Hildebrand et al. v. Commissioner, 93 T. C. 1029 (1989)

Partners are considered ‘at risk’ for partnership debt obligations only to the extent of their personal recourse liability as it accrues annually, not the total potential liability.

Summary

In Hildebrand et al. v. Commissioner, the Tax Court addressed whether investors in limited partnerships involved in oil and gas activities could claim loss deductions based on their ‘at-risk’ status under section 465. The court ruled that partners were at risk only to the extent of their personal liability for partnership debts as they accrued each year, rejecting claims for the full amount of potential liabilities. The court also found that the investors were not protected against loss by partnership arrangements, but left open issues regarding creditors’ other interests due to insufficient facts.

Facts

Petitioners invested in two limited partnerships, Technology Oil and Gas Associates 1980 and Barton Enhanced Oil Production Fund, which were engaged in oil and gas exploration and production using enhanced oil recovery (EOR) technology. These partnerships entered into agreements with TexOil, Elektra, and Hemisphere for working interests in properties and EOR technology licenses. The partnerships’ debt obligations to these creditors were structured with annual payments and promissory notes, with limited partners assuming personal liability for a portion of these debts. The IRS challenged the deductibility of losses claimed by the investors, arguing they were not at risk under section 465.

Procedural History

The case involved cross-motions for partial summary judgment filed by the petitioners and the Commissioner. The Tax Court reviewed the motions based on stipulated facts and legal arguments concerning the application of section 465 to the partnerships’ activities. The court granted and denied parts of the motions, addressing the issues of personal recourse liability, protection against loss, and creditors’ interests other than as creditors.

Issue(s)

1. Whether the limited partners were personally liable and at risk under section 465(b)(1)(B) and (b)(2) for the full amount of their per unit maximum liability on the recourse debt obligations of the partnerships in the year they first invested.
2. Whether the limited partners were protected against loss under section 465(b)(4) with respect to the recourse debt obligations of the partnerships.
3. Whether the creditors associated with the partnership debt obligations had continuing prohibited interests in the activity other than as creditors under section

465(b)(3).

Holding

1. No, because the limited partners were at risk only to the extent of the debt obligations as they accrued each year, not the full potential liability.
2. No, because the limited partners were not protected against loss by the partnership arrangements.
3. Undecided, due to insufficient facts regarding the legal defense fund, the joint marketing organization, and the nature of the EOR technology activities.

Court’s Reasoning

The court applied section 465 to determine the at-risk status of the limited partners. For the first issue, the court emphasized that the partners’ at-risk amount was limited to the annual accrual of the debt obligations, not the total potential liability, due to the partnerships’ ability to terminate agreements and the structure of the debt obligations. Regarding the second issue, the court rejected the argument that the partners were protected against loss, stating that the availability of other funds to pay the debts did not detract from the partners’ ultimate liability. On the third issue, the court found insufficient facts to determine if creditors had prohibited interests under section 465(b)(3), particularly regarding the legal defense fund and the joint marketing organization. The court also noted that the absence of regulations under section 465(c)(3)(D) left open whether the EOR technology activities were new activities subject to the at-risk rules.

Practical Implications

This decision clarifies that for tax purposes, investors in partnerships are at risk only to the extent of their personal liability for partnership debts as they accrue each year. This ruling impacts how similar cases involving tax deductions for partnership losses should be analyzed, emphasizing the importance of the timing and structure of debt obligations. Legal practitioners must carefully structure partnership agreements to ensure that investors’ at-risk amounts align with the annual accrual of debts. The case also highlights the need for clear regulations regarding the application of section 465 to new activities, as the absence of such regulations can leave significant issues unresolved. Future cases may need to address the impact of creditors’ other interests more definitively, potentially influencing how partnerships structure their relationships with creditors and manage legal defense funds.

