HISTORIC
TAX CREDIT
COALITION

September 18, 2015

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IRS Office of Chief Counsel
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Room 5111
Washington DC 20224

Re: Code §50(d) Income

Dear Paul:

We wanted to thank you once again for giving us the opportunity to meet with you and your colleagues on August 19 to discuss issues concerning the effective date of regulations issued in connection with your current priority guidance project relating to the tax treatment of Code §50(d) income.

I am writing now for three purposes. First, we thought that it might be helpful to provide a short written discussion of the partnership vs. partner item issue and how we think it affects the §50(d) analysis. Second, we wanted to provide you with our further thoughts on the "hybrid" method of switching to a basis reduction approach (as opposed to acceleration, or some other technique) following a put or other disposition of the investor's interest in the master tenant. Finally, we wanted to note a few other items that we have discussed in previous meetings and letters to assure that they aren't inadvertently dropped as you finalize the regulations.

Partnership vs. Partner Item Analysis.

In our meeting it appeared that your position is that Code §50(d) income does not generate "outside" basis for the partners or members of a lessee that is a partnership or other passthrough entity for federal income tax purposes. If that is the case, we think it is very important for practitioners to understand the technical basis for such position in order to assess any ancillary consequences. For example, if §50(d) income is treated as a partner level item under an aggregate theory of partnership taxation, it is difficult for us to see how the mere disposition of a partner's interest would have any impact on such partner's obligation to continue to report its allocable share of the unrealized §50(d) income over the remaining portion of the applicable recovery period.

Conversely, if your decision is to treat the §50(d) income as a partnership item that does not generate outside basis under Code §705, it is difficult to see why the sale or other disposition by a partner of its interest would affect any unrealized §50(d) income. Instead, it should simply continue as a partnership tax item for the remaining partners. Indeed, in the absence of guidance to the contrary, partnership treatment suggests that the unrealized §50(d) income could be "flipped" to the safe harbor of Rev. Proc. 2014-12 (e.g., flipping the principal-investor percentages from 1-99 to 95-5). Even this is not totally clear because of the notional nature (and arguable lack of economic effect) of such income. This final thought suggests that it may not be subject to allocation under the Code §704(b) regulations at all

You also raised the possibility that any unrealized Code §50(d) income could be accelerated simply as a result of the termination of the lease. As discussed below, such an approach appears to be contrary to what little existing guidance exists with respect to this issue.

While the acceleration issue has no practical impact in energy ITC transactions, because the 50(d) income is fully realized prior to exit on account of the short 5-year recovery period that applies to energy property, 50(d) income acceleration has an enormous impact in historic tax credit lease transactions. In HTC transactions, the investor may exit many years before the end of the applicable recovery period (typically 39 years) leaving significant unrealized 50(d) income.

We are not aware of any definitive authority concerning the treatment of unrealized Code §50(d) income after the 5-year recapture period where the lessee is a partnership. Prop. Reg. §1.48-4(n), which was issued in 1982, addresses the question of how such income should be treated in the event of a disposition of the property <u>during</u> the 5-year recapture period. Specifically, Prop. Reg. 48-4 provides:

> (n) *Adjustment to lessee's income.* – (1) In *general* – If a lesser 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.
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> (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
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> > (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.
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> (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.
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> (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.
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> (3) *Effective dates*. — The effective dates described in paragraph (m) of §1.48-7 (relating to adjustment to basis) shall apply to this paragraph.

Prop. Reg. §1.48-4 does not deal with what happens to unrealized Code §50(d) income if the lease is terminated after the recapture period. The only published guidance on the issue is in Priv. Ltr. Rul. 8943074, which was released a number of years after Prop. Reg. §1.48-4 was issued. In the ruling, which involved a Code §48(d) lease transaction, the taxpayer requested, among other things, that the IRS rule on whether or not the lessee would be required to accelerate unrealized (then Code §) 48(d) income if there was a termination of or failure to renew the lease. The IRS concluded that no such acceleration was mandated, stating:

> Although the IRS 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 IRS, 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.
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> Accordingly, the IRS concluded:
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> 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 IRS.

Implicit in the foregoing ruling is the notion (discussed below) that, in the event of a termination of the lease, the lessee (as an entity) is required to continue to report the (then Code §48(d)) income over the remaining recovery period for the property.

Hybrid Method Switching to Basis Reduction.

Because of the technical issues raised by acceleration, one of the issues we discussed at the meeting was the possibility, in lieu of requiring acceleration, of permitting or mandating a downward adjustment in the depreciable basis of the rehabilitation improvements at the time of the appropriate “triggering event” (which for purposes of this discussion I will assume to be the termination of the master lease). Interestingly, former Treas. Reg. §1.48-7(b) (which was effective for transactions before 1964 and was removed from the regulations in 1993) contained a similar requirement. The former regulations provided that in the case of a Code §48(d) election, and in lieu of acceleration of the unrealized income, the lessee would reduce its basis in the property by the excess of the amount of investment tax credits over what at the time was the functional equivalent of what is now Code §50(d) income. Under the law in effect at that time, reduced Code §162 deductions by the lessee rather than notional income was the quid pro quo for the lack of a basis reduction.

