BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84A-687-KP
PAUL M. AND GAIL D. FLETCHER)

For Appellants: Jason G. Brent
Attorney at Law

For Respondent: Baldev Singh Heir
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 1/ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Paul M. and Gail D. Fletcher against a proposed assessment of additional personal income tax in the amount of $8,025.29 for the year 1979.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

The issue presented by this appeal is whether appellants were "at risk," under the terms of section 17599, for the face value of the letter of credit they contributed to a limited partnership during the year at issue.

In 1979, appellants, husband and wife, became limited partners in an oil drilling partnership known as Energy Search. Any party choosing to become a limited partner was given the option of contributing the subscription price in cash or a combination of cash and an irrevocable, transferable letter of credit. The partnership planned to use the letters of credit as collateral for the partnership's operating loan. Appellants chose the latter arrangement and their investment contribution consisted of $135,000 cash and a $315,000 letter of credit.

By an agreement dated September 13, 1979, the partnership obtained its operating loan. As security for the loan, the partnership pledged all of its assets as well as all of the letters of credit transferred by the various limited partners. In the event of the partnership's default, the bank could look to the limited partners for satisfaction of the loan only to the extent of their respective letters of credit.

For the taxable year 1979, the partnership reported an ordinary loss of $2,857,667. Appellants claimed their entire distributive share of that loss, $271,465, on their 1979 joint tax return. Initially, respondent denied appellants' claimed partnership loss in its entirety. Appellants protested the disallowance contending that the entire contribution of cash and credit was "at risk" in the partnership venture. As a result of the protest, respondent allowed the partnership loss to the extent of appellants' cash contribution but determined that appellants were not "at risk" for the face value of the letter of credit. Respondent revised its assessment accordingly. Appellants maintained their contention that they were "at risk" for the face amount of the letter of credit during 1979 and this appeal followed.

The United States Supreme Court clarified the general rule regarding deductions in New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 [78 L.Ed. 13481 (1934), where it stated:

> Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision **therefor** can any particular deduction be allowed.
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> * * *
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> Obviously, therefore, a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.

A limitation of deductions based upon investment losses is provided by section 17599, which states, in pertinent part, that:

> (a) In the case of a taxpayer engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subdivision **(b))** for such **activity** at the close of the taxable' year. ...
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> **(b)** (1) For purposes of this section, a taxpayer shall be considered at risk for an activity with respect to amounts including--
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> * * *
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> **(B)** Amounts borrowed with respect to such activity (as determined under paragraph **(2)).**
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> **(2)** For purposes of this section, a taxpayer shall be considered at risk with respect to amounts borrowed for use *in* an activity to the extent that he--
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> (A) Is personally liable for the repayment of such amounts, or
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> **(B)** Has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property).

> No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in paragraph (1).
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> * * *
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> (c)(1) This section applies to any taxpayer engaged in the activity of--
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> * * *
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> (D) Exploring for, or exploiting, oil and gas resources as a trade or business or for the production of income. ...

Finally, we note that section 17599 is based upon Internal Revenue Code section 465 and that the legislative history behind the enactment of a federal statute is a very relevant factor in dotermining how the equivalent state statute should be applied to a given fact situation. (Appeal of Estate of Ray Murphy, Deceased, Dorothy D Walton and Adrian Arendt, Executors, Cal. St. Bd. of Equal., June 29, 1982; see also State v. Mitchell, 563 S.W.2d 18 (Mo. 1978).) Congress intended that "[t]he 'at risk' inquiry for the purposes of section 465 [be] an annual one made on the basis of the facts existing at the end of each taxable year." (Pritchett v. Commissioner, 85 T.C. No. 35 (Oct. 25, 1985), citing S. Rept. No. 94-938, 1976-3 C.B. 48, 86.)

As appellants could have been called upon to pay the debts of the partnership at any time, it is their contention that this contingent liability put them "at risk" for the face value of the irrevocable letter of credit during the appeal year. In support of this position, appellants cite the general rule that "each partner is permitted to increase the basis of his partnership interest by the portion of the liability which he is contingently liable for if the partnership fails . ..." (McKee, Nelson, and Whitmire, Federal Taxation of Partnerships and Partners, ¶ 8.01[1], p. 8-4 (1977).) Respondent maintains that the letter of credit cannot be considered "at risk" until funds are actually drawn against the letter, and then they are "at risk" only to the extent of the draw.

