DocuSign Envelope ID: 24237A15-3AA9-43AF-A293-F119CBEF073B

2022 – OTA – 137
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **R. CROCKER AND T. CROCKER**	) OTA Case No. 19105408

OPINION

Representing the Parties:

For Appellants: Brendan T. Lund, Esq.

For Respondent: Kamalpreet Khaira, Tax Counsel
Louis A. Ambrose, Tax Counsel IV

For Office of Tax Appeals: William J. Stafford, Tax Counsel III

K. GAST, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, R. Crocker and T. Crocker (appellants) appeal actions by respondent Franchise Tax Board (FTB) proposing the following: additional tax of $888,443 and an accuracy-related penalty of $154,028,[1] plus interest, for the 2011 tax year; and additional tax of $61,615 and an accuracy-related penalty of $12,323, plus interest, for the 2012 tax year.[2]

Appellants waived their right to an oral hearing; therefore, the matter is being decided on the written record.

ISSUE

Whether appellants are entitled to increase the adjusted basis in certain limited partnership interests sold in 2011 by a $9.5 million guarantee.

[1] Appellants have not raised any arguments concerning the accuracy-related penalty for the 2011 tax year. Accordingly, we will not discuss it further.

[2] During the pendency of this appeal, Office of Tax Appeals sent appellants an additional briefing letter asking them to clarify whether they were still disputing FTB's proposed assessment for the 2012 tax year, involving issues unrelated to those for 2011, because they provided no arguments or evidence on appeal. Appellants did not respond. Accordingly, we find no error in FTB's proposed assessment for that year and will not discuss it further.

DocuSign Envelope ID: 24237A15-3AA9-43AF-A293-F119CBEF073B

FACTUAL FINDINGS

1. Appellants owned 100 percent of 1400 Folsom Street, LLC (Folsom).[3] Folsom held a storage facility, including real property, located along Folsom Street in San Francisco, California (the Storage Property).

2007 Contribution Agreement

2. In 2007, Folsom contributed the Storage Property to an unrelated third-party called Extra Space Storage, L.P. (ESS), in exchange for limited partnership interests (known as the OP Units) in ESS.[4] At the time of contribution, the Storage Property was encumbered by a mortgage of approximately $14 million, which was assumed by ESS. Also at that time, Folsom's OP Units had a gross value of $18,820,000 but a net value of $3,833,688 after adjustments for the assumed indebtedness by ESS and other costs and expenses. The contribution was intended to qualify as tax-free under Internal Revenue Code (IRC) section 721(a).
3. Folsom's contribution was governed by a 2007 Contribution Agreement (the Contribution Agreement). According to appellants, it provided "certain protective provisions . . . to ensure that they would not pay tax on the transaction if ESS took various actions subsequent to the contribution of [the Storage Property] by [Folsom]."
4. Under section 18(b) of the Contribution Agreement, ESS agreed not to sell or dispose of the Storage Property in a transaction that would cause appellants during the "Sale Restriction Period" to recognize any "Protected Gain." The "Sale Restriction Period"

[3] Appellants owned Folsom, a disregarded entity for income tax purposes, through another entity they collectively wholly owned called RLC, LLC. It appears RLC, LLC was classified as a partnership for income tax purposes and that Folsom's activity was reported by RLC, LLC. In any event, since for state law purposes Folsom was the legal entity that owned and sold the limited partnership units at issue, for ease of reading, we generally refer to Folsom throughout this Opinion, unless the context otherwise requires, although we note for income tax purposes, appellants, as taxpaying individuals, bear the ultimate tax responsibility on the flow-through gain.

