

IRS Withdraws Controversial Pronouncement on “Bad Boy” Guarantees

April 21, 2016

In a client advisory dated February 25, 2016 (“[Prior Advisory](#)”), we described a legal memorandum released by the Office of Chief Counsel of the Internal Revenue Service (the “Memorandum”) which took the position that a typical “carve-out” or “bad boy” guarantee provided by a partner/member of a partnership/limited liability company to a lender in connection with an otherwise non-recourse real estate mortgage loan caused the loan to be treated as being recourse to the guarantor. As described in the Prior Advisory, this position would result in the full amount of the loan being included in the guarantor’s basis in the partnership/LLC rather than being shared by the partners/members. If sustained, this position would prevent the non-guaranteeing members from being able to deduct partnership/LLC losses in excess of their equity contributions. Such a result would obviously have a huge negative tax impact on thousands of past, present and future real estate partnerships and LLCs.

In response to the Memorandum, a small task force from the Real Estate Roundtable drafted an industry position paper and met with IRS Chief Counsel William Wilkins to share the real estate community’s concerns. The meeting was held on March 8 at the IRS in Washington, and was attended by Mr. Wilkins and eight other attorneys from the IRS. At the meeting, the legal and practical evolution of the particular “bad boy” guarantee at issue in the memorandum was described. The participants explained to the IRS, among other matters, that the “bad boy” guaranty is a device to prevent the borrower from taking certain voluntary actions, such as a bankruptcy filing, and the guarantor is very unlikely to ever take any of the prohibited actions or have liability on the guaranty.

On April 15, the IRS Office of Chief Counsel released a new memorandum (“New Memorandum”) reversing the position taken in the original Memorandum. The New Memorandum acknowledged that a “carve-out” or “bad boy” guarantee is a device to prevent the borrower from taking actions which violate the terms of the loan in a manner which might harm the value of the property or interfere with the lender’s exercise of remedies. The IRS concluded that the adverse financial impact to the guarantor resulting from the prohibited acts would be contrary to the guarantor’s self-interest, making the acts and resulting personal liability very unlikely to occur. The IRS acknowledged that the “bad boy” acts were all voluntary acts of the guarantor, not matters which a lender could use to enforce personal liability in the absence of specific voluntary actions. Therefore, the New Memorandum concludes that a “bad boy” guarantee does not cause a non-recourse loan to become recourse unless one of the enumerated “bad boy” acts actually occurs.

Although withdrawal of the original Memorandum had been anticipated by the real estate industry, issuance of the New Memorandum removes a cloud over the tax treatment of carve-out guarantees.

Please feel free to contact with any questions:

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