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IRS Memo on Bad Boy Guarantees May Recharacterize Non-Recourse Debt as Recourse Liability

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On February 5, 2016, the Office of Chief Counsel of the Internal Revenue Service ("IRS") released a memorandum (a "Memo") related to the appropriate tax treatment of individuals or entities that invest in real estate limited partnerships and limited liability companies ("LLCs") with non-recourse financing.[1] In essence, the Memo determined that, for the taxpayer in question, (i) the existence of a traditional non-recourse carve-out guaranty (a "Bad Boy Guaranty"), would cause an otherwise non-recourse financing to be treated as recourse liability for tax purposes and (ii) any portion of such non-recourse financing that is personally guaranteed by an investor (even if only for actions that are in the control of the guarantor and which may or may not occur) would not meet the definition of a "qualified non-recourse financing" under §465(b)(6)(B) of the Internal Revenue Code (the "Code"). Both of these positions run contrary to market understandings about how such debt should be treated for the purposes of determining the tax liability of both the guaranteeing and non-guaranteeing investors in such entities.

The Memo does not represent established law and on its face states that it may not "be used or cited as precedent." However, it does provide insight into a position that the IRS may adopt with regard to tax treatment of similarly situated investors in real estate limited partnerships or LLCs, and therefore introduces a level of uncertainty regarding tax treatment of members and partners in real estate investments.

The Memo

The Memo was issued in response to a request for advice from an investor in a real estate LLC and technically only responds to that particular taxpayer's inquiry, but it may signal a change in the IRS' thinking with regard to the potential impact of Bad Boy Guarantees on non-recourse financing. In an LLC that has opted to be taxed as a partnership (as is the case with most real estate investment entities), a member's tax basis is calculated by taking the sum of that member's contributed capital (or other equity), any liability with respect to which such member bears the risk of economic loss (i.e., recourse liability), and that member's share of non-recourse liabilities, including qualified non-recourse financing. Generally, losses that result from qualified non-recourse liabilities are allocable to members in proportion to their percentage interest in the LLC or their interests in the company's profits, while only those members who bear the risk of economic loss are allocated losses attributable to recourse liabilities.

Prior to the issuance of the Memo, the real estate industry's practice has been to treat financing that includes a Bad Boy Guaranty, but that is only recourse under certain limited circumstances that are preventable by the LLC or its manager (e.g., voluntary bankruptcy or collusive involuntary bankruptcy), as non-recourse financing. This interpretation is seemingly supported by Reg. §1.752-2(b)(4), which provides 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." Mortgage lenders on commercial real estate require Bad Boy Guarantees specifically to make the circumstances that trigger personal liability less likely to occur. Lenders believe that an investor will think twice before engaging in behaviors that are typically prohibited by the guaranty, such as (i) filing a borrower into bankruptcy, (ii) entering into subordinate financing without lender consent or (iii) committing waste on the property,

[1] The IRS Memo is available here.

if the result of such behavior is that the loan becomes recourse to that investor. This thinking also explains why many mortgage lenders require that the operating investor, who can control whether or not the borrower commits bad acts, provide the Bad Boy Guarantee. Despite the above facts and the fact that Bad Boy Guarantees are almost always required by Lenders, but very rarely triggered by guarantors, the IRS came to a different conclusion in the Memo. The IRS found instead that "certain contingencies such as the partnership admitting in writing that it is insolvent or unable to pay its debts when due, its voluntary bankruptcy, or its acquiescence in an involuntary bankruptcy, after taking into account all the facts and circumstances, are not so remote a possibility that it is unlikely the obligation will ever be discharged within the meaning of §1.752-2(b)(4) that would cause the obligation to be disregarded under §1.752-2(b)(3)." Notably, the Memo seems to entirely disregard the second portion of the regulation, which requires that an obligation be ignored if it would arise in the future after an event that is not "determinable with reasonable certainty."

Implications of the Memo

In issuing the Memo, the IRS Chief Counsel took a position that is at odds with longstanding industry practices. Although the Memo is not law, nor precedential authority, it may indicate that the IRS is trending towards this changed approach to allowable losses for real estate investors. The real estate industry is likely to speak out aggressively against such a shift in tax treatment, if the IRS begins to take this position with other similarly situated investors. At this point it is unclear whether the IRS' conclusion in the Memo would hold up in the long term under court review and scrutiny. However, if the IRS' current approach stands, guarantors under Bad Boy Guarantees would gain the benefit of claiming full recourse liability, while other, non-guaranteeing investors would be unable to take advantage of losses related to such financing. Such differential treatment could affect the economic terms bargained for between operating investors, who often contractually agree to guarantee non-recourse carve-out liability on CRE loans, and more passive investors who typically refuse to take on such contractual liability.

In light of the IRS' position, risk-averse investors, particularly those who have significant cash on hand and do not need to rely on debt to finance their investments, may be less likely to borrow in an uncertain environment where tax allocations of losses are unclear. Alternatively, creditworthy borrowers and guarantors may pressure lenders to cap their potential recourse liability under Bad Boy Guarantees, in an effort to limit the amount of a loan that would fail to meet the requirements of "Qualified Non-Recourse Financing." Further, if this new interpretation means the guarantor on Bad Boy Guarantees will be getting a larger share of such losses from a tax perspective, the tilting of such losses away from other investors may trigger a rebalancing of economics between the parties to a joint venture or other investment arrangement to account for such new tax result. Also, in light of a shifting tax interpretation, perhaps investors in borrowers will revisit the benefits (as well as detriments) of stepping up to guarantee non-recourse carve-out liabilities and may be more willing, in appropriate circumstances, to be guarantors. It is unclear how this new tax view will apply with respect to backstop guarantees and reimbursement and indemnity agreements, where investors may agree to cover their allocable share of bad boy liability under certain circumstances, but are not direct guarantors. The Memo determined, in the case of the relevant taxpayer, that the requirements set forth in the LLC's operating agreement for additional capital contributions by non-guaranteeing investors were insufficient to result in direct liability for such investors. At least at the margins, these new considerations may shift how CRE investors structure their arrangements and who will be willing, and under what circumstances, to be a guarantor, which could then affect the borrower-lender relationship on non-recourse CRE mortgage loans. In any event, the savvy lender and borrower should both be aware of the potential issues that are raised in the Memo.

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