

# **Bond Case Briefs**

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## **New Rules for Lessees of Investment Tax Credit Property: Baker Botts**

On July 22, 2016, the Internal Revenue Service (the “IRS”) and the Department of the Treasury (“Treasury”) released proposed and temporary regulations under Section 50 of the Internal Revenue Code of 1986, as amended (the “Code”), setting forth certain operating rules on the calculation of the investment tax credit (the “ITC”) where the lessor has elected to treat the investment tax credit property (“ITC Property”) as having been acquired by the lessee. In such case, the lessee, rather than the lessor, is entitled to claim the ITC in respect of the property that is the subject of such election. Of particular note, these rules change the way partners and shareholders of such lessees who are partnerships or S corporations must report the gross income inclusion that applies in lieu of a tax basis adjustment.

### **I. Background**

In general, a 30% ITC is available under current law for certain types of renewable energy property placed in service by a taxpayer during a taxable year. Under the Code and the Treasury Regulations applicable to the ITC, the taxpayer receiving the ITC must reduce its basis in the ITC Property by 50 percent of the credit (or 100 percent for certain rehabilitation expenditure credits) (the “Basis Adjustment Rule”). A recapture rule also requires the taxpayer to increase its tax liability by a recapture amount that decreases over time for the taxable year in which the ITC Property is transferred or otherwise ceases to be ITC Property (or upon disposition of interests in the taxpayer, in the case of partnerships claiming the ITC) if such transfer or cessation occurs within five years of being placed in service (the “Recapture Rule”).

A lessor of ITC Property may elect to effectively pass through the ITC to its lessee by treating the lessee as having purchased the property for purposes of computing the ITC (the “Lessor Election”). Because a lessee generally does not obtain a tax basis in leased ITC Property, the lessee cannot, if the Lessor Election were made, take a reduction in tax basis as required under the Basis Adjustment Rule. Instead, the lessee must include in gross income an amount equal to 50 percent of the credit (or 100 percent if the credit was for certain rehabilitation expenditures) ratably over the shortest recovery period applicable to the ITC Property under section 168 of the Code (the “Income Inclusion Rule”).

When the lessee taxpayer is an entity taxed as a partnership or an S corporation, the Income Inclusion Rule potentially could have the odd effect of increasing the “outside” tax basis in the interests of partners of the partnership or shareholders of the S corporation under Code Sections 705(a) and 1367(a), respectively. Whether this result was authorized or permitted by existing tax law has been an area of uncertainty. With the issuance of these new regulations, however, the IRS and Treasury have stated their belief that such a benefit, not available to other lessees of ITC Property, is inappropriate and is inconsistent with the purposes of Sections 48, 705 and 1367 of the Code.

### **II. The Temporary and Proposed Regulations**

The proposed and temporary regulations cement the application of the Income Inclusion Rule and provide rules coordinating the Income Inclusion Rule with the Recapture Rule for ITC Property subject to a Lessor Election. Therefore, in lieu of the Basis Adjustment Rule, the lessee must include in gross income an amount equal to the amount of the credit (or, in the case of an energy credit under section 48 of the Code, 50 percent of the credit) ratably over the shortest recovery period applicable to the ITC Property.

In addition, the proposed and temporary regulations provide special rules for lessees that are entities classified as partnerships or S corporations if the Lessor Election has been made. Under these rules, any income resulting from the application of the Income Inclusion Rule is not a partnership item or an S corporation item subject to the tax basis adjustment rules applicable to those entities. Rather, the proposed and temporary regulations generally provide that each partner or shareholder that is the “ultimate credit claimant” is treated as the lessee of the ITC Property and must include its share of the income under the Income Inclusion Rule. Because the income inclusion under this approach does not flow through the entity, there is no tax basis increase in the equityholder’s interest in the entity. An “ultimate credit claimant” is any partner or S corporation shareholder that files an IRS Form 3468, Investment Credit, with its income tax return to claim the ITC.

The proposed and temporary regulations also allow taxpayers to elect to accelerate the income inclusion upon a termination or other disposition of a lease. For partnerships and S corporations, the election is available to the ultimate credit claimant. Furthermore, partners and S corporation shareholders can elect to accelerate the income inclusion when they dispose of their entire interest, direct or indirect, in the partnership or S corporation. The election is available only if the recapture period has ended, and the taxpayer must make the election by including in gross income the relevant amount on the tax return for the taxable year of the termination or other disposition of the lease or the disposition of the taxpayer’s entire interest in the partnership or S corporation.

These regulations are prospective and apply to ITC Properties that are placed in service on or after September 19, 2016. Taxpayers wishing to comment on the proposed regulations have until October 20, 2016, to submit such comments or to request a public hearing.

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