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Memorandum**

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subject: Guarantee of Qualified Non-Recourse Financing

This memorandum responds to your request for assistance dated August 13, 2015.  
This advice may not be used or cited as precedent.

LEGEND

X =

Y =

Z =

A =

B =

C =

Country =

n1 =

n2 =

n3 =

n4 =

n5 =

n6 =

n7 =

n8 =  
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Date =  
Year1 =  
Year2 =  
Year3 =

### ISSUES

1. If one partner guarantees a partnership's obligation to satisfy a promissory note in the event of, among other events, the partnership admitting in writing that it is insolvent or unable to pay its debts when due, or its voluntary bankruptcy or acquiescence in an involuntary bankruptcy, does this guarantee preclude the promissory note from qualifying as a nonrecourse obligation of the partnership under § 752 of the Internal Revenue Code ("Code") and regulations promulgated thereunder?
2. If the partnership's sole business activity involves acquiring existing hotels, renovating them, installing personal property appropriate to improve the properties' utility as hotels, and holding and maintaining the premises, but does not include the hotels' day-to-day operations, does this business activity qualify as an "activity of holding real property" within the meaning of § 465(b)(6)(A)?
3. If a partner guarantees partnership debt that otherwise had met the requirements of qualified nonrecourse financing within the meaning of § 465(b)(6), are the other non-guarantor partners entitled to treat the obligation as qualified nonrecourse financing within the meaning of § 465(b)(6) and regulations promulgated thereunder or otherwise at risk with respect to the guaranteed obligation?
4. If the partnership operating agreement provides that, in the event that the guaranteeing partner makes a payment under a guarantee, the guaranteeing partner has the right to call for the non-guaranteeing partners to make capital contributions and, if they fail to do so, treat ratable portions of the payment as loans to those partners, adjust their fractional interests in the partnership, or enter into a subsequent allocation agreement under which the risk of the guarantee would be shared among the partners, is this provision sufficient to make the non-guaranteeing partners personally liable with respect to the guaranteed obligation for the purposes of §§ 752 and 465?

### CONCLUSIONS

1. If a partner guarantees an obligation of the partnership and the guarantee is sufficient to cause the guaranteeing partner to bear the economic risk of loss for that obligation within the meaning of § 1.752-2(b)(1) of the Income Tax Regulations, the guaranteed debt is properly treated as recourse financing for purposes of applying the basis allocation rules of § 752. For this purpose, 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 § 1.752-2(b)(4) that would cause the obligation to be disregarded under § 1.752-2(b)(3).
2. Where the partnership's sole business activity includes acquiring existing hotels, renovating them, installing personal property appropriate to improve the properties' utility as hotels, and holding and maintaining the premises, but does not include the hotels' day-to-day operations, the partnership is engaged in an "activity of holding real property" within the meaning of § 465(b)(6)(A).
3. When an individual partner guarantees a partnership obligation, the amount of the guaranteed debt no longer meets the definition of "qualified nonrecourse financing" under § 465(b)(6)(B), and the amount of the guaranteed debt will no longer be includible in the at-risk amount of the other non-guaranteeing partners, if the guarantee is bona fide and enforceable by creditors of the partnership under local law.
4. To the extent the guaranteeing partner has the right under the partnership operating agreement to call for the non-guaranteeing partners to make capital contributions and, if they fail to do so, treat ratable portions of the payment as loans to those partners, adjust their fractional interests in the partnership, or enter into a subsequent allocation agreement under which the risk of the guarantee would be shared among the partners, this right generally will not be sufficient to make the non-guaranteeing partners personally liable with respect to the guaranteed obligation for the purposes of §§ 752 and 465.

### FACTS

X is a limited liability company electing to be taxed as a partnership. Its members are A, an individual who owns n1% of the profits and equity interest in X; B, an individual who owns n2% of X; and C, an individual who owns the remaining n3% of X. A, B and C each owns more than 10% of the profits and equity of X. X directly or indirectly owns a number of corporate subsidiaries (hereinafter "the subsidiaries").

Section 7.5 of the Amended and Restated Operating Agreement of X ("Operating Agreement") contains a number of provisions with respect to additional capital contributions to X.

Section 7.5(a) of the Operating Agreement states that, except as otherwise provided for therein or mutually agreed upon by the Members, no Member shall be obligated to make capital contributions to X.

Section 7.5(b) of the Operating Agreement states that in the event additional capital is needed for X's business, C, or an affiliate (the "Lender") may elect to loan funds to X for its business purposes ("C loans"). Such C loans shall be made on commercially reasonable terms and conditions, and the Members agree that such loans shall bear interest at a rate equal to n4% per annum, compounded annually. Such loans shall be an obligation of X and, at the option of the Lender, may be repaid prior to any distributions to the Members. C or its affiliates shall have no obligation to make C loans to X. If C elects to make C loans to X, A and B shall be given the opportunity to make similar loans in accordance with their respective ownership percentage interests in X. If C makes any C loans to X, C may at any time convert such C loans into additional capital.