[4] Appellants provide further factual background on ESS: It "is a real estate investment trust, formed in 1998, with 1,817 locations covering 40 states and is the second largest owner of self-storage units in the United States and the largest self-storage manager in this country. ESS became a public company in 2004 and has remained a public company to this day." A legal organizational chart reveals ESS had the following direct partners: ESS Holdings Business Trust I (general partner with a 1 percent ownership interest); ESS Holdings Business Trust II (limited partner with a 92 percent ownership interest); and "OP Unit Holders" (presumably all of the remaining limited partners with a collective 7 percent ownership interest). Extra Space Storage, Inc. wholly owned the two business trust partners and therefore was the ultimate parent company (and majority owner) of ESS. For the 2011 tax year, Extra Space Storage, Inc. was a publicly traded real estate investment trust with total assets of $2.5 billion, total debt of $1.3 billion, and net income of $58 million.

was a period of time commencing on the closing date of the Contribution Agreement and ending on the earlier of seven years following that date or the date on which Folsom sold more than 80 percent of the OP Units. The initial "Protected Gain" as of the closing date of the Contribution Agreement was $13,923,995.[5]

5. Section 18(c) of the Contribution Agreement also provided for a "Negative Capital Protection Period" during which ESS made available to appellants, through Folsom, an opportunity to either (1) make a guarantee of "Qualifying Debt" in an amount at least equal to $9,503,995 (such amount being Folsom's "Negative Capital Account"), or (2) enter into a special loss allocation and "deficit restoration obligation" in an amount at least equal to the "Negative Capital Account." The "Negative Capital Protection Period" was a period of time commencing on the closing date of the Contribution Agreement and ending 10 years following that date or the date on which Folsom sold more than 80 percent of the OP Units. Under the Contribution Agreement, "Qualifying Debt" generally meant (1) the unsecured debt of ESS (or the debt of an entity that is disregarded as an entity separate from ESS for federal income tax purposes), with respect to which the lender had recourse, without limitation, to all assets of ESS, (2) the debt of ESS (or the debt of an entity that is disregarded as an entity separate from ESS for federal income tax purposes) that is secured by real property owned by ESS or any such disregarded entity provided certain conditions were met, (3) or any combination thereof.

6. Section 18(c) of the Contribution Agreement further provided the following with respect to the guarantee provision: "Any [g]uarantee shall be a 'bottom dollar' guarantee and may, at [ESS's] option, either directly guarantee to the lender of such Qualified Debt the repayment of such debt up to the amount of [Folsom's] Negative Capital Account or indemnify [ESS] and its affiliates from risk of loss under any liability that they may have with respect to such Qualifying Debt to the extent of [Folsom's] Negative Capital Account."

7. Under section 18(d) of the Contribution Agreement, if ESS breached either section 18(b) or (c), it would essentially have to reimburse appellants, through Folsom, for the

[5] The Contribution Agreement defines the "Protected Gain" as "the taxable gain that [Folsom] would be allocated and recognize under Section 704(c) of the Code if [the Storage Property] is sold in a fully taxable transaction." In general, IRC section 704(c) involves a situation in which a partner who contributes built-in gain property must recognize that gain if the same property is distributed by the partnership to another partner within seven years of the contribution. (IRC, § 704(c)(1)(B).)

difference between the tax that would be incurred with respect to the "Protected Gain" attributable to the Storage Property and the present value of that tax amount.

2011 Guaranty Agreement

8. On January 22, 2011, Folsom entered into a Guaranty Agreement (the Guaranty Agreement) in which Folsom guaranteed debt of Extra Space Properties Thirty-Three LLC (Extra Space 33), an entity that was disregarded as separate from ESS for income tax purposes.[6] The Guaranty Agreement was made by and among Folsom (as guarantor) and Extra Space 33 (as borrower), in favor of U.S. Century Bank (Lender). It was signed by Folsom (as guarantor) and Extra Space 33 (as borrower), but appellants apparently could not locate and provide a signature page showing Lender signed such agreement.

