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## *IRS Releases Guidance under Section 50(d)*

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On July 22, 2016, the IRS published concurrent temporary and proposed regulations under Section 1.50-1T in the Federal Register that will affect lessees of investment credit property that are treated as having acquired the property when the lessor of such property makes an election to do so under Treas. Reg. Section 1.48-4. These temporary regulations (1) provide guidance for income inclusion rules under Section 50(d)(5) of the Internal Revenue Code of 1986, as amended (the “Code”); (2) provide special income inclusion rules for partners and S corporation shareholders of lessee partnerships and S corporations; (3) coordinate recapture rules with the income inclusion rules; and (4) provide an election to accelerate income inclusion upon a lease termination, lease disposition by a lessee, or disposition of a partner’s or S corporation shareholder’s entire interest in a lessee partnership or S corporation outside of the recapture period.

### **General Rules for Income Inclusion**

When a lessor makes an election under Treas. Reg. Section 1.48-4 to treat the lessee of investment credit property as having acquired such property for purposes of calculating the investment credit (a “Section 1.48-4 Election”), the temporary regulations provide that Section 50(c) (the successor to former Section 48(q)) does not apply. Therefore, the lessor is not required to reduce its basis in the investment credit property by the amount of the credit determined under Section 46 (or 50% of the amount of an energy credit under Section 48). Under Section 1.50-1T(b)(2) of the temporary regulations, a lessee must include in gross income an amount equal to the amount of the credit determined under Section 46 (or 50% of the amount of the credit in the case of an energy credit under Section 48). Unless an election is made otherwise, the lessee includes such amount ratably over the shortest recovery period applicable under the accelerated cost recovery system provided in Section 168. Generally, these recovery periods will be 39 years for nonresidential real property, 27.5 years for residential real property, and five years for solar energy property. The recovery period for income inclusion begins on the date the investment credit property is placed in service and continues on each one-year anniversary date thereafter until the end of the applicable recovery period.

### **Special Rules for Income Inclusion Related to Partners and S Corporation Shareholders and Effect on Basis and Capital Accounts**

Special rules apply for partners and S corporation shareholders of a partnership or an S corporation that is a lessee for which a Section 1.48-4 Election is made. Each partner or S corporation shareholder that is the “ultimate credit claimant” is treated as the lessee for purposes of the income inclusion rules. The term “ultimate credit claimant” is defined as any partner or S corporation shareholder that files (or that would file) Form 3468, “Investment Credit” (or its successor form), with such partner’s or S corporation shareholder’s income tax return to claim an investment credit determined under Section



46 with respect to such partner or S corporation shareholder. Each ultimate credit claimant must include in gross income the amount required under the income inclusion rules in proportion to the amount of the credit determined under Section 46 (or 50% of the amount of the credit in the case of an energy credit under Section 48) with respect to the partner or S corporation shareholder. In addition, the Treasury Department and IRS believe that the income inclusion is a partner, not a partnership, item so that the income does not increase a partner's outside basis, an S corporation shareholder's stock basis, or a partner's capital account.

## **Coordination of Income Inclusion Rules with Recapture Rules**

If there is an event that causes the investment credit recapture rules under Section 50(a) to be triggered (including if there is a lease termination), Section 1.50-1T(c) provides that an adjustment will be made to the lessee's (or the ultimate credit claimant's) gross income for any discrepancies between the total amount of the credit included in gross income and the total credit allowable after recapture. This adjustment would be made in the taxable year in which the property is disposed of or otherwise ceases to be investment credit property.

The lessee's (or the ultimate credit claimant's) gross income is increased if the amount of the unrecaptured credit (i.e., the allowable credit after taking into account the recapture amount), or 50% of the unrecaptured credit if an energy credit exceeds the amount previously included in gross income. The amount of the increase in income equals the excess of the amount of the credit that is not recaptured (or 50% of the amount of the credit that is not recaptured in the case of an energy credit) over the amount of the total increases in gross income previously made under Section 1.50-1T(b)(2). This increase is in addition to the amounts of the credit previously included in gross income.

The lessee's (or the ultimate credit claimant's) gross income is reduced if the income inclusion prior to recapture under Section 1.50-1T(b)(2) exceeds the unrecaptured credit, or 50% of the unrecaptured credit if an energy credit. The amount of the reduction of income equals the excess of the total increases in gross income previously made under Section 1.50-1T(b)(2) over the amount of the credit that is not recaptured (or 50% of the amount of the credit that is not recaptured in the case of an energy credit).

## **Election to Accelerate Income Inclusion Outside of the Recapture Period**

The temporary regulations allow for an election to be made to accelerate any remaining required gross income inclusion in the taxable year that a lessor or an ultimate credit claimant is exiting its investment. If a lease is terminated or is otherwise disposed of, a lessee or an ultimate credit claimant has the option to make an irrevocable election to include in gross income any remaining income required to be taken into account under Section 1.50-1T(b)(2). Also, if an ultimate credit claimant disposes of its entire direct or indirect interest in a partnership or an S corporation, the ultimate credit claimant has the option to make the same irrevocable election. This election can only be made outside of the Section 50(a) recapture period and if the lessee or the ultimate credit claimant was not already required to accelerate gross income because of a recapture event during the recapture period.

## **Conclusion**

By issuing Section 1.50-1T, the IRS has provided widely-expected guidance addressing the income inclusion rules under Section 50(d)(5) of the Code for investment tax credit transactions involving certain leasing transactions, as well as special rules related to partners and S corporation shareholders of lessee partnerships and S corporations, recapture rules that coordinate with the income inclusion rules, and an income acceleration election that can be made after triggering events that take place



outside of the recapture period. These concurrent temporary and proposed regulations apply to investment credit property that is placed in service on or after September 19, 2016, so these rules are crucial for parties that have entered into investment credit property leases where the property has not yet been placed in service. Please contact our investment tax credit expert, Michael Haun, if you would like to discuss further.



*If you have any questions concerning these developing issues, please do not hesitate to contact the following Atlanta Paul Hastings lawyer:*

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