Section 465–Qualified Nonrecourse Financing

26 CFR 1.465–27: Qualified non recourse financing.

T.D. 8777

DEPARTMENT OF THE TREASURY
Internal Revenue Service

26 CFR Part 1

Qualified Nonrecourse Financing Under Section 465(b)(6)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on certain issues regarding qualified nonrecourse financing under section 465(b)(6). These final regulations affect individuals and C corporations for which the stock ownership requirement of section 542(a)(2) is satisfied. These regulations provide guidance on certain issues relating to section 465(b)(6).

DATES: *Effective date :* These regulations are effective August 4, 1998.

Applicability dates : See Effective Dates under Supplementary Information of the preamble.

FOR FURTHER INFORMATION CONTACT: Jeff Erickson at (202) 622-3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends 26 CFR part 1 to provide rules regarding qualified nonrecourse financing under section 465(b)(6). Section 465 limits a taxpayer's loss deduction for an activity to the taxpayer's amount at risk in the activity at the close of the taxable year. A taxpayer's amount at risk generally includes the amount of any cash and the adjusted tax basis of any property contributed by the taxpayer to the activity plus any amounts borrowed for use in the activity to the extent the taxpayer is personally liable for repayment. For the activity of holding real property, section 465(b)(6) provides that a taxpayer may include as an amount at risk the taxpayer's share of any qualified nonrecourse financing that is secured by real property used in the activity of holding real property, even though the taxpayer is not personally liable for repayment of the financing.

On August 13, 1997, the IRS published in the **Federal Register** (62 FR 43295 [REG–105160–97, 1997–37 I.R.B. 22]) a notice of proposed rulemaking regarding section 465(b)(6). A number of comments were received on the proposed regulations. The public hearing scheduled for December 10, 1997, was canceled because no one requested to speak. After considering the written comments, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

I. *Secured by Real P roperty*

A. Proposed Rule

Section 465(b)(6)(A) provides that qualified nonrecourse financing must be secured by real property used in the activity of holding real property. The proposed regulations provided that a financing can be a qualified nonrecourse financing if, in addition to the real property used in the activity of holding real property, the financing is secured by other property that is incidental to the activity of holding real property (incidental property).

B. Discussion of Comments

A commentator recommended that the final regulations clarify the term *incidental property*. Another commentator asked that the IRS and Treasury define incidental property as any property with a value of not more than 15 percent of the value of the real property held by the borrowing partnership. A third commentator explained that real estate partnerships often hold assets in addition to real property and incidental property. This commentator was concerned that only financings held by partnerships that own only real estate assets could satisfy the proposed regulations. Under the final regulations, if the total gross fair market value of property that is neither real property used in the activity of holding real property nor incidental property is less than 10 percent of the total gross fair market value of all the property securing the financing, such other property is ignored in determining whether the financing satisfies the secured-by-real-property requirement.

Another commentator asked for a look-through rule for partnerships that own an interest in another partnership to determine the character of the assets securing a qualified nonrecourse financing. The final regulations adopt this suggestion by requiring a borrower (whether or not a partnership) to determine the character of its assets by treating itself as owning directly its proportional share of the assets in any partnership in which it owns (directly or indirectly through a chain of partnerships) an equity interest. If a borrower pledges a partnership interest as security for a financing, the partnership assets attributable to the borrower's proportional share of the partnership's assets will be treated as security for the financing.

Commentators also asked under what circumstances qualified nonrecourse financing will be treated as secured by real property. Because this issue is closely-related to the determination of whether the personal liability of a partnership will be disregarded, those issues are addressed together and are discussed in II. *Personal Liabilit y*of this preamble.

A commentator suggested that the final regulations adopt a rule to allocate a single debt obligation among multiple brother-sister partnerships when the obligation is secured by the assetsof more than one partnership. The IRS and Treasury believe this issue is beyond the scope of these regulations.

II. *Personal Liability*

A. Proposed Rule

Section 465(b)(6)(B)(iii) provides that, except to the extent provided in regulations, no person may be personally liable for repayment of a qualified nonrecourse financing. The proposed regulations provided that the personal liability of a partnership (including a limited liability company that is treated as a partnership) is disregarded in determining whether a fi-

nancing is a qualified nonrecourse financing if the entity's only assets are real property used in the activity of holding real property or both real property and other property that is incidental to the activity of holding real property, and no other person is liable for the financing.