9. The Guaranty Agreement indicated Lender previously loaned $26,560,000 to Extra Space 33 pursuant to a promissory note secured by a security instrument dated as of April 22, 2009.[7] In the event Extra Space 33 defaults on that loan, Folsom "absolutely and unconditionally guarantees and promises to pay directly to Lender on behalf of [Extra Space 33] . . . an amount equal to the Shortfall Amount ...." The "Shortfall Amount" essentially means the remaining loan amount prior to default over the sum of all amounts recovered and the fair market value of any real property obtained by Lender, "if any, from or on behalf of [Extra Space 33] after the [d]efault in proceedings against [Extra Space 33] or the [p]roperties under the documents which set forth the [l]oan (including, without limitation, the [m]ortgage)." However, Folsom's "Maximum Liability" was capped at $9.5 million, the amount at issue here and what the parties refer to as a "bottom dollar" guarantee.[8]

[6] "Guarantee" can generally be defined as: "1. To assume a suretyship obligation; to agree to answer for a debt or default. 2. To promise that a contract or legal act will be duly carried out. 3. To give security to." (Black's Law Dict. (11th ed. 2019).)

[7] The promissory note and security instrument are not in the record.

[8] According to FTB, a bottom dollar guarantee "is an arrangement where a partner guarantees a liability in an amount less than the full face value of the liability. A typical arrangement might have a partner guarantee the last $1 million of a $20 million bank note; for instance, the guarantee would only be paid if the bank foreclosed on the property and suffered a loss in excess of $19 million ($20 million less the $1 million guarantee). The terms of the Guaranty Agreement describe this type of arrangement." Appellants do not dispute FTB's characterization.

10. The Guaranty Agreement provided that "[n]o demand shall be made under this [g]uarantee for payment of the Shortfall Amount or any portion thereof . . . until such time as Lender shall have fully and completely exercised (and not waived) all rights, powers, and remedies it has with respect to foreclosure of the [real] [p]roperties or . . . following the date any such [d]efault is cured."

11. The Guaranty Agreement included an indemnification provision that essentially provided that if any member of Extra Space 33 (or any affiliate thereof) is required by Lender to make any payment to Lender or any contribution to Extra Space 33 "with respect to the portion of the [l]oan for which a payment pursuant to this [g]uarantee is required," then Folsom "shall absolutely and unconditionally reimburse the [i]ndemnified [p]arty........"

12. Exhibit A attached to the Guaranty Agreement contains a table of information regarding five real properties securing the loan between Extra Space 33 and Lender: (1) the five properties had a fair market value that totaled $39,905,875; (2) the five "loan amount[s]" totaled $26,560,000, which matches the loan amount listed above in connection with the April 22, 2009 promissory note; (3) the five "loan balance[s]" totaled $25,851,952;[9] and (4) the five properties had an occupancy rate ranging between 82.46 percent to 87.11 percent. In addition, "ESS - REIT" is listed as the owner of each property and "ESS LLC" is listed as a guarantor for each of the five loan amounts/balances.[10]

Sale of the OP Units

13. Folsom sold a portion of its OP Units in 2011. Subsequently, ESS issued a Schedule K-1 to Folsom for the 2011 tax year, which showed Folsom was allocated a recourse liability of $9.5 million based on the guarantee. On their 2011 California income tax return, appellants took the position that Folsom's tax basis in its OP Units had been increased by

[9] FTB indicates the principal balance of the loan was $22,156,952 when the Guaranty Agreement was signed in 2011, but the agreement seems to show a principal balance of $25,851,952. The difference, however, is immaterial for our purposes here. For sake of convenience, we treat the principal balance of the loan as being $25,851,952, as shown in Exhibit A of the Guaranty Agreement.

[10] It is not clear what Extra Space 33 used the $26,560,000 loan for—to purchase the five real properties listed in Exhibit A or for some other purpose. It is also not clear from Exhibit A which entities these abbreviated names—"ESS - REIT" and "ESS LLC"—are referring to. In any event, based on the legal organizational chart, it appears they are affiliated entities of Extra Space 33.

DocuSign Envelope ID: 24237A15-3AA9-43AF-A293-F119CBEF073B

the purported recourse liability of $9.5 million, thus eliminating any of flow-through gain on the 2011 sale of those units.

