When Borrowed Amounts are At Risk

Prepared by:
John R. Dundon II, E.A.
Taxpayer Advocacy Services Inc.

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John R Dundon II, Enrolled Agent #00085353EA PTIN P00605639
(c) 720-234-1177 John@JohnRDundon.com http://JohnRDundon.com

When Borrowed Amounts are At Risk.

A taxpayer's "at-risk" amounts with respect to a covered activity include borrowed amounts to the extent of the taxpayer's personal liability or if property was pledged as security.

A taxpayer is considered at-risk with respect to amounts borrowed for use in an activity only to the extent that:

(1) is personally liable for the repayment; or
(2) has pledged property, other than property used in the activity, as security for the borrowed amount, to the extent of the net fair market value of the taxpayer's interest in the **pledged property.**

*But no **pledged property** is treated as security if it's directly or indirectly financed by indebtedness secured by property contributed by the taxpayer to the activity. This is intended to prevent increasing at-risk amounts by **cross-collateralizing** property used in the activity with property not used in the activity.*

Examples

Illustration 1:

An individual calendar-year taxpayer engaged in an activity subject to the at-risk rules, borrows $8,000 using assets in the activity as security. He isn't personally liable on the loan.

He uses the funds to buy an auto. He then uses the auto as security to borrow another $8,000. These funds are used to buy a truck contributed to the activity.

Because no property's treated as security if it is directly or indirectly financed by debt secured by property the taxpayer contributed to the activity, these transactions would have no impact on his at-risk amount in the activity.

Illustration 2:

Taxpayer, the deceased sole owner of an equipment-leasing limited liability company (LLC), couldn't increase his at-risk amount in the LLC by the amount the LLC borrowed to purchase a recreational vehicle (RV).

Taxpayer failed to show that the RV was used by the LLC, as opposed to being used solely by taxpayer for his personal use. So, the contribution wasn't borrowed "for use in an activity" of the LLC, and the amount borrowed wasn't an amount for which the taxpayer was at risk.

The Tax Court held that a cellular service entrepreneur wasn't at risk when he pledged stock of a related corporation as collateral for a bank loan because the stock was property used in the cellular activity.

Illustration 3:

Taxpayer owned an S corporation (RFB) that provided analog cellular service. He was also 99% owner of the "Alpine entities," which were formed to expand RFB's business into new areas.

Taxpayer pledged his RFB stock as security for a bank loan.

RFB was related to Alpine because it used digital licenses held by Alpine to provide service to its analog areas and then allocated the income back to Alpine.

The Sixth Circuit, while affirming the Tax Court's denial of taxpayer's deduction based on his lack of any debt basis to support a loss pass-through, held that it was unnecessary to reach the question of whether taxpayer had been at-risk.

The at-risk rules could apply only if there had been a loss pass-through, which wasn't the case here.

Points to Remember

Amounts borrowed with respect to an activity include amounts borrowed by the taxpayer and then contributed to the activity or used to buy property contributed to the activity.

But if a taxpayer borrows money to finance a contribution to an activity, he can't increase the amount at-risk by the contribution and the amount borrowed to finance the contribution.

He can increase the at-risk amount only once.

An obligation to pay interest in the future isn't considered an amount borrowed for use in the activity and so doesn't qualify as an amount at-risk. Here, taxpayer was at-risk with respect to interest-only promissory notes only in the tax years taxpayer's obligations were actually paid.

Where a taxpayer's liable on borrowed funds for the loan principal but not the interest, he's considered at risk for the entire amount of the principal.

IRS had argued the at-risk amount should be reduced to the present value of the principal, but the court held present-value computations aren't made for at-risk rule purposes.

A taxpayer isn't considered at-risk for amounts borrowed from a person having an interest in the activity or from a person related to a person having such an interest, nor is a taxpayer considered at-risk for amounts protected against loss.

Under proposed regulations, if a taxpayer guarantees the repayment of the debt of another (the primary obligor), for use in an activity, the guarantee wouldn't increase the taxpayer's at-risk amount.

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But if the taxpayer makes a payment under his guarantee, then his at-risk amount would be increased by the payment, but only when he has no remaining legal rights for reimbursement from the primary obligor.

Prohibited interest in the activity defined under at-risk rules.