Section 7.5(c) of the Operating Agreement states that in the event that C determines in his sole discretion that additional capital is needed for X's operations in addition to the initial capital contributions (as set forth in Section 7.2 of the Operating Agreement) and C loans under section 7.5(b) above, if any, C may elect to make additional capital contributions to X. If C elects to contribute additional capital, A and B shall be given the opportunity to make similar additional capital contributions in accordance with their respective ownership percentages in X. C's additional capital shall not exceed an amount which would cause C's adjusted contribution amount at any point to exceed \$n5.

Section 7.5(d) of the Operating Agreement states that in the event C's adjusted contribution amount exceeds \$n5 and C determines in his sole discretion that additional capital is needed for X's business in addition to the initial capital contributions, any C loans under section 7.5(b), and C's additional capital contributions under section 7.5(c) (but excluding guarantee contributions, which are subject to section 7.5(e)), the Members shall contribute their ownership percentage interest of the required capital to X within 20 days of receiving notice from C of the amount of required additional capital (the "Demand Notice"). If a Member fails to contribute an amount required pursuant to this section 7.5(d) (a "Defaulting Member") within 20 days of receipt of a Demand Notice from C, then C may elect one or more of the following remedies:

- (i) C may elect to loan to X the amount that a Defaulting Member failed to contribute which loan shall be treated as a loan to the Defaulting Member and which shall bear interest at the rate of n6% per annum compounded annually from the date of the advance until the date the loans are paid in full, and shall be payable out of any distributions to the Defaulting Member (which payments will be applied first to accrued interest on the loans and then to the outstanding principal balance of such loans). If C elects to make such a loan, the other non-defaulting members shall be given a

- similar opportunity to make similar loans in accordance with their respective ownership percentage interests in X; or
- (ii) C may elect to adjust the ownership percentage interest of each Defaulting Member by n7% for each \$n8 a Defaulting Member failed to contribute, and the ownership percentage interest of the Members who contributed their proportionate share in response to the Demand Notice (the "Contributing Members") shall increase n7% by each \$n8 the Defaulting Member failed to contribute, which increase in the ownership percentage interest of the Contributing Members shall be allocated among the Contributing Members based on the existing ownership percentage interests held by the Contributing Members. However, a Defaulting Member shall have the right to negate an adjustment of ownership percentage interests under this section 7.5(d)(ii) pursuant to the provisions of section 7.5(g).

Section 7.5(e) states that in the event any Member makes a Guaranty Contribution, the other Members shall contribute their ownership percentage interest of the Guaranty Contribution to X (and X shall return a portion of the Guaranty Contribution to the Member making such Guaranty Contribution) within 20 days of receiving written notice from the Member making the Guaranty Contribution of the amount of the Guaranty Contribution and the amount due from such Members (the "Guaranty Contribution Demand Notice"). If a Member fails to contribute the amount required pursuant to this section 7.5(e) (a "Guaranty Contribution Defaulting Member") within 20 days of receipt of the Guaranty Contribution Demand Notice, then the Member making the Guaranty Contribution may elect one of the following remedies:

- (i) The Member making the Guaranty Contribution may elect to loan to X the amount of the Guaranty Contribution Defaulting Member failed to contribute, which loan shall be treated as a loan to the Guaranty Contribution Defaulting Member and which shall bear interest at the rate of n9% per annum, compounded annually from the date of the Guaranty Contribution until the date the loan is repaid in full, and shall be payable out of any distributions to the Guaranty Contribution Defaulting Member (which payments shall be applied first to accrued interest on the loans, and then to the outstanding principal balance of the loans). If the Member making the Guaranty Contribution elects to make such a loan, the other non-defaulting Members shall be given a similar opportunity to make similar loans in accordance with their ownership percentage interest; or
- (ii) The Member making the Guaranty Contribution may elect to adjust the ownership percentage interest of the Guaranty Contribution Defaulting Member by n7% by each \$n10 a Guaranty Contribution Defaulting Member failed to contribute, and the ownership percentage interests of the Members who contributed their proportionate share in response to a Guaranty Contribution Demand Notice (the "Guaranty Contribution Contributing Members") shall increase n7% by each \$n10 the Guaranty

Contribution Defaulting Member failed to contribute, which increase in the ownership percentage interest of the Guaranty Contribution Contributing Members shall be allocated among the Guaranty Contribution Contributing Members. However, a Guaranty Contributing Defaulting Member shall have the right to negate an adjustment of ownership percentage interests under this section 7.5(e)(ii) pursuant to the provisions of section 7.5(g).

