

Recent Guidance on Recourse and Nonrecourse Debt

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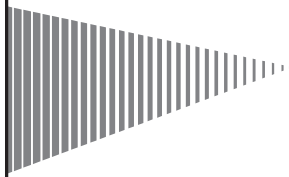


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I. Non-Recourse Debt: General Observations

- ▶ In *Thomas E. Brersi* 62 TCM 1668 (1991), the court looked to Black's Law Dictionary to determine whether the debt issue constituted a recourse or non-recourse debt. From there, the Court determined that the term "nonrecourse" meant that "the lender cannot look to the debtor personally for payment."
- ▶ IRC Section 752, states that a partnership liability is recourse to the extent that any partner or related person bears the "economic market loss" for that liability." Conversely, a partnership liability is nonrecourse to the extent no partner or related person bear the economic burden of loss for that liability under Treas. Reg. 1.752-2. This regulation, however, provides that this definition applies for "purposes of Section 752" and not for any purpose beyond the application of Section 752 allocation of partnership liabilities.
- ▶ David C. Garlock in *Federal Income Taxation of Debt Instruments* 1501.04[c] (6th Ed.) points out that the analysis of whether a debt is nonrecourse both in form and substance involves determining whether: "the security/collateral/financing documents only identify and designate a reasonably limited number, amount, and value of property to serve as debt's security (because a debt that is secured by all or virtually all of the debtor's assets is functionally the same as recourse debt). Moreover, a pledge of income or property after the debt originates (excluding income from the collateral specially designated in the debt instrument) generally causes a debt to be treated as recourse."



II. Important Distinctions between Nonrecourse Debt and Recourse Debt

- ▶ Treas Reg. 1.1001-2(a)(1) generally provides that 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.
- ▶ Treas. Reg. 1.1001-2(a)(2) provides that the amount realized on a sale or disposition of property that secures a recourse liability does not include amounts that are income from the discharge of indebtedness under Section 61(a)(12). However, the regulations do not exclude nonrecourse liabilities from being included in amounts realized on a sale or exchange of property.
- ▶ The inclusion of nonrecourse liabilities in amounts realized is illustrated in Treas. Reg. 1.1001-2(c) Example 7. The taxpayer in the example had a note that was recourse to a herd of cattle purchased with the same note. However, the taxpayer was not personally liable for the repayment of the note. Therefore, the note was nonrecourse to the taxpayer. Upon default, the taxpayer's recognized gain was the entire outstanding amount of the note less the taxpayer's adjusted basis in the herd of cattle
- ▶ Treas. Reg. 1.1001-2(c) Example 7 is supported by the following cases:
 - ▶ *Commissioner v. Tufts* 461 U.S. 300 (1983)
 - ▶ *Crane v. Commissioner* 35 AFTR 776 (331 US1)
 - ▶ *Estate of Delaware v. Commissioner* 73 TC 15 (1979)
- ▶ In the case of determining whether taxpayer is insolvent within the meaning of IRC Section 108 (d)(3), Rev. Rul. 92-53 states that "excess" nonrecourse debt is taken into account in determining whether and to what extent a taxpayer is insolvent under IRC Section 108(d)(3), but only to the extent the excess nonrecourse debt is discharged. Excess nonrecourse debt is defined as an amount by which the nonrecourse debt exceeds the fair market value of the property by which it is secured. This is contrasted with recourse debt where the entire face value amount of the debt is taken into account in determining insolvency under IRC Section 108(d)(3).
- ▶ The treatment of recourse v. nonrecourse debt in the regulations under Section 1.1000-3 is different in application
- ▶ The application of Section 108(a) and the bankruptcy exception could have different results if the debt of a disregarded entity is treated as nonrecourse as opposed to recourse to the D regarded owner.

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