A taxpayer isn't considered at-risk with respect to borrowed amounts if the amounts are borrowed from a person who has an interest in the activity.

However, this rule doesn't apply to an interest as a creditor in the activity.

Also, in the case of amounts borrowed by a corporation from a shareholder, the rule doesn't apply to an interest as a shareholder.

For purposes of determining a corporation's amount at risk, an interest in the corporation as a shareholder isn't an interest in any activity of the corporation.

Thus, amounts borrowed by a corporation from a shareholder may increase the corporation's amount at risk.

When the taxpayer, a shareholder in an S corporation, borrowed funds from another shareholder (i.e., a person with an interest in the activity) and lent the funds to the corporation, the exception above, will not apply. Thus, the funds the taxpayer borrowed weren't at-risk.

Although the borrowed funds became "amounts borrowed by a corporation from a shareholder," the exception only applies when the taxpayer claiming to be at-risk for the borrowed amount is the corporation.

Amounts borrowed from a person with an interest in the activity are generally not at-risk.

Unless IRS regulations provide otherwise, amounts borrowed aren't considered at-risk in an activity if the amounts are borrowed from a person having an interest in the activity (except an interest as a creditor, or as a shareholder in the case of amounts borrowed by corporations or from a person related to a person (other than the taxpayer) having such an interest).

Such amounts are treated in the same manner as borrowed amounts for which the taxpayer has no personal liability and for which no security is pledged.

The taxpayer apparently is considered at-risk for amounts borrowed from a member of his own family or from an entity in which he has an interest, if the family member or entity doesn't have a prohibited interest in the activity.

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Taxpayer wasn't at-risk for amounts he borrowed from a company in which he indirectly owned over 50% of the stock. But, another shareholder who didn't own more than 50% of the same company was at risk with respect to amounts borrowed from the company.

The prohibited-interest rule applies even if the borrower is personally liable for the loan or the loan is secured by property not used in the activity. But the rule doesn't apply to financing that is secured by real property used in an activity and either is qualified nonrecourse financing or would be qualified nonrecourse financing if it were nonrecourse. This ensures that recourse financing is treated no worse than qualified nonrecourse financing.

Amounts protected against loss are NOT at risk.

Not withstanding any other provision of the at-risk rules, a taxpayer is NOT considered at-risk with respect to any amount protected against loss by nonrecourse financing, guarantees, stop loss agreements or other similar arrangements.

Amounts (whether or not borrowed) that are protected against loss are treated in the same manner as amounts for which the taxpayer has no personal liability and for which no security is pledged.

Thus, a taxpayer isn't at-risk, even as to the equity capital he has contributed to the activity, to the extent he is protected against economic loss of all or part of the capital by reason of an agreement or arrangement for compensation or reimbursement to him of any loss he may suffer.

Under this rule, a taxpayer isn't at-risk if he is entitled to reimbursement for part or all of any loss by reason of a binding agreement between himself and another person.

For these purposes it will be assumed that a loss-protection guarantee, repurchase agreement or insurance policy will be fully honored and that the amounts due under the agreement will be fully paid to the taxpayer.

The possibility that the party making the guarantee to the taxpayer will fail to carry out the agreement (because of factors such as insolvency or other financial difficulty) isn't material unless and until the time when the taxpayer becomes unconditionally entitled to payment and, at that time, demonstrates that he cannot recover under the agreement.

Under proposed regulations, a taxpayer's at-risk amount wouldn't be increased by:

(1) assets (including money) contributed to an activity to the extent the taxpayer is protected against loss of the assets,
(2) amounts borrowed by the taxpayer to the extent he is protected against loss of the borrowed amounts, and
(3) amounts borrowed where the taxpayer is protected against the loss of property pledged as security and is not personally liable for repayment.

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Under proposed regulations, if the taxpayer's liability to repay a borrowed amount only arises on the occurrence of a contingency, he would not be at-risk for the amount if the likelihood of the contingency occurring is such that he is effectively protected against loss.

On the other hand, the taxpayer would be at-risk if the likelihood is such that he isn't effectively protected, or if the protection against loss doesn't cover all likely possibilities.

For example

A taxpayer who gets casualty insurance or insurance against tort liability would NOT ordinarily be considered not at-risk by virtue of this hazard insurance protection.