Procedural History

14. On audit, FTB disregarded the Guaranty Agreement as invalid under California law because it was not signed and/or acknowledged by the Lender. Alternatively, FTB determined that even if the guarantee were valid, it did not increase Folsom's tax basis in the OP Units because Folsom did not bear an economic risk of loss for income tax purposes. FTB thus decreased Folsom's tax basis in the OP Units, which had the effect of increasing appellants' flow-through gain on the sale of those units in 2011.[11]
15. FTB issued to appellants a Notice of Proposed Assessment (NPA) for the 2011 tax year that reflected its determination. Appellants protested the NPA, but FTB affirmed it by issuing a Notice of Action. This timely appeal followed.

DISCUSSION

Introduction

FTB's determination is presumed correct, and a taxpayer has the burden of proving error. (*Appeal of Davis*, 2020-OTA-182P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Ibid*.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Ibid*.) The burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c).) To meet this evidentiary standard, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of Belcher*, 2021-OTA-284P.)

The parties debate at length whether the Guaranty Agreement is valid and enforceable because it is not signed and/or acknowledged by the Lender. However, we do not need to resolve that debate. As discussed below, even if the Guaranty Agreement is legally valid and enforceable, appellants have not shown, for income tax purposes, Folsom bore an economic risk of loss in relation to such guarantee. Thus, they are not entitled to a $9.5 million increase in the adjusted basis of the OP units sold in 2011.

[11] Appellants note they were never audited by the IRS.

Applicable Partnership Tax Principles – In General

The adjusted basis of a partnership interest held by a partner is generally referred to as the "outside" basis. (McKee et al., Federal Taxation of Partnerships & Partners (WG&L, 4th ed. 2007 & Supp. 2022-1), ¶ 6.01 *The Fundamental Concepts*.) A partner's outside basis is significant, among other reasons, whenever the partnership interest is transferred or liquidated. (*Ibid*.) Gain or loss realized by a partner selling a partnership interest is equal to the difference between the amount realized on the sale and seller's adjusted basis in the partnership interest at the time of sale. (See IRC, §§ 741, 1001.)[12] A partner's initial outside basis in a partnership interest acquired by contribution is the sum of money and the contributor's adjusted basis in any property contributed. (IRC, § 722.)

As relevant here, a partner's adjusted basis in its partnership interest is increased by the partner's share of partnership liabilities, which is considered a contribution of money under IRC section 722. (IRC, § 752(a); Treas. Reg. § 1.752-1(b).) The determination of how a partnership liability is allocated among partners depends on whether the liability is treated as a "recourse liability" or "nonrecourse liability." (Treas. Reg. §§ 1.752-1, 1.752-2, 1.752-3.) In general, a partnership liability is a recourse liability to the extent that any partner or related person bears "the economic risk of loss" for that liability, and if so, the partner is entitled to an adjusted basis increase in the partnership interest by the amount of the liability. (Treas. Reg. §§ 1.752-1(a)(1), 1.752-2(a).)[13] In contrast, a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability, and if so, the partners generally share such liabilities in proportion to their share of partnership profits. (Treas. Reg. §§ 1.752-1(a)(2), 1.752-3(a).)

[12] "California incorporates [IRC] sections 701-761 relating to partners and partnerships with certain exceptions. (R&TC, § 17851.) When applying the IRC, California also incorporates Treasury Regulations to the extent that they do not conflict with regulations promulgated by FTB. (R&TC, § 17024.5(d).)" (*Appeal of Rios*, 2021-OTA-341P.) In addition, under R&TC section 18031, California generally conforms to Subchapter O of the IRC, which includes rules on the determination of gain or loss under IRC section 1001.

[13] All references to Treasury Regulations are based on the version that applies to the transactions and/or tax year at issue. Specifically, references here to Treasury Regulation section 1.752 2 will be based on that version in effect for liabilities incurred or assumed prior to October 5, 2016, since the Guaranty Agreement was entered into in 2011. (See Treas. Reg. § 1.752-2(l).) Thus, the more recently added changes under Treasury Regulation section 1.752-2(b)(3)(ii) regarding bottom dollar payment obligations are not implicated here.

