

## Notice of Proposed Rulemaking and Notice of Public Hearing

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

REG-105160-97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 465(b)(6) regarding qualified nonrecourse financing. The proposed regulations address whether the personal liability of an entity prevents financing from being treated as qualified nonrecourse financing and whether qualified nonrecourse financing may be secured by property that is incidental to the activity of holding real property. The proposed regulations would affect partnerships and their partners. This document also gives notice of a public hearing scheduled for December 10, 1997.

DATES: Written comments and requests to speak (with outlines of oral comments) at the public hearing scheduled for December 10, 1997, must be received by November 19, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-105160-97), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-105160-97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: [http://www.irs.ustreas.gov/prod/tax\\_regs/comments.html](http://www.irs.ustreas.gov/prod/tax_regs/comments.html). The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Jeffrey A. Erickson, (202) 622-3070; concerning submissions and the hearing, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### *Introduction*

This document contains proposed regulations under section 465(b)(6) of the Internal Revenue Code (Code). Section 465, which applies to individuals and certain corporations, limits a taxpayer's loss deduction for an activity to the amount of 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, a taxpayer may also 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. Section 465(b)(6) defines qualified nonrecourse financing as any financing that (i) is borrowed by the taxpayer for the activity of holding real property; (ii) 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) except to the extent provided in regulations, no person is personally liable for repayment; and (iv) is not convertible debt.

##### *Explanation of Provisions*

###### *I. Secured by Real Property*

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 legislative history of section 465(b)(6) suggests that qualified nonrecourse financing can be secured only by real property. H.R. Rep. No.

426, 99th Cong., 1st Sess. 293 (1985), 1986-3 (Vol. 2) C.B. 293; S. Rep. No. 313, 99th Cong., 2d Sess. 748 (1986), 1986-3 (Vol. 3) C.B. 748. Section 465(b)(6)(E), however, provides that the activity of holding real property includes the holding of personal property that is incidental to making real property available as living accommodations. Section 465(b)(6) does not specifically provide that such incidental property may be used to secure qualified nonrecourse financing. The proposed regulations provide that financing can qualify as qualified nonrecourse financing if, in addition to the real property used in the activity of holding real property, the financing is secured by both real property and other property that is incidental to the activity of holding real property.

###### *II. Personal Liability*

Section 465(b)(6)(B)(iii) provides that, except to the extent provided in regulations, no person may be personally liable for repayment of qualified nonrecourse financing. The legislative history of section 465 states that regulations may provide rules under which the guaranty, indemnity, or personal liability of a person other than the taxpayer does not cause the financing to be treated as other than qualified nonrecourse financing. H.R. Rep. No. 426, 99th Cong., 1st Sess. 294 (1985), 1986-3 (Vol. 2) C.B. 294; S. Rep. No. 313, 99th Cong., 2d Sess. 749 (1986), 1986-3 (Vol. 3) C.B. 749.

A partnership is treated as a person under the Code. Thus, any financing for which a partnership is personally liable is not qualified nonrecourse financing under section 465(b)(6)(B)(iii), even if no partner is personally liable for the financing. This result is inappropriate if the only activity of the partnership is the real property activity; the personal liability of the partnership in that situation is not meaningful and the financing is the equivalent of nonrecourse financing. Situations in which a partnership is liable for repayment, but no partner is personally liable, may be unusual for general and limited partnerships; however, such situations may become increasingly common with the use of limited liability companies (LLCs) in which the LLC is personally liable for its debts and the members of the

LLC are not liable. In response, the proposed regulations provide that the personal liability of a partnership (including an LLC that is treated as a partnership) is disregarded in determining whether a financing is 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.

In addition, section 465(b)(6) does not specifically provide that financing may qualify as qualified nonrecourse financing if a person is personally liable for a portion of the financing. Treating the portion of the financing for which no person is personally liable as qualified nonrecourse financing would not be inconsistent with the underlying policy of section 465. Therefore, the proposed regulations provide that the portion for which no person is personally liable can qualify as qualified nonrecourse financing.

#### *Proposed Effective Date*

These regulations are proposed to be effective for financing incurred on or after the date final regulations are published in the **Federal Register**.

#### *Special Analyses*

It has been determined that this notice of proposed rulemaking 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 these regulations do not impose on small entities a collection of information requirement, 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) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### *Comments and Public Hearing*

Before these proposed regulations are adopted as final regulations, consideration will be given to any written com-

ments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for December 10, 1997, at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit timely written comments (preferably a signed original and eight (8) copies) and an outline of the topics to be discussed and the time to be devoted to each topic by November 19, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### *Drafting Information*

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

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#### *Proposed Amendments to the Regulations*

Accordingly, 26 CFR Part 1 is proposed to be 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(b)(3) 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, in the case of an

activity of holding real property, a taxpayer is considered at risk with respect to the taxpayer's share of any qualified nonrecourse financing that is secured by real property used in such activity.

(b) *Qualified nonrecourse financing—*  
(1) *In general.* For 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) Except as otherwise provided in paragraph (b)(3)(ii) of this section, for which no person is personally liable for repayment; and

(iv) Which is not convertible debt.

(2) *Secured by incidental property.* A taxpayer will be considered at risk with respect to the taxpayer's share of any qualified nonrecourse financing secured by real property used in the activity of holding real property, where such financing is also secured by property that is incidental to the activity of holding such real property.

(3) *Personal liability—*(i) *Partial liability.* If a person is personally liable for repayment of a portion of a financing, the portion of the financing for which no person is personally liable can qualify as qualified nonrecourse financing.

(ii) *Partnership liability.* The personal liability of an entity classified as a partnership for repayment of a financing shall be disregarded in determining whether the financing is qualified nonrecourse financing, if the only assets of the partnership are either real property used in the activity of holding real property or both such real property and other property that is incidental to the activity of holding such real property, and no other person is liable for repayment of the financing.

(4) *Examples.* The following examples illustrate the rules of paragraph (b) of this section:

*Example 1. Personal liability of partnership; Incidental property.* X is a limited liability company that is classified as a partnership for federal tax purposes. X is engaged 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 prop-

erty. 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 paragraph (b)(3)(ii) of this section, the personal liability of X for repayment of the financing is disregarded when determining whether the financing is qualified nonrecourse financing. Under paragraph (b)(2) of this section, the personal property is treated as incidental personal property used in the activity of holding real property. Therefore, assuming the financing satisfies the other requirements for qualified nonrecourse financing, the financing will be treated as qualified nonrecourse financing.

*Example 2. Bifurcation of 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. Under paragraph (b)(3)(i) of this section, the portion of the financing for which A is not personally liable for repayment (\$400) can qualify as qualified nonrecourse financing.

(c) *Effective date.* This section is effective for financing incurred on or after the date the final regulations are published in the **Federal Register**.

Michael P. Dolan,  
*Acting Commissioner of  
Internal Revenue.*

(Filed by the Office of the Federal Register on August 12, 1997, 8:45 a.m., and published in the issue of the Federal Register for August 13, 1997, 62 F.R. 43295)

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