Further, the typical buy-sell agreement partners enter into providing for a partner's interest to be bought out on his death or retirement is not the type of loss-limiting arrangement that would prevent the partner from being at-risk under the principles discussed above.

The Tax Court has held that a taxpayer was not at-risk with regard to an installment note protected against loss by a stop-loss arrangement.

The court has rejected a taxpayer's contention that he was at-risk since the stop-loss agreement would NOT survive the guarantor's bankruptcy.

In determining whether the taxpayer is protected from loss through a stop-loss or similar agreement, the potential insolvency of the party providing protection under the stop-loss agreement is irrelevant.

The above rule applies to cash contributions as well as borrowed amounts.

For example

- A limited partnership which bought a film wasn't at-risk with respect to the cash portion of the purchase price since the funds were guaranteed to be repaid within a specific time period.
- In livestock feeding operations, where a feedlot offers to reimburse investors for losses sustained on sales of the fed livestock above a stated dollar amount per head, the investor is at-risk only on the portion of his capital against which he isn't entitled to reimbursement.

Nonrecourse debt for which property not used in the activity is pledged—effect on the at-risk amount.

A taxpayer's at-risk amount is increased by nonrecourse borrowings for use in the activity if the taxpayer pledges property not used in the activity as security.

Under proposed regulations, the increase would NOT be able to exceed the net fair market value of the pledged property.

Illustration 1:

In Year 1, A, a calendar-year individual, pledges A's house (which isn't used in the activity) as well as an asset used in the activity as security to borrow $8,000 on a nonrecourse basis to be used in an activity to which the at-risk rules apply.

On the day the house is pledged as security, its fair market value is $60,000, and it is subject to a superior lien of $54,000.

If the amount of the superior lien isn't reduced during the balance of the year, at the close of Year 1 the net fair market value of the house is $6,000 ($60,000 − $54,000), since the net fair market value of the security ($6,000) is less than the amount borrowed ($8,000), the increase in A's amount at-risk would be limited to $6,000.

If net fair market value changes after the funds are borrowed, the at-risk amount would be re-determined using the new figure.

Illustration 2:

Assume the facts as in Illustration (1) above, except that in Year 2 A reduces the superior lien to $53,000.

Accordingly, the house's net fair market value at the close of Year 2 is $7,000 ($60,000 − $53,000).

A redetermination of the amount at-risk is made using the new net fair market value.

Using the new value, the amount borrowed ($8,000) is still more than the net fair market value ($7,000).

Therefore, the new net fair market value would be used to measure the increase in A's amount at-risk in the activity.

The new amount ($7,000) exceeds the earlier amount ($6,000) by $1,000. Thus, A's amount at-risk would be increased by $1,000.

Changes in fair market value are NOT taken into account in determining changes to net fair market value.

Illustration 3:

Assume the facts as in Illustration (2) above, except that in Year 3, the fair market value of A's house increases to $75,000.

On Dec. 31 of Year 3, A gets a $10,000 second mortgage on the house.

The second mortgage is made superior to the lien for the $8,000 loan made in Year 1.

At the close of Year 3 the original lien on the house has been reduced to $52,000 and the second mortgage is $10,000.

Since changes in the fair market value of security are ignored for purposes of determining net fair market value, the net fair market value of the house at the end of Year 3 is determined by comparing its fair market value at the time the $8,000 was borrowed in Year 1, $60,000, with the amount of superior liens outstanding at the end of Year 3, $62,000 ($52,000 + $10,000).

Since the fair market value of the house as so determined is less than the total of the superior liens to which the house is subject at the end of Year 3, the net fair market value of the house at that time is zero.

A redetermination of the amount at-risk would be made using the new net fair market value and would thus be limited to zero. The new amount (zero) is less than the earlier amount ($7,000) by $7,000. Thus, A's amount at-risk would be decreased by $7,000.

Under proposed regulations, to the extent a portion of a nonrecourse liability for which property is pledged increased the taxpayer's at-risk amount, the repayment of that portion would be treated as the repayment of a loan for which the taxpayer is personally liable (i.e., it wouldn't affect the taxpayer's at-risk amount).

Illustration 4:

In Year 1, B, a calendar year individual, pledges shares of stock that are not used in the activity as security to borrow $20,000 on a nonrecourse basis to be used in an activity subject to the at-risk rules.

