Client Alert

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Tax Treatment of "Bad Boy Guarantees" Challenged by Recent IRS Memorandum

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I. OVERVIEW

A recently released legal memorandum by the Internal Revenue Service (**IRS**) Office of Chief Counsel, CCA 201606027 (the "**Memorandum**"), concluded that a so-called "bad boy guarantee" provided by a sponsor of a real estate partnership should cause an otherwise non-recourse financing to be treated as recourse for partnership tax purposes. This Memorandum has come as a surprise to many in the real estate community as taxpayers typically have treated otherwise non-recourse loans as non-recourse for basis and loss allocation purposes even if there was a bad boy guarantee, given the low risk that the events triggering the guarantee obligation would occur. Although the Memorandum is limited to its facts and is not precedential, it remains to be seen whether the Memorandum reflects a broader position by the IRS on the treatment of otherwise non-recourse loans subject to bad boy guarantees.

II. BACKGROUND

Real estate partnerships and limited liability companies (**LLCs**) typically use a combination of equity and non-recourse loans to finance the cost of acquiring and developing real estate. Under the terms of the non-recourse loans, lenders can only look to the property securing the borrowing, rather than the investors or sponsors, to satisfy defaults under the loans. To reduce their exposure, lenders often require a so-called "bad boy guarantee" from one or more partners (typically, the sponsor) of the partnership, which guarantee is only triggered upon the occurrence of certain stated conditions. These conditions typically consist of deliberate actions by the fund or the sponsors such as the filing of a voluntary bankruptcy petition. Since the sponsor generally has the ability to ensure that the partnership refrains from these actions, the conditions are rarely violated and bad boy guarantees are rarely triggered in practice.

Whether liabilities are characterized as recourse or non-recourse is important because a partner's tax basis in its partnership interest includes the partner's share of partnership liabilities. A non-recourse liability of the partnership generally increases the tax basis and at-risk investment of each of the partners in proportion to their share of profits or capital, whereas a recourse liability only increases the tax basis and at-risk investment of the partner who bears the risk of loss with respect to the liability. Under the U.S. partnership tax rules, a partner generally recognizes gain from a partnership distribution to the extent the amount of the distribution exceeds the partner's tax basis in its partnership interest. In addition, a partner generally can claim losses from the partnership only to the extent of its tax basis and the amount of its "at-risk investment."

Liabilities are treated as being recourse to a partner if that partner bears the so-called “risk of loss” in the event that the partnership fails to satisfy the liability. In determining whether a partner bears the risk of loss with respect to a partnership liability, the partnership tax rules look to whether a partner has an obligation to repay the liability upon a constructive liquidation of the partnership, taking into account all statutory and contractual obligations (including a partner’s guarantee of the debt). However, a partner’s guarantee 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*” (a “**Disregarded Guarantee**”). Further, if an “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.”

An example found in Treas. Reg. §1.752-2 best illustrates when a contingent obligation will be disregarded. J and K form a general partnership with cash contributions. J and K share partnership profits and losses equally. The partnership purchases an apartment building for its cash and a non-recourse loan from a commercial bank. The non-recourse loan is secured by a mortgage on the building. The loan documents provide that the partnership will be liable for the outstanding balance of the loan on a recourse basis to the extent of any decrease in the value of the apartment building resulting from the partnership’s failure properly to maintain the property. There are no facts that establish with reasonable certainty the existence of any liability on the part of the partnership (and its partners) for damages resulting from the partnership’s failure properly to maintain the building. Therefore, no partner bears the economic risk of loss, and the liability constitutes a non-recourse liability.

As illustrated in the example, since sponsors can ensure that the bad boy guarantees are not triggered, practitioners generally take the position that the guarantees are Disregarded Guarantees and, as a result, the underlying liabilities are non-recourse liabilities for partnership tax purposes.

III. THE MEMORANDUM

In the Memorandum, the IRS concludes that a loan to a real estate partnership should be treated as a recourse liability as a result of the specific bad boy guarantee described therein.

In the Memorandum, partnership *X* and its subsidiaries incurred several non-recourse loans (the “**Loans**”). In connection with the loans, one of *X*’s members (the “**Guarantee Partner**”) entered into a personal guarantee (the “**Guarantee**”) that would be triggered upon any of the following conditions (the “**Conditions**”):

1. The co-borrowers fail to obtain the lender’s consent before obtaining subordinate financing or transfer of the secured property;
2. Any co-borrower files a voluntary bankruptcy petition;
3. Any person in control of any co-borrower files an involuntary bankruptcy petition against a co-borrower;
4. Any person in control of any co-borrower solicits other creditors to file an involuntary bankruptcy petition against a co-borrower;
5. Any co-borrower consents to or otherwise acquiesces or joins in an involuntary bankruptcy or insolvency proceeding;

6. Any person in control of any co-borrower consents to the appointment of a receiver or custodian of assets; or

7. Any co-borrower makes an assignment for the benefit of creditors, or admits in writing or in any legal proceeding that it is insolvent or unable to pay its debts as they come due.

Under *X*'s operating agreement, in the event the Guarantee is triggered, the Guarantee Partner could request additional capital contributions from the other partners in proportion with their ownership in *X* ("**Guarantee Contributions**"). If any partner fails to make a Guarantee Contribution, the operating agreement provides that the Guarantee Partner can elect to (i) treat a portion of its liability as a deemed loan to the defaulting partner, or (ii) reduce the defaulting partner's ownership interest in *X*.

In analyzing the loan, the IRS concludes that, generally, a bona fide guarantee that is enforceable under local law is sufficient to cause the guaranteeing partner to be treated as bearing the risk of loss with respect to the applicable liability. In addition, the IRS argues that upon a constructive liquidation of partnership *X*, it is reasonable to assume that one or more of the Conditions, more likely than not, would be met, in which case the Guarantee Partner would be personally liable to repay the Loans. Thus, the IRS concludes that the Guarantee is not a Disregarded Guarantee, and the Loans should be treated as recourse liabilities for partnership tax purposes and should only increase the tax basis and at-risk investment of the Guarantee Partner.

The IRS also concludes that the Guarantee Contributions do not cause the other partners in *X* to be treated as bearing the risk of loss with respect to the Loans. The partners do not have any mandatory obligation to make the Guarantee Contributions; indeed, the Guarantee Partner does not have any contractual or legal remedy to compel a partner to make a Guarantee Contribution. The Guarantee Partner's sole remedies are as stated in the operating agreement: to make a deemed loan to the defaulting partner, or to adjust the defaulting partner's ownership interest in *X*. As a result, the IRS concluded that only the Guarantee Partner ultimately bears the risk of loss with respect to the loans.

IV. ANALYSIS

At this time, it is impossible to make general conclusions about the tax treatment of bad boy guarantees with respect to partnership liabilities based on the Memorandum. The Memorandum cannot be used as precedent and is limited to the particular taxpayer requesting the advice based on its specific facts.

On the one hand, the Memorandum could illustrate an isolated case that is limited to its facts. Notably, as has been suggested by an attorney-advisor for the Treasury Office of the Tax Legislative Counsel, the IRS may have been focused on Condition 7, that the Guarantee is triggered if any co-borrower makes an assignment for the benefit of creditors, or admits in writing or in any legal proceeding that the co-borrower is insolvent or unable to pay its debts as they come due, rather than the other conditions in the Memorandum which are more typically contained in a bad boy guarantee. On the other hand, the Memorandum could signify an increased focus by the IRS on the appropriate treatment of bad boy guarantees in general. We await further guidance from the IRS on the exact scope of the Memorandum, its precedential value, and its intended effect on the treatment of bad boy guarantees.

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