Historic Tax Credit Coalition

August 20, 2014

[Internal Revenue Service]

Re: Treatment of Section 50(d) income in Rehabilitation Tax Credit Pass-Through Transactions

To Whom It May Concern:

On December 30, 2013, the Internal Revenue Service (the "Service") issued Rev. Proc. 2014-12, 2014-3 I.R.B.1 providing a safe harbor (the "Safe Harbor") pursuant to which the Service will not challenge a partnership's allocation of validly claimed rehabilitation credits ("Rehabilitation Tax Credits") under Section 47 of the Internal Revenue Code of 1986, as amended (the "Code"). On January 8, 2014, a revised revenue procedure was issued that incorporated certain technical changes. Rev. Proc. 2014-12, as so amended, is referred to herein as the "Revenue Procedure". Capitalized terms used herein and not otherwise defined shall have the meanings set forth in the Revenue Procedure.

The Revenue Procedure and the Safe Harbor specifically contemplate the possibility of an election by the owner of the rehabilitated Building (referred to in the Revenue Procedure as the "Developer Partnership") under Section 50(d)(5) of the Code to pass the Rehabilitation Tax Credit relating to such Building through to another partnership (the "Master Tenant Partnership") which in turn will allocate the credit to its partners, including the Investor. Section 3 of the Revenue Procedure states, among other things, that "this revenue procedure does not address how a Partnership is required to allocate the income inclusion required by §50(d)(5)." Section 4.07 of the Revenue Procedure goes on to provide that "[s]oley for purposes of determining whether a Partnership meets the requirements of this section 4.07, the Partnership's allocation to its partners of the income inclusion required by § 50(d)(5) shall not be taken into account."

The Revenue Procedure thus explicitly stated that Section 50(d) income is a partnership tax item while implicitly acknowledging that the proper tax treatment of such income under the Section 704(b) regulations is uncertain. It is vitally important to participants in Rehabilitation Tax Credit transactions, including members of the Historic Tax Credit Coalition, that the current uncertainty concerning this issue be eliminated. In particular, we would ask the Service to confirm that, as is the case with other items of partnership income or gain, a partner's share of Section 50(d) income may be subject to a "flip" in the manner contemplated in Section 4.02 of the Revenue Procedure. Since the Section 50(d) income must be reported over the applicable depreciation recovery period of the rehabilitation improvements, and since the Revenue

The Historic Tax Credit Coalition • 325 7th Street, NW • Suite 400 • Washington, DC 20004

Procedure permits a “flip” in profit and loss sharing ratios prior to the end of such recovery period, guidance on this issue is essential.

At a recent ABA Affordable Housing Forum in Washington, DC, representatives of the Service indicated that, while the issue is not on the formal priority guidance list, the question of how to allocate Section 50(d) income in a transaction involving a Master Tenant Partnership currently is being reviewed by the Service.

The Historic Tax Credit Coalition believes it would be helpful to share with the Service the Coalition’s views concerning the history and application of the Section 50(d)(5) income provisions in syndicated Rehabilitation Tax Credit transactions.

1. Statutory Framework

1.1 Allocations of Tax Credits by a Partnership

In the case of a partnership that incurs expenses or owns property generating a tax credit, the treasury regulations generally provide that an allocation of such credit does not affect the capital accounts of the partners and thus cannot have economic effect under Section 704(b) of the Code. *See* Treas. Reg. § 1.704-1(b)(4)(ii). However, the regulations provide rules for determining when an allocation of a credit will be deemed to be in accordance with the partners’ interests in the partnership and thus will be respected. *See* Treas. Reg. § 1.704-1(b)(4)(ii). A special rule applies in the case of investment tax credits such as the Rehabilitation Tax Credit. Under this special rule, a partner’s share of “section 38 property” (which includes qualified rehabilitation expenditures generating a Rehabilitation Tax Credit) generally is based on such partner’s share of the “bottom line” profits of the partnership determined under Section 702(a)(8) (formerly Section 702(a)(9)) of the Code. An exception to this general rule applies if “all related items of income, gain, loss, and deduction with respect to any item of partnership section 38 property are specially allocated in the same manner” so long as that special allocation is valid under the more general rules of Section 704(b). *See* Treas. Reg. § 1.46-3(f).

2. General Basis Adjustment Rules

Section 50(c) of the Code requires that the basis of the property generating the Rehabilitation Tax Credit must be reduced dollar for dollar by the amount of the credit. As a result, the owner will have reduced depreciation deductions for the entire recovery period applicable to the building after the rehabilitation is completed and the improvements arising from the qualified rehabilitation expenditures giving rise to the Rehabilitation Tax Credit are placed in service. Since a building eligible for the Rehabilitation Tax Credit must be depreciated using a straight-line method, the annual depreciation deductions for the property will be reduced by the amount of the Rehabilitation Tax Credit taken divided by the applicable cost recovery period for the property (i.e., 39 years for nonresidential real property and 27½ years for residential real property that is a certified historic structure).

Under Section 50(c)(5) of the Code, any such downward basis adjustment to property owned by a partnership in turn triggers an equivalent downward adjustment to the aggregate bases of the partnership interests of the partners. Section 1.46-3(f) of the treasury regulations provides that any such downward basis adjustments must be allocated among the partners in the same proportion as the basis of the property is allocated. The treasury regulations under Section 704(b) of the Code require that the capital accounts of the partners be adjusted by their shares of any such basis adjustments. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(*j*).