On the day the shares are pledged, they are worth $40,000 and are NOT subject to any superior liens.

At the close of the year the fair market value of the shares is $30,000.

Nevertheless, at the close of the year the net fair market value of the shares is $40,000, because changes in the fair market value of security are ignored for purposes of determining net fair market value.

Since the net fair market value of the shares ($40,000) is greater than the amount borrowed ($20,000).

B's amount at-risk in the activity would be increased by $20,000.

In Year 2, B, using personal assets, repays $4,000 of the loan secured by the stock.

Repayments of the loan would be treated like repayments of a loan for which the taxpayer is personally liable.

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Thus, B's amount at-risk wouldn't be affected by the repayment.

However, to the extent the liability exceeds the net fair market value of property not used in the activity which secures the loan, repayment of that portion of the loan would be treated as repayment of a nonrecourse loan for which property outside the activity was not pledged (i.e., property inside the activity was pledged)—the taxpayer's at-risk amount would increase (see below).

Repayments would be treated as made first for that portion of the loan which exceeds net fair market value.

Also, if part of the borrowed funds are used outside of the activity, repayments would first be treated as made for that part, and only thereafter for the loan proceeds used in the activity.

Illustration 5:

Assume the facts as in Illustration (4) above, except that in Year 3, the shares of stock are made subject to a $30,000 lien superior to the previous lien.

At the close of Year 3 the net fair market value of the stock is $10,000 ($40,000 fair market value minus $30,000 superior lien).

Accordingly, a redetermination would have to be made of B's amount at-risk.

Since the new net fair market value of the stock ($10,000) is less than the amount of the loan outstanding ($16,000), the net fair market value would be used to measure any change in A's amount at-risk.

The new amount ($10,000) is less than the earlier amount ($16,000) by $6,000.

Thus, B's amount at-risk would be decreased by $6,000.

In Year 4, B repays $7,000 of the loan secured by the stock.

The repayment would be first considered to be made for that portion of the loan, $6,000, which exceeds the net fair market value of property not used in the activity which secures the loan.

Thus, the repayment would result in a corresponding increase of $6,000 in the amount at-risk.

The remaining $1,000 repayment would be treated as the repayment of a loan for which the taxpayer is personally liable.

Repayment of the loan would result in no change in the amount at-risk.

Accordingly, as a result of the $7,000 repayment, B's amount at-risk would be increased by $6,000.

Under proposed regs, if property pledged for funds borrowed for use in the activity is later itself contributed to the activity, the taxpayer's amount at-risk would be redetermined as though the property's net fair market value dropped to zero.

That is, the at-risk amount would decrease.

On the other hand, the contribution of the property to the activity would be treated as a contribution of unencumbered property which would increase the at-risk amount.

Transfers and dispositions of interests in the at-risk activity.

Under proposed regulations, the following rules would apply to a transfer (or disposition) in which:

(1) the taxpayer transfers or disposes of his entire interest in the activity, or entity conducting the activity,
(2) the transferee's basis is determined by reference to the transferor's, and
(3) the transferor had previously disallowed losses under the at-risk rules at the time of the transfer or disposition.

If, at the close of the tax year of the transfer or disposition, the taxpayer's losses subject to the at-risk rules exceed his at-risk amount, the excess would be added to his basis in the activity under proposed regulations.

This addition to basis would be made after determining the transferor's gain and would apply solely for determining the basis of the property in the hands of the transferee.

Under proposed regulations, the following rules would apply to a transfer (or disposition) in which:
(1) the taxpayer transfers or disposes of his entire interest in the activity, or entity conducting the activity,
(2) the transferee's basis is determined by reference to the transferor's, and
(3) the transferor's at-risk amount exceeds his losses from the activity.

At the end of the transferor's tax year of the transfer, his amount at risk (after reduction for that year's losses) would be added to the transferee's amount at risk under proposed regulations. The transferee's at-risk amount would also be increased to the extent his basis is increased for gift tax paid by the transferor.

However, under proposed regulations, the transferee's at-risk amount could not be increased under these rules by more than the excess of his or her basis over the amount he or she is considered to have paid at the time of the transfer (including, for these purposes, the amount of debt to which the transferred property is subject).

Examples

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Illustration 1:

On the last day of the year, F makes a gift to G of his entire interest in an activity subject to the at-risk rules.