Analysis

The crux of the issue is whether Folsom's $9.5 million guarantee of Extra Space 33's debt to Lender causes that portion of the debt to be a recourse liability to Folsom, entitling appellants to increase the adjusted basis in the OP units by that same amount. The answer to that question requires us to determine whether Folsom bore "the economic risk of loss" for that portion of the debt. For reasons that follow, we find Folsom did not.

Constructive Liquidation Test

A partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership underwent a "constructive liquidation," the partner (or related person) would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable, and the partner (or related person) would not be entitled to reimbursement from another partner (or person that is a related person to another partner). (Treas. Reg. § 1.752-2(b)(1).) Under the constructive liquidation test, all of the following events are deemed to occur simultaneously:

i. All of the partnership's liabilities become payable in full;
ii. With the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero;
iii. The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right torepayment is limited solely to one or more assets of the partnership);
iv. All items of income, gain, loss, or deduction are allocated among the partners; and
v. The partnership liquidates.

(Treas. Reg. § 1.752-2(b)(1)(i-v).) The determination of the extent to which a partner or related person has an obligation to make a payment under the hypothetical constructive liquidation test is based on the facts and circumstances at the time of the determination and all statutory and contractual obligations relating to the partnership liability, such as a guarantee, are taken into account. (Treas. Reg. § 1.752-2(b)(3)(i).)

Applying the constructive liquidation test, we assume all of ESS's assets (including those of Extra Space 33) are deemed worthless and all of ESS's liabilities (including Extra Space 33's $26,560,000 liability owed to Lender) become due and payable in full. If this were to happen, it

DocuSign Envelope ID: 24237A15-3AA9-43AF-A293-F119CBEF073B

is not clear from the evidentiary record Folsom would be required to pay the $9.5 million guarantee. Exhibit A of the Guaranty Agreement strongly suggests there is at least one other guarantor of Extra Space 33's liability: "ESS LLC." This entity, ESS LLC, appears to be affiliated with ESS based upon a legal organizational chart appellants submitted. But appellants have not explained why "ESS LLC" is listed in the Guaranty Agreement as a guarantor of the $26,560,000 liability or Folsom's relationship to that entity or any other affiliates of Extra Space 33 that may also be guarantors of the debt. For example, we do not know whether "ESS LLC" (or another guarantor affiliate of Extra Space 33) is required to satisfy the entire $26,560,000 prior to Folsom's guarantee obligation.

In addition, we do not know anything about the other partners of ESS, including the general partner, ESS Holdings Business Trust I, and what contractual or state law obligations they may have, if any, to satisfy Extra Space 33's liability and how that relates to Folsom's obligation.[14] We also do not know whether Lender's right to repayment is limited to the property securing the original mortgage such that ESS would be deemed to have received income from the relief of these liabilities pursuant to Treasury Regulation section 1.752-2(b)(iii).[15] Accordingly, appellants have not shown Folsom would be required to satisfy its $9.5 million guarantee upon a hypothetical constructive liquidation of ESS.

Contingency Obligations[16]

Our conclusion that Folsom does not bear the economic risk of loss for $9.5 million of Extra Space 33's debt to Lender is further supported by Treasury Regulation section 1.752-2(b)(4). That provision provides that "[a] payment obligation is disregarded if,

[14] A full copy of ESS's limited partnership agreement is not in the record.

[15] As noted above, the promissory note and security instrument between Lender and Extra Space 33 are not in the record.

[16] Appellants argue the contingency obligation test is a separate test from the constructive liquidation test. However, the constructive liquidation test begins with "[e]xcept as otherwise provided in *this section*" (i.e., Treasury Regulation section 1.752-2) and the contingency obligation test is found in that same section. (Italics added.) Therefore, it appears the contingency obligation test must be applied in conjunction with the constructive liquidation test, such that an obligation subject to contingencies that make it unlikely the obligation will ever be discharged would not pass the constructive liquidation test. (See *Tribune Media Company v. Commissioner*, T.C. Memo. 2021-122, at p. *97 (*Tribune*) [addressing the IRS's argument that the constructive liquidation test fails because of contingent obligation, without indicating two separate tests].) We nonetheless independently find both that the constructive liquidation test has not been passed, and Folsom's guarantee is subject to contingencies that make it unlikely the obligation will ever be discharged such that the contingent obligation test also has not been passed.

taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs." (Treas. Reg. § 1.752-2(b)(4).)