3. <u>Impact of Section 50(d)(5) Election</u>

Since the original enactment of the investment tax credit provisions, a lessor of property that otherwise qualifies for the investment tax credit has been authorized to make a special election passing the credit through to the lessee. Prior to its repeal in 1990, Section 48(d)(1) of the then existing Internal Revenue Code provided as follows:

> (d) CERTAIN LEASED PROPERTY.–
>
> (1) GENERAL RULE.–A person (other than a person referred to in section 46(e)(1)) who is a lessor of property may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary) elect with respect to any new section 38 property (other than property described in paragraph (4)) to treat the lessee as having acquired such property for an amount equal to–
>
> (A) except as provided in subparagraph (B), the fair market value of such property, or
>
> (B) if the property is leased by a corporation which is a component member of a controlled group (within the meaning of section 38(c)(3)(B)) to another corporation which is a component member of the same controlled group, the basis of such property to the lessor.

Section 50(d) of the Code provides that, "for purposes of this subpart, rules similar to the rules of the following provisions (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) shall apply: ...(5) Section 48(d) (relating to certain leased property)." Accordingly, it is clear that the election described in Section 48(d) continues to be available. For federal income tax purposes, Section 48(d) created the legal fiction that the lessee has purchased the property from the lessor at its fair market value, resulting in the ability of the lessee to take the investment tax credit attributable to the lessor's basis in the property. *See* Treas. Reg. § 1.48-4(a)(1). As reflected in the Revenue Procedure, the election is available with respect to property that is attributable to "qualified rehabilitation expenditures" described in Section 47 of the Code. See, also, Treas. Reg. § 1.48 – 12(f)(1).

In order to qualify for the special election in former Section 48(d) (which is incorporated by reference in current Code Section 50(d)(5)), the following conditions must be satisfied:

> (i) The property must be "section 38 property" in the hands of the lessor; that is, it must be property with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the lessor and it must satisfy the other requirements set forth in Treas. Reg. § 1.48-1.
>
> (ii) The property must be "new section 38 property" (within the meaning of Treas. Reg. § 1.48-2) in the hands of the lessor, and the original use of such property must commence with the lessor.

(iii) The property must be such that it would have constituted "new section 38 property" to the lessee if such lessee had actually purchased the property.

(iv) A statement of election to treat the lessee as a purchaser must be filed in the manner described in the treasury regulations.

(v) The lessor cannot be a mutual savings bank, cooperative bank, or certain other types of entities. *See* Treas. Reg. § 1.48-4(a)(1).

Notwithstanding the general basis adjustment rules discussed above, in the case of a pass-through election under former Section 48(d), special rules apply. Section 48(d)(5) of the Internal Revenue Code, as in effect prior to the Revenue Reconciliation Act of 1990, provided as follows:

> (5) COORDINATION WITH BASIS ADJUSTMENT.–In the case of any property with respect to which an election is made under this subsection–
>
> (A) subsection *(q) (other than paragraph (4)*) shall not apply with respect to such property,
>
> (B) the lessee of such property shall include ratably in gross income over the shortest recovery period which could be applicable under section 168 with respect to such property an amount equal to *50 percent of the amount of the credit* allowable under section 38 to the lessee with respect to such property, and
>
> (C) in the case of a disposition of such property to which section 47 applies, this paragraph shall be applied in accordance with regulations prescribed by the Secretary. *(emphasis added)*

Former Section 48(q) provided:

> (q) Basis Adjustment to Section 38 Property. –
>
> (1) In general. – For purposes of this subtitle, if a credit is determined under section 46(a) with respect to section 38 property, the basis of such property shall be reduced by 50 percent of the amount of the credit so determined.
>
> (2) Certain dispositions. – If during any taxable year there is a recapture amount determined with respect to any section 38 property the basis of which was reduced under paragraph (1), the basis of such property (immediately before the event resulting in such recapture) shall be increased by an amount equal to 50 percent of such recapture amount. For purposes of this preceding sentence, the term "recapture amount" means any increase in tax (or adjustment in carrybacks or carryovers) determined under section 47.
>
> (3) Special rule for qualified rehabilitated buildings. – In the case of any credit determined under section 46(a) for any qualified expenditure in connection with a qualified rehabilitated building, paragraphs (1) and (2) of this subsection and *paragraph (5) of subsection (d) shall be applied without regard to the phrase* "*50 percent of*".
>
> (4) Election of reduced credit in lieu of basis adjustment for regular percentage. –

(A) In general. – If the taxpayer elects to have this paragraph apply with respect to any recovery property.-

(i) paragraphs (1) and (2) shall not apply to so much of the credit determined under section 46(a) with respect to such property as is attributable to the regular percentage set forth in section 46(b)(1); and

(B) Reduction in credit.- In the case of any recovery property to which an election under subparagraph (A) applies –

(i) solely for the purposes of applying the regular percentage, the applicable percentage under subsection (c) or (d) of section 46 shall be deemed to be 100 percent, and

(ii) notwithstanding section 46(b)(1), the regular percentage shall be –

(I) 8 percent in the case of recovery property other than 3-year property; or

(II) 4 percent in the case of recovery property which is 3-year property.

For purposes of the preceding sentence, RRB replacement property (within the meaning of section 168(f)(3)(B) shall be treated as property which is not 3-year property. *(emphasis added)*

Section 48(q)(3) was enacted in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). However, when it was originally enacted, the provision was slightly different from the version described above. The original provision stated:

(3) Special rule for qualified rehabilitated buildings.- In the case of any credit determined under section 46(a) for any qualified rehabilitation expenditure in connection with a qualified rehabilitated building, *other than a certified historic structure*, paragraphs (1) and (2) of this subsection shall be applied without regard to the phrases "50 percent of".