F's at-risk amount was $500, his basis in the activity was $9,500, the fair market value of the activity is $20,000 and the interest is subject to a nonrecourse debt of $9,000.

G takes the gift subject to the debt. Since F's at-risk amount is $500 at year-end, $500 would be added to G's at-risk amount under proposed regulations.

The limitation described above would NOT apply because G's basis ($9,500) (F's basis carried over to her) exceeds the amount she is considered to have paid ($9,000) by $500. Her at-risk amount would be $500.

Illustration 2:

In Illustration (1), if G had paid $1,500 in cash in addition to assuming the debt, her at-risk amount would not increase because her basis would not exceed the amount paid.

Her basis would be $10,500 ($1,500 cash paid + $9,000 debt assumed) and her amount paid would be the same.

In this case, however, G's at-risk amount would be increased (to $1,500) by the $1,500 cash she paid.

Carryover of disallowed losses under the at-risk limitation rule.

Any loss from an activity which is barred because of the at-risk limitation is treated as a “deduction allocable to such activity” in the first succeeding year.

Treatment of the disallowed loss as a deduction in the following year means it can be used as a deduction against the following year's income from the same activity.

If, however, this results in a loss from the activity in that year, or increases the loss from the activity in that year, those losses can only be deducted to the extent there is then the necessary at-risk investment.

While the Code specifies that the unused loss can be treated as a loss “in the first succeeding year,” Senate Finance Committee Reports indicate that the unused losses may be carried over indefinitely to be used in later years.

In theory if a taxpayer's amount at-risk increases in later years, he can get the benefit of previously suspended losses to the extent the increase in risk capital exceeds his losses in later years.

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Losses attributable to an equipment leasing activity which were suspended as a result of the application of the at-risk rule, are to become fully deductible for the first tax year in which the corporation meets the 50% or more gross receipts requirement.

For the first tax year in which a corporation fails to meet the 50% or more gross receipts requirement, the at-risk basis in the equipment leasing activity is to be computed in accordance with the rules (including transitional rules) normally applicable to computing at-risk basis for the first year that an activity is subject to the at-risk rule.

Thus, amounts paid or incurred with respect to the equipment leasing activity for tax years beginning before the year of disqualification, and deducted in that tax year, will generally be treated as reducing first that portion of the taxpayer's basis which is attributable to amounts not at-risk.

On the other hand, withdrawals made in tax years beginning before the year of disqualification will be treated as reducing the amount which the taxpayer is at-risk.

For 2003, in connection with the disallowance of capital loss carryforwards because of the at-risk rules, IRS will have to develop and apply rules that take into account the different tax rates on capital gains applicable to net capital gain properly taken into account before May 6, 2003 and after May 5, 2003.

Late-year increases to the at-risk amount will be closely examined.

Under proposed regulations, increases in at-risk amounts occurring late in the year would be examined closely.

If, considering all the facts and circumstances (see below), it appears that the event causing an increase will be accompanied by an event decreasing the at-risk amount after the close of the year, the increase would be disregarded.

An increase in a taxpayer's at-risk amount would not be disregarded under this rule, however, where the taxpayer can establish a valid business purpose for the increase and decrease, and that they are not devices to avoid the at-risk limitations.

Under proposed regulations, the facts and circumstances which would be considered in these situations would include the following:

(a) the amount of time between the increase and the decrease;
(b) the nature of the activity and deviations from normal business practice in conducting the activity;
(c) the use of the amounts which increased the at-risk amount toward the close of the tax year;
(d) contractual arrangements between parties involved in the activity; and
(e) the occurrence of unanticipated events which make the later decrease in the at-risk amount necessary.

Examples

Illustration:

P contributes $10,000 to his partnership in December of Year 1 in response to a partnership call for all partners to contribute cash to help the partnership meet increased costs.

In January of Year 2, P asks for and receives a $10,000 partnership distribution which he needs for medical expenses for an operation for his wife for a condition which arose in Year 2.

Presumably, under these facts and circumstances, the increase in P's Year 1 at-risk amount caused by the $10,000 contribution wouldn't be disallowed.

Allowance of credit for later decreases in nonqualified nonrecourse financing for at-risk investment credit property.

If there is a net decrease in the amount of nonqualified nonrecourse financing (under the at-risk limitation rules) as of the close of a tax year following the tax year in which property was placed in service, the net decrease will be treated as an increase in the credit base for the property.

