 IRS Issues Long Awaited 50(d) Guidance

The Internal Revenue Service (IRS) recently issued regulations that provide guidance regarding the income inclusion rules under Internal Revenue Code (IRC) Section 50(d)(5), when a lessee is treated as having acquired investment credit property. Many properties claiming federal historic tax credits (HTC) have used this tax structure as a means of allocating most of the HTC to a tax credit investor while allocating most of the cash flow to the building owner. This guidance also applies to certain energy investments.

Background

In the 1990s, the government allowed the lessor to elect investment credit property to have been acquired by the lessee. In general, the cost of the property built was the fair value of the property. Any credits generated by this investment property would have to be recognized as income by the lessee under code section 50(d).

Prior to this guidance, interpretations of 50(d) have varied significantly, which prompted the IRS to issue this guidance. So what controversy was the IRS addressing with this guidance? An example may help to illustrate the controversy.

Assume that a HTC is being claimed for a commercial building with a 39-year life, where $3,900,000 of tax credits are being passed through to the lessee (the investor) by the lessor (the building owner) and $100,000 of income is being passed through annually for 39 years to the lessee. Further assume that the investor disposes of its interest after the 5-year HTC recapture period has expired.

Prior to this guidance, investors generally took one of two positions regarding treatment of the $100,000 of annual income that was to be allocated to the lessor over the remaining 34 years.

- When the investor disposed of their interest, there was no obligation on their part to recognize any of the remaining $3.4 million of income, or
- The investor recognized the $3.4 million of remaining income immediately when they disposed of their interest.

So, prior to this guidance, it was not clear when an investor sold its interest how much income should be claimed by which taxpayer, and when the income should be claimed.

New Guidance

The new guidance addresses these issues by answering the following questions:

1) How much 50(d) income should be claimed and by which taxpayer?
• The IRS clarified that the term ultimate credit claimant referred to any partner or S-corporation shareholder that files Form 3468.
• The IRS then specified that the 50(d) income is reported in proportion to the tax credit claimed by the ultimate claimant.
• The guidance also specifies that 50(d) income is not a partnership item and therefore does not increase a partner’s basis in its partnership interest.

So, in our example, if the investor is entitled to 99% of the $3.9 million of HTC, then the investor is also responsible for reporting 99% of the $3.9 million of 50(d) income.

2) When should the 50(d) income be reported?
• The IRS indicates that the investor should continue recognizing income for the remaining 34 years even though the investor is no longer a partner.
• This guidance provides the claimant with the option of recognizing all of the remaining 50(d) income in the year that the claimant either disposes of its interest or when the lease is terminated. There are no future opportunities to exercise this election and the election must be made in a year while the claimant was a partner.
• If either the investor’s interest is sold or the lease terminates during the 5-year recapture period, then the amount of 50(d) income to be reported is adjusted to reflect the amount of tax credits actually realized by the claimant.

These regulations apply to all properties placed in service after September 19, 2016.

Investors that previously claimed tax credits under the lease pass-through structure and took the position that the pass-through income increased basis may want to consult with their tax advisors.

Kevin P. Martin & Associates specializes in the Affordable Housing industry and has decades of experience in assisting clients with a variety of tax credits including federal historic tax credits.

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