Specifically, former Treas. Reg. §1.48-7(b) provided:

> (1) If a lessor of property placed in IRS before January 1, 1964, makes a valid election under §1.48-4 to treat the lessee as having purchased such property for purposes of the credit allowed by section 38 and if such lessee at a later date (in a taxable year of the lessee beginning before January 1, 1964) actually purchases such property, the basis of such property shall be reduced, as of the time of the actual purchase by an amount equal to the excess of:
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> (i) the credit earned (as defined in paragraph (k)(2)(i) of §1.48-4) with respect to such property, over
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> (ii) the sum of the amounts by which the lessee-purchaser has decreased, under paragraph (k)(2) of §1.48-4, his deductions otherwise allowable under section 162 for amounts paid or accrued to the lessor-vendor under the lease with respect to such property.
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> (2) The operation of this paragraph may be illustrated by the following example:
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> Example: X Corporation acquires on January 1, 1962. an item of new section 38 property with a basis of $12,000 and with a useful life of 8 years. Y Corporation, which makes its return on the basis of a calendar year, leases such property from X Corporation and places it in IRS on February 1, 1962. Under §1.48-4, X Corporation makes a valid election to treat Y Corporation as having purchased such property for purposes of the credit allowed by section 38. Under paragraph (k)(2)(i) of §1.48-4. the amount of the credit earned with respect to such property is $840 (7 percent of $12,000). For the taxable year 1962, Y Corporation decreases, under paragraph (k)(2)(ii) of §1.48-4, its deductions otherwise allowable under section 162 for amounts paid to X Corporation under the lease with respect to such property by $96.25 ($840 multiplied by 11/96). On January 1, 1963, Y Corporation actually purchases such property from X Corporation for $9,000.) As of January 1, 1963, Y Corporation must reduce the basis of the property by $743.75 ($840 minus $96.25). Thus, for purposes of determining a reasonable allowance for depreciation under section 167 with respect to such

> property tor the taxable year 1963, its adjusted basis is $8,256.25 ($9,000 minus $743.75).

Adopting a similar approach in the upcoming regulatory guidance would appear to be consistent with your stated objective of insuring that the overall federal income tax treatment of a lease transaction with a Code §50(d) election is substantially the same as that of a single tier transaction in which the ITC is allocated to the partners or members of a passthrough entity that owns the eligible property. During the period in which the investor is a partner or member of the lessee, the investor would report its ratable share of the Code §50(d) income in accordance with the principles of former Code §48(d) and Treas. Reg. §1.48-4. If the lease is terminated upon the investor's exit, the owner/lesser would be required to reduce its adjusted basis in the property by the remaining unrealized 50(d) income, thereby insuring that no unintended "double benefit" occurs. If the owner/lesser is a partnership or other passthrough entity, its partners would be required to correspondingly reduce their outside basis for their interests in such entity.

A slight variation of the foregoing approach is possible that would result in even more consistency with the principles of Prop. Reg. §1.48-4. Under this variation, at the time of the purchase of an investor's interest, the master tenant could be merged into and with the owner/landlord. Such a merger would functionally be very similar to a purchase of the underlying property by the lessee. Under Prop. Reg. §1.48-4, there is no acceleration if "the lessee continues the use of the property in a trade or business or in the production of income." Even if the lease is subsequently terminated, there is no acceleration if such termination occurs by reason of the "purchase of the property by the lessee."

In short, mandating or allowing a basis adjustment in lieu of acceleration achieves substantial parity between the federal income tax consequences of a transaction in which a Code §50(d) election is made and a transaction using a single tier structure. Such an approach also would address the administrative difficulties in continuing to monitor the reporting of §50(d) income over a long period of time. We believe that the adoption of the basis adjustment approach would help immeasurably in attracting new equity to the rehabilitation of historic properties and stabilizing the existing equity market. We hope you will give this proposal serious consideration.

<u>Other Issues</u>.

Finally, we wanted to note a few open issues that we hope will be addressed by the regulations:

1. Effective Date. We continue to request that any change to the treatment of 50(d) income not apply to transactions which met certain requirements prior to the publication of the regulations, as discussed in our previous letter. For example, the effective date of the regulations might exempt transactions (unless they elected to the contrary) where one or more investors had signed a partnership or LLC agreement and contributed not less than 20 percent of the total reasonably anticipated capital contributions of all investors prior to the date that regulations are published in the Federal Register.

2. Allocating 50(d) Income in Accordance with Current Partnership Percentages. If the Service concludes that 50(d) income is a partnership item, then we suggest that it should be allocated among the partners in accordance with their interests in the partnership in the particular year that the income is recognized.

3. Election. We suggest that there be the opportunity for the taxpayers to elect to apply the substance of these regulations in those situations where grandfathering would otherwise render them inapplicable.

Thanks very much for your consideration. Please do not hesitate to contact us if you have questions or would like to discuss these matters in more detail.

Very truly yours,

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