Section 7.5(f) of the Operating Agreement states that at any time when A or B has an adjusted contribution amount in relation to the combined amount of all Members' adjusted contribution amounts which is less than the ownership percentage interest of A or B, either A or B may make voluntary capital contributions to X, which capital contributions will be used to repay the capital contributions of the Members who have adjusted capital amounts in relation to the combined amount of all Members' adjusted contribution amounts which are greater than such Member's ownership percentage interest. Similarly, at any time C has made a C loan under section 7.5(b) or a default loan under section 7.5(d)(i), the creditor under such loan may repay such loan (with interest) at any time and thus discontinue the interest accrual thereunder. Finally, if the Members receive commissions or other fees generated in connection with the facilitation of a transaction in which X has an interest, and if C has an adjusted contribution amount which is greater than n11% of the combined amount of all Members' adjusted contribution amounts, C can require all Members to contribute the net after-tax proceeds from such commissions and fees to the capital of X (with such net after-tax amount calculated based on all foreign, national, state and local taxes associated with such commissions and fees).

Section 7.5(g) of the Operating Agreement states that a Member may negate the dilution of its ownership percentage interest under section 7.5(d)(ii) or section 7.5(e)(ii) if, within 12 months of the date of the Demand Notice or the Guaranty Contribution Demand Notice, as applicable, the defaulting Member or Guaranty Contribution Defaulting Member contributed to X the amount which would be due under section 7.5(d)(ii) or section 7.5(e)(ii) if the failure of such Member to make a contribution was treated as a loan under such sections. Under such circumstances, the dilution shall be negated, the prior contributions shall be treated as loans in accordance with section 7.5(d)(i) or section 7.5(d)(ii) [sic], as applicable, and such loans shall be repaid from the amounts contributed by the Defaulting Member or Guaranty Contribution Defaulting Member.

Section 7.7 of the Operating Agreement states that in the event any Member shall fail to contribute any cash or property when due hereunder, such Member shall remain liable therefor to X, which may institute proceedings in any court of competent jurisdiction in connection with which such Member shall pay the costs of such collection, including reasonable attorneys' fees. Any compromise or settlement with a Member failing to contribute cash or property due hereunder may be approved by the Manager.

Section 7.9 of the Operating Agreement states that in the event X's financing or other X undertakings whereby any Member of X elects or is required to become

personally obligated (including execution of guarantees of indebtedness, non-recourse carve-out guarantees, environmental indemnities, etc.), the Members agree to enter into a contribution agreement pursuant to which all Members agree to allocate the risks of such personal obligations in accordance with their ownership percentage interests in X.<sup>1</sup>

A senior promissory note was executed in Year1 by some (but not all) of the subsidiaries of X as co-borrowers (“the senior promissory note”). The purpose of the funds borrowed under the senior promissory note (and the “mezzanine financing” discussed below) included acquiring and renovating real property used in the activity of Z and financing its operation. The senior promissory note is secured by a security trust agreement under the laws of Country; the security covers property constituting the activity of Z. The activity of Z includes the acquisition and renovation of two hotel properties in Country; the installation of furniture, fixtures, and equipment appropriate to improve the properties’ use as hotels; and holding the hotel properties. Another entity (also owned by A, B, and C) is responsible for managing the hotel properties; it hired a hotel management company to conduct the day-to-day operation of the hotels comprising Z. Starting in Year1 and continuing through Year3, X owned the hotel properties used in the activity of Z.

The senior promissory note provides that Y will provide \$n12 as of the date of closing, and will provide up to \$n13 between the date the loan transaction closes and the date that the obligations under the senior promissory note mature.

C executed three personal guarantees of the senior promissory note, each subject to different terms. The first guarantee, entitled “Guaranty of Recourse Obligations,” executed on Date, provides that C “hereby unconditionally, absolutely and irrevocably, as a primary obligor and not merely as a surety, guarantees to Lenders the punctual and complete payment of the entire amount of the Guaranteed Obligations upon demand by [Y, as agent for the Lenders]” (the “First Guarantee”). Section 1(b) of the First Guarantee provides that the term “Guaranteed Obligations” means, among other things, the entire outstanding principal amount of the Loan, together with all interest thereon and all other amounts due and payable under the Loan Documents in the event that:

(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,

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<sup>1</sup> The taxpayer has not provided the examining agent with a separate contribution agreement and, for purposes of this analysis, we are assuming that no separate contribution agreement has been entered into pursuant to section 7.9 of X’s Operating Agreement.

(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.

The second guarantee, entitled “Required Amortization Guaranty,” provides that C, “as a primary obligor and not merely as a surety,” guarantees the punctual and complete payment of all required amortization payments under the promissory note, but in an amount not to exceed \$n14. The required amortization payments represent amounts required to be paid as necessary to maintain minimum yields on the underlying obligation.

The third guarantee, a completion guarantee, provides that C will guarantee part of the \$n13 “as a primary obligor and not merely as a surety.” In addition, the third guarantee provides that C will personally guarantee repayment of any amounts expended to complete the renovation of Z. C’s liability under the third guarantee will not be subject to, or limited by, any non-recourse provisions contained in the promissory note.