Both parties have sought to draw support for their respective arguments by extensively arguing the application of Proposed Treasury Regulation section 1.465 and the examples cited therein. Appellants contend that this situation is like the example in section 1.465-24, subsection (a)(i), which provides that:

> General Rule. A taxpayer's amount at risk in an activity is increased by the amount of any liability incurred in the conduct of an activity for use in the activity to the extent the taxpayer is personally liable for repayment of the liability.

On the other hand, respondent argues that the present case is more accurately described in Proposed Treasury Regulation section 1-465-22, subsection (a), as a promise to contribute money at a later date and that "[n]either shall a partner's amount at risk be increased in the case of a note payable to the partnership for which a partner is personally liable until such time as the proceeds of the note are actually devoted to the activity."

The difficulty with appellants' contention is that not all liabilities for which a partner may be personally liable become part of his basis in a partnership or are considered "at risk" in the partnership's activities. Some obligations have been found to be too contingent due to the failure of all events to occur which would fix the terms of liability sufficiently to permit their inclusion in a taxpayer's "at risk" amount. (See Estate of Baron v. Commissioner, 83 T.C. 542, 549 (1984), and cases cited therein.) Furthermore, the trend in federal decisions, when faced with facts similar to the ones before us, has been to disallow the inclusion of contingent contributions of limited partners in their "at risk" amounts. (See, e.g., Pritchett v. Commissioner, supra; Brand v. Commissioner, 81 T.C. 821, 828 (1983).) In Pritchett, the leading case on oil and gas limited partnerships, the court stated that as of the close of the years in issue, it was:

> not known . . . whether there would or would not be sufficient partnership revenues to satisfy the ... note, or in the event the . . . note was not satisfied in full on maturity, the amount of the capital contributions need (sic) to cover the deficiency. ... Hence, as of the close of the taxable year in issue, petitioners had no current ascertainable

liability to their partnership for future contributions.

(Pritchett v. Commissioner, supra, 85 T.C. at 332.)

While Pritchett factually differs from the case now before us in that the Pritchett limited partnerships did not involve irrevocable letters of credit, the ultimate inquiry of that case was into the likelihood of the partnership's default and the uncertainty of the amount of additional contribution the limited partners may have had to make. In these respects; the facts before us present an even more compelling reason to uphold respondent's position than those in Pritchett. The first principal and interest payment on the partnership loan was not due until March 1980. It was highly unlikely that the letter of credit would be drawn upon in 1979 as the likelihood of default prior to the due date of that first payment was minimal, at best. Further, there was a possibility that prior to the due date of that first payment, the partnership could have generated enough income to pay all or a portion of the debt payments. Even if the partnership ceased all operations and was dissolved in 1979, there would presumably have been some assets of the partnership, which was the primary obligor, against which the bank could satisfy at least part of the loan. Thus, appellants' liability on the loan would have been reduced at least to some extent. Clearly, not all of the events which would fix the fact or the amount of appellants' liability for the partnership's debt occurred before the end of the appeal year. Therefore, we find appellants' ascertainable liability on the letters of credit during the year at issue to be too contingent to be considered "at risk" for that year. This decision is in accord with the current trend of federal cases (Pritchett v. Commissioner, supra; Brand v. Commissioner, supra), and with the general rule that a cash-basis taxpayer who gives a note as payment may not deduct an expense while something remains to be done to complete payment. (Chapman v. United States, 527 F.Supp. 1053 (D. Minn. 1981).)

Appellants' alternative argument that the letter of credit created an assumption of partnership debt by appellants, thereby increasing appellants' basis, is also unpersuasive; There was no formal assumption of partnership debt by appellants either in the original partnership agreement or in the partnership's loan agreement with the bank. In fact, it is evident from both documents that the letters of credit were intended to be

security for the partnership loan, not an assumption of the debt. Accordingly, appellants' agreement with the partnership cannot fit under the terms of Treasury Regulation 1.752-1, subsection (a) (2), to increase appellants' basis.

For the above stated reasons, we find that appellants have failed to produce sufficient evidence to satisfy their burden of proving that the face amount of their letter of credit was "at risk" under section 17599 during the appeal year. (New Colonial Ice Co. v. Helvering, supra.) Accordingly, respondent's action in this matter will be sustained.

Appeal of Paul M. and Gail D. Fletcher

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Paul M. and Gail D. Fletcher against a proposed assessment of additional personal income tax, in the amount of $8,025.29 for the year 1979, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of March, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9