At long last, the IRS Publishes 50(d) Regulations. What does it mean to the historic and renewables industries?

By Forrest Milder

This client alert discusses just-published tax rules related to the lease-pass-through (or “inverted lease”) tax credit structure that is employed in many historic and renewable energy transactions. In this structure, the landlord, which owns the property (either an historic building eligible for the rehabilitation tax credit provided in Section 47 of the Internal Revenue Code, or a renewable energy facility that is eligible for the investment tax credit found in Section 48), does not claim the credit; instead, the credit is passed through to the lessee of the building or facility (the “Credit Property”).

Lease pass-through structures: a little background

If the landlord had claimed the credit, then the applicable tax rules require the landlord to reduce its basis in the Credit Property by the amount of the credit (in historic transactions) or half that amount (in renewables). This basis reduction means that the depreciation deductions available to the landlord are reduced. In addition, if and when an historic property is sold, the landlord will recognize a larger gain, because the property's basis will be less than it would have been but for the reduction. With a renewable energy property, the basis will fall to zero after five years regardless.

When the parties instead make a pass-through election, the lessee claims the credit, and there is no basis reduction on account of the credit. Instead, the tax rules require the lessee to have annual income equal to the tax credit (if it’s the rehabilitation credit) or half the credit (if it’s a renewables credit) divided by the shortest possible depreciation period for the Credit Property. For example, assume a rehabilitation credit of $3.9 million and a commercial property with a shortest depreciation period of 39 years. The lessee would have $100,000 of income each year.

When the lessee is a partnership (or an LLC taxed as a partnership), this income would be allocated among its partners. For many years, the prevailing view in the tax community has been to treat this income (often referred to as “50(d) income” after the Code section that provides the lease-pass-through provision) as a partnership tax item that increases the basis in its partnership interest for each partner to whom the income is allocated. This has the potential to provide a tax benefit if and when that partner sells its interest, a common exit strategy in historic and energy transactions. By giving the partner a higher basis in its interest, it will either suffer a larger loss if it disposes of its
interest for a low price, or simply reduce its gain if the sales price is higher than its basis in its interest.

For example, in the illustration above, if 99 percent of the $100,000 of income was allocated to the investor, and it included this income in its basis in its partnership interest, then its basis in its interest would go up by $99,000 each year, a total of $495,000 after five years. With a corporate capital gains rate of 35 percent, having a basis that is $495,000 higher could save the investor as much as $173,250 in taxes.

In the case of the rehabilitation tax credit, there's one additional tax issue—typically, when the investor sells its interest, only five years of a far longer period, as much as 39 years, of 50(d) income will have been recognized. It has never been clear whether the remaining income should continue to be recovered annually by the investor, even though it is no longer a partner, or accelerated and immediately taxable in full to the investor, or simply recovered annually by the other, remaining partners of the master tenant after the investor departs. It hasn’t been uncommon for the investor to both accelerate the ordinary income and take the capital loss, since both are generally at a 35 percent tax rate for a large corporation, recognizing that not every taxpayer can make use of a capital loss. For a taxpayer unable to use the capital loss, the acceleration of the 50(d) income would not be desirable.

And that brings us to the subject of this client alert. With investor benefits so dependent on the tax consequences of the issues I’ve described above, and something of an uptick in IRS audit activity with respect to tax credits, the historic tax equity community urged the IRS to provide some guidance on these questions. The IRS recognized that very similar rules applied to renewables; indeed, the person responsible for drafting the regulations is in the energy branch.