Also in Year1, some (but not all) of the subsidiaries of X executed two other promissory notes (“the Z mezzanine notes”) in addition to the senior promissory note described above. The co-borrowers on the Z mezzanine notes are the same co-borrowers on the senior promissory note. The Z mezzanine notes are secured by security trust agreements under the laws of Country; the security covers property constituting the activity of Z. The Z mezzanine notes provide that Y will provide \$n15 and \$n16 for the first and second Z mezzanine notes, respectively. Both of the Z mezzanine notes are subject to guarantees (“Guaranty of Recourse Obligations” and “Required Amortization Guaranty”) substantially similar to the first and second guarantees of the senior promissory note described above.

In Year2, the parties to the senior promissory note and the Z mezzanine notes amended the terms of the notes, deleting and releasing some co-borrowers from the notes. The loan modification agreements explicitly recites that all of the guarantees in effect with respect to the notes remain in effect. As of the end of Year3, none of the members of X have been called upon to make an additional capital contribution or a Guaranty Contribution to X in accordance with X’s Operating Agreement, although C made a loan to X that remains outstanding.



In Year3, A claimed a pass-through loss for the current year as well as a pass-through net operating loss (NOL) deduction from X. A claims that he is entitled to the net operating loss deduction without limitation, because the business activity that generated the loss was funded with “Qualified Non-Recourse Financing” within the meaning of § 465(b)(6), and that C’s First Guarantee for this debt should be disregarded for this purpose under § 1.752-2(b)(4) and § 1.465-27(b)(4)(i) because the First Guarantee is a “contingent” liability. There are no other amounts for which A could be considered at-risk with respect to the business activity of X within the meaning of § 465(b). Your request for advice asks whether A’s deduction is allowable in Year3 in light of the basis limitations of § 704(d) and the at-risk limitations of § 465.

## LAW AND ANALYSIS

### Section 752 Basis

Section 704(d) provides that a partner’s distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner’s interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time.

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 1.752-2(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) All 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.

As a threshold matter, a bona fide guarantee that is enforceable by the lender under local law generally will be sufficient to cause the guaranteeing partner to be treated as bearing the economic risk of loss for the guaranteed partnership liability for purposes of § 1.752-2(a). For purposes of § 1.752-2, we believe it is reasonable to assume that a third-party lender will take all permissible affirmative steps to enforce its rights under a guarantee if the primary obligor defaults or threatens to default on its obligations. In this case, we view the "conditions" listed in section 1(b) of the First Guarantee as circumstances under which the lender may enforce the guarantee to collect the entire outstanding balance on the loan, beyond an actual default by X on its obligations. As such, we do not believe these "conditions" are properly viewed as

conditions precedent that must occur before Y is entitled to seek repayment from C under the guarantee.<sup>2</sup> In addition, we believe it is reasonable to assume that one or more of these conditions, more likely than not, would be met upon a constructive liquidation of X under § 1.752-2(b)(1). Accordingly, we believe that these “conditions” do not fall within the definition of “contingencies” as intended by § 1.752-2(b)(4).

For these reasons, we conclude that, for the purposes of §§ 704(d) and 752, and § 1.752-2(a), the promissory notes described above are recourse partnership liabilities allocable to the guaranteeing partner (C), and not to either A or B.

### Section 465 At-Risk Amount

Section 465(a)(1) (by reference to § 465(c)(3)(A)) allows losses incurred by an individual engaged in a trade or business activity or an activity for the production of income only to the extent of the amount by which the individual is at risk (within the meaning of § 465(b)) for such activity at the close of the taxable year.

Section 465(b)(1) includes in a taxpayer’s amount at risk for an activity (A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and (B) amounts borrowed with respect to such activity (as determined under § 465(b)(2)).

Section 465(b)(2) includes amounts borrowed for use in an activity in a taxpayer’s at-risk amount to the extent that he (A) is personally liable for the repayment of such amounts, or (B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer’s interest in such property). No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in § 465(b)(1).

Section 465(b)(4) provides that, notwithstanding any other provision of § 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)(A) includes in a taxpayer’s amount at risk the taxpayer’s share of any qualified nonrecourse financing which is secured by real property used in such

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<sup>2</sup> According to the submission, it appears the taxpayer may assert that the various events listed in section 1(b) of the First Guarantee, upon the occurrence of which the First Guarantee will become immediately due and payable for the entire outstanding balance of the loan, are the only events under which the First Guarantee will become due and payable. It appears to us that a failure of X to repay the loan, by itself, likely would be sufficient to trigger the First Guarantee, as evidenced by the first sentence of section 1 of the First Guarantee. Assuming, arguendo, that the taxpayer’s assertion is correct, we nevertheless believe that the likelihood that X or any other co-borrower will ever meet any one of these conditions, in the aggregate, is not so remote a possibility that would cause the obligation to be considered “likely to never be discharged” within the meaning of § 1.752-2(b)(4).

activity. Section 465(b)(6)(B) defines qualified nonrecourse financing as any financing (i) which is borrowed by the taxpayer with respect to the activity of holding real property, (ii) which 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, with respect to which no person is personally liable for repayment, and (iv) which is not convertible debt.