B. Discussion of Comments

Commentators focused on how the proposed regulations apply to tiered partnership structures—when a partnership (the upper-tier partnership) owns a partnership interest in another partnership (the lower-tier partnership). These commentators questioned whether the personal liability of an upper-tier partnership that holds, directly or indirectly, only real property or incidental property should disqualify a financing under section 465(b)(6). As mentioned in I. *Secured by Real Property* of this preamble, commentators also requested guidance as to the situations in which a nonrecourse financing will be treated as secured by real property.

In order to address these comments, the final regulations adopt a three-part test. Under the final regulations, the personal liability of any partnership will be disregarded and, provided certain other requirements 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 that is permitted as security for qualified nonrecourse financing (applying a look-through rule for lower-tier partnerships); 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 permitted as security for qualified nonrecourse financing and that is held by the partnership or partnerships (applying a look-through rule for lower-tier partnerships). Similar principles apply in determining the treatment of financing incurred by an entity that is disregarded for federal tax purposes under §301.7701–3 of the Procedure and Administration Regulations. The final regulations contain three examples illustrating the application of these rules to tiered partnerships and one example addressing a situation that involves a disregarded entity.

III. *Other Issues*

A commentator asked that the final regulations clarify whether an entity is disregarded for purposes of section 465(b)(6) if that entity is disregarded as separate from its owner under §301.7701–3. An entity that is disregarded as an entity separate from its owner under §301.7701–3 is disregarded under section 465(b)(6). Certain rules that apply to financings involving disregarded entities are discussed above.

Commentators also raised several other issues, including the treatment of publicly traded financing, that are beyond the scope of these regulations.

IV. *Effective Dates*

The final regulations are effective for any financing incurred on or after August 4, 1998. In response to comments, however, the final regulations include a provision allowing taxpayers to apply the regulations retroactively for financing incurred before August 4, 1998. If a taxpayer chooses to apply these regulations retroactively to financing incurred before August 4, 1998, the IRS will require the taxpayer to reduce the amounts at risk as a result of the application of the regulations to taxable years ending before August 4, 1998**,** only to the extent the application increases the losses allowed for such years.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f), the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Jeff Erickson, Office of the Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the offices of
the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1–INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

§1.465–27 also issued under 26 U.S.C. 465(b)(6)(B)(iii). * * *

Par. 2. Section 1.465–27 is added to read as follows:

§1.465–27 Qualified nonrecourse financing.

(a) *In general.* Notwithstanding any provision of section 465(b) or the regulations under section 465(b), for an activity of holding real property, a taxpayer is considered at risk for the taxpayer's share of any qualified nonrecourse financing which is secured by real property used in such activity.

(b) *Qualified nonrecourse financing secured by real property*—(1) *In general.* For purposes of section 465(b)(6) and this section, the term *qualified nonrecourse financing* means 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) For which no person is personally liable for repayment, taking into account paragraphs (b)(3), (4), and (5) of this section; and

(iv) Which is not convertible debt.

(2) *Security for qualified nonrecourse financing*—(i) *Types of property.* For 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. For this purpose, however, property that is incidental to the activity of holding real property will be disregarded. In addition, for this purpose, property that is neither real property used in the activity of holding real property nor incidental property will be disregarded if the aggregate gross fair market value of such property is less than 10 percent of the aggregate gross fair market value of all the property securing the financing.

(ii) *Look-through rule for partnerships.* For purposes of paragraph (b)(2)(i) of this section, a borrower shall be treated as owning directly its proportional share of the assets in a partnership in which the borrower owns (directly or indirectly through a chain of partnerships) an equity interest.

(3) *Personal liability; 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 qualified nonrecourse financing.

(4) *Partnership liability.* For purposes of section 465(b)(6) and this paragraph (b), the personal liability of any partnership for repayment of a financing is disregarded and, provided the requirements contained in paragraphs (b)(1)(i), (ii), and (iv) of this section 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 paragraph (b)(2)(i) of this section (applying the principles of paragraph (b)(2)(ii) of this section 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 paragraph (b)(2)(i) of this section and that is held by the partnership or partnerships (applying the principles of paragraph (b)(2)(ii) of this section in determining the property held by the partnership or partnerships).

(5) *Disregarded entities.* Principles similar to those described in paragraph (b)(4) of this section shall apply in determining whether a financing of an entity that is disregarded for federal tax purposes under §301.7701–3 of this chapter is treated as qualified nonrecourse financing secured by real property.