The phrase "*and paragraph (5) of subsection (d)*" was *added* in the Technical Corrections Act of 1982, and was treated as if it has been included in the original version enacted in TEFRA. The phrase "*other than a certified historic structure*" was *deleted* in the Tax Reform Act of 1986 *(emphasis added).* It appears that the addition of the words "*and paragraph (5) of subsection (d)*" was made to require lessees to include in income 100 percent of 15% or 20% Rehabilitation Tax Credits claimed on qualified rehabilitated buildings (other than certified historic structures), reflecting the fact that from 1982 through 1986, lessees of certified historic structures eligible for what was then a 25% Rehabilitation Tax Credit continued to be required to include only 50 percent of such credit in income. The Joint Committee Report on the Technical Corrections Act of 1982 explained the provision as follows:

> When lessors elect to pass through the investment credit to lessees under section 48(d), the lessor does not have to make a basis adjustment. Instead, the lessee includes in income ratably over the ACRS recovery period for the property an amount equal to one-half of the credit allowable.[1]
>
> ______________________
>
> [1]Congress intended that in the case of the 15- or 20-percent rehabilitation credit, the lessee must include in income an amount equal to the full credit allowable.

In 1986, Section 48(q)(3) was amended a second time to delete the reference to *"other than a certified historic structure."* Accordingly, after the enactment of the Tax Reform Act of 1986 a basis reduction equal to the full amount of the Rehabilitation Tax Credit claimed was required for certified historic structures. However, there was no corresponding change to the provisions of former Section 48(d)(5)(B) requiring inclusion in income by the lessee of an amount equal to 100 percent (instead of 50 percent) of the credit allowable to the lessee in the event of an election under Section 48(d).

Prop. Reg. §1.48-4, which was issued in September of 1987 – nearly a year after the Tax Reform Act of 1986 – appears to interpret "Section 48(q)(3) as it existed before its amendment in 1986, providing:

> (o) *Special rule for qualified rehabilitated buildings.*–In the case of a credit determined under section 46(a) (section 46(a)(2) in the case of taxable years beginning on or before December 31, 1983) for any qualified rehabilitation expenditure in connection with a qualified rehabilitated building *other than a certified historic structure*, paragraph (n) of this section shall be applied by substituting the phrase "100 percent of" for the phrase "50 percent of."

Based on the foregoing, and while many industry participants have assumed that a 100 percent rather than a 50 percent income inclusion would apply to a lessee in a transaction in which an election has been made under Code Section 50(d)(5), repealed Section 48(d)(5)(B) literally states that a 50 percent income inclusion is required. Moreover, repealed Section 48(d)(5)(A) literally provides that former Section 48(q) (other than Section 48(q)(4)) does not apply to property where such an election has been made. Accordingly, without further legislative or regulatory changes, only a 50 percent rather than a 100 percent income inclusion may be required.

Since Section 50(c) (formerly Section 48(q)) of the Code is not by its terms applicable in the case of an election under Code Section 50(d)(5) (formerly Section 48(d)), Section 50(c)(5) (formerly Section 48(q)(6)) of the Code, which requires that the adjusted basis of a partner's interest in a partnership or a shareholder's stock in an S corporation be reduced by the amount of the Rehabilitation Tax Credit, also does not apply.

There are no treasury regulations interpreting the provisions of Sections 50(c) or 50(d). However, Treas. Reg. § 1.48-12(e), which deals with qualified rehabilitation expenditures, does address the basis adjustment, providing:

> (e) *Adjustment to basis.–(1) General rule.*–Except as otherwise provided by this paragraph (e), if a credit is allowed with respect to property attributable to qualified rehabilitation expenditures incurred in connection with the rehabilitation of a qualified rehabilitated building, the increase in the basis of the rehabilitated property that would otherwise result from the qualified rehabilitation expenditures must be reduced by the amount of the credit allowed. See section 48(q) and the regulations thereunder for other rules concerning adjustments to basis in the case of section 38 property.

Presumably, the basis adjustment contemplated in this section of the treasury regulations is trumped by the specific statutory language in former Section 48(d)(5) providing that the basis adjustment provisions of Section 48(q) (other than paragraph (4)) will not apply to property which is subject to the election described in former Section 48(d).

4. Impact of Section 50(d) Income on Basis and Capital Account of a Partner in a Lessee-Partnership

Section 703 of the Code provides, subject to certain exceptions, that the taxable income of a partnership is computed in the same manner as that of an individual. Section 705(a)(i) of the Code goes on to state that the basis of a partner's interest in a partnership is increased by the sum of such partner's distributive share of (i) the taxable income of the partnership, (ii) income of the partnership that is exempt from tax, and (iii) the excess of the deduction for depletion over the basis of the property subject to depletion. A basis increase generally is appropriate in the case of taxable income in order to avoid double taxation on a partner's share of such income – once when it is allocated to the partner and again when the partner's interest is sold or distributions are made to the partner. Similarly, if a partner's basis for its interest was not increased by its share of tax-exempt income, the partner would be taxed on the value attributable to such income upon a sale of the partner's interest or distributions to the partner. *See*, H.R. Rep. No. 1337, 83d Cong., 2d Sess. A 225 (1956). S. Rep. No. 1622, 83d Cong., 2d Sess 384 (1954).

Section 50(d) income is taxable income and, in the case of a lessee that is a partnership, clearly appears to be a partnership item, a conclusion that is reflected in Section 4.07 of the Revenue Procedure. There is no statutory exclusion that would prevent the inclusion of a partner's distributive share of such income in outside basis nor is there any regulation, ruling, or other administrative authority suggesting such a result. Furthermore, our research has disclosed no judicial authority addressing the Section 50(d) income issue.

