Tax Law

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Bad Boy Guarantee May Cause Deductions From Nonrecourse Loan to be Reallocated

In a recent Internal Litigation Memorandum, the Internal Revenue Service found that a nonrecourse loan containing certain "bad boy" guarantees required the loan to be treated as a recourse loan for federal income tax purposes. As a result, the loan and related deductions were allocable only to the partners who provided the guarantees.

In the memo, there are seven nonrecourse carve-out provisions, which require payment of the entire outstanding principal balance of the loan, together with all interest and any other amount due and payable, if:

1. the borrowers fail to obtain the lender's consent before obtaining subordinate financing or transfer the secured property,
2. any borrower files a voluntary petition in bankruptcy,
3. any person in control of any borrower files an involuntary bankruptcy petition against a borrower,
4. any person in control of any borrower solicits other creditors to file an involuntary bankruptcy petition against a borrower,
5. any borrower consents to or otherwise acquiesces or joins in an involuntary bankruptcy or insolvency proceeding,
6. any person in control of any borrower consents to the appointment of a receiver or custodian of assets, or
7. any 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.

Although the memo indicates that "one or more" of the conditions was sufficient to cause the otherwise nonrecourse loan to be recharacterized, the IRS informally advised that it was only condition 7 that caused the concern. The IRS views condition 7 — the guarantee in the event of an assignment for the benefit of creditors or admission to being insolvent or an inability to pay debts as they become due — as a payment guarantee, indicating that lenders have been able to enforce these provisions in that capacity. According to the informal advice, the other bad boy conditions in the memo are not an issue and do not cause a recharacterization.

Practitioners have been critical of the memo, even if it is limited to condition 7. There is little difference between condition 7 and many of the other conditions. They should all be considered contingent and extremely remote. If they weren't, it is unlikely the loan would be made.

If you have any questions, please contact Alan J. Tarr (212-407-4900, atarr@loeb.com) or Tom Lawson (310-282-2289, tlawson@loeb.com).

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