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Internal Revenue Service  
memorandum**

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subject: Recourse Loan v. Nonrecourse Loan

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=
Members	=
Year 1	=
Year 2	=
Bank	=
Corporation	=
Affiliate	=
Notes	=
Date 1	=
\$ <u>a</u>	=
\$ <u>b</u>	=
\$ <u>c</u>	=
\$ <u>d</u>	=
\$ <u>e</u>	=
\$ <u>f</u>	=

$\$g$  =  
 $\$h$  =  
 $\$i$  =  
 $\$j$  =

### ISSUE

For purposes of determining if a limited liability company taxed as a partnership has cancellation of debt income under § 61(a)(12) or gains from dealings in property under § 61(a)(3) upon foreclosure of its property, do the regulations under § 752 determine if the indebtedness is recourse or nonrecourse to the partnership?

### CONCLUSION

The regulations under § 752 do not determine if a debt is recourse or nonrecourse to a partnership for purposes of determining whether, upon foreclosure of the property, the partnership has cancellation of debt income under § 61(a)(12) or gains from dealings in property under § 61(a)(3).

### FACTS

Taxpayer was formed as a California limited liability company in Year 1 and is taxable as a partnership for federal tax purposes. Taxpayer has three Members: two individuals and an S corporation. The S corporation is Taxpayer's manager and Tax Matters Partner. Taxpayer is a TEFRA partnership.

Taxpayer was organized to purchase specified real property and then construct, market, and sell homes that it may build on that real property ("Property"). Article 2.4 of Taxpayer's Operating Agreement provides that Taxpayer is a Special Purpose Entity ("SPE"), which "(i) was and is organized solely for the purpose of owning the Property, (ii) has not and will not engage in any business unrelated to the ownership of the Property, and (iii) has not had and will not have any assets other than those related to the Property."

On Date 1, Taxpayer relinquished its last unsold parcel of real property from the Property to Bank in a non-judicial foreclosure. Bank had a loan to Taxpayer with an outstanding balance of  $\$a$ , which was secured with a first deed of trust to the Property ("Senior Loan"). Bank cancelled the entire Senior Loan as part of the non-judicial foreclosure. Bank issued a Form 1099-A to Taxpayer that estimated the fair market value of the Property at  $\$b$ .

During Year 2, Corporation or Affiliate, another of Taxpayer's lenders, cancelled outstanding loans ("Notes") to Taxpayer in the amount of  $\$c$ . Notes were created in connection with loans made to Taxpayer in order to develop Property in Year 1. In Year 1, the principal amount of Notes was  $\$d$ . Taxpayer made no principal payments on Notes and  $\$e$  of interest accrued. Notes were secured by a second deed of trust to the

Property (which was subordinated only to the Senior Loan from Bank); a general assignment of Taxpayer's rights, title, and interest in and to the Property; a general assignment of Members' rights, title, and interest in and to the Property; pledges of the membership interests in Taxpayer by the Members; and unlimited, unconditional, and irrevocable guarantees by each Member of Taxpayer.

Notes are at the center of the controversy in this case. Notes do not contain express language providing that they are recourse or nonrecourse to Taxpayer. Notes also do not expressly state whether Taxpayer, as borrower, would be unconditionally and personally liable for repayment if the collateral securing Notes was insufficient to fully repay the outstanding balance on Notes with interest. Section 8.16 of the Loan Agreement contains an affirmative covenant that Taxpayer is contractually bound to maintain its status as a SPE. Taxpayer also entered into several loan Amendments and Reaffirmations with Affiliate, which specifically provided that Taxpayer, as borrower, executed and delivered to Lender Assignments and Spreaders to the Deed of Trust, Assignment of Leases and Rents, Security Agreements and Fixture filings. Notes are expressly governed by California law. Since Notes constitute junior debt, Corporation and Affiliate did not receive any proceeds from the Year 2 non-judicial foreclosure.

Taxpayer reported the income from the discharge of indebtedness from cancellation of Notes on its Schedule K as \$f of cancellation of debt ("COD") income for the Year 2 taxable year, which was allocated to Members on their respective Schedules K-1. To the extent of their reported insolvencies, Members in the aggregate excluded \$g from gross income under § 108(a)(1)(B), and eliminated net operating losses of \$h pursuant to the tax attributes reduction rules of § 108(b). Members will achieve a permanent tax benefit of close to \$i on the \$j of excluded COD, which was passed through to them from Taxpayer.