In addition, the regulations require that a partner's capital account be increased by its allocable share of any partnership taxable income. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(*b*), which provides, in relevant part:

> *(b) Basic rules.*–Except as otherwise provided in this paragraph (b)(2)(iv), the partners' capital accounts will be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) if, and only if, each partner's capital account is increased by *(1)* the amount of money contributed by him to the partnership, *(2)* the fair market value of property contributed by him to the partnership (net of liabilities that the partnership is considered to assume or take subject to), and *(3) allocations to him of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in paragraph (b)(2)(iv)(g) of this section,* but excluding income and gain described in paragraph (b)(4)(i) of this section; and is decreased by *(4)* the amount of money distributed to him by the partnership, *(5)* the fair market value of property distributed to him by the partnership (net of liabilities that such partner is considered to assume or take subject to), *(6)* allocations to him of expenditures of the partnership described in section 705(a)(2)(B), and *(7)* allocations of partnership loss and deduction (or item thereof), including loss and deduction described in paragraph (b)(2)(iv)(g) of this section, but excluding items described in (6) above and loss or deduction described in paragraphs (b)(4)(i) or (b)(4)(iii) of this section; and is otherwise adjusted in accordance with the additional rules set forth in this paragraph (b)(2)(iv).
>
> (emphasis added).

Treas. Reg. § 1.704-1(b)(2)(iv)(n) goes on to provide that the capital account treatment of any item generally is determined by the tax treatment. In the absence of authority to the contrary, this appears to require that a partner's capital account be increased by such partner's share of the Section 50(d) income even though no partnership "asset" results from the allocation from such income to the partner. Similarly, since the Section 50(d) income does not result from a revaluation of partnership assets, it is not subject to the provisions of Code Section 704(c).

On the other hand, since the Section 50(d) income functions as a substitute for a downward capital account adjustment under Treas. Reg. § 1.704-1(b)(2)(iv)(*j*) and the allocation of such income has no economic effect, some practitioners have suggested, in the case of a lessee that is a partnership, that such income should increase the outside basis of the partner but not such partner's capital account, resulting in a book-tax difference. We have found no authority that specifically addresses this issue.

Although Code Section 705(a) by its terms requires that a partner's outside basis be increased by the partner's share of Section 50(d) income, and there is nothing in the Code or treasury regulations mandating a different approach, some commentators have expressed a concern that a literal application of the rules relating to basis and/or capital account increases for Section 50(d) income may lead to unintended results. In particular, the concern is that an unforeseen tax benefit might be conferred upon the partners of the Master Tenant Partnership since the allocation of the Section 50(d) income is offset by the "outside" basis increase mandated by Code Section 705.

In this regard, it is well established that policy arguments permit a court to override the literal wording of a statutory provision only in rare and extraordinary circumstances. This is particularly so in the case of tax statutes. *See Demarest v. Manspeaker*, 498 U.S. 184, 190-191 (1991); *United States v. James*, 478 U.S. 597, 606 (1986); *Consumer Prod. Safety Commission v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980); *American Tobacco Co. v. Patterson*, 456 U.S. 63, 75 (1982); *Rubin v. U.S.*, 449 U.S. 424, 430 (1981); *Crooks v. Harrelson*, 282 U.S. 55, 60 (1930). As the Supreme Court has stated:

> [T]o justify a departure from the letter of the law…, the absurdity must be so gross as to shock the general moral or common sense. And there must be something to make plain the intent of Congress that the letter of the statute is not to prevail… It is not enough merely that hard and objectionable or absurd consequences, which probably were not within the contemplation of the framers, are produced by an act of legislation. Laws enacted with good intention, when put to the test, frequently, and to the surprise of the lawmaker himself, turn out to be mischievous, absurd, or otherwise objectionable. But in such case the remedy lies with the lawmaking authority, and not with the courts.
>
> *Crooks v. Harrelson*, 282 U.S. 55, 61 (1930).

Courts have not hesitated to adhere to statutory language even when the result is so unfair that it clearly was not contemplated. In *Babin v. Commissioner*, 23 F3d 1032 (6th Cir. 1994) (cert. denied), aff'g 64 TCM 1357 (1992), for example, the Sixth Circuit stated:

> We refuse to speculate as to the tax implications petitioner would have faced had he held the Partnership assets as a sole proprietor, as a tenant in common, or, for that matter, in any other type of relationship. When taxpayers select a particular form to hold property, they may not enjoy the tax benefits offered by that form and at the same time seek to avoid the adverse tax consequences. Thus, given his choice to hold property in a partnership, petitioner is bound by the provisions in the Internal Revenue Code that govern such entities.
>
> *Babin v. Commissioner*, 23 F3d 1032, 1039.

Although the result in *Babin* was unfavorable to the taxpayer, the court's statement is no less true when the result is favorable. The fact that the lessee making an election under Code Section 50(d)(5) is a partnership should not deprive the lessee (or its partners) of the outside basis increase mandated by an explicit statutory provision.

The tax treatment of Section 50(d) income has not been addressed by the courts. However, the U.S. Supreme Court addressed a similar situation in *Gitlitz v. Comm'r.*, 531 U.S. 206 (2001). In *Gitlitz*, the Court held that cancellation of indebtedness income realized by an S corporation was excluded from income but that the taxpayer-shareholders to whom such income was allocated were entitled to a basis increase for their stock in the corporation. In *Gitlitz*, an S corporation realized more than $2 million of income from the cancellation of indebtedness. At the time of the cancellation, the corporation was insolvent by more than the amount of the debt. As a result, the corporation excluded the cancellation of debt income under Section 108(a)(1)(B) of the Code. The shareholders of the corporation increased their stock basis by their pro-rata share of this cancellation of debt income and used the increased stock basis to claim losses that previously had been suspended under Section 1366(d) of the Code. The IRS disallowed the increase in basis and the resulting loss deductions.

