



The Cost of Clarity: IRS Issues Regulations Addressing Proper Treatment of Code Section 50(d) Income

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On July 21, 2016, the IRS issued long-awaited regulations under Section 50 of the Internal Revenue Code (the "Code") clarifying the manner in which "Section 50(d) Income" is to be recognized in lease pass-through investment tax credit arrangements. The new Temporary Regulations Section 1.50-1T (the "New 50(d) Regulations") apply to investment credit property placed in service on or after September 19, 2016 and will have an economic effect on federal tax credit deals that utilize a lease pass-through structure, including certain historic rehabilitation credit and energy credit transactions.

Background

In a single-tier investment credit arrangement, the owner of investment credit property is generally required, pursuant to Code Section 50(c), to reduce its tax basis in such property by the amount of the credit allowed, thereby causing the recipient of the investment credit to eventually recognize taxable income attributable to receipt of the credit. However, in the case of a lease pass-through arrangement (i.e., where the lessor of the investment credit property properly elects to treat the lessee as having acquired the investment credit property such that the lessee, not the lessor, may claim the investment tax credit), in lieu of the basis reduction under Code Section 50(c), the lessee generally is required, pursuant to Code Section 50(d), to recognize an amount of income ratably over the recovery period for the property equal to the investment credit claimed (the "Section 50(d) Income").

Until the IRS issued the New 50(d) Regulations, there was uncertainty as to how the Section 50(d) Income would be taken into account by lessees that are partnerships, limited liability companies (LLCs), or S corporations. Namely, the issues were (i) whether the inclusion of the Section 50(d) Income gives rise to an increase in the partners' or shareholders' bases in their respective interests or stock of the lessee (a position which many investors have taken), (ii) whether, for partnerships and LLCs, the Section 50(d) Income can be specially allocated among the partners or members of the lessee, and (iii) what happens in the event that a partner or shareholder of the lessee transfers its interest during the Section 50(d) Income recovery period.

The New 50(d) Regulations

The New 50(d) Regulations make it clear that, for investment credit property placed in service after September 19, 2016 and passed through to a lessee that is taxed as a partnership or S corporation, the inclusion of Section 50(d) Income is not an item of partnership or S corporation income. Under the New 50(d) Regulations, therefore, the Section 50(d) Income can neither be specially allocated nor give rise to an increase in the outside bases of the equity of the lessee's partners or shareholders. Instead, the New 50(d) Regulations provide that the Section 50(d) Income is taken into account by the "ultimate credit claimant," which is defined as each partner or shareholder of the lessee that files (or would file) IRS Form 3468 with his, her or its annual federal income tax return to claim the investment credit. The New 50(d) Regulations further provide that, upon a lease termination or upon a disposition by such "ultimate credit claimant" of his, her or its interest in the lessee occurring after the expiration of the credit recapture period but before all of the Section 50(d) Income has been recognized, the ultimate credit claimant may elect to accelerate his, her or its recognition of the remaining Section 50(d) Income in the year of such termination or disposition. If no such election is made, the ultimate credit claimant should continue to recognize the Section 50(d) Income over the remaining recovery period for the property despite the termination of the lease or the disposition of his, her or its interest in the lessee. The New 50(d) Regulations also provide special rules for calculating adjustments to Section 50(d) Income in the event of a recapture of the credit. Finally, the New 50(d) Regulations amend the safe harbor under Revenue Procedure 2014-12 for allocating historic rehabilitation credits to remove all references to allocations of Section 50(d) Income.

The Effect on Investment Credit Transactions

The New 50(d) Regulations will have an effect on the economics of federal tax credit transactions, such as historic tax credit deals. To the extent that such transactions utilize lease pass-through structures, the Section 50(d) Income recognition likely will cause a reduction in credit values or an increase in the ultimate credit claimant's equity on exit. In either scenario, developers and investors involved in historic tax credit transactions or other similar federal tax credit arrangements should take note of the New 50(d) Regulations and consider alternative tax structures or review their financial projections to determine the economic consequences of the recognition of the Section 50(d) Income under the New 50(d) Regulations.

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