Taxpayer is under examination. The examining agent raised the issue of whether this COD income should be reclassified as amount realized from a sale or other disposition of property under § 61(a)(3). The agent reasons that pursuant to §§ 1.1001-2(a)(1) and (4)(i) of the Treasury Regulations, if debt that is discharged in connection with the sale or other disposition of property is nonrecourse to the borrower, the full amount of the discharged debt is included in the amount realized, and thus the transaction will result in gain or loss. One result of this reclassification at the partnership level is that Taxpayer's Members will be unable to exclude part of the income under § 108 at the partner level.

Taxpayer argues that the regulations under § 752 determine whether a loan to a partnership is recourse or nonrecourse to the partnership for § 1001 purposes.

### LAW AND ANALYSIS

Section 61(a) provides that gross income includes all income from whatever source derived, including gains derived from dealings in property under § 61(a)(3) and income from discharge of indebtedness under § 61(a)(12).

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted, and the loss is the excess of the adjusted over the amount realized. Section 1.1001-2(a)(1) provides that, except as otherwise provided in §§ 1.1001-2(a)(2) and (3), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. See also Commissioner v. Tufts, 461 U.S. 300, 309 (1983).

Section 1.1001-2(a)(2) provides that the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) COD income under § 61(a)(12). Accordingly, when property encumbered by recourse indebtedness is transferred in satisfaction of a debt secured by the property, the transaction is bifurcated into an amount realized on sale and an amount of COD income. The amount realized on sale is the fair market value ("FMV") of the property, and any excess of debt over FMV is COD income. Section 1.1001-2(c), Example (8); Rev. Rul. 90-16, 1990-1 C.B. 12. The difference between the FMV of the property and its basis thus is recognized as gain or loss pursuant to § 61(a)(3), and the excess of the debt discharged in the transaction over the FMV of the property is COD under § 61(a)(12). The amount of COD could be excludible from income under § 108(a)(1)(B) if the taxpayer were insolvent.

Section 1.1001-2(a)(4)(i) provides that for purposes of § 1001, the sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability. For property encumbered by nonrecourse indebtedness, the amount realized on disposition includes the entire amount of the debt on the properties. Section 7701(g) (in determining gain or loss, fair market value of property is treated as not less than the amount of nonrecourse indebtedness to which the property is subject); Tufts, 461 U.S. at 312; § 1.1001-2(c), Example (7). This is also true when a taxpayer agrees to surrender property in exchange for cancellation of debt in a foreclosure sale or in a transfer in lieu of foreclosure. 2925 Briarpark, Ltd. v. Commissioner, T.C. Memo 1997-298, aff'd, 163 F.3d 313, 318 (5<sup>th</sup> Cir. 1999). No part of such a transaction represents COD income taxable under § 61(a)(12) and the exclusions under § 108 do not apply to the transaction.

Under § 1.1001-2(c), a loan is recourse if the borrower is personally liable for the debt, and nonrecourse if the borrower is not personally liable for the debt and the creditor's recourse is limited to the secured asset. Otherwise, the Code and regulations do not define recourse and nonrecourse for purposes of § 1001. Generally, however, whether a debt is recourse or nonrecourse depends on whether a creditor's right of recovery is limited to a particular asset (or assets) of the borrower. If a creditor's right of recovery is limited to a particular asset securing the liability, the liability is nonrecourse. If a creditor's right of recovery extends to all assets of a taxpayer, the liability is recourse.

Raphan v. United States, 759 F.2d 879, 885 (Fed. Cir. 1985); Great Plains Gasification Associates v. Commissioner, T.C. Memo 2006-276.

The partnership aggregate, and each partner's share, of items of income, gain, loss, deduction, or credit of the partnership and whether a partnership's debt is recourse or nonrecourse are properly determined at the partnership level. Section 301.6231(a)(3)-1(a)(1)(i) and (v), *Proced. & Admin. Regs.*

For purposes of determining a partner's basis in a partnership, §§ 1.752-1(a)(1) and (2) provide that a partnership liability is recourse to the extent that any partner or related person bears the economic risk of loss for that liability under § 1.752-2, and a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss under § 1.752-2.

Sections 1.752-2(a) and (b)(1) provide that a partner's share of a recourse partnership liability equals the portion of that liability for which the partner bears the economic risk of loss, and a partner bears the economic risk of loss to the extent that, if the partnership constructively liquidated, the partner would be obligated to make a payment and is not entitled to reimbursement from another partner (or related person).

Sections 1.752-2(b)(3)(i), (ii) and (iii) recognize payment obligations such as guarantees, indemnifications, reimbursement agreements, and other contractual obligations imposed outside the partnership agreement, capital calls and deficit restoration obligations, etc., imposed by the partnership agreement, and payment obligations imposed by state law.

