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## **At-Risk Rules —IRS Issues Regulations for Qualified Nonrecourse Financing**

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The IRS recently issued final regulations regarding the definition of “qualified nonrecourse financing” and the treatment of such financing under the at-risk rules of Internal Revenue Code section 465.

### **Background**

Code section 465 limits the deductions that one may take for tax purposes to the taxpayer’s “amount at risk” with respect to each business or investment activity in which an individual or closely held C corporation is engaged (whether directly or indirectly through an entity such as a partnership or an S corporation).

In general, the amount at risk is the sum of (a) the cash and other property contributed to the activity and (b) the amounts borrowed with respect to the activity, to the extent the taxpayer is either personally liable to repay such amounts or has pledged property not used in the activity as collateral for the borrowing.

In 1986 (when the at-risk rules were extended to real property), the amount at risk with respect to the activity of holding real property was expanded to include qualified nonrecourse financing (known as “QNF”) which is secured by real property used in the activity. QNF is defined as financing (i) which is borrowed with respect to the activity of holding real property, (ii) which is borrowed from a “qualified person” or governmental entity, (iii) with respect to which no person is personally liable, except as otherwise provided in regulations, and (iv) which is not convertible debt.

Twelve years after this amendment to section 465, final regulations have been issued concerning some of the requirements relating to QNF. Section 1.465-27 of the regulations relates principally to the third definitional requirement enumerated above, regarding no personal liability, and to the requirement that QNF be secured by real property in order to be included in a taxpayer’s amount at risk.

The new regulation is effective for any financing incurred on or after August 4, 1998, but taxpayers may apply the regulation retroactively to financing incurred before that date.

### **Secured by Real Property**

The regulation initially states that, “[f]or a taxpayer to be considered at risk under section 465(b)(6), qualified nonrecourse financing must be secured only by real property used in the activity of holding real property.” Property that is incidental to the activity of holding real property, however, is disregarded for

this purpose. For instance, one example in the regulations concludes that office equipment, a truck, and maintenance equipment used to support a real property activity of a limited liability company is incidental property, and therefore is disregarded for this purpose.

In addition, property that is neither real property nor incidental to the activity of holding real property is disregarded if the aggregate gross fair market value of such property is less than 10% of the aggregate fair market value of all property securing the financing. Thus, for example, cash, securities, or other property that otherwise secures a real property financing, but which is not or may not be incidental to the real property activity, will not disqualify the financing if the amount thereof is less than 10%, by value, of all of the property securing the financing.

For purposes of determining whether a financing is secured by real property, a borrower is treated as owning its proportional share of the assets of a partnership in which the borrower owns an equity interest, either directly or indirectly through a chain of partnerships. Thus, for example, a nonrecourse borrowing by an individual to purchase an interest in a partnership owning real property, secured only by the individual's interest in the partnership, is treated as secured by real property for purposes of applying the QNF rules.

### **Partial Liability**

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 QNF. Thus, an example in the regulations provides that, where an LLC classified as a partnership for tax purposes borrows \$500, and one member of the LLC is personally liable for \$100 of the financing, the \$400 portion of the financing for which no member is personally liable may qualify as QNF.

### **Personal Liability of Partnerships**

For purposes of determining whether a financing is QNF and includible as such in a taxpayer's amount at risk, the personal liability of any partnership for repayment is disregarded if (i) the only person or persons that are personally liable are partnerships, (ii) each partnership with personal liability holds only real property (or incidental property and other property below the 10% threshold described above), and (iii) upon a default under the financing, the lender may proceed only against property described in (ii) that is held by the partnerships.

Thus, for example, a borrowing with full recourse to the borrower may qualify as QNF if the borrower is a partnership (or an entity treated as a partnership for federal tax purposes) and if no person other than the borrower is personally liable, as would typically be the case if the borrower is an LLC and no provision is made to impose personal liability for repayment of the financing on LLC members or any other person.

Also, a recourse borrowing by an entity that is a partnership under local law may qualify as QNF if each partner liable for the partnership's obligations is itself an LLC which is classified as a partnership for tax purposes and which holds only real property.

Principles similar to those described above with respect to partnerships also apply with respect to financing obtained by an entity that is disregarded for federal tax purposes under the so-called check-the-box regulations, such as, typically, a single member LLC. Thus, for example, a borrowing by a single member

LLC that is personally liable for repayment of the financing, but which owns only real property and other permitted property, may qualify as QNF to the owner (member) of the LLC.

Implicit in these rules is that, given the right circumstances, a financing may be treated as QNF secured by real property even if the financing is not secured by a mortgage or other encumbrance on specific property.

## **Observations**

As liberal as the regulations appear to be in certain respects, there remain pitfalls that could cause unwelcome surprises. For example, if an individual or any entity other than a partnership or an entity disregarded for tax purposes is personally liable for a partnership financing, the entire financing is precluded from qualifying as QNF, even if much or all of the financing is allocable, under Code section 752, to partners who are not personally liable.

Also, where financing is treated as QNF secured by real property by reason of the rule disregarding the personal liability of partnerships, care must be taken that any partnership with personal liability does not acquire other property that may cause the financing to cease to be treated as QNF secured by real property (assuming, without concluding, that QNF ceases to be includible in a taxpayer's amount at risk if it fails to meet the "secured by real property" requirement during the relevant tax year). For example, a contribution of cash or other assets (other than real property) to an upper-tier partnership that is personally liable for a lower-tier partnership's financing, or a sale by such an upper-tier partnership of real property for cash or property other than real property, could cause the lower-tier financing to cease to qualify as QNF secured by real property.

This potential hazard suggests that, as a planning matter, it may be preferable where QNF treatment is desired to obtain financing which is nonrecourse in all respects, or to establish a structure under which liability for the financing is limited to an entity owning (and expected to own) only the real property being financed and incidental property.

The new regulation does not address, and the IRS has not otherwise provided definitive guidance with regard to, other QNF issues that have been of concern to practitioners, including those relating to the definition of a "qualified person" from which QNF may be borrowed and related issues that have arisen in the context of structuring securitized loans.

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