SQUIRE PATTON BOGGS

New Regulations Affect Historic Tax Credit and Energy Tax Credit Transactions

New Temporary and Proposed Regulations, scheduled to be published in the Federal Register July 22, 2016, detail the tax treatment of so-called "**50(d) income**" when an Historic Tax Credit or Energy Tax Credit (or certain other less common investment tax credits) is "passed through" to a lessee. The new regulations have been anticipated for over two years.

Highlights of the new regulations are as follows:

- The regulations apply to property placed in service on or after **September 19, 2016**. While superficially this would seem to effectively grandfather existing transactions (including transactions where the project can be completed and placed in service by September 18, 2016), the background discussion in the preamble and some examples in the regulations indicate that the IRS apparently intends to apply the new rules to all transactions.
- 50(d) income is taken into account directly by partners in a lessee partnership, and thus there is **no stepped-up basis in the partnership interest** resulting from the income.
- On an exit from a lessee partnership following the recapture period, a partner **may, but is not required to, elect to** accelerate the remaining 50(d) income.

Code §50(d)(5), by cross-reference to certain Code provisions repealed in 1990, has always required a lessee of investment credit property where a "pass through" election has been made to allow the lessee to claim the credit, to take into account notional income over the recovery period of the property equal to the amount of the credit, or, for energy credit property, one-half of the credit.

Prop. Reg. §1.48-4(n) (never finalized) provided rules concerning adjustments of 50(d) income on a recapture event, but there has been no other guidance concerning 50(d) income, including the treatment of 50(d) income by a lessee that was a partnership.

In light of this dearth of guidance, taxpayers applied general tax rules, including the requirement in Code §705 that the partners step-up the basis of their partnership interest by the amount of 50(d) income allocated to them.

The result of such basis step-up was that an investor partner in the lessee partnership realized a loss on the sale of the partnership interest following the recapture period. This meant that the tax treatment of the basis reduction required by Code §50(c) where the credit was not passed through was different from the treatment under Code §50(d)(5) where the credit was passed through.

The IRS became aware of this discrepancy in connection with preparation of the Boardwalk Guidance, Rev. Proc. 2014-12, and publicly announced that they considered the disparate treatment inappropriate, and that these regulations would be forthcoming. Some two years later, they are finally here.

Application of New Regulations

The regulations specifically provide that they are applicable to property placed in service on or after September 19, 2016, which is 60 days after the date of filing in the Federal Register. The regulations specifically provide that they should not be construed to create any inference concerning the proper interpretation of Code §50(d)(5) prior to the effective date.

This would seem to effectively grandfather existing transactions where the property has been placed in service (and those properties that can be completed and placed in service by September 18, 2016). Despite this, several examples in the regulations apply the new rules to property specified to be placed in service on July 1, 2016, prior to both the effective date (July 22, 2016) and the applicability date (September 19, 2016) of the new regulations. In light of the discussion in the preamble, this likely illustrates the view of the IRS that the new rules are a clarification of what current rules require, despite the statement to the contrary that they should not be construed in that manner.

Basic Rules

The basic rules concerning 50(d) income, for which there was no disagreement, are restated in the regulations.

When an Historic Tax Credit, Energy Tax Credit or certain other investment tax credits are "passed through" to the lessee pursuant to an election under Code §48(d) (as in effect prior to repeal in 1990):

- The lessor **is not** required to reduce the basis of the property under Code §50(c);
- The lessee **is** required to include in income over the shortest recovery period applicable to the property (*i.e.,* 5 years for solar or wind energy property, 27.5 years for residential rental property, and 39 years for nonresidential real property) an amount equal to the Historic Tax Credit claimed, or one-half of the Energy Tax Credit claimed; and
- If the credit is recaptured, a positive or negative adjustment is made to 50(d) income so that total 50(d) income taken into account equals the amount of the Historic Tax Credit not recaptured, or one-half of the Energy Tax Credit not recaptured.

New Rules

The regulations add several new rules:

- The notional 50(d) income accrues on a date-certain each year, being the date the property is placed in service and each anniversary thereof;
- Where the lessee is a partnership, the partners must take into account their share of 50(d) income directly, *i.e.,* the income is not allocated to them from the partnership – the result of this rule is that the basis of the partnership interest is not stepped-up by the 50(d) income;
- Following the recapture period, on the disposition of a partner's interest in the lessee partnership, or the termination of the lease, the partners may, but are not required to, elect to accelerate the remaining 50(d) income – if no such election is made, the partners continue to include 50(d) income over the remainder of the recovery period, regardless of whether they remain partners in the lessee partnership; and
- The lessee (or its partners) must take into account 50(d) income even though the credit itself is limited by Code §38(c) – such limitation currently does not apply to either the Historic Tax Credit or the Energy Tax Credit.

Contact

Steven F. Mount
T +1 614 365 2727
E steven.mount@squirepb.com