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Memorandum

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to: Division Counsel
(Large Business & International)
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subject: LLC Member Guarantees of LLC Debt and "Qualified Nonrecourse Financing"

This memorandum addresses the tax consequences under § 465 of the Internal Revenue Code (the "Code") of certain guarantees by a member of a limited liability company ("LLC") classified as a partnership for federal tax purposes. This advice may not be used or cited as precedent.

ISSUES

1. What are the tax consequences under § 465 when an LLC member guarantees debt of an LLC classified as a partnership or disregarded entity for federal tax purposes?
2. What are the tax consequences under § 465 when an LLC member guarantees debt of an LLC classified as a partnership for federal tax purposes that is qualified nonrecourse financing as defined in § 465(b)(6)(B)?
3. What are the tax consequences under § 465 to the other members when an LLC member guarantees debt that had been treated as qualified nonrecourse financing of an LLC classified as a partnership for federal tax purposes?

CONCLUSIONS

1. When a member of an LLC classified as a partnership or disregarded entity for federal tax purposes guarantees the LLC's debt, the member is at risk with respect to the amount of the guaranteed debt, without regard to whether such member waives any right to subrogation, reimbursement, or indemnification from the LLC, but only to the extent that the member has no right of contribution or reimbursement from persons other than the LLC, the member is not otherwise protected against loss within the meaning of § 465(b)(4), and the guarantee is bona fide and enforceable by creditors of the LLC under local law.
2. When a member of an LLC classified as a partnership for federal tax purposes guarantees qualified nonrecourse financing of the LLC, the member's amount at risk is increased by the amount guaranteed, 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 persons other than the LLC, the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4), and the guarantee is bona fide and enforceable by creditors of the LLC under local law.
3. When a member of an LLC guarantees qualified nonrecourse financing of the LLC, the amount of the guaranteed debt no longer meets the definition of "qualified nonrecourse financing" under § 465(b)(6)(B) if the guarantee is bona fide and enforceable by creditors of the LLC under local law, and the amount of the guaranteed debt will no longer be includible in the at-risk amount of the other non-guarantor members of the LLC.

LAW AND ANALYSIS

Section 465(a)(1) of the Code (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.

Prop. § 1.465-6(b) provides that a partner shall not be at risk with respect to any partnership liability to the extent the partner would be entitled to contributions from other partners if the partner were called upon to pay the partnership's creditor, because to that extent, the partner is protected against loss. That sub-section then refers to Prop. § 1.456-24(a)(2)(ii) for an example that illustrates the rule. That example involves a partnership, AB, with two equal general partners, A and B. AB borrows \$25,000 from a bank for use in the partnership's activity, giving the bank a security interest in equipment purchased with the proceeds of the loan. In addition, both A and B assume personal liability for the loan. The example notes that although the bank could call upon either A or B to pay the entire amount of the \$25,000 loan, the partner that paid would be entitled to reimbursement of \$12,500 from the other partner. Accordingly, the loan increased both A's and B's amount at risk by \$12,500.

Prop. § 1.465-6(d), promulgated prior to the proliferation of state limited liability company acts, provides that a taxpayer who guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, will not be at risk with respect to the amount guaranteed. If the taxpayer repays to the creditor the amount borrowed by the primary obligor, the taxpayer's amount at risk shall be increased at such time as the taxpayer has no remaining legal rights against the primary obligor.

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 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) of the Income Tax Regulations 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)(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)(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).

Member Guarantees of LLC Debt, Generally

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 and 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 example in Prop. § 1.465-24(a)(2)(ii) illustrates that point when it concludes that the

general partners in AB partnership may include in their amount at risk their full \$12,500 share of the partnership's debt for which they would not be entitled to reimbursement from the other partner.

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 is in a position akin to the general partners in the example in Prop. § 1.465-24(a)(2)(ii) who had personally assumed the partnership's debt and who had no right of reimbursement for their \$12,500 share. 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 without regard to whether the LLC member waives any right to subrogation, reimbursement, or indemnification against the LLC, but only to the extent that,

- (1) the guaranteeing member has no right of contribution or reimbursement from persons other than the LLC,
- (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.

We further advise that, in the case of an LLC treated as a partnership or disregarded entity for federal tax purposes, Prop. § 1.465-6(d) does not apply in cases where an LLC member guarantees LLC debt, the member has no rights of contribution or reimbursement, the guarantee is bona fide and enforceable by creditors of the LLC under local law, and the member is not otherwise protected against loss.

Member Guarantees of LLC Qualified Nonrecourse Financing

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 nonrecourse 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 that amount of the debt from the personal assets of the guarantor. Because the guarantor is personally liable for that debt, that 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, that 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.

Because that debt is no longer qualified nonrecourse financing, the non-guaranteeing members of the LLC who previously included that portion of the qualified nonrecourse financing in their amount at risk and who have not guaranteed any portion of that debt may no longer include that 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 persons other than the LLC, 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.:

The Field Office noted that non-guaranteeing LLC members may assert that a guarantee of qualified nonrecourse financing by another LLC member does not increase the guarantor's amount at risk and, therefore, should not reduce the at-risk amount of the non-guaranteeing members with respect to that financing. As discussed above, we do not adopt that reading of Prop. § 1.465-6(d). Even if it did apply in this situation, it would not aid the non-guaranteeing members because the financing would still cease to be qualified nonrecourse financing under Section 465(b)(6)(B). Section 465(b)(6)(B)(iii) defines qualified nonrecourse financing as financing for which no person *is personally liable*. Because a guarantor becomes personally liable for the amount guaranteed, any liability previously treated as qualified nonrecourse financing no longer meets the definition of qualified nonrecourse financing once it is guaranteed (whether or not the guarantor is at risk). As a result, the non-guaranteeing members may no longer avail themselves of the exception in § 465(b)(6)(A) to include any portion of the guaranteed liability in their at-risk amounts regardless of the impact of the guarantee on the guarantor's amount at risk. Whether Prop. § 1.465-6(d) applies to a guarantor of LLC debt is an inquiry that does not affect the analysis of whether a guaranteed liability constitutes qualified nonrecourse financing.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This memorandum does not address the effect of a member guarantee of qualified nonrecourse financing in the context of a single member LLC taxed as a

disregarded entity for federal tax purposes, because the member's at-risk amount generally will not be affected by the guarantee. As the sole owner of an LLC with qualified nonrecourse financing, the single member is at risk prior to guaranteeing the debt because the debt is qualified nonrecourse financing. After guaranteeing the debt, the debt no longer meets the definition of qualified nonrecourse financing, but as the guarantor, the single member is still at risk to the extent of the amount guaranteed and to the extent the single member is not otherwise protected against loss.

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Please call (202) 622-3060 if you have any further questions.

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