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# IRS Reverses Position on "Bad Boy" Guarantees

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We previously reported that in February 2016, the IRS issued a Chief Counsel Advice memorandum (Original CCA), which addressed the tax treatment afforded investors in real estate limited partnerships and limited liability companies that utilize non-recourse financing. Pursuant to the Original CCA, non-guaranteeing partners of a limited partnership (or members of a limited liability company) were in danger of being deprived of the necessary tax basis to claim losses from the limited partnership in excess of their capital contributions to the partnership. The conclusions set forth in the Original CCA were viewed by many in the real estate and tax industries as a departure from prior practice as it relates to the tax treatment of so-called "bad boy guarantees" in non-recourse real estate financing transactions.

In guidance released on April 15, 2016, available here (AM 2016-001), the IRS has reversed the position taken in the Original CCA and concluded that if a partner's guarantee of a partnership's non-recourse obligation is conditioned on the occurrence of certain non-recourse carve-out events, the guarantee *will not* cause the obligation to fail to qualify as a non-recourse liability of the partnership for tax purposes until such time as one of those events actually occurs and causes the guarantor to become personally liable under the guaranty. The AM 2016-001 seems to remove at least some of the uncertainty over the tax treatment of non-recourse carve-out guarantees that was created by the Original CCA.

In AM 2016-001, the IRS acknowledged that typical non-recourse carve-out provisions (for example, the filing of a voluntary bankruptcy petition by the borrower or a transfer of the mortgaged property in violation of the loan documents) are each within the control of the borrower and/or the guarantor, and as such, they have an economic self-interest to avoid those "bad acts" which would subject them to liability.

As such, unless the facts and circumstances indicate otherwise, a typical "non-recourse carve-out" provision that allows the borrower or the guarantor to avoid committing the enumerated "bad act" should not cause an otherwise non-recourse liability to be treated as recourse for tax purposes until such time as the contingency actually occurs.

It should be noted that neither the AM 2016-001 nor the Original CCA is binding authority and is limited in its application to the facts of the particular situation addressed therein. The conclusions in AM 2016-001 have been viewed by many in the real estate and tax industries as a welcome change from the Original CCA.

If you have questions on this topic or would like further information, please contact Timothy Davis (davist@whiteandwilliams.com; 215.864.6829) or Kevin Koscil (koscilk@whiteandwilliams.com; 215.864.6827).

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