NOTES

PHANTOM OF THE 50(d) INCOME

Leonard I. Greenberg[*]

INTRODUCTION

Taxpayers have long dealt with a specter of uncertainty surrounding their investments in certain tax credit projects, especially the phantom income attributed to taxpayers that lease investment tax credit properties and claim the tax credits arising from the projects.[1] This ghastly situation finally came to an end in July 2016 when the Internal Revenue Service ("IRS") dispatched the

[*] J.D. candidate, LL.M. in Taxation candidate, Boston University School of Law, 2018; B.A., Political Science, Anthropology, Tufts University, 2012. I would like to thank Professor Theodore Sims for his invaluable insights and for challenging me to improve this Note (although he may not agree with some of the Note's conclusions), as well as the editors and staff of the Boston University Law Review for their thorough editorial work. I would also like to thank my friends and colleagues who supported and contributed to this Note in ways large and small.

[1] *See* I.R.C. § 50(d)(5) (2012) (providing, by reference, for the pass-through of investment tax credits to lessees and related requirements).

Ghostbusters to issue new regulations.[2] However, as with many ghost stories, the new regulations leave us with several lingering questions.

I.R.C. § 50(d)(5) effectively requires lessees of investment credit property who claim the resulting tax credits (which include, among others, the rehabilitation credit[3] and the energy credit[4]) to include in their gross income an amount equal to the tax credits (or, in the case of the energy credit, 50% of that amount) ratably over the applicable recovery period of the property.[5] However, until 2016, the law was unclear as to how lessees that are treated as partnerships should treat this so-called "phantom" income, usually referred to as "Section 50(d) income," named for its progenitor statute.[6] Specifically, practitioners were uncertain whether the partners could use an allocation of Section 50(d) income to increase their basis in the lessee partnership, often called the partner's

[2] *See* Temp. Treas. Reg. § 1.50-1T (2016) (providing temporary regulations under § 50 concerning the "inclusion in gross income required when a lessor elects to treat a lessee as having acquired investment credit property").

[3] I.R.C. § 47 (providing for a tax credit for rehabilitations of certified historic structures).

[4] *Id.* § 48 (providing for a tax credit for investments in solar energy, geothermal power, fuel cells, microturbines, small wind power, and other energy sources). The credit provided for in § 48 is often colloquially referred to as the "Investment Tax Credit" or "ITC," because the credit is based on the taxpayer's investment in the renewable energy facility, whereas the "Production Tax Credit," provided for in § 45, is based on the amount of renewable energy produced. *Compare id.* § 48(a) (calculating the energy credit as a percentage of the basis of energy property), *with id.* § 45(a) (calculating the production credit by multiplying 1.5 cents by the kilowatt hours of electricity produced and sold by the taxpayer from qualified energy resources at a qualified facility). However, the Internal Revenue Code refers to several different tax credits, including the credits under §§ 47 and 48, collectively as the "investment credit" as a result of their historical legacy evolving from the former investment tax credit that covered a wide variety of business investments. *See id.* § 46 (providing that the "investment credit" is the sum of the rehabilitation credit, the energy credit, and others). The distinction is of importance to this Note, as § 50(d) applies to all investment credits. *See id.* § 50(d) (providing special rules for "purposes of this subpart," which includes §§ 46 and 48). To avoid confusion, this Note uses the Internal Revenue Code's terminology and refers to the credit under § 47 as the "rehabilitation credit," the credit under § 48 as the "energy credit," and all credits to which § 50(d) applies as "investment credits." Further, although "investment tax credits" under § 50(d) includes other credits available pursuant to §§ 48A-48D, this Note will not explicitly discuss those credits.

[5] I.R.C. § 48(d)(5)(B) (1988) (amended 1990) ("[T]he lessee of such property shall include ratably in gross income over the shortest recovery period which could be applicable under section 168 with respect to such property an amount equal to 50 percent of the amount of the [investment] credit allowable . . . to the lessee with respect to such property.").