The primary argument of the IRS in *Gitlitz* was that the cancellation of debt income of an insolvent S corporation is not an "item of income" and thus never passes through to the shareholders of the corporation. The Supreme Court concluded that this argument was inconsistent with a plain reading of the applicable Code provisions. Section 61(a)(12) of the Code states that cancellation of debt generally is included in gross income. Section 108(a)(1)(B) provides an exception to this general rule for "any amount which (but for this subsection) would be includable in gross income by reason of the discharge (in whole or part) of indebtedness of the taxpayer if…the discharge occurs when the taxpayer is insolvent." The opinion of the Supreme Court emphasizes that Section 108(a) does not say that cancellation of debt income ceases to be an item of income if the S corporation realizing such income is insolvent but simply states that cancellation of debt income ceases to be included in gross income at such time.

The Supreme Court also focused on the conclusion of the Tenth Circuit that the S corporation's tax attributes should be reduced under Section 108(b) <u>before</u> the cancellation of debt income was passed through to the shareholders. Under this approach, the losses of the shareholders in excess of their basis would be treated as net operating losses that were reduced by the amount of the discharged debt. The effect would be that no suspended losses would remain that could be deducted by the shareholders. Conversely, if the reduction in tax attributes was deemed to occur <u>after</u> the cancellation of debt income was passed through to the shareholders, the shareholders would be able to deduct their losses (up to the amount of the increase in basis) under Section 1366(d) of the Code. The Supreme Court concluded that this issue was expressly addressed by the statutory language. Section 108(b)(4)(A) of the Code specifically provided that the reduction in tax attributes would be made <u>after</u> the determination of tax for the taxable year of the discharge. The court pointed out that the exclusion under Section 108(a) was not dependent upon a reduction of tax attributes. The cancellation of debt income of an insolvent S corporation is excluded from income whether or not the shareholders of the corporation have tax attributes that are subject to reduction. In what may be the most important and telling portion of the opinion, the court also addressed the argument that, from a tax policy perspective, the shareholders of insolvent S corporation might receive a "double windfall." That is, they would be exempt from paying taxes on the full amount of the cancellation of debt income and also would be able to increase the basis of their stock and thus deduct their previously suspended losses. The court responded to this policy concern by stating: "Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern." As a result of the *Gitlitz* decision, the Code was amended to provide that, with respect to debt discharges occurring after October 11, 2001, if cancellation of debt income is excluded from an S corporation's income due to the bankruptcy or insolvency of the corporation, the shareholders cannot increase their bases for their stock by the amount of the excluded income. *See* Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147 (codified as amended in scattered sections of 26 U.S.C.).

The Coalition recognizes that the Service has broad authority under Treas. Reg. §1.701-2 to recast certain partnership transactions. Specifically, if a partnership is formed or availed of in connection with a transaction" a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Commissioner can recast the transaction for federal tax purposes even though the transaction may fall within the literal words of a particular statutory or regulatory provision..." *See* Treas. Reg. §1.701-2(b). The Treasury subsequently announced that it would apply the anti-abuse rule only to income taxes. *See* Ann 95-8, 1995-7 IRB 56 and Treas. Reg. §1.701-2(h)). In general, if, based on the applicable facts and circumstances, an abuse of Subchapter K is found, the IRS may (i) disregard the partnership; (ii) treat a purported partner as a non-partner; (iii) adjust the partnership's or a partner's method of accounting; (iv) modify the partnership's allocations; and/or (v) otherwise adjust or modify the claimed tax treatment. Treas. Reg. §1.701-2(b).

The regulations also contain an abuse of entity treatment rule that permits the IRS to treat a partnership as an aggregate of its partners as appropriate to carry out the purpose of any provision of the Code or regulations unless the relevant provision prescribes entity treatment and such treatment and the ultimate tax results are clearly contemplated by the provision. Treas. Reg. §1.701-2(e).

The Coalition believes that the application of the abuse of Subchapter K rule in Treas. Reg. §1.701-2 to limit a partner's ability to include a partnership tax item in basis under Code Section 705(a) would be improper. In particular, it would be incorrect to conclude that a "principal purpose" of the use of a partnership as the lessee in a transaction involving an election under Section 50(d)(5) is to obtain such an outside basis increase. Similarly, in the absence of any authority on point, it is difficult to conclude that any tax benefits from such a basis increase are inconsistent with the intent of Code Section 705 (which is the relevant Subchapter K provision). Examples (1) through (4) set forth in Treas. Reg. §1.701-2 make it clear that the use of a partnership to avoid restrictions contained in provisions that are not in Subchapter K generally is permitted.

Similarly, since Section 50(d) income appears to be a partnership tax item, it is difficult to see the logic in applying an aggregate approach to deny outside basis treatment in the face of the clear and unequivocal language of Code Section 705(a).

5. Treatment of Section 50(d) Income Upon Exit

A related issue is how any unrealized Section 50(d) income is treated in the event of the sale or other disposition of the Investor's interest in the Master Tenant Partnership. There is very little authority addressing this question.