This means that an increase in the amount that the taxpayer has at risk with respect to a particular investment credit property is additional qualified investment.

This does not necessarily preclude an increase in an amount at risk via a capital improvement to the property.

The increase in credit base attributable to a decrease in nonrecourse financing is treated as having been invested in the tax year the property was first placed in service.

However, the credit is allowed in the tax year the amount at risk is increased.

Example

Illustration:

In Year 1, XYZ purchases for $100,000 energy credit property that qualifies for the 10% energy credit.

$85,000 of the $100,000 purchase is attributable to nonqualified nonrecourse financing.

Thus, the allowable credit for Year 1 is only $1,500 (10% of $15,000).

This credit would also be subject to other limitations on the investment credit (e.g., tax liability limitation, ceiling, see).

In Year 3, XYZ becomes at-risk for an additional $20,000 with respect to the property, so an additional $2,000 credit (10% of $20,000) would be allowed against tax liability for Year 3.

Any other limitations on allowance of the credit would be applied using Year 1 as the year in which the credit was allowed.

The rule of Code Sec. 49(a)(2)(A) means that a taxpayer who increases the at-risk investment (or conversely, decreases nonqualified nonrecourse financing) in a year with respect to qualified Sec. 38 property is not prevented by the energy investment credit termination rule from claiming the additional investment credit due to the increase in at-risk investment (or conversely, the decrease in nonqualified nonrecourse financing) in that year.

Under the above rule, there is no need to amend the return for the year the qualified property was first placed in service in order to claim the investment credit on the increased at-risk base.

For purposes of the above rules, nonqualified nonrecourse financing is not treated as decreased through the surrender or other use of the property.

At-risk amounts as partnership items-tax years beginning before 2018.

The 2015 Bipartisan Budget Act has replaced the unified partnership audit procedures described below with the partnership audit rules.

The replacement of the unified partnership audit procedures will generally be effective for tax returns for partnership tax years beginning after Dec. 31, 2017.

Although application of the Code Sec. 465 at-risk limitation to a partner is not a partnership item, many of the legal and factual determinations that underlie the determination of whether a partner is at risk under those rules are themselves partnership items.

The following amounts that affect the determination of whether a taxpayer is at risk are appropriate for determination at the partnership level:

(1) amounts invested by the partnership in activities subject to the at risk rules;
(2) losses incurred by the partnership in activities subject to the at risk rules;
(3) partners' shares of losses incurred in activities subject to the at risk rules; and
(4) partners' shares of partnership liability and the character of the liabilities as recourse or nonrecourse.

Arrangements with third parties insulating a partner from loss and whether a partner is a related party are not partnership level items.

The Tax Court has concluded that the determination of partners' amounts “at risk” with respect to partnership liabilities personally assumed by individual partners isn't a “partnership item” because that determination isn't required to be taken into account in the partnership's books and records for its tax year.

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The court says that the reference to Code Sec. 465 is confined to issues relating only to the nature and extent of the partnership liabilities, i.e., whether they are recourse or nonrecourse and their amounts.

Furthermore, the Tax Court also concluded that the determination of whether property in the form of promissory notes contributed to a partnership was "at risk" to the contributing partner is not a "partnership item".

Therefore the Tax Court could not appropriately decide that issue in a partnership-level proceeding, which permit a court to consider and resolve "partnership items" and the proper allocation of those items among the partners.

All issues determined at the partnership level are res judicata (i.e., can't be re-litigated) for purposes of the partner level proceeding concerning the final determination of whether the partner was at risk.

Citing Hambrose, the Court of Federal Claims agreed with taxpayer-partner that IRS's adjustment of its at-risk amount was improperly made in a Final Partnership Administrative Adjustment as a partnership-level adjustment, rather than via a partner-level adjustment.

IRS sought to establish a "hook" to the partnership by noting taxpayer's at-risk amount is comprised of both partnership and non-partnership components, including partnership liabilities.

IRS argued that implicit in the FPAA was an adjustment to the partnership liabilities because taxpayer's share of those liabilities was adjusted. But the court disagreed, noting that, in fact, no adjustment was made to the partnership liabilities, and only the individual partner's at-risk amount, a non-partnership item, was adjusted.