[6] *See, e.g.*, *Section 50(d) Regulations Address Income Inclusion for Certain Investment Tax Credit Claimants*, PwC: TAX INSIGHTS FROM MERGERS & ACQUISITIONS 2 (Aug. 3, 2016), http://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-sec.-50(d)-regs-address-income-inclusion-for-some-itc-claimants.pdf [https://perma.cc/Y9EQ-ABBT] (referring to the ratable share of the income inclusion as the "Section 50(d) income").

"outside basis."[7] Almost all participants in the investment tax credit industry filed tax returns reflecting an increase in their outside basis in the lessee partnership,[8] believing it to be consistent with the textual provisions of the Internal Revenue Code,[9] despite misgivings about whether Congress intended such partners to be able to report a basis increase and whether the IRS would respect such a basis increase. These misgivings were based largely on I.R.C. § 50(c), which requires owners of investment tax credit property to *decrease* their basis in the property when the owner is the claimant of the tax credits.[10] It was difficult to believe Congress and the IRS[11] would permit partners of a credit-claiming lessee to *increase* their basis in the lessee partnership while requiring credit-claiming owners to *decrease* their basis in the property (and partners of such owners to decrease their basis in the owner partnership).

Temporary Treasury Regulation § 1.50-1T[12] resolved this longstanding ambiguity under § 50(d)(5).[13] Among other things, the regulations provide that Section 50(d) income cannot increase a partner's basis in the lessee partnership.[14] By their terms, the regulations apply to properties "placed in service on or after September 19, 2016."[15] They carry the caveat, however, that "[t]he temporary regulations should not be construed to create any inference concerning the proper interpretation of section 50(d)(5) prior to the effective date of the regulations."[16] At the same time, though, the regulations claim to be

---

[7] *See* WILLIAM F. MACHEN, THE REHABILITATION TAX CREDIT: A PRACTITIONER'S GUIDE TO THE TECHNICAL TAX ISSUES 72 (2015) ("[T]he Treasury Regulations do not address how the 'phantom' income in lieu of a basis adjustment is treated by a lessee partnership when an election is made under [I.R.C.] § 50(d)(5).").

[8] Jerome Breed, *Guidance on 50(d) Income Will Make a Major Impact*, NOVOGRADAC J. OF TAX CREDITS, Sept. 2016, at 54, 54 ("Most HTC investors included Section 50(d) income in the basis of their interest in the master tenant.").

[9] *See infra* Section III.B (arguing that such a basis increase is consistent with statutory text and judicial precedent).

[10] I.R.C. § 50(c)(1) (2012) ("[I]f a credit is determined under this subpart with respect to any property, the basis of such property shall be reduced by the amount of the credit so determined.").

[11] This Note will frequently refer to actions taken by the IRS alone or in conjunction with the Department of the Treasury. For simplicity, this Note refers to both organizations collectively as the "IRS."

[12] Temp. Treas. Reg. § 1.50-1T (2016).

[13] I.R.C. § 50(d)(5) (providing, by reference, for the pass-through of investment tax credits to lessees and related requirements).

[14] *See* Temp. Treas. Reg. § 1.50-1T(b)(3) ("[I]f the lessee of the property is a partnership . . ., the gross income includible under . . . paragraph [(b)(2)] is not an item of partnership income to which the rules of subchapter K of Chapter 1, subtitle A of the Code apply.").

[15] *Id.* § 1.50-1T(f).

[16] Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,703 (July 22, 2016).

consistent with congressional intent and statutory purpose,[17] and further claim that contrary positions taken by taxpayers prior to the new regulations are "inconsistent with Congressional intent,"[18] suggesting that the new regulations could be applied retroactively. The regulations make this claim, and the potential for retroactive application exists, despite the fact that the regulations are themselves somewhat inconsistent with prior guidance from the IRS that suggested different treatment of § 50(d)(5).[19] These seemingly contradictory positions raise two questions. The first question is a technical tax question: Are the regulations themselves the best interpretation of § 50(d)(5)? The second question is normative: How should the IRS treat transactions that fall outside of the purview of § 1.50-1T?

