members, it was unlikely the taxpayer would make a demand upon himself (or his wife) to contribute the funds.

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In addition, the court found that LLC1 did not acquire any basis in its interest in LLC 2 during the years at issue on account of the purported promissory note, LLC 2's third-party debt, or otherwise. The court also specifically rejected the taxpayer's argument that the purported promissory notes were a direct or indirect pledge of property as security for a partnership liability within the context of Treas. Reg. § 1.752-2.

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