We find Folsom's guarantee obligation, taking into account all the facts and circumstances, is subject to contingencies that make it unlikely it would ever have to pay $9.5 million to Lender. Folsom's payment obligation under the Guaranty Agreement was contingent on Lender first foreclosing on various real properties securing the loan. At the time of execution of the Guaranty Agreement, those properties had a fair market value of $39,905,875 and the principal balance on the $26,560,000 loan was $25,851,952. Thus, in the event Lender foreclosed on and sold the properties, Folsom's full payment obligation of $9.5 million would have been triggered only if the properties had been sold for $16,351,952 or less ($25,851,952 loan balance due minus $9.5 million). But since the fair market value of the properties of $39,905,875 (with an occupancy rate ranging between 82.46 percent to 87.11 percent) more than covered the principal loan balance of $25,851,952, we conclude it is unlikely Folsom's $9.5 million guarantee would have become due. In addition, the Guaranty Agreement suggests Lender could only seek recovery from Folsom of the remaining loan amount due "*after* the [d]efault in proceedings *against [Extra Space 33] or the [p]roperties* under the documents which set forth the [l]oan (including, without limitation, the [m]ortgage)." (Italics added.) This also suggests Lender had to at least exhaust remedies against Extra Space 33, in addition to foreclosing on the real properties, before requiring payment from Folsom.[17]

Appellants assert, however, that the requirement for Lender to foreclose on the real properties was waived via a conflicting provision contained in section 5 of the Guaranty Agreement, which provides, in part, that Folsom (as guarantor) "waives any and all rights and defenses that [Folsom] may have because [Extra Space 33's] debt is secured by real property . . . ." However, section 5 indicates this means, "among other things, that if Lender forecloses on any real property collateral pledged by [Extra Space 33], then (A) the amount of the debt may be reduced only by the price for which that collateral is sold at the foreclosure sale, even if the collateral is

[17] This is not to imply a guarantee will always be considered contingent. (See *Tribune*, *supra*, at pp. *97-*98 ["If it were, most if not all collection guaranties would be disregarded as conferring an obligation under the constructive liquidation test, when the regulations clearly intend to treat guaranties—including collection guaranties—as obligations"].) Rather, on the facts before us, we find it unlikely Lender would ever require payment from Folsom.

worth more than the sale price, and (B) Lender may collect from [Folsom] even if Lender, by foreclosing on real property collateral, has destroyed any right [Folsom] may have to collect from [Extra Space 33].” In other words, Lender still had to exhaust remedies by foreclosing on the real properties before seeking repayment from Folsom. In any event, we agree with FTB that even if the requirement for Lender to foreclose on the real property was waived, the economic risk of loss for Folsom would still be unlikely, given the ultimate parent of Extra Space 33 (i.e., Extra Space Storage, Inc.) was a publicly traded company in the 2011 tax year, with total assets of $2.5 billion, total debt of $1.3 billion, and net income of $58 million.

Indeed, it is undisputed Extra Space 33 issued the 2009 promissory note to Lender two years before the Guaranty Agreement was entered into in 2011. This shows the guarantee did not induce Lender to loan funds to Extra Space 33 and there is no evidence to suggest Lender sought a guarantee years after issuing the original loan (e.g., due to a change of facts or circumstances involving that loan). And since there is no evidence Lender subsequently knew of the Guaranty Agreement, we find it unlikely Lender would have called upon Folsom to pay it.[18] Moreover, even assuming appellants' contention is true—that if a borrower defaulted, it would, as a practical matter, produce a guaranty agreement that the lender did not know existed—we still find it unlikely Extra Space 33 would ever have to do this for reasons discussed in this Opinion.