This Note seeks to provide a framework to answer these two questions. Part I provides background on investment credits, their political and social history, and why they matter. It then describes the basic structures of investment tax credit transactions, as they are somewhat varied but are driven in several ways by § 50. This Note then explains the treatment of a taxpayer's adjusted basis in investment tax credit transactions, including the differences between §§ 50(c) and 50(d)(5), and the long-standing open issues under § 50(d)(5) that preceded the promulgation of § 1.50-1T.

Part II analyzes § 1.50-1T. It begins by reviewing the long process leading up to § 1.50-1T's promulgation, including the conflicting information the IRS provided through the years. It then discusses § 1.50-1T's text, emphasizing the special partnership rules, but also discussing the credit recapture rules, the income acceleration option, and the applicability provisions. This Note then analyzes the impact of § 1.50-1T post-promulgation and responses to it from industry participants.

Part III discusses the applicability of § 1.50-1T by reviewing the status of preexisting transactions under § 50 in light of precedent regarding retroactive tax regulations. It further examines whether § 1.50-1T reaches the most reasonable conclusions. This Note ultimately argues that the IRS's conclusions expressed in § 1.50-1T, specifically that an increase in a partner's outside basis as a result of the inclusion of Section 50(d) income should be disallowed, are, for the most part, sound from a policy perspective. However, this Note also argues that such conclusions have little support in either the Internal Revenue Code's text or judicial precedent, much of which suggests the treatment of Section 50(d) income as a partnership-level tax item and a resulting increase in outside basis is proper. As a result, the IRS should clarify that its damning

[17] *See id.* ("Congress did not intend to allow partners and S corporation shareholders the full benefit of the credit without any of the corresponding burden.").

[18] *Id.* at 47,702.

[19] *See, e.g.*, Rev. Proc. 2014-12, 2014-3 I.R.B. 415, 416 (providing that "this revenue procedure does not address how a Partnership is required to allocate the income inclusion required by § 50(d)(5)," thus implying that the income inclusion *is*, in fact, a partnership item to be allocated by the partnership in the first place).

statements condemning taxpayers that have reported a basis increase will not create a foundation for the IRS to assess deficiencies against such taxpayers.

I. Background

A. *History of Investment Tax Credits*

1. The Rehabilitation Credit

In 1966, Congress passed the National Historic Preservation Act, which created the National Register of Historic Places and certain programs for the preservation of historic structures.[20] Congress felt compelled to act because it believed the nation's "historic past" and "cultural foundations" should be preserved and future generations should have "a genuine opportunity to appreciate and enjoy the rich heritage of our Nation."[21]

While this Act created programs and courses of action for the federal and state governments,[22] it offered little incentive for private parties to take on a significant role in the historic preservation process. The Tax Reform Act of 1976 offered such an incentive in the form of accelerated depreciation for taxpayers that rehabilitated historic properties.[23] Two years later, the accelerated depreciation option was converted into an investment tax credit, which provided for credits against federal tax liability for a wide variety of business investments, as part of the larger investment tax credit statute.[24] The rehabilitation credit entered its current form and structure with the Tax Reform Act of 1986 as a two-tiered credit that has not substantially changed in the ensuing years.[25]

---

[20] National Historic Preservation Act, Pub. L. No. 89-665, § 101(a), 80 Stat. 915, 915 (1966) (codified as amended at 54 U.S.C. §§ 300101-307108 (Supp. III 2015)) (authorizing the Interior Secretary "to expand and maintain a national register of districts, sites, buildings, structures, and objects significant in American history, architecture, archeology, and culture," and "to grant funds to States . . . for the preservation, acquisition, and development of such properties"); *see* NAT'L PARK SERV., U.S. DEP'T OF THE INTERIOR, *A History of the Secretary of the Interior's Standards for the Treatment of Historic Properties & Guidelines for Preserving, Rehabilitating, Restoring and Reconstructing Historic Buildings*, https://www.nps.gov/tps/standards/history-of-standards.htm [https://perma.cc/ GUR7-48VX] (last visited Sept. 17, 2017) (detailing the history of the Interior Secretary's standards for the treatment of historic properties).

[21] 80 Stat. at 915.

