



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	Recourse vs. Nonrecourse Liabilities	
Primary UIL Code	752.00-00	Treatment of Certain Liabilities

Library Level	Title
Knowledge Base	Partnerships
Shelf	General Concepts
Book	Partnership Liabilities
Chapter	Basic Concepts

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General Overview

Recourse vs. Nonrecourse Liabilities

This Practice Unit addresses the definition of liabilities for federal income tax purposes in the context of partnerships. Both recourse and nonrecourse liabilities are discussed in this Unit. Rules for allocating partnership liabilities among the partners are covered in a separate Concept Unit, *Determining Liability Allocation*.

Understanding partnership liabilities is critical to understanding a partner's outside basis. Outside basis is a partner's basis in his partnership interest. A partner's outside basis is the sum of his capital account plus his share of the partnership's liabilities. A separate Practice Unit, *Partner's Outside Basis*, provides an overview of how to calculate a partner's outside basis in a partnership interest.

As previously stated, a partner's outside basis in his partnership interest is the sum of his capital account plus his share of the partnership's liabilities. An increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership and thus increases his outside basis. A decrease in a partner's share of partnership liabilities is treated as a distribution of money to the partner and thus decreases his outside basis. IRC 752(a) and (b). Each partnership liability is part of at least one partner's outside basis.

Liabilities affect partnerships and their partners (and limited-liability companies treated as partnerships and their members) differently from any other types of flow-through entity. Generally, S corporation shareholders and owners of interests in trusts cannot include the respective entity's liabilities in calculating their ownership basis in the entity.

Detailed Explanation of the Concept

Recourse vs. Nonrecourse Liabilities

This Practice Unit addresses the definition of liabilities for federal income tax purposes in the context of partnerships. Both recourse and nonrecourse liabilities are discussed in this Unit.

Analysis	Resources
<p><u>Liabilities Defined</u></p> <p>The IRC 752 regulations speak of both “obligations” and “partnership liabilities.” “Obligations” are an umbrella term that includes partnership liabilities. However, not all obligations are partnership liabilities. Only partnership liabilities can increase a partner’s outside basis.</p> <p>An obligation is an IRC 752 liability only if, when, and to the extent that incurring the obligation does the following:</p> <ol style="list-style-type: none">1. Creates or increases the basis of the obligor’s assets (including cash);2. Gives rise to an immediate deduction to the obligor; or3. Gives rise to an immediate expense that is not deductible in computing the obligor’s taxable income and is not chargeable to the obligor’s capital. <p>In this context, the term “obligor” refers to the partnership which is borrowing money, generally from a third-party creditor or a partner acting in the capacity of a creditor. The following slides articulate this concept in terms of debits and credits reflected in the partnership’s accounting records.</p>	<ul style="list-style-type: none">▪ IRC 752▪ Treas. Reg. 1.752-1(a)

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Liabilities Defined (cont'd)</u></p> <p>If a partnership borrows the purchase price of an asset, rather than using its own cash to buy the asset, then the loan meets the definition of a liability for IRC 752 purposes.</p> <p>A liability of \$100 that currently creates or increases the basis of any of the obligor's assets (including cash) would be booked as follows:</p> <p>Debit Asset Purchased \$100 Credit Loan to Purchase Asset \$100</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.752-1(a)

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities

Analysis

Resources

Liabilities Defined (cont'd)

If an accrual basis partnership obtains \$500 worth of services today, and under the service agreement is billed for those services later, then the account payable meets the definition of a liability for IRC 752 purposes.

Assuming such a liability gives rise to an immediate deduction, it would be booked as follows:

Debit Expense for General and Administrative Services \$500

Credit Accounts Payable to Service Provider \$500



CAUTION: A cash basis partnership's accounts payable are not partnership liabilities under IRC 752 as discussed in Rev. Rul. 88-77, 1988-2 CB 129.

▪ Treas. Reg. 1.752-1(a)

▪ Rev. Rul. 88-77

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Liabilities Defined (cont'd)</u></p> <p>A liability that gives rise to an expense that is not deductible in computing the obligor's taxable income, and is not chargeable to the obligor's capital, meets the definition of liability under IRC 752.</p> <p>For example, if an accrual basis partnership charges \$1,800 in country club membership dues on a credit card, then the expense is not deductible under IRC 274(a)(3). However, the credit card charge would still meet the definition of a liability for IRC 752 purposes, and would be booked as follows:</p> <p>Debit Expense for Country Club Dues \$1,800 Credit to Credit Card Charge Payable \$1,800</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.752-1(a)

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities

Analysis

Liabilities Defined (cont'd)

As previously stated, not all obligations are partnership liabilities as defined by IRC 752. Confusingly, the regulations use the term “liability” when discussing non-liability obligations. Examples of this are Treas. Reg. 1.752-6 liabilities (partnership’s assumption of partner’s contingent liability after October 18, 1999, and before June 24, 2003) and Treas. Reg. 1.752-7 liabilities (partnership’s assumption of partner’s contingent liability on or after June 24, 2003). Treas. Reg. 1.752-7 non-liability obligations, known in the regulations as 1.752-7 liabilities, are discussed on the next slide.

