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IRS Releases CCA 201606027

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On February 5, 2016, the ***Internal Revenue Service (IRS)*** released ***Chief Counsel Advice 201606027*** (the 2016 CCA) in which the IRS concluded, among other things, that guarantees by a partner of a partnership's liabilities that could only be called by the partnership's lenders in certain narrow circumstances (commonly referred to as "nonrecourse carve-outs" or "bad boy" guarantees) caused the guaranteed liabilities to be treated as "recourse liabilities" allocable solely to the guarantor partner under Treasury Regulation § 1.752-2.

Below is a basic description of the rules regarding the allocation of partnership liabilities among partners and a summary of the 2016 CCA.

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Background

In general, a partner's outside tax basis in its partnership interest is increased by the amount of cash and the tax basis of property contributed by such partner to the partnership. For this purpose, any increase in a partner's share of partnership liabilities is treated as a contribution of cash to the partnership by such partner. Thus, a partner's outside tax basis in its partnership interest is increased by the partner's share of partnership liabilities.

The determination of how a partnership liability is allocated among the partners depends on whether the liability is treated as a "nonrecourse liability" or a "recourse liability" under Internal Revenue Code Section 752 and the treasury regulations issued thereunder.

A partnership liability is a nonrecourse liability to the extent that no partner or related person bears economic risk of loss for that liability. *Treas. Reg. § 1.752-1(a)(2)*. A partnership has some flexibility with respect to allocating nonrecourse liabilities among its partners, but nonrecourse liabilities are often allocated in accordance with the partners' relative sharing of partnership profits. *Treas. Reg. § 1.752-3.*

A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss. *Treas. Reg. § 1.752-1(a)(1)*. With respect to a recourse liability, a partner's share of the liability equals the portion of that liability for which the partner (or related person) bears the economic risk of loss. *Treas. Reg. § 1.752-2(a).*

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 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).* The net effect of this constructive liquidation test is to create a hypothetical scenario where the partnership's assets (including cash) become worthless and the partnership is left with liabilities for which at least one of the partners (or a related person) is personally liable. The purpose of the test is to determine which partner would be ultimately responsible to pay the debt in this "doomsday scenario," and the partner ultimately responsible is allocated the liability (and the related increase in outside tax basis) for federal income tax purposes.

In applying the constructive liquidation test, all statutory and contractual obligations relating to the partnership liability are taken into account. For example, a partner will be considered to have economic risk of loss on a partnership liability where the partner provides a personal guaranty to the lender or where the partner personally indemnifies a guarantor (without any right to reimbursement). *Treas. Reg. § 1.752-2(b)(3).* However, the treasury regulations provide that a contractual obligation will be disregarded if the obligation is subject to contingencies that make it unlikely that the obligation will ever be called upon. The treasury regulations state that an obligation will be ignored if the payment obligation would arise only after the occurrence of an event that is not determinable with reasonable certainty. *Treas. Reg §§ 1.752-2(b)(4), (f) Ex. 8*.

CCA 201606027

The basic facts of the 2016 CCA are as follows:

X—a tax partnership—had three partners: A, B and C. X, through various subsidiaries, was engaged in the activity of acquiring and renovating hotel properties. Certain of X's subsidiaries executed senior and subordinated promissory notes, which were secured by property owned by certain of X's subsidiaries. C provided guaranties with respect to these notes, which were only callable by the lenders upon the occurrence of certain specified events (the Nonrecourse Carveout Events), including: (1) if any co-borrower fails to obtain the lender's consent before obtaining subordinate financing or transferring the secured property; (2) if any co-borrower admits in writing that it is insolvent; (3) if any co-borrower declares voluntary bankruptcy; (4) if any co-borrower acquiesces in an involuntary bankruptcy; and (5) if any co-borrower makes an assignment for the benefit of creditors, or admits in writing or in a legal proceeding that it is insolvent.

X's operating agreement provided that, if C determined that X needed additional equity capital, A and B were required to contribute to X their *pro rata* share of such additional equity capital but gave C certain alternative remedies in the event that A or B failed to contribute their ratable share of such capital contributions (*e.g*., diluting the defaulting partner's percentage interest in X and loaning money to the defaulting partner). In addition, X's operating agreement provided that if any member made a "guaranty contribution," the other members were required to contribute their *pro rata* share of the guaranty contribution to X but gave the partner making the guaranty contribution the same alternative remedies in the event that the other partners failed to contribute their ratable share of the guaranty contribution.

A claimed certain losses allocated by X to A, asserting that it had sufficient tax basis in its partnership interest in X because the liabilities guaranteed by C were nonrecourse for Code Section 752 purposes and therefore partially allocated to A. A claimed that C's guaranty of the senior and subordinated notes should be disregarded and the liabilities should be considered contingent liabilities under Treasury Regulation § 1.752-2(b)(4).

The 2016 CCA began its analysis by stating that a bona fide guaranty that is legally enforceable by the lender will be sufficient to cause the partner making the guaranty to be treated as bearing the economic risk of loss with respect to guaranteed liability for purposes of Treasury Regulation § 1.752-2. The 2016 CCA stated that it was reasonable to assume that a third-party lender would take all reasonable steps to enforce its rights under a guaranty if the primary obligor threatened to default on its obligations. The 2016 CCA concluded that the Nonrecourse Carveout Events, after considering all the facts and circumstances, were not so remote a possibility that it was unlikely the guarantee would ever be discharged within the meaning of Treasury Regulation § 1.752-2(b)(4). Further, the 2016 CCA noted that it was reasonable to assume that one or more of the Nonrecourse Carveout Events, more likely than not, would be met upon a constructive liquidation of X under Treasury Regulation § 1.752-2(b)(1). Therefore, the 2016 CCA concluded that the guaranteed promissory notes were recourse liabilities solely allocable to C.

The IRS also concluded that the provision in X's operating agreement requiring A to make additional capital contributions as a result of C's guaranty contribution should be considered a contingent liability because C had the ability to choose alternate remedies (*e.g*., diluting A's percentage interest in X and loaning money to A) that would not have caused A to bear the ultimate economic risk of loss for the guaranteed liability.

Conclusion

The IRS' position in the 2016 CCA was a surprise to many tax practitioners because taxpayers have typically taken the position that similar guarantees do not render the guaranteed liability a "recourse liability" for purpose of allocating the partnership's liabilities. Specifically in the real estate industry, partnerships sometimes rely on nonrecourse liabilities to supply investors with sufficient tax basis to utilize tax losses at the partner level.

It is unclear whether the conclusions reached in the 2016 CCA will have any impact on the way future real estate deals are structured or the way partnerships allocate liabilities containing nonrecourse carve out guarantees.