[22] *See, e.g.*, § 101(a), 80 Stat. at 915.

[23] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2124, 90 Stat. 1520, 1916-20 (allowing "a deduction with respect to the amortization of the amortizable basis of any certified historic structure . . . based on a period of 60 months").

[24] Revenue Act of 1978, Pub. L. No. 95-600, § 315, 92 Stat. 2763, 2828-29 (allowing investment credits for certain rehabilitated buildings).

[25] Tax Reform Act of 1986, Pub. L. No. 99-514, § 251, 100 Stat. 2085, 2183-89 (reducing credit percentages to 20% of rehabilitation expenditures for certified historic structures and 10% of rehabilitation expenditures with respect to other qualified rehabilitated buildings).

As explained in further detail below, the rehabilitation credit is a dollar-for-dollar credit against a taxpayer's tax liability equal to 20% of expenditures related to the rehabilitation of historic structures that are listed in the National Register of Historic Places or contribute to the significance of a registered historic district.[26] The rehabilitation credit has created significant incentives to rehabilitate historic buildings, thus maintaining historic architecture in America's cities and towns, as well as creating jobs, enhancing property values, and encouraging the construction of housing units.

Rehabilitation tax incentives have helped to finance over 42,000 historic rehabilitation projects in every state, the District of Columbia, Puerto Rico, and the Virgin Islands.[27] In fiscal year 2016 alone, the National Park Service, which oversees the historic rehabilitation process and certifies projects that are eligible for the rehabilitation credit, approved 1299 proposed historic rehabilitation projects and over $7.16 billion in proposed rehabilitation work.[28] Completed historic rehabilitation projects created over 108,000 jobs and over 7000 new units of low- and moderate-income housing during that same period.[29] Since its inception, the rehabilitation credit is claimed to have generated over $84 billion in historic rehabilitation investment, created an estimated 2.44 million jobs, and has resulted in the construction of hundreds of thousands of housing units, including over 153,000 units of low- and moderate-income housing.[30] The rehabilitation credit has been shown to be a more effective economic driver than other types of investment.[31] Furthermore, the rehabilitation credit pays for itself by increasing the tax base and generating economic activity.[32]

The rehabilitation credit is often utilized through partnerships between real estate developers and some of America's largest financial institutions and corporations, including Bank of America, U.S. Bank, JPMorgan Chase Bank, PNC Bank, Goldman Sachs, Royal Bank of Canada, Sherwin-Williams

---

[26] *See infra* Section I.B (explaining the structure of the rehabilitation credit).

[27] NAT'L PARK SERV., U.S. DEP'T OF THE INTERIOR, FEDERAL TAX INCENTIVES FOR REHABILITATING HISTORIC BUILDINGS: STATISTICAL REPORT AND ANALYSIS FOR FISCAL YEAR 2016 1 (2016).

[28] *Id.*

[29] *Id.* at 3.

[30] *Id.*

[31] CTR. FOR URBAN POLICY RESEARCH, RUTGERS UNIV. EDWARD J. BLOUSTEIN SCH. OF PLANNING & PUB. POLICY, ANNUAL REPORT ON THE ECONOMIC IMPACT OF THE FEDERAL HISTORIC TAX CREDIT FOR FY 2015, at 4, https://www.nps.gov/tps/tax-incentives/taxdocs/economic-impact-2015.pdf [https://perma.cc/N32A-ZV7L] (last visited Sept. 17, 2017) (finding that "in many parts of the country, a $1 million investment in historic rehabilitation yields markedly better effects on employment, income, [gross state product], and state and local taxes than an equal investment in new construction or many other economic activities (e.g., manufacturing or services)").

[32] *Id.* (finding that the rehabilitation credit "yields a net benefit to the U.S. Treasury, generating $28.1 billion in federal tax receipts over the life of the program, compared with $23.1 billion in credits allocated").

Company, and Chevron USA.[33] Rehabilitation projects vary widely and include rehabilitations of historic mills, manufacturing facilities, post offices, banks, schools, hotels, theatres, department stores, prisons, naval facilities, and urban skyscrapers.[34]

All of this illustrates that the rehabilitation credit plays a significant and underappreciated role in the American economy and in achieving socially desirable outcomes. Thus, the development of the laws surrounding the rehabilitation credit can have significant economic and social effects.

