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Understanding the Tax Consequences of Partnership and LLC Debt

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One of the more confusing aspects of ownership in either a partnership or Limited Liability Company (LLC) is understanding the effect that partnership or LLC debt has on an individual partner's or member's basis in that entity. Knowing how debt affects one's basis in an entity is important in determining how much a partner or member can deduct in losses that pass through *from* that entity. For simplicity, where there is no difference in treatment between a partnership and an LLC, I will use the term, "partnership".

Basis 101

Perhaps this is a good time to review the general rules of partnership basis. Basis, in the context of a partner's ability to deduct losses from their partnership, is derived as follows:

- Basis is increased by –
 - The amount of cash or the value of other assets a partner contributes to the partnership,
 - Any profits or gains allocated to that partner, and
 - Any increase in the partner's share of partnership debt.
- Basis is decreased by –
 - The amount of cash or value of other assets withdrawn from the partnership by the partner,
 - Any losses allocated to that partner, and
 - Any decrease in the partner's share of partnership debt.

That was simple enough, but, now, it's time to introduce another concept; at-risk basis. Under what are known as the at-risk rules, one can only deduct losses to the extent he is considered to be economically at-risk. So, in order to be able to deduct a \$100 loss, one has to actually be in a position to lose \$100 in real money. This is generally referred to as at-risk basis.

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Why is this important? If you look back to the items that increase or decrease basis, you will note that an increase or decrease in a partner's share of partnership debt can either increase or decrease that partner's basis in the partnership. However, it is important to understand that there are two different types of debt that will have very different effects on a partner's at-risk basis; recourse and nonrecourse debt.

Simply stated, *recourse* debt is debt of the partnership where one or more partners has **personal liability for repayment** of that debt. *Nonrecourse* debt is the opposite. It is debt of the partnership where **no partner has personal liability for its repayment**.

So, a partner's at-risk basis includes cash or property they have contributed to the partnership, plus their share of partnership debt for which they (1) are personally liable for repayment, (2) have pledged property outside of the partnership as security, or have directly loaned to the partnership.

There is one additional type of debt that can increase a partner's at-risk basis; **qualified** nonrecourse debt. Qualified nonrecourse debt is financing that is (1) borrowed from a qualified lender (2) for the purpose of holding real property (3) for which **no** person is personally liable for repayment and (4) which is not convertible debt. So, here we have a case of debt that no one is responsible for repaying that still increases all the partners' at-risk basis amounts.

Now, with a fundamental understanding of at-risk basis and recourse vs. nonrecourse debt, let's look at the differences between partnership and LLC treatment. In the partnership world, there are two types of partners; general partners and limited partners. General partners generally receive no protection from personal liability for the debts of the partnership and are fully liable for those debts, where limited partners generally **are** protected from personal liability for any partnership debts, except for any debts they have personally guaranteed.

While virtually every partnership has at least one general partner who is fully liable for partnership debts, that is not the case with LLCs. In most cases, LLC members are treated as limited partners, having no personal liability for the LLC debts. How does that affect an LLC member's at-risk basis?

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The IRS Clarification

The IRS recently released an Associate Chief Counsel Memorandum (AM 2014-003) that provides guidance to that issue by answering four specific questions. This guidance applies both to LLCs classified as partnerships and single member LLCs (SMLLCs) treated as disregarded entities for federal tax purposes. The first of the four questions starts out fairly simply as it relates to this topic with each subsequent question adding an additional layer of complexity. It is through this process that the guidance is developed.

Question 1 asks what the tax consequences are, under Code Sec. 465, to an LLC member who guarantees debt of that LLC. The response to this question explains in fairly significant detail that, assuming the guarantee is legitimate, that LLC member will increase their at-risk basis by the amount of the debt they have personally guaranteed.

Question 2 then asks what the tax consequences are to an LLC member who guarantees debt of that LLC when the guaranteed debt is qualified nonrecourse financing. The response to *this* question explains that once a member has guaranteed qualified nonrecourse debt, his (and only his) at-risk basis will increase, as in question 1, but then goes on to explain that, since a member is now guaranteeing the repayment of this debt, it no longer meets the definition of qualified nonrecourse financing. The significance of that point is addressed in the next question.

Question 3 builds upon question 2 by asking what the tax consequences are to the **other** members where one member has guaranteed qualified nonrecourse financing. As explained in the response to question 2, the debt no longer meets the definition of qualified nonrecourse financing and, as a result, the non-guarantor members may no longer include their share of that debt as part of their at-risk basis. It then goes on to say that, if the reduction of that at-risk basis to the non-guarantor members causes their cumulative at-risk basis to fall below zero, they must recognize income to that extent.

Question 4 deviates from the above scenarios by repeating question 2, above, but limiting it to the member of an SMLLC. In this case, there are no other LLC members who are affected, and the SMLLC member sees no change in his at-risk basis. Why? As qualified nonrecourse debt, the member already had at-risk basis for that debt. By guaranteeing that debt, he still has at-risk basis, so the amount of his at-risk basis didn't change. Unfortunately,

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in this case, his personal liability with regard to that debt went from zero to the amount he guaranteed.

With this memorandum, the IRS has provided some relatively uncomplicated guidance to a very complex issue (even though it probably didn't sound particularly **un**complicated). That doesn't happen often. However, the question of partnership and member basis remains one of the more complex areas of partnership tax law. For answers to your questions on this or any other tax issue, please contact one of the tax professionals at Zinner & Co. LLP.

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