Taxpayer is a state law limited liability company taxed as a partnership and a SPE. Taxpayer argues that Notes are recourse to it because Members are personally liable for repayment under the guaranty agreements. Taxpayer reasons that Members' guarantees are payment obligations under § 1.752-2(b)(3)(i) that represent an economic risk of loss to Members, and, as a result, Notes meet the definition of "recourse" loans under §§ 1.752-1(a)(1) and 1.752-2. Taxpayer's position is that the § 752 regulations determine if partnership debt is characterized as recourse or nonrecourse to a partnership for § 1001 purposes.

Taxpayer cites footnote 35 in Great Plains, in which the court addressed the Service's argument that partnership's debts were nonrecourse because the partners did not sign personal guarantees that would have resulted in an economic risk of loss to the partners for purposes of § 1.752-1(a)(2). The implication of footnote 35 is that it is the Service's position that whether a debt is recourse or nonrecourse at the partnership level is determined by whether the partners personally guarantee the debt at the partner level. In Great Plains, the partners did not personally guarantee the partnership's debt. Here, Members of Taxpayer did sign personal guarantees.

The Tax Court did not decide Great Plains by reference to the regulations under § 752. Instead, footnote 35 merely points out that the regulations cited by the Service were not in effect at any time relevant to the case. Moreover, as discussed below, the Tax Court held that the debt in Great Plains was nonrecourse to the partnership.

The implication created by Great Plains is erroneous. The regulations under § 752 are limited to determining the partners' basis in the partnership. The definition of a recourse liability found in § 1.752-1(a)(1) is limited to issues under § 752, rather than a definition intended to extend to issues under §§ 61 and 1001. The primary authority for this conclusion is found in the regulatory text of § 1.752-1(a) which states, prefacing the definition of "recourse liability," "nonrecourse liability," "related person," and "liability," that the definitions found in this paragraph apply "for purposes of § 752."

In addition, the § 1.752-1(a)(1) definition of "recourse liability" does not even extend to all of Subchapter K. For instance, the regulations concerning the allocation of deductions that are attributable to nonrecourse liabilities found under § 704, define "nonrecourse liabilities" in a way that may encompass liabilities classified as "recourse" under § 752. Specifically, § 1.704-2(b)(4) defines "partner nonrecourse liability" as:

[A]ny partnership liability to the extent the liability is nonrecourse for purposes of § 1.1001-2, and a partner or related person (within the meaning of § 1.752-4(b)) bears the economic risk of loss under § 1.752-2 because, for example, the partner or related person is the creditor or guarantor.

Additionally, the preamble to the final regulations which contains the above-cited regulation states:

The regulations contain rules which generally parallel the rules applicable to nonrecourse debt, covering nonrecourse debt for which a partner bears the economic risk of loss ("partner nonrecourse debt"). A liability is treated as partner nonrecourse debt to the extent a partner bears the economic risk of loss solely because the partner or a related person (within the meaning of the § 752 regulations) is the creditor or guarantor and the debt is considered nonrecourse for purposes of §1.1001-2.

56 FR 66978-01, 1992-5 IRB 4 (1991). See also William S. McKee, William F. Nelson and Robert L. Whitmire, Federal Taxation of Partnerships and Partners, ¶ 8.02[2] (2014) ("[A] 'fundamental concept' of the § 752 regulations is that [a] liability that is treated as a nonrecourse liability for other tax and business purposes may nonetheless constitute a recourse liability under the § 752 Regulations. For example, a partner is treated as bearing the economic risk of loss for a liability (and therefore the liability is treated as recourse for § 752 purposes) to the extent that the partner (or a related person) holds or guarantees the liability, even if the liability would be treated as nonrecourse for purposes of Regulation § 1.1001-2 or for nontax purposes.").

A partner's guarantee of partnership debt, and thus the classification of that debt as recourse or nonrecourse under the § 752 regulations, will not affect the determination of whether the debt is recourse or nonrecourse to the partnership for purposes of § 1001.

The determination of whether the loan in the instant case is recourse or nonrecourse for § 1001 purposes requires a factual analysis of the operating and loan documents and any relevant state law. We defer to your office and the examining agent to conduct this factual analysis; this memorandum does not reach a conclusion as to whether Notes are recourse or nonrecourse. To aid your analysis, we offer the following observations.

