"Bad Boy" Guarantees Reviewed by the IRS

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A recent IRS Chief Counsel Advice memorandum (CCA) addressed the tax treatment afforded investors in real estate limited partnerships and limited liability companies that utilize non-recourse financing.

In a typical non-recourse mortgage financing, the owner/borrower grants a mortgage or deed of trust in favor of its lender encumbering the owner/borrower's interest in a particular real estate project and one or more of the equity owners of the owner/borrower execute a non-recourse carve-out guaranty. Upon an event of default, the lender's recovery is limited to the mortgaged property, unless an event has also occurred that triggers recourse under the guarantee. Personal liability under a so-called "bad boy" guarantee is triggered upon the occurrence of certain stipulated future events, including, for example, the filing of a voluntary bankruptcy petition by the borrower or a transfer of the mortgaged property in violation of the loan documents.

Pursuant to the CCA, non-guaranteeing partners of a limited partnership could be deprived of the necessary tax basis to claim losses from the limited partnership in excess of their capital contributions to the company.[1] The conclusions set forth in the CCA are viewed by many in the real estate and tax industries as a departure from prior practice as it relates to the tax treatment of so-called "bad boy guarantees" in non-recourse real estate financing transactions.

A partner's distributive share of partnership loss is only allowed to the extent that the loss does not exceed the partner's adjusted basis in his or her partnership interest.[2] A partner's initial basis in his or her partnership interest includes, among other things, cash contributed to the partnership. The Internal Revenue Code considers any increase in a partner's share of the liabilities of a partnership to be a contribution of money by such partner to the partnership and thus an increase in that partner's basis in his or her partnership interest. In applying this basis adjustment rule, the Treasury Regulations draw a distinction for tax purposes between the treatment of "recourse" and "non-recourse" liabilities and that is why the recent CCA is important.

With respect to recourse liabilities, a partner's share of a partnership liability equals the portion of the liability, if any, for which the partner or a related person bears the economic risk of loss. By contrast, non-recourse liabilities are allocated among the partners via a complex three-part analysis, which, generally speaking, results in an allocation among the partners according to the way in which they share partnership profits. As such, a threshold question in determining a partner's share of a partnership liability, and consequently whether the partner receives a basis increase on account of the liability, is whether the liability is for purposes of the Treasury Regulations recourse or non-recourse. If the liability is recourse, only partners that bear an economic risk of loss are allocated a share of the partnership liability in their basis.

A bona fide guarantee is generally sufficient to cause the guaranteeing partner to be deemed to bear the economic risk of loss for the guaranteed partnership debt. Accordingly, the debt would be recourse as to the guaranteeing partner (to the extent of the guarantee). If, on the other hand, a guarantee is subject to contingencies that make it unlikely that the guarantee will ever be called upon, the guarantee is disregarded in the recourse versus non-recourse analysis. The CCA essentially casts doubt on the prevailing custom that has treated many such guarantees in the latter category and disregarded them in determining whether a liability is recourse or non-recourse for tax purposes.

The facts in the CCA involved what can be considered customary bad boy acts triggering recourse to the guarantors. The IRS determined that the stipulated events were not so remote a possibility that it is unlikely the obligation of the guaranteeing partner will

ever be discharged; as such, the IRS did not disregard the guaranty and treated the debt as recourse to the guaranteeing partner. The facts also involved a right of the guaranteeing partner to seek reimbursement from the other partners, though the other partners could be diluted in lieu of being forced to make a reimbursement payment. This, in the IRS's view, was insufficient to shift the economic risk of loss to the non-guaranteeing partners.

It should be noted that the CCA is not binding authority and is limited in its application to the facts of the particular situation addressed therein. The conclusions in the CCA have, however, been met with considerable surprise by many in the real estate and tax industries. If these views should become the prevailing law, it would mean that when a typical non-recourse carve-out guarantee is issued by one or more partners to the lender, the non-guaranteeing partners would not be able to increase their bases in their partnership interests by a share of the partnership liability. This could prevent those non-guaranteeing partners from receiving a distributive share of partnership loss, which is often a valuable benefit.

Real estate owners and the lenders that finance their projects need to be aware of this issue. As this issue develops further, we will keep you updated. If you have any questions or comments, please contact Kevin Koscil (215.864.6827; koscilk@whiteandwilliams.com) or Tim Davis (215.864.6829; davist@whiteandwilliams.com).

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[1] In this context, references to partners and partnerships apply equally to members in LLCs taxed as partnerships.

[2] In this context, certain so-called "at-risk rules" and other Internal Revenue Code provisions may also be applicable, an in depth discussion of which is beyond the scope of this alert.