Prop. Reg. § 1.48-4 provides insight into how the Treasury Department interpreted the Section 50(d) income issue in the event of a disposition of the underlying property <u>during</u> the 5-year recapture period applicable to the Rehabilitation Tax Credit. Proposed Treas. Reg. § 1.48-4 states:

> (n) *Adjustment to lessee's income*. -- (1) In *general*. -- If a lessor of new section 38 property makes a valid election under section 48(d) with respect to such property, section 48(q) (except paragraph (4) thereof) and § 1.48-7 (except paragraphs (b) and (m) thereof) shall not apply. Thus, the lessor is not required under section 48(q) to reduce the basis of such property. However, if such an election is made, the lessee shall include ratably in gross income, over the shortest recovery period which could be applicable under section 168 with respect to the property, an amount equal to 50 percent of the amount of the credit allowable under section 38 with respect to such property. For purposes of this paragraph (n), the amount of the credit allowable is determined by multiplying the qualified investment (as defined in section 46(c)) with respect to such property by the percentage specified in section 46(a) (section 46(a)(2) in the case of taxable years beginning on or before December 31, 1983) for such property, without regard to the limitation based on tax which, under 38(c) (section 46(a)(3) in the case of taxable years beginning on or before December 31, 1983), may limit the amount of credit the lessee may take into account in any one year.
>
> (2) *Adjustments as a result of an early disposition, etc*. -- (i) Except as provided in paragraph (n)(2)(iii) of this section, if section 47 requires an increase in the lessee's tax or a reduction in the carryback or carryover of an unused credit as a result of an early disposition, etc., of leased property for which an election had been made under section 48(d), the lessee's gross income shall be reduced by an amount equal to the excess (if any) of the total increases in gross income previously made under paragraph (n)(l) of this section over 50 percent of the portion of the credit that is not recaptured for the taxable year in which the early disposition, etc., occurred.
>
>> (ii) If the total increases in gross income of the lessee previously made under paragraph (n)(l) of this section are less than 50 percent of the credit that is not recaptured for the taxable year in which the early disposition, etc., occurred, the lessee shall include the difference in income in the year of disposition.
>>
>> (iii) If, after the event which caused section 47 to apply, the lessee continues the use of the property in a trade or business or in the production of income, the amount described in paragraph (n)(2)(i) or (ii) of this section shall be taken into account ratably over the remaining portion of the recovery period described in paragraph (n)(l) of this section.

> (iv) If paragraph (n)(2)(iii) of this section applies, and if, prior to the expiration of the recovery period described in paragraph (n)(l) of this section, the lease is terminated other than by purchase of the property by the lessee, any deduction allowable or inclusion necessitated under this paragraph not previously taken into account shall be taken into account for the taxable year in which the lease is terminated. In the case of a purchase of the property by the lessee, see paragraph (b) of § 1.48-7.
>
> (3) *Effective dates*. -- The effective dates described in paragraph (m) of § 1.48-7 (relating to adjustment to basis) shall apply to this paragraph.

Proposed Reg. § 1.48-4 contains several examples illustrating the operation of the proposed rules.

Based on the foregoing, it appears to be clear that, in the view of the Treasury Department, if a "disposition" occurs <u>during the 5-year recapture period</u> that would result in the recapture of all or a portion of the Rehabilitation Tax Credit passed through to a lessee under former Code Section 48(d), and the total Section 50(d) income previously reported by the lessee is less than the amount of the <u>unrecaptured</u> Rehabilitation Tax Credit, the lessee must include in its gross income in the year of disposition the amount of the difference. However, the proposed regulations further provide that if, after the disposition, the lessee "continues the use of the property in a trade or business or in the production of income," the unrealized basis adjustment income "shall be taken into account ratably over the remaining portion of the recovery period…" *See* Prop. Reg. § 1.48-4(n)(2)(iii). In the event of such continued use, the proposed regulations provide that, <u>if the lease is terminated</u> prior to the end of the applicable recovery period "other than by purchase of the property by the lessee," any unrealized basis adjustment income must be taken into account for the taxable year in which the lease is terminated. *See* Prop. Treas. Reg. § 1.48-4(n)(2)(iv).

Implicit in the foregoing approach is the notion that there could be a "disposition" causing a recapture of the Rehabilitation Tax Credit in the hands of the lessee in a situation in which the lessee continues to use the property in a trade or business. This could happen, for example, if the lessor conveyed the property to a person who could not, under Treas. Reg. § 1.48-4, make a valid pass-through election. Such a transfer would cause recapture to the lessee if it occurred during the 5-year recapture period but, assuming that the lease was not terminated, the lessee would continue to be using the property in a trade or business.

The treasury regulations contain a major exception to the rule requiring recapture of the Rehabilitation Tax Credit in the event of a "disposition" or "cessation" described in Treas. Reg. § 1.47-2. Under this exception, the recapture rules do not apply to "section 38 property" (including improvements arising from "qualified rehabilitation expenditures"), which is disposed of, or otherwise ceases to be "section 38 property" with respect to the taxpayer "by reason of a mere change in the form of conducting the trade or business in which such section 38 property is used," provided that certain conditions are satisfied. Treas. Reg. § 1.47-3(f)(1)(ii) lists the conditions as follows:

(i) The property must be retained as "section 38 property" in the same trade or business;

(ii) The transferor (or in a case where the transferor is a partnership, a state, trust, or electing small business corporation, the partner, beneficiary or shareholder) of such "section 38 property" retains a substantial interest in such trade or business;

(iii) Substantially all of the assets (whether or not "section 38 property" necessary to operate the trade or business are transferred to the transferee; and

(iv) The basis of such "section 38 property" in the hands of the transferee is determined in whole or in part by reference to the basis of such "section 38 property" in the hands of the transferor.

