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Internal Revenue Service  
Memorandum**

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to: Division Counsel  
(Small Business/Self-Employed)  
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subject: "Nonrecourse Carve-Out" Guarantee of a Partnership Liability

This memorandum addresses the treatment under sections 752 and 465 of the Internal Revenue Code of a guarantee of a partnership nonrecourse liability when the guarantee is conditioned on certain "nonrecourse carve-out" events (sometimes referred to as "bad boy guarantees"). This document may not be used or cited as precedent.

ISSUES

1. If a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the occurrence of certain "nonrecourse carve-out" events described below, does the guarantee cause the obligation to fail to qualify as a nonrecourse liability of the partnership under section 752 and regulations promulgated thereunder?
2. If a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the occurrence of certain "nonrecourse carve-out" events described below, does the guarantee cause the obligation to fail to qualify as qualified nonrecourse financing under section 465(b)(6) and regulations promulgated thereunder?

## CONCLUSIONS

1. If a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the occurrence of certain "nonrecourse carve-out" events described below, the guarantee will not cause the obligation to fail to qualify as a nonrecourse liability of the partnership under section 752 and regulations promulgated thereunder until such time as one of those events actually occurs and causes the guarantor to become personally liable for the partnership debt under local law.
2. If a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the occurrence of certain "nonrecourse carve-out" events described below, the guarantee will not cause the obligation to fail to qualify as qualified nonrecourse financing for purposes of section 465(b)(6) and the regulations promulgated thereunder until such time as one of those events actually occurs and causes the guarantor to become personally liable for the partnership debt under local law.

## LAW AND ANALYSIS

### Section 752 Basis

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

Section 1.752-1(a) provides that a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under § 1.752-2.

Section 1.752-2(a) provides that a partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in § 1.752-2(b) through (k).

Section 1.752-2(b)(1) provides generally that, except as otherwise provided, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person 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. Upon a constructive liquidation, all of the following events are deemed to occur simultaneously --

- (i) All of the partnership's liabilities become payable in full;
- (ii) With the exception of property contributed to secure a partnership liability (see § 1.752-2(h)(2)), all of the partnership's assets, including cash, have a value of zero;
- (iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);
- (iv) items of income, gain, loss, or deduction are allocated among the partners; and
- (v) The partnership liquidates.

Section 1.752-2(b)(3) provides that the determination of the extent to which a partner or related person has an obligation to make a payment under § 1.752-2(b)(1) is based on the facts and circumstances at the time of the determination. All statutory and contractual obligations relating to the partnership liability are taken into account for these purposes, including (i) contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or other partners, or to the partnership; (ii) obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership, and (iii) payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute. To the extent that the obligation of a partner to make a payment with respect to a partnership liability is not recognized under § 1.752-2(b)(3), § 1.752-2(b) is applied as if the obligation does not exist.

Section 1.752-2(b)(4) 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 obligations 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.

Sometimes guarantees of partnership nonrecourse obligations are conditioned upon the occurrence of one or more of the following "nonrecourse carve-out" events:

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

(6) any person in control of the borrower consents to the appointment of a receiver or custodian of assets; or

(7) the 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.

We understand that including some form of one or more of these “nonrecourse carve-out” provisions in loan agreements is a fairly common practice throughout the commercial real estate finance industry and has been for many years. By including these provisions, the lender seeks to protect itself from the risk that the borrower or a guarantor in charge of the borrower will undertake “bad acts” that will diminish or impair the value of the property securing the loan, that might disrupt the cash flow from the property, or that could delay, complicate or prevent the lender’s repossession of the property in the event of a default. An important aspect of these nonrecourse carve-outs is that the bad acts that they seek to prevent are within the control of the borrower or guarantor—the borrower or a guarantor in control of the borrower can prevent them from occurring by, for example, obtaining the lender’s consent before seeking subordinate financing, or not acquiescing in an involuntary petition for bankruptcy. Because it is in the economic self-interest of borrowers and guarantors to avoid committing those bad acts and subjecting themselves to liability, they are very unlikely to voluntarily commit such acts.

One of the common, “nonrecourse carve-out” events, however, deserves further discussion because it could be interpreted to give the lender, at least in some unusual circumstances, the ability to cause the borrower or guarantor to commit one of the bad acts, i.e., to admit in writing or in any legal proceeding that the borrower is insolvent or unable to pay its debts as they come due. For example, upon a default by the borrower, a lender could bring suit for a deficiency and in the course of that litigation, or in a subsequent collection action, seek to force a written admission of insolvency in the course of discovery. Similarly, if the loan agreement required the borrower to provide the lender with periodic written financial reports, and those reports revealed that the borrower was insolvent, the lender might argue that those reports constituted a written admission of insolvency. That was exactly the argument of the lender in D.B. Zwirn Special Opportunities Fund, L.P. v. SCC Acquisitions, Inc., 902 N.Y.S.2d 93 (App.Div. 2010), who tried to enforce the guarantee. The state appellate court disagreed with the lender, stating

Although the affiliates' financial reports show they were experiencing financial difficulty, the statements contained in the reports were not written admissions as contemplated by section 1 (b) (ii) (e) because they did not contain the express statement required by the contract.