Resources

- Treas. Reg. 1.752-1(a)
- Treas. Reg. 1.752-6
- Treas. Reg. 1.752-7

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Liabilities Defined (cont'd)</u></p> <p>Treas. Reg. 1.752-7 prevents the duplication or acceleration of loss from transfers and assumptions of obligations that are not liabilities for IRC 752 purposes. When a partnership assumes a Treas. Reg. 1.752-7 liability from a partner, that partner's outside basis is reduced, but the reduction is deferred until a triggering event affects the partner's share of the liability.</p> <p>A common example of a Treas. Reg. 1.752-7 liability is an environmental remediation liability. A partnership may have booked a \$100,000 liability to clean up pollution on its property from a time when the business improperly disposed of hazardous chemicals in its production processes. That \$100,000 was deductible for Generally Accepted Accounting Principles (GAAP) purposes but was not allowed as an immediate deduction on its tax return. The partnership should have reported the environmental remediation expense on Schedule M-1 as an expense allowed for books but not for tax. Although the environmental remediation liability appears on the partnership's GAAP balance sheet in the liability section, it is a non-liability obligation for IRC 752 purposes.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.752-7

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Recourse vs. Nonrecourse Liabilities</u></p> <p>After determining that a partnership's obligation is an IRC 752 liability, the next step is to determine if the liability is recourse or nonrecourse.</p> <p>There are two important reasons to make this determination:</p> <ol style="list-style-type: none"> 1. A partner's allocable share of partnership liabilities increases outside basis. The amount of outside basis has significant tax consequences in several situations. See Practice Unit, <i>Partner's Outside Basis</i>. However, recourse and nonrecourse liabilities are allocated among partners under two different regimes. 2. Unrepaid recourse debt forgiven by a creditor gives rise to ordinary cancellation-of-debt income. Nonrecourse debt forgiven by a creditor is generally treated as an amount realized on the sale or exchange of the asset securing the nonrecourse debt. The debt forgiveness can potentially result in taxable gain. 	<ul style="list-style-type: none"> ▪ Practice Unit - <i>Partner's Outside Basis</i>

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Recourse Liabilities</u></p> <p>A partnership liability is a recourse liability to the extent a partner or related person bears the economic risk of loss for the liability. In other words, if the partnership were unable to pay the creditor, the extent to which a partner would be obligated to pay the debt from personal funds, with no right of reimbursement from another partner, indicates the partner's economic risk of loss.</p> <p>To determine each partner's economic risk of loss, the regulations post a worst-case scenario in which all of the partnership's assets (including cash) become worthless and the partnership's liabilities become due and payable. In this worst-case scenario, the partnership sells its assets for no consideration and liquidates. The impact of the partnership's allocations on the partners' capital accounts indicates the partners' economic risk of loss. The extent to which a partner must contribute to the partnership to eliminate a capital account deficit or directly pay the partnership's creditors represents the partner's economic risk of loss.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.752-2

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Recourse Liabilities (cont'd)</u></p> <p>It is important to note that all the facts and circumstances come into play in this worst-case scenario. In addition to the terms of the partnership agreement and the terms of the partnership's loan agreement(s), there may be other documents that impact the partner's ultimate risk of loss, for example:</p> <ul style="list-style-type: none">▪ Side agreements;▪ Reimbursement agreements;▪ Guarantees;▪ Indemnification agreements;▪ Provision of applicable state law.	<ul style="list-style-type: none">▪ Treas. Reg. 1.752-2

