

May 9, 2016

## Update: New IRS Memo on Bad Boy Guarantees

This update relates to our [Alert](#) dated March 17, 2016.

**Prior Alert.** The March 17 Alert noted that the IRS in a Chief Counsel Advice ("CCA") had discussed the effect that certain "bad boy carve-out guarantees" (that would trigger contingent guarantee obligations if, for example, the borrower voluntarily entered into bankruptcy proceedings or cooperated with involuntary bankruptcy filings) would have on the characterization of purported non-recourse debt as either recourse or non-recourse for tax purposes. The CCA stated that such bad boy carve-out guarantees could cause debt that purported to be non-recourse to be characterized as recourse for purposes of section 752 of the Code and could also cause the relevant debt not to qualify as qualified non-recourse financing for purposes of the at-risk rules. The CCA in particular stated that the enumerated "bad boy" acts were not "so remote a possibility" as to make it unlikely that the obligation of the contingent guarantor would ever be discharged, and accordingly the debt should be treated as recourse. The position implied by the CCA that the mere existence of certain common non-recourse carve-out guarantees could cause non-recourse debt to be treated as recourse debt was a surprise to many practitioners and inconsistent with much of the practice in the industry. Further, although not noted in the CCA, the reasoning of the CCA could have adversely affected certain structures designed to limit the generation of UBTI to certain tax-exempt institutions investing in real estate. While the CCA did not have the effect of law, the views expressed in the CCA concerned many practitioners.

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**Developments Since Prior Alert.** On April 15, 2016, the Office of Chief Counsel of the IRS released a general legal advice memorandum ("GLAM") expressing its position on the tax treatment of the types of non-recourse carve-out guarantees that were considered in the CCA. As was the case with the CCA, the GLAM may not be cited as legal precedent and does not have the effect of law.

The GLAM, like the CCA, stated that the relevant test is whether the guarantee is subject to contingencies that make it unlikely that the obligation would ever be discharged by the contingent guarantor. Unlike the CCA, however, the GLAM concluded that "because it is not in the economic interest of the borrower or the guarantor to commit the bad acts," it is unlikely that the contingency (the bad act) will occur, provided that no facts or circumstances indicate otherwise. Accordingly, the GLAM concluded that, in the absence of facts or circumstances indicating otherwise, the non-recourse carve-outs were sufficiently unlikely to be triggered that the debt should be treated as non-recourse debt until such time as one of the events giving rise to the carve-out actually occurred. We have communicated with the authors of both the CCA and the GLAM, who indicated that the GLAM represents a reversal of the position expressed in the CCA and that the GLAM reflects the current position of the IRS.

**Points to Note.** Notwithstanding the foregoing, the GLAM is limited in scope. As noted, it is based on specific facts, including the likelihood of the relevant contingencies occurring in the future. Inclusions of certain contingencies may increase the likelihood that a guarantee would be enforced, thereby increasing the risk that the non-recourse debt could be treated as recourse. For instance, if a particular carve-out references environmental liabilities where diligence has shown that a material risk of such liability is present, such carve-out could increase the risk that the non-recourse debt would be treated as recourse. As a result, non-recourse carve-outs should be considered in light of the specifically applicable facts.

Real estate tax practitioners should in general view the reasoning of the GLAM as comforting and in accordance with common practices in the industry. On the other hand, the GLAM also emphasizes that there cannot be a "one size fits

all” approach to non-recourse carve-outs, since on particular facts the carve-outs could produce debt that should be treated as recourse for tax purposes, which for many real estate transactions would be an unintended and undesirable result. Given recent developments in this area investors would be well advised to focus their attention on the relevant facts and the specific terms of carve-outs to non-recourse aspects of real estate loans.

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