2. The Energy Credit

The first iteration of the energy credit appeared in 1962 and was denominated part of the "investment tax credit," a set of tax credits for a wide variety of business-related investments.[35] This version of the energy credit provided a modest and temporary subsidy for qualified investments in utilities and other infrastructure projects, and ultimately was repealed in 1986 (but not before being amended, suspended, reinstated, abolished, reenacted, increased, and made permanent).[36] President George W. Bush signed the current version of the

---

[33] *See, e.g.*, *About Us: Coalition Members*, HISTORIC TAX CREDIT COALITION, http://historiccredit.com/about/members/ [https://perma.cc/NF4F-DQ2R] (last visited Sept. 17, 2017); Amos Maki, *Goldman Sachs 'Confident' in Memphis*, MEM. DAILY NEWS (Mar. 3, 2015), https://www.memphisdailynews.com/news/2015/mar/3/goldman-sachs-confident-in-memphis/ [https://perma.cc/9NGE-E2RV] (describing a rehabilitation credit investment by Goldman Sachs in the Sears Crosstown rehabilitation project in Memphis, Tennessee); *Tax Credit Investment Group*, PNC FIN. SERVS. GRP., INC., https://www.pnc.com/en/ corporate-and-institutional/financing/lending-options/pnc-real-estate/tax-credit-investments-group.html [https://perma.cc/ZG8L-W8DZ] (last visited Sept. 17, 2017) (noting PNC's services of providing historic tax credit equity); Richard Vanderford, *Chevron Sues For $6.3M Over Building Tax Scheme*, LAW360 (Oct. 15, 2009, 2:50 PM), https://www.law360.com/tax/articles/128491/chevron-sues-for-6-3m-over-building-tax-scheme (describing a lawsuit initiated by Chevron with respect to a rehabilitation credit transaction in which it was engaged).

[34] *See, e.g.*, *Impact Investing: Brooklyn Navy Yard, New York City*, GOLDMAN SACHS, http://www.goldmansachs.com/what-we-do/investing-and-lending/impact-investing/case-studies/brooklyn-navy-yard.html [https://perma.cc/HJT2-PTDU] (last visited Sept. 17, 2017) (describing investments to preserve historic infrastructure of Brooklyn Navy Yard); Maki, *supra* note 33 (describing rehabilitation credit investment in former Sears department store); NAT'L PARK SERV., *supra* note 27, at 4, 14-15 (describing notable 2016 rehabilitation credit projects in banks and schools); *The Liberty Hotel (Charles Street Jail)*, ARCHITIZER, http://architizer.com/projects/the-liberty-hotel-charles-street-jail/ [https://perma.cc/ZF6B-FQEA] (last visited Sept. 17, 2017) (noting that Boston's Liberty Hotel, formerly the Charles Street Jail, was rehabilitated using rehabilitation credits).

[35] *See* Revenue Act of 1962, Pub. L. No. 87-834, § 2, 76 Stat. 960, 962-73 (providing a credit for qualified investments in certain utilities).

[36] Tax Reform Act of 1986, Pub. L. No. 99-514, § 211, 100 Stat. 2085, 2166-70 (providing for the expiration of the investment tax credit and various phase-out provisions). *See generally* Rachael I. Lambert, The History of the Investment Tax Credit (Aug. 21, 2013) (unpublished

energy credit into law in 2005 as an incentive specifically focused on investments in renewable energy projects.[37] Congress has since approved several extensions of the energy credit, and it is currently set to phase out entirely by 2022.[38]

The energy credit offers a tax credit equal to 30% of the cost of a newly-constructed renewable energy facility.[39] Since its inception, the energy credit has significantly increased construction of solar energy facilities in the United States.[40] The energy credit, together with the wind production tax credit, is expected to continue to accelerate renewable energy deployment through the early 2020s, and has likely saved the solar energy industry from considerable setbacks.[41] These credits could cause a measurable reduction in carbon dioxide emissions.[42] It is expected that the number of gigawatts of solar energy installed will quadruple by 2020, while doubling the number of jobs in the solar energy sector and growing the economy.[43]

Like the rehabilitation credit, the energy credit is an important driver of economic activity as well as a key piece of American energy policy. Changes in

B.B.A. thesis, Columbus State University) (on file with Columbus State University ePress) (detailing the tortured history of the former investment tax credit).

