MARCH 2016
www.bdo.com

AN ALERT FROM THE BDO FEDERAL TAX PRACTICE

BDO KNOWS: FEDERAL TAX

SUBJECT

CHIEF COUNSEL ADVICE RAISES QUESTIONS REGARDING IMPACT OF "BAD-BOY" CONDITIONS ON PARTNERSHIP LIABILITY ALLOCATIONS

SUMMARY

A recently issued Chief Counsel Advice (CCA 201606027) determined that a partner's limited guarantee was sufficient to create economic risk of loss with respect to a partnership liability. Of particular interest is the Internal Revenue Service's ("Service") belief that inclusion of so-called "bad-boy" conditions may alone be sufficient to cause an otherwise nonrecourse liability to be classified as recourse for purposes of Treasury Regulation Section ("Treas. Reg. §") 752. If correct, the Service's conclusion could call into question the manner in which many partnerships have historically allocated liabilities.

Given the importance of liability allocations for the purpose of determining basis and at-risk limitations, a reallocation of partnership liabilities could have significant tax consequences to the partners. Reconsideration of limited guarantees may be warranted.

DETAILS

Allocation of Partnership Liabilities

A partnership is required to allocate liabilities to those partners who bear economic risk of loss from the liability. Where no partner bears economic risk of loss, i.e., in the case of nonrecourse liabilities, Treas. Reg. §1.752-3 provides specific rules that typically result in a different allocation of partnership liabilities. Therefore, determining whether a partner bears economic risk of loss is critical to establish how liabilities should be allocated among the partners.

A partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated for no consideration, the partner or related person would be obligated to make a payment to any

CONTACT:

JEFFREY N. BILSKY
Senior Director, National Tax Office
(404) 979-7193 / jbilsky@bdo.com

DAVID PATCH
Senior Director, National Tax Office
(703) 336-1520 / dpatch@bdo.com

JULIE ROBINS
Senior Director, National Tax Office
(512) 391-3534 / jrobins@bdo.com

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.

The extent to which a partner or related person has an obligation to make a payment 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.

Treas. Reg. § 1.752-2(b)(4) provides that a payment obligation (such as a guarantee) 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. Further, if a payment obligation (including one arising under a guarantee) should arise after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs.

Impact of Bad-Boy Conditions Under CCA 201606027

According to the facts included within CCA 201606027, one of the members of the LLC (the "Guarantor") agreed that it would be unconditionally obligated on the outstanding loan balance upon any of the following events (the "bad-boy" conditions):

1. The LLC fails to obtain the lender's consent before obtaining subordinate financing or transfer of the secured property;
2. The LLC files a voluntary bankruptcy petition;
3. Any person in control of the LLC files an involuntary bankruptcy petition against the LLC;
4. Any person in control of the LLC solicits other creditors to file an involuntary bankruptcy petition against the LLC;
5. The LLC consents to, or otherwise acquiesces or joins in an involuntary bankruptcy or insolvency proceeding;
6. Any person in control of the LLC consents to the appointment of a receiver or custodian of assets; or
7. The LLC 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 Service found that the guarantee was sufficient to cause the Guarantor to bear the economic risk of loss with respect to the liability. This conclusion was predicated on the Service's determination that a default on the loan would itself be sufficient to create a payment obligation by the Guarantor even in the absence of the above events.

However, the Service went on to say that even if the obligation of the Guarantor was conditioned on the occurrence of one of the listed events, such an occurrence was not so remote a possibility that it would cause the obligation created by these provisions to be considered "likely to never be discharged" within the meaning of Treas. Reg. § 1.752-2(b)(4). In other words, the IRS concluded that the "bad-boy" provisions in themselves cause the liability to be recourse.

BDO INSIGHTS

- It is common practice for lenders to require limited guarantees from partners in order to protect the lender from certain acts that might be committed by the borrowing partnership or its affiliates. For example, a guarantee may provide that the partner is obligated to pay the debt only in the event that the partnership commits fraud or misappropriates assets.
- Violation and enforcement of these so-called “bad-boy” provisions is generally considered to be so remote as to be disregarded for purposes of allocating liabilities under Treas. Reg. § 752. However, over the past several years lenders have required inclusion of additional carve-out provisions that may be pushing the bounds of traditional “bad-boy” guarantees. As illustrated by the CCA, if the IRS were to conclude that the possibility of such conditions occurring is not sufficiently remote, it may consider the guarantor to bear the economic risk of loss, altering the character and allocation of the guaranteed liabilities.
- Because of the broad use of various “bad-boy” guarantees, the allocation of liabilities by many partnerships could be affected. Consequently, partnerships and their partners should review their limited guarantee arrangements to ensure the treatment of partnership liabilities is consistent with the regulations. As part of this analysis, careful attention should be given to: (i) whether the terms of a limited guarantee are subject to contingencies so remote that make it unlikely the guarantee will ever be discharged, or (ii) if the future events giving rise to the payment obligation can be determined with reasonable certainty.