(6) *Examples.* The following examples illustrate the rules of this section:

Example 1. Personal liability of a partnership; incidental property. (i) X is a limited liability company that is classified as a partnership for federal tax purposes. X engages only in the activity of holding real property. In addition to real property used in the activity of holding real property, X owns office equipment, a truck, and maintenance equipment that it uses to support the activity of holding real property. X borrows $500 to use in the activity. X is personally liable on the financing, but no member of X and no other person is liable for repayment of the financing under local law. The lender may proceed against all of X's assets if X defaults on the financing.

(ii) Under paragraph (b)(2)(i) of this section, the personal property is disregarded as incidental property used in the activity of holding real property. Under paragraph (b)(4) of this section, the personal liability of X for repayment of the financing is disregarded and, provided the requirements contained in paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, the financing will be treated as qualified nonrecourse financing secured by real property.

Example 2. Bifurcation of a financing. The facts are the same as in *Example 1*, except that A, a member of X, is personally liable for repayment of $100 of the financing. If the requirements contained in paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, then under paragraph (b)(3) of this section, the portion of the financing for which A is not personally liable for repayment ($400) will be treated as qualified nonrecourse financing secured by real property.

Example 3. Personal liability; tiered partnerships. (i) UTP1 and UTP2, both limited liability companies classified as partnerships, are the only general partners in Y, a limited partnership. Y borrows $500 with respect to the activity of holding real property. The financing is a general obligation of Y. UTP1 and UTP2, therefore, are personally liable to repay the financing. Under section 752, UTP1's share of the financing is $300, and UTP2's share is $200. No person other than Y, UTP1, and UTP2 is personally liable to repay the financing. Y, UTP1, and UTP2 each hold only real property.

(ii) Under paragraph (b)(4) of this section, the personal liability of Y, UTP1, and UTP2 to repay the financing is disregarded and, provided the requirements of paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, UTP1's $300 share of the financing and UTP2's $200 share of the financing will be treated as qualified nonrecourse financing secured by real property.

Example 4. Personal liability; tiered partnerships. The facts are the same as in *Example 3*, except that Y's general partners are UTP1 and B, an individual. Because B, an individual, is also personally liable to repay the $500 financing, the entire financing fails to satisfy the requirement in paragraph (b)(1)(iii) of this section. Accordingly, UTP1's $300 share of the financing will not be treated as qualified nonrecourse financing secured by real property.

Example 5. Personal liability; tiered partnerships. The facts are the same as in *Example 3*, except that Y is a limited liability company and UTP1 and UTP2 are not personally liable for the debt. However, UTP1 and UTP2 each pledge property as security for the loan that is other than real property used in the activity of holding real property and other than property that is incidental to the activity of holding real property. The fair market value of the property pledged by UTP1 and UTP2 is greater than 10 percent of the sum of the aggregate gross fair market value of the property held by Y and the aggregate gross fair market value of the property pledged by UTP1 and UTP2. Accordingly, the financing fails to satisfy the requirement in paragraph (b)(1)(iii) of this section by virtue of its failure to satisfy paragraph (b)(4)(iii) of this section. Therefore, the financing is not qualified nonrecourse financing secured by real property.

Example 6. Personal liability; Disregarded entity. (i) X is a single member limited liability company that is disregarded as an entity separate from its owner for federal tax purposes under §301.7701–3 of this chapter. X owns certain real property and property that is incidental to the activity of holding the real property. X does not own any other property. For federal tax purposes, A, the sole member of X, is considered to own all of the property held by X and is engaged in the activity of holding real property through X. X borrows $500 and uses the proceeds to purchase additional real property that is used in the activity of holding real property. X is personally liable to repay the financing, but A is not personally liable for repayment of the financing under local law. The lender may proceed against all of X's assets if X defaults on the financing.

(ii) X is disregarded so that the assets and liabilities of X are treated as the assets and liabilities of A. However, A is not personally liable for the $500 liability. Provided that the requirements contained in paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, the financing will be treated as qualified nonrecourse financing secured by real property with respect to A.

(c) *Effective date.* This section is effective for any financing incurred on or after August 4, 1998. Taxpayers, however, may apply this section retroactively for financing incurred before August 4, 1998.

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

Approved July 16, 1998.

Donald C. Lubick,
Assistant Secretary of the Treasury (Tax Policy).

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