<u>Appellants' Other Arguments are Unpersuasive</u>

Appellants direct us to two examples in the Treasury Regulations to support their position, but we find both are unhelpful. The first is Example 3 of Treasury Regulation 1.752-2(f), which involves a limited partnership with two partners, one general and the other limited. The partnership purchases depreciable property using cash from its partners and a recourse loan obtained from a bank. The limited partner guarantees payment on the loan to the extent it remains unpaid after the bank has exhausted its remedies against the partnership. To

[18] Treasury Regulation section 1.752-1(d)(2) provides, in part, that a person is considered to "assume" a liability only to the extent "the person to whom the liability is owed *knows of the assumption* and can directly enforce the partner's or related person's obligation for the liability .... " (Italics added.) The parties disagree over what this provision means and its applicability here because it is undisputed Lender did not know of Folsom's guarantee. Appellants assert it is inapplicable because an assumption is when a party (here, Folsom) steps into the shoes of Extra Space 33 (the debtor) and becomes the new debtor, whereas a guaranty is when a party (again, here Folsom) guarantees it will perform on the debt if the original debtor cannot. In contrast, FTB asserts the regulatory provision applies to either an assumption or guarantee. Regardless of which party has the better argument here, we still find the fact that Lender did not know of the Guaranty Agreement to be relevant to our conclusion.

determine which partner bears the economic risk of loss, the constructive liquidation test is performed in which all the partnership's assets, including the depreciable property, are deemed worthless and the depreciable property is sold for a value of zero. Under the partnership agreement's rules for allocating losses, the general partner's capital account is reduced below zero, whereas the limited partner's is reduced to zero but not below. The example concludes that because the general partner is obligated by operation of law to make a net contribution to the partnership in the amount of the loan to restore its negative capital account to zero, that partner is assumed to satisfy the obligation and the limited partner's guarantee is not respected.

Since this example illustrates a situation where a limited partner's guarantee is not respected, it would appear to support FTB's position. Appellants nonetheless assert they cited the example to try to factually distinguish it. But on the record before us, we are unable to discern any relevant distinction. As previously noted, here, we do not know what contractual or state law obligations ESS's general partner, ESS Holdings Business Trust I, or any other partner may have with respect to restoring negative capital accounts and how that could impact Folsom's $9.5 million guarantee of Extra Space 33's liability.

Appellants also assert Example 2 of Treasury Regulation 1.737-4(b) is "an even stronger example" to support Folsom bore an economic risk of loss. That example involves a situation in which a partner agrees to be solely liable for the repayment of a partnership recourse debt with a principal purpose of increasing that partner's outside basis under IRC section 752(a) and avoiding gain. Appellants assert this example shows that contrary to FTB's view, a guaranty can still be respected even if it is tax-motivated and lacks a business purpose. But regardless of Folsom's motivation for entering into the Guaranty Agreement, unlike this example where the partner assumed sole responsibility for the partnership's debt, appellants have not shown Folsom bore an economic risk of loss.

We find Example 5 of Treasury Regulation 1.752-2(f) instructive, although it was not discussed by either party. That example involves a situation in which a partnership incurs a loan secured by a mortgage on real property. The mortgage note contains an exoneration clause that in the event of default, the holder's only remedy is to foreclose on the property and may not look to any other partnership asset or any partner to pay the liability. A partner guarantees a portion of the loan to induce the lender to make the loan, and the exoneration clause does not apply to this guarantee. That partner is subrogated to the rights of the lender in the amount of the

guarantee but is not otherwise entitled to reimbursement from the partnership or any partner. The example concludes the portion of the mortgage liability that is guaranteed is treated as recourse, which is allocated in full to the guaranteeing partner.

This example is helpful because it illustrates when a guarantee will be respected. Unlike the facts in the example, Folsom's guarantee, as discussed above, was made two years *after* Lender made the loan to Extra Space 33 and therefore the Guaranty Agreement did not induce Lender to make the loan (and there is no evidence to suggest Lender sought a guarantee years after issuing that loan or even knew about the Guaranty Agreement). Accordingly, unlike the partner in Example 5, Folsom did not bear the economic risk of loss.