A facts and circumstances analysis was performed in Great Plains Gasification Associates v. Commissioner, T.C. Memo 2006-276, a case with similarities to the instant case, and which supports a nonrecourse conclusion. In Great Plains, a partnership of five major energy companies borrowed \$1.5 from a bank to develop a project. The partnership secured the loan with a mortgage on the partnership assets, which was guaranteed by the United States Department of Energy ("DOE"). Pursuant to the credit agreement, the bank agreed that upon default of the loan "any recovery on a claim against Borrower [the partnership] or any Partner which may arise under this Agreement...shall be limited to the assets of the Borrower and such Partner's interests in such assets." None of the partners personally guaranteed the loan. The partnership subsequently defaulted on the loan, the DOE paid off the loan. By subrogation, the partnership debt shifted from the bank to DOE. Pursuant to a foreclosure sale, DOE acquired the partnership's mortgaged assets for \$ 1 billion, effectively reducing the partnership's outstanding liability. At issue was whether the partnership had to take into account the full \$1.57 billion debt as amount realized from the discharge of the debt by the foreclosure sale.

The Tax Court in Great Plains held that the debt was nonrecourse to the partnership and therefore the partnership had to take into account the full amount of the \$1.57 billion debt as the amount realized by the partnership. In support for this holding, the court specifically stated:

Pursuant to the terms of the loan guarantee agreement, DOE's recovery on any claim was limited to the partnership's assets and to the partners' interests in those assets. Pursuant to the indenture of mortgage for the loan guarantee agreement, the collateral for the debt included all project assets, including all real or personal property "now owned or hereafter acquired by" the partnership. Insofar as the record reveals, the partnership had no significant assets apart from the project assets that were foreclosed upon. Indeed, pursuant to the partnership agreement and loan guarantee agreement, the partnership was not authorized to acquire nonproject assets or to engage in any business other than the project. After DOE took control of the project and acquired the project assets, there was no realistic possibility that the partnership was going to acquire additional assets. In these circumstances, the partnership's liability on the debt was effectively limited to the project assets that collateralized

the indebtedness, and the partners' liabilities were effectively limited to their interests in those project assets. In these circumstances, the debt was in substance nonrecourse against the partnership and the partners. We do not believe that the partners should be considered to have had any personal liability for the partnership's debt within the meaning of the then-applicable regulations.

T.C. Memo 2006-76 at \*25 [footnotes omitted].

In the instant case, the operating documents and the loan documents, as well as the Taxpayer's status as a SPE, expressly limit Taxpayer's assets to those related to developing Property, a single project. Any and all assets (including future leases, rents and fixtures) held by Taxpayer necessarily relate to Property, and thus secure Notes. Since Taxpayer was not authorized to acquire non-Property assets, the operating documents and loan documents stop short of imposing full, unconditional, personal liability on Taxpayer for repayment of Notes. The lenders, therefore, had no further recourse against Taxpayer once Property and the assets related to Property were exhausted when the senior lender foreclosed on the property.

On the other hand, while the facts in the instant case are in some ways analogous to Great Plains, the value of Great Plains as precedent is diminished because the opinion does not have internal case cites supporting its conclusions and because it's a memorandum decision, as opposed to a full Tax Court decision or a circuit court decision. In addition, the instant case may be distinguished from Great Plains based on the fact that in Great Plains, unlike the instant case, the partners did not pledge their interests in the partnership as additional security for the loan, nor did they personally guarantee the loan.

In addition, even though Notes lack language expressly imposing an unconditional personal liability for repayment on the Taxpayer, Notes are secured by all assets Taxpayer will ever have, including rents. Notes also are secured by a pledge of Members' interests in the Taxpayer and a general assignment of Members' rights, title, and interest in and to the Property. Thus, in the event of default, a lender could act on Members' pledges and acquire Members' rights, title, and interest (i.e., ownership) in Taxpayer and thus acquire all assets held by Taxpayer. Consequently, when dealing with an LLC that is also a SPE, all assets of the entity necessarily secure the loans used to acquire or construct such assets when Members pledge their interests in the entity to secure a loan. Express unconditional personal liability language may not be necessary to make the debt recourse to an entity under these facts. The combination of Members' pledges, general assignment of rights, and guarantees, in addition to the loan being secured by all assets of the Taxpayer as a result of its status as a SPE, may be sufficient for the loan to be recourse to the entity. The lender's recourse was not limited to the assets immediately acquired with the debt but extended to all assets of the Taxpayer.



We are available to discuss further if additional factual development based on the operating documents, loan documents, and relevant state law identifies additional (or changed) facts that you think bear on the question.

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