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Recourse Liabilities (cont'd)</u></p> <p>In a general partnership, state law ordinarily provides that the partners are personally liable for the partnership liabilities, except for those that are expressly nonrecourse. For example, in the case of a recourse mortgage on real property, if the partnership was unable to pay the mortgage and the lender foreclosed, the partners would be obligated to pay any deficiency out of their own assets.</p> <p>Similarly, in a limited partnership, state law generally provides that the general partners are personally liable for partnership liabilities. Limited partners are not personally liable for any unpaid debts of the partnership, except to the extent they have a deficit restoration obligation.</p> <p>Members of a limited liability company (LLC) taxed as a partnership are generally treated under state law as limited partners in a limited partnership. LLC liabilities are generally allocated to partners in a manner similar to nonrecourse liabilities.</p> <p>While the resources in the right pane lists various provisions of “uniform” statutes for partnerships and LLCs, it is critically important to research the state law that applies to the entity under examination to determine which uniform statute provisions the applicable state adopted. The entity’s operating agreement should specify which state law applies.</p>	<ul style="list-style-type: none"> ▪ <i>Uniform Partnership Act</i>, Part III, Sec. 15, Nature of Partner’s Liability ▪ <i>Revised Uniform Partnership Act</i>, Article 3, Sec. 306, Partner’s Liability ▪ <i>Uniform Limited Partnership Act</i>, Sec. 7, Limited Partner Not Liable to Creditors ▪ <i>Revised Uniform Limited Partnership Act</i>, Sec. 303, No Liability as Limited Partner for Limited Partnership ▪ <i>Uniform Limited Liability Company Act</i>, Sec. 304, Liability of Members and Managers

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Recourse Liabilities (cont'd)</u></p> <p>As previously stated, it is important to review all of the facts and circumstances when determining a partner's economic risk of loss. For example, a partner may actually bear economic risk of loss even if a debt is labeled as nonrecourse. Debt labeled as nonrecourse is treated as recourse if:</p> <ol style="list-style-type: none">1. The partner is also the creditor; i.e., the partner lent money to the partnership;2. The partner is related to the creditor; or3. The partner guarantees an otherwise nonrecourse liability.	<ul style="list-style-type: none">▪ Treas. Reg. 1.752-2

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Nonrecourse Liabilities</u></p> <p>A partnership liability is nonrecourse if no partner, or person related to a partner, bears the economic risk of loss. In the partnership context, a nonrecourse liability is only paid in full out of the partnership's profits.</p> <p>There are generally two types of nonrecourse liabilities:</p> <ol style="list-style-type: none">1. Unsecured liabilities.2. Secured Liabilities, such as automobile loans, that are secured by property. <p>Unsecured liabilities are not backed by any collateral. In this situation, the lender has limited protection against any default. While the lender may sell the debt on the secondary market and report the default to credit agencies, the lender may not enforce payment against the partners. However, if the nonrecourse debt is collateralized by property, the lender may foreclose on the property. Nonrecourse debt in the context of real estate partnership is typically secured by the underlying property.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.752-3

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Nonrecourse Liabilities (cont'd)</u></p> <p>A detailed discussion of qualified nonrecourse liabilities is beyond the scope of this Practice Unit. In most cases, qualified nonrecourse financing involves nonrecourse liabilities secured by real estate used in the activity of holding real property, most commonly nonrecourse real estate mortgages.</p>	

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Bifurcated Liability</u></p> <p>A liability can be both recourse and nonrecourse; this is known as a bifurcated liability. For example, a partnership borrows \$1,000,000 on a nonrecourse basis and a partner guarantees \$100,000 of the liability. The liability is therefore bifurcated into a nonrecourse portion and a recourse portion that increases the guaranteeing partner's outside basis.</p> <p><u>Bottom Dollar Payment Obligation</u></p> <p>Prior to October 4, 2016, partners were able to engage in "bottom dollar" payment obligations. Using the above example, the partner would only be liable to pay the \$100,000 guaranteed amount after the creditor had collected on the first \$900,000. Although this was unlikely, the "bottom dollar guarantee" or payment obligation of \$100,000 was still allocated to the guaranteeing partner as a recourse debt. In many situations, the guaranteeing partner did not truly bear an economic risk of loss. For obligations entered into after October 4, 2016, the creditor must be able to immediately enforce payment on the guaranteeing partner in order for the partnership to allocate that debt as recourse.</p> <p>Guarantees entered into in a binding contract before October 5, 2016, are excepted from this requirement. Also, any obligation may be a bottom dollar payment liability if it is deficit restoration obligation under Treas. Reg. 1.704-1(b).</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.752-2 ▪ Treas. Reg. 1.752-2 • Treas. Reg. 1.704-1(b)

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Bad Boy Guarantees</u></p> <p>Generally, “bad boy guarantees” do not convert nonrecourse debt to recourse debt for federal income tax purposes. A bad boy guarantee occurs when a partner’s guarantee of partnership nonrecourse debt is conditioned on certain “nonrecourse carve-out” events described below.</p> <p>The Associate Chief Counsel (Passthroughs and Special Industries) has identified at least seven nonrecourse carve-out events contained in bad boy guarantees: (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. IRS AM 2016-001.</p> <p>Consistent with commercial practices of not treating these guarantees as creating recourse debt, the IRS does not treat bad boy guarantees as creating recourse debt unless the condition actually occurs.</p>	<ul style="list-style-type: none">▪ IRS AM 2016-001