Appellants next cite two U.S. Tax Court decisions for the proposition that a guaranty or deficit restoration obligation entered into by the limited partner, such as Folsom, will establish economic risk of loss and convert a nonrecourse partnership liability to a recourse liability. However, these decisions do not support Folsom bore an economic risk of loss.

In *Bordelon v. Commissioner*, T.C. Memo. 2020-26 (*Bordelon*), the tax court agreed with the taxpayer that his outside basis in a partnership could be increased by his personal guarantee of a partnership loan. The court noted there were no other guarantors on the loan and no other partner had personal liability for any amount of the loan. (*Bordelon*, *supra*, at p. *29.) Applying the constructive liquidation test, the court found "[t]here were no other partnership assets securing any of the debt; no other partner was liable for any portion of the debt; and if the debt were due in full, [the lender] would certainly have sought payment directly from [the taxpayer]." (*Id.* at p. *30.) Thus, the court concluded the loan became a recourse obligation to the taxpayer through his guarantee, which properly increased his basis in the partnership. (*Id.* at pp. *30-*31.)[19]

In contrast, here, there likely was another guarantor to Extra Space 33's liability, "ESS LLC," and the liability was secured by real properties that had a total fair market value that more than covered the outstanding loan balance. Further, it is unclear what role, if any, ESS's general partner (or any other partner) had in the liability if Lender sought repayment and there is no evidence Lender even knew about Folsom's guarantee.

[19] See also *Tribune*, *supra*, at p. *96 [taxpayer bore economic risk of loss because "[n]o other party was liable for the debt, no partnership assets secured the loans, and if the debt were due in full in the world of a constructive liquidation, the senior debt creditors would seek repayment from [the taxpayer] and no other party"].)

DocuSign Envelope ID: 24237A15-3AA9-43AF-A293-F119CBEF073B

In *Abramson, et al. v. Commissioner* (1986) 86 T.C. 360 (*Abramson*), the tax court also sided with the taxpayers that they were entitled to increase their outside basis because they guaranteed partnership debt. Appellants direct us, in part, to the following language in the decision: "The guarantee of an otherwise nonrecourse note places each guaranteeing partner in an economic position indistinguishable from that of a general partner with liability under a recourse note—except that the guaranteeing partner's liability is limited to the amount guaranteed. While recognizing that under state law there may be differences between the obligations of a general partner and those of a limited partner guarantor, such differences should not be controlling for Federal tax purposes." (*Abramson*, *supra*, at p. 374.) We do not disagree with these general statements of partnership tax law as they pertain to recourse liabilities. However, on the facts before us, appellants have not shown Folsom bore a $9.5 million economic risk of loss.

Lastly, appellants cite IRS Chief Counsel Advice 201606027 because, in their view, it shows "the IRS is acknowledging that in the moment that we apply the constructive liquidation test, we must consider all outstanding guarantees" and "[t]o the extent these guarantees are contractually valid, then that could change the nature of the debt from nonrecourse to the partnership to recourse as to an individual partner." However, again, we do not disagree with the IRS's general statements of partnership tax law. We simply are not persuaded the evidentiary record shows Folsom bore a $9.5 million economic risk of loss.[20]

[20] Given our conclusion that Folsom did not bear the economic risk of loss with respect to the $9.5 million guarantee, we need not discuss the anti-abuse rules under Treasury Regulation section 1.752-2(j).

HOLDING

Appellants are not entitled to increase the adjusted basis in certain limited partnership interests sold in 2011 by a $9.5 million guarantee.

DISPOSITION

FTB's actions for the 2011 and 2012 tax years are sustained.

DocuSigned by:
Kenneth Gast
3AF5C32BB93B456...
Kenneth Gast
Administrative Law Judge

We concur:

DocuSigned by:
Huy "Mike" Le
A11783ADD49442B...
Huy "Mike" Le
Administrative Law Judge

DocuSigned by:
Cheryl L. Akin
1A8C8E38740B4D5...
Cheryl L. Akin
Administrative Law Judge

Dated: 3/21/2022