Section 465(b)(6)(C) requires, in the case of a partnership, a partner to determine its share of partnership qualified nonrecourse financing on the basis of that partner's share of partnership liabilities incurred in connection with such financing (within the meaning of § 752).

Section 465(e)(1) requires taxpayers to include in gross income the amount by which zero exceeds a taxpayer's amount at risk in any activity at the close of any taxable year. An amount equal to the amount so included in gross income shall be treated as a deduction allocable to such activity for the first succeeding taxable year.

Section 1.465-27(b)(1) defines qualified nonrecourse financing, for purposes of § 465(b)(6), as financing (i) which is borrowed by the taxpayer with respect to the activity of holding real property; (ii) which 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) for which no person is personally liable for repayment, taking into account § 1.465-27(b)(3), (4), and (5); and (iv) which is not convertible debt.

Section 1.465-27(b)(2)(i) provides that, for a taxpayer to be considered at risk under § 465(b)(6), qualified nonrecourse financing must be secured only by real property used in the activity of holding real property. For this purpose, however, property that is incidental to the activity of holding real property will be disregarded. In addition, for this purpose, property that is neither real property used in the activity of holding real property nor incidental property will be disregarded if the aggregate gross fair market value of such property is less than 10 percent of the aggregate gross fair market value of all the property securing the financing.

Section 1.465-27(b)(3) provides that if one or more persons are personally liable for repayment of a portion of a financing, the portion of the financing for which no person is personally liable may qualify as qualified nonrecourse financing.

Section 1.465-27(b)(4) provides that for purposes of § 465(b)(6), the personal liability of any partnership for repayment of a financing is disregarded and, provided the requirements contained in § 1.465-27(b)(1)(i), (ii), and (iv) are satisfied, the financing will be 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) (applying the

principles of § 1.465-27(b)(2)(ii) in determining the property held by each partnership); 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) that is held by the partnership or partnerships (applying the principles of § 1.465-27(b)(2)(ii) in determining the property held by the partnership or partnerships).

Generally, a limited partner, in a limited partnership organized under state law, who guarantees partnership debt is not at risk with respect to the guaranteed debt, because the limited partner has a right to seek reimbursement from the partnership and the general partner for any amounts that the limited partner is called upon to pay under the guarantee. The limited partner is “protected against loss” within the meaning of § 465(b)(4) unless or until the limited partner has no remaining rights against the partnership or general partner for reimbursement of any amounts paid by the limited partner. To the extent that a general partner does not have a right of contribution or reimbursement under local law against any other partner for the debts of the partnership, the general partner is at risk for such debts under § 465(b)(2). The general partner’s right to subrogation, reimbursement, or indemnification from the partnership’s assets (and only the partnership’s assets) does not protect the general partner against loss within the meaning of § 465(b)(4).

In the case of an LLC, all members have limited liability with respect to LLC debt. In the absence of any co-guarantors or other similar arrangement, an LLC member who guarantees LLC debt becomes personally liable for the guaranteed debt and more closely resembles a general partner with respect to the guaranteed debt. If called upon to pay under the guarantee, the guaranteeing member may seek recourse only against the LLC’s assets, if any. As in the case of a general partner, a right to subrogation, reimbursement, or indemnification from the LLC (and only the LLC) does not protect the guaranteeing LLC member against loss within the meaning of § 465(b)(4). Therefore, in the case of an LLC treated as a partnership or disregarded entity for federal tax purposes, we conclude that an LLC member is at risk with respect to LLC debt guaranteed by such member, but only to the extent that

- (1) the guaranteeing member has no right of contribution or reimbursement from other guarantors,
- (2) the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and
- (3) the guarantee is bona fide and enforceable by creditors of the LLC under local law.

As a general rule, LLC members may not include liabilities of the LLC in their at-risk amounts unless the members are personally liable for the debt as provided by

§ 465(b)(2)(A). Further, under § 465(b)(4), taxpayers are not at risk with respect to amounts protected against loss through nonrecourse financing. Section 465(b)(6)(A) creates an exception to these rules when a liability meets the definition of qualified nonrecourse financing. Under § 465(b)(6)(B)(iii), a liability is qualified nonrecourse financing only if no person is personally liable for repayment. When a member of an LLC treated as a partnership for federal tax purposes guarantees LLC qualified nonrecourse financing, the member becomes personally liable for that debt because the lender may seek to recover the amount of the debt from the personal assets of the guarantor. Because the guarantor is personally liable for the debt, the debt is no longer qualified nonrecourse financing as defined in § 465(b)(6)(B) and § 1.465-27(b)(1). Further, because the creditor may proceed against the property of the LLC securing the debt, or against any other property of the guarantor member, the debt also fails to satisfy the requirement in § 1.465-27(b)(2)(i) that qualified nonrecourse financing must be secured only by real property used in the activity of holding real property.