It should be noted that Treas. Reg. § 1.47-3(f)(4) provides that the condition set forth in clause (iv) above does not apply in a situation where a valid election has been made under Treas. Reg. § 1.48-4.

Under the approach reflected in the treasury regulations, a transferor (including a partner in a partnership that owns the property) is considered to have retained a substantial interest in the trade or business only if, after the change in form, his interest in such trade or business (i) is substantial in relation to the total interest of all persons or (ii) is equal to or greater than his interest prior to the change in form. *See* Treas. Reg. § 1.47-3(f)(2). If the transferor does not retain a substantial interest, the property in question will cease to be "section 38 property" with respect to the transferor (including a partner) and the transferor will be subject to recapture. *See* Treas. Reg. § 1.47-3(f)(5)(ii). It is clear from the treasury regulations that a recapture event can occur at the partnership level and the partner level. *See* Priv. Ltr. Rul. 200033030 (May 18, 2000); Priv. Ltr. Rul. 200033033 (May 18, 2000); Priv. Ltr. Rul. 200033035 (May 18, 2000). In particular, even if partnership level recapture is avoided by application of the "mere change in form" exception, partner level recapture may still result.

Based on the foregoing, the sale of the Investor's interest in the Master Tenant Partnership to another unrelated member would result in recapture of the Rehabilitation Tax Credit under former Code Section 47 (currently Section 50) if the sale occurred prior to the end of the 5-year recapture period. The "mere change in form" exception would not apply since the Investor does not retain any interest in the continuing partnership. Under the rules set forth in Prop. Reg. § 1.48-4, such a transaction presumably also would result in the acceleration of the Investor's share of any unrealized Section 50(d) income, although, unlike the treasury regulations under Section 47, proposed Treas. Reg. § 1.48-4 does not specifically address the tax consequences to a partner of the lessee as opposed to the lessee itself. It is important to note that, if the transfer occurred <u>after</u> the 5-year recapture period, there would be no recapture of the Rehabilitation Tax Credit nor, under the provisions of proposed Treas. Reg. § 1.48-4, would there be any acceleration of the unrealized Section 50(d) income.

As discussed above, Prop. Reg. § 1.48-4(n)(2)(iii) provides that if, after an event causing recapture, the lessee "continues the use of the property in a trade or business or in the production of income," there is no acceleration of the unrealized section 50(d) income. If, in the case of a lessee that is a partnership, the term "lessee," as used in Prop. Reg. § 1.48-4, means the partnership rather than the individual partners, the sale by a partner of the lessee that causes recapture of the Rehabilitation Tax Credit to the transferring partner would not cause recapture to the remaining partner or partners nor would it cause an acceleration of the unrealized section 50(d) income. As to the purchasing or remaining partners, the transaction would qualify as "a mere change in the form of conducting the trade or business [in which the section 38 property is used]" within the meaning of the exception to recapture described in Treas. Reg. § 1.47-3(f)(1)(ii). The fact that the sale or transfer of the interest caused a tax termination of the lessee partnership under Section 708(b) of the Code should not alter this result. *See Siller Bros. v. Commissioner*, 89 T.C. 256 (1987).

Since Prop. Reg. § 1.48-4 is addressing adjustments as a result of early dispositions of section 38 property that result in credit recapture, it is reasonable to conclude that the Treasury Department intended the provisions of proposed Treas. Reg. § 1.48-4 to be interpreted in a manner that is consistent with the provisions of Treas. Reg. § 1.47-1 through 1.47-6 dealing with recapture.

Treas. Reg. § 1.47-6 contains specific rules relating to a recapture event triggered by a reduction of a partner's proportionate interest in the general profits of the partnership (or in a particular item of "section 38 property") as a result, for example, of a sale, a change in the partnership agreement, or the admission of a new partner. If the partner's interest is reduced to less than 66 2/3 percent of the partner's proportionate interest in profits for the year in which the property was placed in service, there will be recapture. If Prop. Reg. § 1.48-4 is applied in the context of the partner level recapture rule, a transferring partner would be required to accelerate its allocable share of any unrealized Section 50(d) income since such partner would not be continuing the use of the property in a trade or a business or in the production of income. However, this result is not totally clear from the language used in Prop. Reg. § 1.48-4.

As discussed earlier, the provisions of Prop. Reg. § 1.48-4 relating to the reporting of Section 50(d) income apply only in the case of a "disposition" or "cessation" during the 5-year recapture period. In the case of a transaction described in the Revenue Procedure, this is not expected to happen. The more relevant issue, therefore, is whether and to what extent the provisions of Prop. Reg. § 1.48-4 would apply to a sale by the Investor of its interest in the Master Tenant Partnership <u>after</u> the 5-year recapture period (if, for example, the Investor exercised a "put" right that complied with the Safe Harbor.).

In a 1989 private letter ruling, the Service addressed a number of issues relating to a transaction in which the Rehabilitation Tax Credit arising from the rehabilitation of a certified historic structure was passed through to a lessee partnership. *See* Priv. Ltr. Rul. 8943074 (August 2, 1989). One of the rulings requested by the taxpayer was whether the lessee would have to recapture any of the Rehabilitation Tax Credit passed through under a lease if, after five full years from the last date on which any portion of the qualified rehabilitation expenditures subject to the lease was placed in service, the lease was terminated or no longer qualified as a net lease under former Code Section 57(c)(1)(B). In its analysis of this issue, the Service noted that under former Code Section 47(a)(5)(B), there was no recapture of the investment credit on section 38 recovery property if there was a disposition of the property after five full years after the property was first placed in service. The Service also noted that under Treas. Reg. § 1.47-2(b)(2)(iii), if the lessor of new section 38 property makes a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by Code Section 38, but the lease is terminated and the property is transferred by the lessee to the lessor or to any other person, such transfer will be considered to be a disposition by the lessee. The Service concluded that if such disposition occurred after the 5-year recapture period, there would be no recapture of the Rehabilitation Tax Credit.

