

# NEW TEMPORARY REGULATIONS DENY BASIS INCREASE IN PARTNERSHIP INTERESTS IN LEASE PASSTHROUGH ITC STRUCTURES

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## Tax Alert

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On July 21, the U.S. Treasury Department ("**Treasury**") released temporary and proposed<sup>[1]</sup> regulations denying a basis increase to equity holders of lessee partnerships and S corporations to account for mandatory income inclusions resulting from the lessee entity's claim of investment tax credits, including the rehabilitation credit under Code<sup>[2]</sup> Section 47 (the "**Rehab Credit**") and the energy credit under Code Section 48 (the "**ITC**"). This position is contrary to that historically taken by many investors in Rehab Credit and ITC lease pass-through and inverted lease structures and will change the financial return on such investments. The new temporary regulations also provide welcome rules for coordinating any Rehab Credit and ITC recapture and applicable income inclusion by a lessee claimant of the ITC.

The temporary regulations are applicable to Rehab Credit and ITC property placed in service on or after September 19, 2016 (60 days after the temporary regulations were filed) and before July 20, 2019. However, the temporary regulations are effective as of July 22, 2016. The earlier effective date may be a consequence of the Congressional Review Act's requirement that regulations issued within the last 60 days of a congressional session be reviewed by the next Congress. Nonetheless, there is some risk that an IRS auditor would view the new temporary regulations as informative of congressional intent with respect to property placed in service on and after July 22, 2016.

Taxpayers may comment on the proposed regulations (which duplicate the temporary regulations) until October 20, 2016. The IRS has specifically requested comments concerning the application of the lessee income inclusion to trusts, estates, and electing large partnerships.

## BACKGROUND

Owners of Rehab Credit and ITC property may elect to pass the tax credit through to a lessee of the facility. In that case, the lessor is not required to reduce the basis of the property by the amount of tax credit. Instead, the lessee must include ratably in its gross income 100 percent of any Rehab Credit claimed or 50 percent of any ITC claimed over the shortest depreciation period applicable to the facility.

Historically, many investors in lessee partnerships and S corporations have treated the income inclusion as a partnership or S corporation item and increased their basis in their equity interests by an amount equal to the income inclusion. The new temporary regulations deny this increase.

## IMPACT OF TEMPORARY REGULATIONS

### **Denial of Basis Increase.**

In the preamble to the new temporary regulations, Treasury indicated that the increased basis referred to above confers "an unintended benefit" on lessee partnership and S corporation investors, which is eliminated by the temporary regulations.

Under the temporary regulations, when an election is made to "pass-through" the Rehab Credit or ITC to a lessee partnership or S corporation, the amount of Rehab Credit or ITC is determined at the equity holder level and the corresponding income inclusion similarly occurs at the equity holder level. Thus, for this purpose, each equity holder in the lessee that is the "ultimate credit claimant" (i.e., any equity holder filing Form 3468 to claim the Rehab Credit or ITC) is treated as a lessee for purposes of the income inclusion rules and their interest in the lessee entity is effectively ignored.

### **Coordination of Recapture and Income Inclusion Rules.**

Although the recapture period for the Rehab Credit or ITC is 5 years, a lessee (or ultimate credit claimant) must account for the mandatory income inclusion ratably over the shortest Code Section 168 depreciation recovery period applicable to that property. In some cases—notably, in respect of property other than wind and solar energy facilities—the Code Section 168 depreciation period may be longer or shorter than the recapture period. Accordingly, the temporary regulations provide that, in the case of a recapture of the Rehab Credit or ITC, a lessee or ultimate credit claimant may include or exclude amounts from its gross income to account for any difference between its unrecaptured Rehab Credit or ITC and aggregate income inclusions up to that time. In addition, after the recapture period has lapsed, a lessee or ultimate credit claimant may irrevocably elect to accelerate any remaining income inclusion upon the earlier of (1) the disposition of the applicable property, (2) termination of an applicable lease, or (3) in the case of an ultimate credit claimant only, its disposition of its direct or indirect equity interest in a lessee partnership S corporation. This election must be made in the tax year of the termination or disposition and may be useful in case a taxpayer has suspended losses under Code Sections 465 or 469.

#### **Notes:**

[1] The text of the proposed and temporary regulations is the same. The Internal Revenue Service ("IRS") has requested comments regarding the proposed regulations, specifically concerning the application of the lessee income inclusion to trusts, estates, and electing large partnerships.

[2] All references to the "Code" are to the Internal Revenue Code of 1986, as amended.

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