**New IRS guidance on 50(d) income**

The guidance, in the form of Temporary Regulations, took some time to get through all of the approvals required from the IRS and Treasury. Indeed, so much time passed that it appears that a curious inconsistency crept into the regulations, as described below. But first, let’s consider the basic rules of the regulations:

1. The regulations define the “ultimate credit claimant” as the person who files the Form 3468 (“Investment Credit”). This person is the one who claims the tax credit.
2. The 50(d) income is reported in proportion to the tax credit claimed by the ultimate credit claimant.
3. The 50(d) income is not a partnership item; it does not increase the partner’s basis in its partnership interest.
4. If during the recapture period, either the property is disposed of or the lease terminates, then there will be a recapture of the “unvested” tax credits. The regulation provides rules for handling the corresponding effect on the 50(d) income. Effectively, the claimant determines the amount of the vested credit, and compares the resulting 50(d) income to the amount already recognized; this can then result in income or a reduction in income, depending on the computation.
5. Once the recapture period has passed, the regulations provide a special rule if the claimant transfers its interest or the lease is terminated. If that happens, then the 50(d) income
to be reported over the balance of the depreciation period, unless the claimant makes an election in (A) the year it terminates its interest or (B) the year the lease terminates, but only if the claimant is still a partner at the time the lease terminates. There is no “formal” election here; the claimant simply reports the accelerated income on its timely-filed tax return for the year, including extensions. Once that year passes, there are no further opportunities to make an election.

Note that if no election is made, the income reporting in a historic transaction could literally go on for decades! On the other hand, with renewables, all of the 50(d) income will be reported in the first five years, because eligible renewables facilities are five-year property. So, this entire issue won't matter to a renewable project.

6. The same rules apply to S corporations and their shareholders.

7. The regulations apply to property placed in service on or after September 19, 2016.

Lingering question: What is the effective date?

In general, the regulations are elegantly simple and clear in their approach. The one place where the tax community still has questions is with respect to their effective date.

First, the regulations are preceded by a discussion of “congressional intent,” leaving the impression that the IRS believes that the law is already consistent with the position it takes in the regulations. If this is the case, then perhaps the effective date only serves to draw a line between the “view” that the IRS might take on audit, and the “binding view” of the IRS. Accordingly, might a zealous auditor try to apply the principles of the regulations to property placed in service before September 19, 2016, even though the regulations were not yet effective? It would seem that the “better” view is that until the regulations become effective, taxpayers can take positions in good faith, and not anticipate being challenged. Unfortunately, there’s no requirement that the exam side of the IRS see it that way.

Second, the regulations include several illustrations with placed in service dates of July 1, 2016, which is before the effective date of the regulations. While this calls into question whether the IRS really “meant” the September 19, 2016, effective date, we have been assured that the July 1 date is really a product of the lengthy approval process that caused the dates in the examples to take on unintended significance. As a result, we are disinclined to worry about this line of argument.

Still, this leaves taxpayers wondering how to handle projects that straddle the effective date of the new regulations, such as:

- Project is placed in service long before the regulations were published; in this case, the regulations, by their terms, do not apply. Will investors continue to include the 50(d) income in basis, or will they shy away to avoid confrontation with the government? Certainly, the IRS could have written the regulations to apply to returns filed after some due date; it did not do that, indicating that taxpayers continue to be free to treat already in-service projects as they have been.

- Project is placed in service after the regulations were published, but before September 19, 2016; again, the plain wording of the regulations makes them inapplicable, but will taxpayers fear an even more obvious opportunity to tweak the IRS? Suppose that the investment was closed prior to the publication of the regulations? Suppose it wasn’t?
Taxpayer wishes to voluntarily follow the regulations, rather than take on the IRS. It’s quite possible that a more conservative taxpayer would take this position, but how would it report income once it terminates its interest? Or accelerate that income as permitted by the regulations? In each case, the regulations simply do not apply, and there is no provision to voluntarily elect an earlier effective date, as is sometimes the case with regulations or other IRS guidance.

Of course, the real source of consternation is whether taxpayers feel comfortable that the compliance side of the IRS will “leave well enough alone,” for projects placed in service before the effective date, or will it pursue taxpayers who are violating the spirit of the just-published regulations?

We’ll continue to think about these rules and keep you posted on what we hear from the IRS.

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