It should be noted that this conclusion generally will not be affected by a determination that the guarantee is a “contingent” liability within the meaning of § 1.752-2(b)(4). Instead, the question is simply whether the guarantee is sufficient to cause the guarantor to be considered personally liable for repayment of the debt, based on all the facts and circumstances, within the meaning of § 465(b)(6)(B)(iii). In this case, we believe the First Guarantee is sufficient for this purpose.

When the debt is no longer qualified nonrecourse financing due to a guarantee of that debt, the non-guaranteeing members of the LLC who previously included a portion of the qualified nonrecourse financing in their amount at risk and who have not guaranteed any portion of the debt may no longer include any amount of the debt in determining their amount at risk. Any reduction that causes an LLC member’s at-risk amount to fall below zero will trigger recapture of losses under § 465(e). The at-risk amount of the LLC member that guarantees LLC debt is increased, but only to the extent such debt was not previously taken into account by that member, the guaranteeing member has no right of contribution or reimbursement from other guarantors, the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and the guarantee is bona fide and enforceable by creditors of the LLC under local law.

In this case, we conclude that, for the purposes of § 465(b)(6)(B)(iii) and § 1.465-27(b)(1)(iii), the First Guarantee described above is sufficient to cause the guaranteeing partner, C, to be considered personally liable for the guaranteed debt obligations of X. Accordingly, the guaranteed debt obligations of X will no longer qualify as “Qualified Non-Recourse Financing” within the meaning of § 465(b)(6)(B) and § 1.465-27. A and B, as non-guaranteeing members of X, will not be considered at-risk with respect to any such amounts as a consequence of the First Guarantee.

Guarantor’s Remedies Under Section 7.5(e) of the Operating Agreement

The taxpayer has presented an alternative argument that, even if the First Guarantee is respected as a full and bona fide guarantee that will cause C to be treated as personally liable for the guaranteed debt of X for purposes of § 1.752-2(a) and § 465(b)(6)(B)(iii), section 7.5(e) of X's Operating Agreement nevertheless operates to cause A and B to be treated as personally liable (i.e., to bear the ultimate economic risk of loss for purposes of § 752, and to be payors of last resort in a worst case scenario for purposes of § 465) with respect to their proportionate share of the guaranteed debt, because A and B are obligated under that provision to reimburse C in proportionate amounts for any payments that C makes under the guarantees. For the reasons discussed below, we disagree with this contention.

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.

Section 1.752-2(b)(5) provides that a partner's or related person's obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to a partner.

Section 1.752-2(b)(6) provides that for purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.

Section 1.752-2(j)(1) provides that an obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of § 1.752-2 if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment obligation may be disregarded include, but are not limited to, the situations described in §§ 1.752-2(j)(2) and (j)(3).

Section 1.752-2(j)(3) provides that an obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

Section 465(b)(3)(A) provides that, except as otherwise provided in regulations, for purposes of § 465(b)(1), amounts borrowed shall not be considered at risk with respect to an activity if such amounts are borrowed from any person who has an

interest in such an activity or from a related person to a person (other than the taxpayer) having such an interest.

Section 465(b)(4) provides that, notwithstanding any other provision of § 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.

With respect to § 465, no temporary or final regulations exist that provide rules for determining when taxpayers will be considered personally liable with respect to partnership debt subject to guarantees, including guarantees that may contain certain reimbursement rights. Nevertheless, the following case law provides helpful guidance in applying § 465.

In Pritchett v. Comm’r, 85 T.C. 581 (1985), rev’d and remanded, 827 F.2d 644 (9<sup>th</sup> Cir. 1987), the taxpayers were limited partners in an oil and gas drilling operation, and they claimed deductions for losses in excess of their cash contributions to the partnership. The taxpayers argued that under the partnership agreement, they were “at risk” for partnership liabilities held by a drilling company that was responsible for developing the oil and gas fields. Under the contract the creditor would receive a portion of profits from the drilling operation. While general partners were the only parties personally liable, under the partnership agreement the general partners were given the right to call on the limited partners to make a capital contribution if the notes issued by the partnership remained unpaid upon their maturity date. The Service argued that the liability was contingent and that the taxpayers were only at risk once general partners called upon them to make a contribution. The Tax Court agreed with this analysis. Upon appeal, the Ninth Circuit held that the contractual obligations of the limited partners under the partnership agreement made them ultimately responsible for the debt. While the Commissioner argued that the liability was contingent simply because the general partners could elect to not make the cash calls, the Ninth Circuit did not agree. The Ninth Circuit determined that the cash calls were mandatory under the partnership agreements and that “economic reality” dictated that the general partners would make the calls.