Detailed Explanation of the Concept (cont'd)

Recourse vs. Nonrecourse Liabilities	
Analysis	Resources
<p><u>Wrapped Debt</u></p> <p>Wrapped debt is a partnership liability owed to a partner or related person that includes (i.e., is wrapped around) underlying debt that a partner or related person owes to an unrelated lender. If the debt is wrapped around a nonrecourse obligation secured by partnership property that is owed to another person, then the partnership liability is treated as two separate liabilities.</p> <p>Generally, wrapped debt situations occur when a partner contributes real estate to a partnership secured by a pre-existing nonrecourse mortgage. The partnership may not want to pay off the existing mortgage as its interest rate may be very low. The partnership enters into a loan agreement with equivalent terms to the original mortgage and the debtor-partner remains liable for the original mortgage. The original mortgage is the wrapped debt and the partnership loan payable to the partner is the wraparound debt.</p> <p>Although owed to a partner, the wraparound debt assumes the characteristics of the wrapped debt. Since in this example, the wrapped debt is a nonrecourse mortgage, the wraparound debt is also treated as a nonrecourse liability, even though owed to a partner.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.752-2(c)

Examples of the Concept

Recourse vs. Nonrecourse Liabilities

Examples

Example 1

- Mr. Apple and Mrs. Pear form a partnership to operate a restaurant. Mr. Apple is a general partner who contributes \$100,000. Mrs. Pear is a limited partner who contributes \$500,000. The partnership buys restaurant equipment for \$500,000, which is subject to a note for \$400,000. The additional \$500,000 that Mrs. Pear contributed is used for working capital. As the general partner, Mr. Apple may be held personally liable for payments on the equipment note. Since Mr. Apple bears the economic risk of loss on the note, the equipment note is a recourse liability.

Example 2

- Assume the same facts as in Example 1, except that the equipment was purchased with a nonrecourse note, the seller of the equipment is limited to repossessing the equipment in the event of default on the note, and the seller cannot collect any balance owed from either partner. As neither partner bears the economic risk for the loan (only the lender does), the equipment note is nonrecourse.

Index of Referenced Resources

Recourse vs. Nonrecourse Liabilities

IRC 274(a)(3)

IRC 752

IRS AM 2016-001

Treas. Reg. 1.704-1(b)

Treas. Reg. 1.752-1(a)

Treas. Reg. 1.752-2

Treas. Reg. 1.752-3

Treas. Reg. 1.752-6

Treas. Reg. 1.752-7

Rev. Rul. 88-77

Uniform Partnership Act

Revised Uniform Partnership Act

Uniform Limited Partnership Act

Revised Uniform Limited Partnership Act

Uniform Limited Liability Company Act

Training and Additional Resources

Recourse vs. Nonrecourse Liabilities	
Type of Resource	Description(s)
Training / Saba Meeting Sessions	<ul style="list-style-type: none"> ▪ <i>Partnership Liabilities</i> - ITM 76268r
Issue Toolkits	<ul style="list-style-type: none"> ▪ <i>Cancellation of Debt (COD) Income and Related Issues FAQs</i>
Articles	<ul style="list-style-type: none"> ▪ <i>Back to Basics - Recourse Liabilities</i> - The Partnerships & TEFRA IPG Newsletter #8 March 2015
Databases / Research Tools	<ul style="list-style-type: none"> ▪ Partnerships Knowledge Base - IRS Virtual Library
Reference Materials - Treaties	<ul style="list-style-type: none"> ▪ <i>Practitioners Publishing Company (PPC) - 1065 Deskbook</i> ▪ <i>McKee, Nelson & Whitmire - Fed. Tax'n of Partnerships</i> ▪ <i>BNA Tax Management U.S. Income Portfolio 714-4th Sec. III</i>
Other Training Materials	<ul style="list-style-type: none"> ▪ IRS VITA Training ▪ Issue Snapshot - Cancellation of Indebtedness

Glossary of Terms and Acronyms

Term/Acronym	Definition
GAAP	Generally Accepted Accounting Principles
IRC	Internal Revenue Code
IRS AM	Internal Revenue Service Advice Memorandum
LLC	Limited Liability Company
Treas. Reg.	Treasury Regulation

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
752-0	<i>Determining Liability Allocations</i>
705-0	<i>Partner's Outside Basis</i>