Real Estate
ADVISOR

Follow us on

June 2016 Issue I.

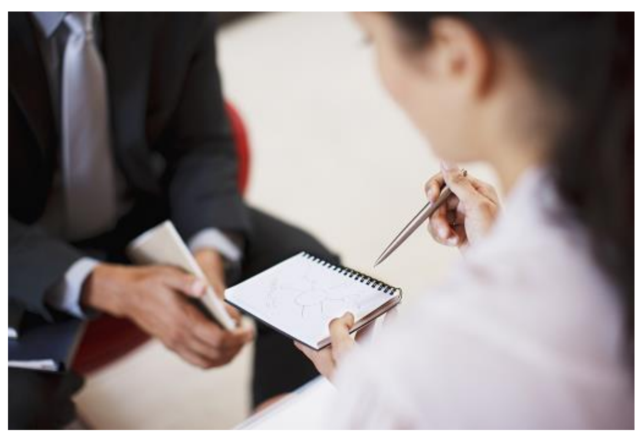
Bad Boy Guarantees: Recourse or Nonrecourse Debt?

By Kyle Wissel, JD | Principal
John Ohannessian, CPA | Senior Manager

A recent legal memorandum (CCA 201606027) released by the IRS Office of Chief Counsel on February 5, 2016 has called into question an industrywide practice involving "bad boy guarantees" and how such clauses impact a debt that would otherwise be classified as non-recourse debt or qualified nonrecourse debt.

Treasury Regulations permit all partners to include their allocable share of nonrecourse liabilities when computing basis in their partnership interest. Qualified non-recourse liabilities, which are in their simplest form nonrecourse liabilities secured by real estate used in an activity of holding real property, are also allocated to all partners when computing basis in a partner's partnership interest.

Recourse liabilities, however, are allocated only to those partners who are economically at risk for satisfying all or part of the debt. Because tax losses can be deducted only up to a partner's basis in his partnership interest, partners are keenly interested in how partnership liabilities are allocated to them. In addition, the amount of a partner's basis can affect the taxable portion of distributions from the partnership.



Treasury Regulations under Section 752 of the Internal Revenue Code of 1986, as amended provide that a partner bears the economic risk of loss if, upon a partnership's constructive liquidation, the partner is obligated to make a payment on a debt to the extent that the partnership is unable to pay the debt and is not entitled to reimbursement from another partner.

The regulations also provide that a payment obligation is disregarded if 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.

"The IRS appears to have stepped back from the previously released guidance, indicating that in most cases a bad boy guarantee would be ignored until such time as the event triggering its application actually occurred."

In the real estate industry, many loan documents for non-recourse indebtedness contain "bad boy guarantees." Actions that can trigger a bad boy guarantee include fraud, misapplication of funds, unauthorized transfers of the mortgage real property and a bankruptcy filing. In CCA 201606027, a partner had guaranteed payment of a promissory note upon the occurrence of various events including the partnership admitting insolvency, voluntary bankruptcy or acquiescence in an involuntary bankruptcy.

In practice, bad boy guarantees are rarely triggered because the party providing the guarantee is generally in control of the events, making it unlikely that the guarantor would render itself fully liable for the loan. Industry-wide practice has generally been to not take bad-boy guarantees into account when making a determination as to whether a debt is recourse or non-recourse.

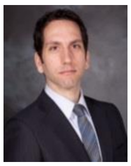
In CCA 201606027, the Office of Chief Counsel concluded that for purposes of allocating partnership tax basis among the limited liability company's (LLC's) members, the bad boy guarantee resulted in the guaranteeing partner bearing the economic risk of loss and caused otherwise non-recourse debt and qualified non-recourse debt to be treated as a recourse liability. The memorandum also concluded that the events of admission of insolvency and/or voluntary bankruptcy were not so remote a possibility that would make the obligation unlikely to be discharged and cause the obligation to be disregarded. Treating the debt as recourse, resulting in the entire amount being included in the basis of only the guaranteeing member deprived the other members of any share of the liability in computing their tax basis in the LLC.

Shortly thereafter, the Office of Chief Counsel released an advice memorandum (AM 2016-001 dated April 15, 2016) with an interpretation more in line with the prevailing understanding among real estate practitioners. The IRS appears to have stepped back from the previously released guidance, indicating that in most cases a bad boy guarantee would be ignored until such time as the event triggering its application actually occurred. This interpretation would treat the underlying debt subject to the bad boy guarantee as nonrecourse or qualified nonrecourse for purposes of determining basis.

These memoranda are not substantial authority and cannot be relied on by the IRS in other cases. However, taxpayers and the real estate industry should be aware (solely based on CCA 201606027) that the IRS may take a more aggressive approach when it comes to bad boy guarantees, which would be a significant departure from an industry-wide practice with respect to how real estate partnerships treat otherwise non-recourse financing in funding real estate acquisitions. That of course seems to be tempered by the later advice memorandum, but as a whole the subject of bad boy guarantees does not seem to be entirely settled.

For more information contact:

Kyle Wissel, JD | Principal,
Real Estate Group
212.375.6550
Kyle.Wissel@WeiserMazars.com



John Ohannessian, CPA | Senior Manager,
Real Estate Group
212.375.6722
John.Ohannessian@WeiserMazars.com

Visit us on **www.weisermazars.com**

MAZARS

WeiserMazars
Exactly Right.