In Melvin v. Comm’r, 88 T.C. 63 (1987), aff’d, 894 F.2d 1072 (9<sup>th</sup> Cir. 1990), the general partnership in which the taxpayer was a partner invested in a limited partnership. In payment for its limited partnership interest, the general partnership paid \$35,000 cash and agreed to make additional capital contributions of \$70,000. The obligation to make the additional capital contributions was evidenced by a \$70,000 recourse promissory note. The taxpayer’s share of the note was \$50,000. The limited partnership obtained a \$3,500,000 recourse loan from a bank and pledged partnership assets to the bank, including the \$70,000 note along with other limited partner notes, as security. These notes were subsequently physically transferred to the bank. The court concluded that the taxpayer was at risk on the \$3,500,000 loan to the extent of his pro rata share thereof. In reaching its conclusion the court reasoned that “a partner will be regarded as personally liable within the meaning of § 465(b)(2)(A) if he has the ultimate



liability to repay the debt obligation of the partnership in the event funds from the partnership's assets are not available for that purpose. The relevant question is who, if anyone, will ultimately be obligated to pay the partnership's recourse obligations if the partnership is unable to do so. It is not relevant that the partnership MAY be able to do so. The scenario that controls is the worst-case scenario, not the best case." Melvin, 88 T.C. at 75 (citations omitted).

We believe that Pritchett and Melvin stand for the proposition that the relevant inquiries when dealing with guarantees of partnership debt, for purposes of § 465, are whether the guarantee causes the guaranteeing partner to become the "payor of last resort in a worst case scenario" for the partnership debt, given the "economic realities" of the particular situation, and whether the guarantor possesses any "mandatory" rights to contribution, reimbursement, or subordination with respect to any other parties, as a result or consequence of paying on the guarantee, that would cause these other parties to be considered the "payors of last resort in a worst case scenario" with respect to that debt.

We do not agree with the taxpayer's interpretation of X's Operating Agreement. We do not believe section 7.5(e) of the Operating Agreement imposes a mandatory payment obligation on A and B to make additional contributions to X if C is called upon to pay on C's personal guarantees. Rather, section 7.5(e) permits C to call for additional capital from A and B, but if A and/or B chooses not to contribute additional capital, C's remedies are limited to the remedies identified in paragraphs (i) and (ii) of that section. As a result, we do not believe the Operating Agreement gives C the right to bring an action against A and B to require them to contribute additional capital to X if they choose not to. Further, because we believe C's remedies are limited to paragraphs (i) and (ii) of section 7.5(e) if C calls for additional capital contributions from A and B if C is required to pay on C's personal guarantee, we believe section 7.7 of the Operating Agreement is not applicable. In addition, because a separate contribution agreement was not entered into by the parties, section 7.9 is also inapplicable. Accordingly, because neither remedy available to C under section 7.5(e) requires A or B to make additional contributions to X if C is called upon to pay on C's personal guarantees, we conclude that A and B do not bear the ultimate economic risk of loss for the guaranteed debt of X for purposes of § 752.

Moreover, for purposes of § 465, we believe the facts of this case are distinguishable from those in Pritchett. Since X's Operating Agreement does not require A and B to make additional capital contributions to X, it does not appear that "economic reality" would dictate that X or C *must* require A and B to make additional contributions to X if C is required to pay on C's personal guarantees. Accordingly, we conclude that A and B are not "payors of last resort in a worst case scenario," as discussed in Pritchett and Melvin, and A and B are not currently at risk with respect to the guaranteed debt of X for purposes of § 465.

It appears that the taxpayer interprets X's Operating Agreement as giving C an enforceable right to require A and B to make additional contributions to X, in addition to the specific remedies provided in paragraphs (i) and (ii) of section 7.5(e) of the Operating Agreement. As noted above, we do not agree with this interpretation of the Operating Agreement. Nevertheless, even if the taxpayer's interpretation of the Operating Agreement is ultimately determined to be correct, we still conclude that the taxpayer is not allocated basis under § 752 and is not at risk under § 465 with respect to the guaranteed debt.

We reach this conclusion because we view the requirement for A and B to make additional capital contributions to X as a contingent liability within the meaning of § 1.752-2(b)(4). Because C may choose alternate remedies that would not cause A or B to be viewed as bearing the ultimate economic risk of loss for the guaranteed debt of X, we believe these alternate remedies are properly viewed as contingencies that make it unlikely that any payment obligations of A or B would ever be discharged. In addition, we believe these remedies may also be viewed as future events that cause the payment obligations of A and B to be "not determinable with reasonable certainty" and cause the obligations to be ignored until A and B are actually required to make payments to X, for purposes of § 1.752-2(b)(4).<sup>3</sup>

In addition, for purposes of § 465, even if we view C as having an enforceable right to require A and B to make additional contributions to X in addition to the other remedies available in section 7.5(e) of X's Operating Agreement, we believe that the facts of this case would continue to be distinguishable from those in Pritchett. In this case, C has been provided with alternate remedies under section 7.5(e) of X's Operating Agreement if A and B choose not to make additional contributions to X under this provision. As a result, it appears that the requirement for A and B to make additional contributions under this provision is not a "mandatory" requirement, since C may elect to use these alternate remedies rather than have X enforce the Operating Agreement under the default provision of section 7.7. Therefore, it does not appear that "economic reality" would dictate that X or C *must* enforce the Operating Agreement under section 7.7 in a court proceeding against A and B in such circumstances. Accordingly, we conclude that A and B are not "payors of last resort in a worst case scenario", as discussed in Pritchett and Melvin, and therefore A and B are not currently at risk with respect to the guaranteed debt of X for purposes of § 465.