One of the other rulings requested by the taxpayer was whether or not the lessee was required to accelerate the amount required to be amortized under former Code Section 48(d)(5)(B) (i.e., the unrealized Section 50(d) income) if there were a termination of or a failure to renew the lease. The Service concluded, without any analysis, that no such acceleration was mandated. The Service stated: "Although the Service has not issued any regulations under section 48(d)(5)(C) of the Code, if, after 5 full years from the last date on which any portion of the qualified rehabilitation expenditures subject to the Lessee Leases was placed in service, either of the Lessee Leases is terminated or Lessee fails to renew either of the Lessee Leases, section 48(d)(5)(C) will not affect the pass-through of any rehabilitation credits to Lessee because the credit recapture period has ended." Accordingly, the Service concluded: "There will not be any acceleration of the amount Lessee will be required to amortize into income if either of the Lessee Leases is terminated after 5 years from the last date on which any portion of the qualified rehabilitation expenditures subject to that particular Lessee Lease was placed in service." Implicit in the ruling is the notion that, in the event of a termination of the lease, the lessee (as an entity) is required to continue to report the Section 50(d) income over the remaining recovery period for the property.

Although we understand that private letter rulings have no precedential value, they are sometimes helpful in gaining insight into how the Service views various technical tax issues. Both Priv. Ltr. Rul. 8943074 and Prop. Reg. § 1.48-4 seem to support the proposition that a "disposition" of property generating an Rehabilitation Tax Credit that has been passed through to a lessee that occurs subsequent to the 5-year recapture period will <u>not</u> result in an acceleration of the unrealized Section 50(d) income. If a sale of the underlying property or a termination of the lease is not an acceleration event, the sale or other disposition of a partnership interest in the lessee partnership likewise should not result in the acceleration of the income.

Based on the approach reflected in both proposed Treas. Reg. §1.48-4(n) and Priv. Ltr. Rul. 8943074, in the case of a transaction described in the Revenue Procedure, neither a sale of the underlying Building, a sale of an interest in the Master Tenant Partnership, nor the termination of the lease <u>subsequent</u> <u>to</u> the 5-year recapture period should cause an acceleration of any unrealized Section 50(d) income at the Master Tenant Partnership level. We have found no statutory or regulatory authority mandating a different result in the event of a sale or liquidation of the Investor's interest in the Master Tenant Partnership.

The Service could consider alternative approaches. For example, for administrative convenience, in the event of the termination of the lease in a Master Tenant Partnership transaction subsequent to the recapture period, in lieu of continuing to report any unrealized Section 50(d) income, the Developer Partnership could be permitted to reduce the basis of the rehabilitation improvements, thereby eliminating future depreciation deductions attributable to such improvements and effectively conforming future results to those that would have occurred had no Section 50(d) election been made.

6. <u>Conclusion and Request for Guidance</u>

As indicated above, based on existing statutory and regulatory provisions, industry participants generally have treated Section 50(d) income as a partnership tax item mandating an increase in both the outside basis and the capital accounts of the members of a Master Tenant Partnership. The provisions of Sections 704(b) and 705 of the Code provide clear and unambiguous statutory authority for this position. Nothing in these sections, nor the regulations interpreting such sections, suggests that Section 50(d) income can be treated any differently for outside basis purposes than any other item of partnership income. The Supreme Court has made it clear that the plain language of the Code will prevail over a perceived unanticipated tax benefit resulting from the literal application of the statute.

Based on the foregoing, we would request that the Service issue guidance confirming the following:

(i) When an election is made under Code Section 50(d)(5), current law requires that the lessee report income in the amount of 50% of the Rehabilitation Tax Credit ratably over the applicable depreciation recovery period.

(ii) Section 50(d) income is an item of partnership income or gain that (i) increases a partner's "outside" basis for its partnership interest under Code Section 705(a) and (ii) may be allocated to a partner in the same manner as other significant items of partnership income and gain are allocated to such partner. Such an allocation shall be deemed to be consistent with the partner's interest in the partnership in accordance with Treas. Reg. §.1.704-1(b)(3).

(iii) In the case of a Master Tenant Partnership that satisfies the conditions of the Safe Harbor, the Investor's distributive share of Section 50(d) income may be reduced in accordance with the provisions of Section 4.02(2) of the Revenue Procedure, provided that the Investor's share of other significant items of partnership income and gain are correspondingly reduced.

(iv) In the event of the sale or liquidation of the interest of a partner in a Master Tenant Partnership, the transferor's allocable share of any unrealized Section 50(d) income will not be accelerated and the remaining partners of the Master Tenant Partnership (or any successor partnership) will succeed to the transferor's share of such unrealized income and will continue to report the same over the applicable recovery period.

If the Service believes this is not the correct treatment, the Coalition believes that either a statutory or, at the very least, regulatory change is necessary to change the result and that any such change should be prospective in application only. See, for example, Notice 99-57, 1999-2 CB 692, in which the Service announced its intention to issue regulations under Code Section 705 covering situations where a corporation acquires an interest in a partnership that owns stock in that corporation and the corporation does not have a Section 754 election in effect for the year of acquisition. Final regulations implementing this change were issued in 2002.

We would be happy to discuss this issue in more detail with you at your convenience.

Very truly yours,

John Leith-Tetrault
Chairman