....

...If the parties had intended to make defendant liable upon being in financial distress, language stating the same could have easily been included in the

guarantees. Here, the guarantees did not include such language and the parties signed carve-out guarantees, rather than general guarantees.

Id., at 95.

We think that the approach to interpreting the “nonrecourse carve-out” event relating to written admissions of insolvency that the court followed in D.B. Zwirn is appropriate not just for that type of carve-out, but for other typical carve-outs as well. In the commercial real estate finance industry, “nonrecourse carve-out” provisions are not intended to allow the lender to require an involuntary action by the borrower or guarantor, or to place borrowers or guarantors in circumstances that would require them to involuntarily commit a “bad act.” Rather, the fundamental business purpose behind such carve-outs and the intent of the parties to such agreements is to prevent actions by the borrower or guarantor that could make recovery on the debt, or acquisition of the security underlying the debt upon default, more difficult. The “nonrecourse carve-out” provisions should be interpreted consistent with that purpose and intent in mind. Consequently, because it is not in the economic interest of the borrower or the guarantor to commit the bad acts described in the typical “nonrecourse carve-out” provisions, it is unlikely that the contingency (the bad act) will occur and the contingent payment obligation should be disregarded under § 1.752-2(b)(4). Therefore, unless the facts and circumstances indicate otherwise, a typical “nonrecourse carve-out” provision that allows the borrower or the guarantor to avoid committing the enumerated bad act will not cause an otherwise nonrecourse liability to be treated as recourse for purposes of section 752 and § 1.752-2(a) until such time as the contingency actually occurs.

#### Section 465 At Risk

Under section 465(c)(3), the activity of holding real property is subject to the rules of section 465 that limit deductions to the taxpayer’s amount at risk in the activity.

Section 465(b)(2)(A) provides that a taxpayer's amount at risk includes amounts borrowed for use in an activity to the extent that the taxpayer is personally liable for the repayment of the borrowed amounts.

Section 465(b)(4) provides that notwithstanding any other provision of section 465, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

Section 465(b)(6), however, allows a taxpayer to treat qualified nonrecourse financing as an amount at risk even though the taxpayer is not personally liable for the repayment of the financing. Section 465(b)(6)(A) provides that notwithstanding any other provision of section 465(b), for an activity of holding real property, a taxpayer is considered at risk for the taxpayer's share of any "qualified nonrecourse financing" that is secured by real property used in the activity of holding real property.

Section 465(b)(6)(B) defines qualified nonrecourse financing to mean any financing (i) that is borrowed by the taxpayer for the activity of holding real property, (ii) that is borrowed by the taxpayer from a qualified person or represents a loan from any federal, state, or local government or instrumentality thereof, or is guaranteed by any federal, state, or local government, (iii) except to the extent provided in regulations, for which no person is personally liable for repayment, and (iv) that is not convertible debt.

Section 1.465-27(b)(4) states that the personal liability of any partnership for repayment of a financing is disregarded and the financing is treated as qualified nonrecourse financing secured by real property if (i) the only persons personally liable to repay the financing are partnerships; (ii) each partnership with personal liability holds only property described in § 1.465-27(b)(2)(i); and (iii) in exercising its remedies to collect on the financing in a default or default-like situation, the lender may proceed only against property that is described in § 1.465-27(b)(2)(i) and that is held by the partnership or partnerships. Section 1.465-27(b)(5) states that principles similar to those found in § 1.465-27(b)(4) apply in determining whether a financing of an entity disregarded for federal tax purposes is treated as qualified nonrecourse financing secured by real property.

Therefore, for the same reasons discussed above with respect to liability under section 752, we conclude that if a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the "nonrecourse carve-out" events enumerated above, the guarantee does not cause the guarantor to be treated as personally liable for the repayment of the partnership's liability, because the likelihood of any of the "nonrecourse carve-out" events occurring is such that the guarantor is effectively protected against loss until such time as one or more of the events actually occurs. Accordingly, we conclude that such guarantee will not cause the nonrecourse financing to fail to qualify as qualified nonrecourse financing under section 465(b)(6) and the regulations thereunder if such financing otherwise meets those requirements.

Please call William Kostak at (202) 317-6852 if you have any further questions.

By: \_\_\_\_\_  
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