We would further note that, to the extent that C may elect to use the remedy described in section 7.5(e)(i) of X's Operating Agreement, in which C may treat the

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<sup>3</sup> We believe that one or more arguments may also be made under §1.752-2(j) in this case, depending on further factual development. [REDACTED]

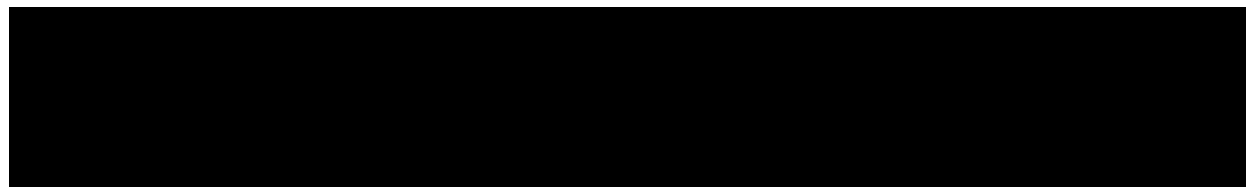
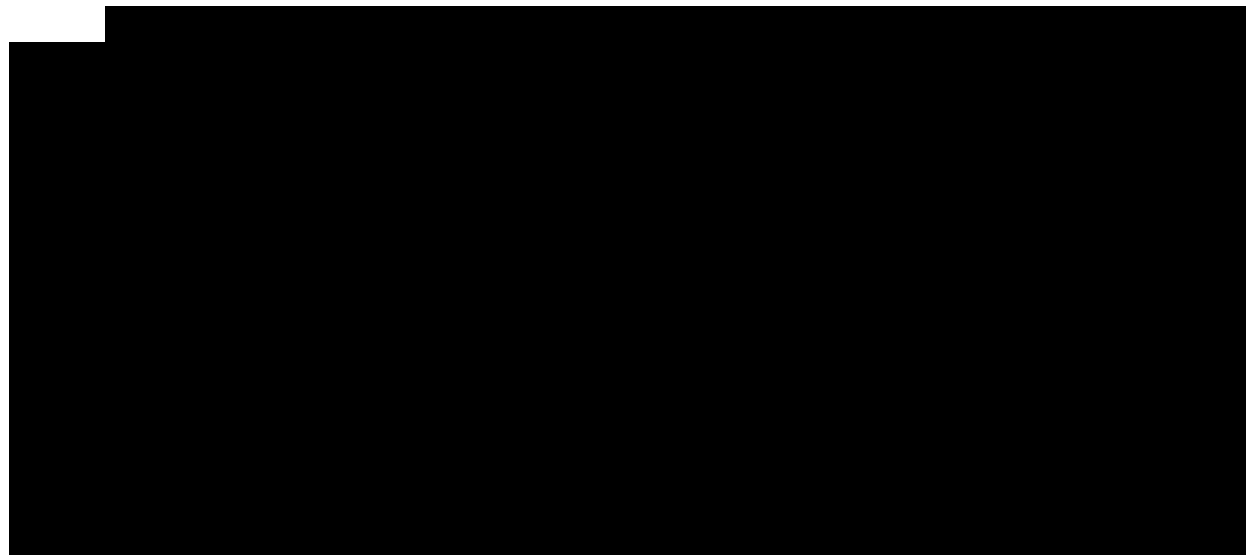
amount of a Guaranty Contribution that a defaulting member failed to contribute as a loan to the defaulting member, such “loan” would appear to be subject to the related-party rule of § 465(b)(3)(A). Under the remedy of section 7.5(e)(i), A and B would be viewed as borrowing money from C with respect to the activity of X, at a time when C also possesses an ownership interest in the activity. Accordingly, A and B would not be considered at risk with respect to such amounts pursuant to § 465(b)(3)(A) under this scenario.

Of course, if a payment obligation does arise in the future which requires A and B to make a payment to X, A and B would properly be viewed as making contributions to X at that time, for purposes of §§ 722, 704(d) and 465(b)(1)(A).

In conclusion, because A and B do not have a mandatory obligation to make additional capital contributions to the X, regardless of which interpretation of X's Operating Agreement is ultimately determined to be correct, A and B do not bear the ultimate economic risk of loss for purposes of § 752, and A and B are not the payors of last resort in a worst case scenario for purposes of § 465.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.





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