37 *See* Energy Policy Act of 2005, Pub. L. No. 109-58, §§ 1300-1364, 119 Stat. 594, 986-1060.

38 I.R.C. § 48(a)(5)(E)-(6)(B) (Supp. III 2015) (providing for gradual reductions in the credit for wind facilities between 2016 and 2020 and for gradual reductions in the credit for solar energy property between 2019 and 2022).

39 I.R.C. § 48 (2012).

40 Stephen D. Comello & Stefan J. Reichelstein, The U.S. Investment Tax Credit for Solar Energy: Alternatives to the Anticipated 2017 Step-Down 2 (Apr. 16, 2015) (unpublished manuscript), *available at* https://www.novoco.com/sites/default/files/atoms/files/us_investment_tax_credit_solar_stanford_report_042215.pdf [https://perma.cc/RZ7X-8GBU].

41 *See id.* at 27 ("[A]n [energy credit] step-down to 10% by early 2017, [which was avoided by the most recent energy credit extension,] would render solar PV uncompetitive across the entire spectrum of applications considered in our study."); *see also* TRIEU MAI ET AL., IMPACTS OF FEDERAL TAX CREDIT EXTENSIONS ON RENEWABLE DEPLOYMENT AND POWER SECTOR EMISSIONS 22 (2016), https://www.nrel.gov/docs/fy16osti/65571.pdf [https://perma.cc/RCJ2-E8TD] (summarizing the anticipated impact of the energy credit and the wind production credit on renewable energy deployment).

42 MAI ET AL., *supra* note 41, at 22 ("[O]ur findings suggest that tax credit extensions can have a measurable impact on future RE deployment and electric sector CO_2 emissions.").

43 *The Solar Investment Tax Credit (ITC)*, SOLAR ENERGY INDUS. ASS'N, http://www.seia.org/sites/default/files/ITC%20101%20Fact%20Sheet%20-%2004-19-2016.pdf [https://perma.cc/SG58-9PSC] (last visited Sept. 17, 2017) ("[W]e expect the roughly 27 gigawatts of solar energy cumulatively installed in the US at the end of 2015 to reach nearly 100 GW by the end of 2020[,] . . . the roughly 210,000 Americans currently employed in solar . . . to double to 420,000 in the same time . . . while spurring roughly $140 billion in economic activity.").

the laws governing the energy credit could have long-term impacts on jobs, economic activity, energy prices, and the global climate.

B. *Investment Tax Credit Structures*

Tax credits are often difficult for members of the general public to understand. Unlike tax deductions, tax credits confer a dollar-for-dollar reduction in a taxpayer's tax liability.[44] Over the years, tax credits have been a popular vehicle for pursuing a wide variety of social policy goals. For example, the new markets tax credit provides a credit for investors in certain businesses located in or benefitting low-income communities[45] and the low-income housing tax credit provides a tax credit for affordable housing developers.[46] The Internal Revenue Code also offers a credit to individuals for expenses associated with qualified child adoptions.[47] The rehabilitation credit also has a policy focus, as it seeks to ensure that "the historical and cultural foundations of the Nation should be preserved as a living part of our community life and development in order to give a sense of orientation to the American people."[48] The energy credit was enacted as part of a comprehensive program to overhaul energy policy in many different areas.[49]

In its most widely used form, the rehabilitation credit confers a credit in the amount of 20% of a taxpayer's qualified expenditures in rehabilitating a certified historic structure.[50] The computation includes most expenditures incurred in connection with a rehabilitation, such as construction, architectural fees, permits, and even legal and accounting fees, but excludes certain categories of costs such as acquisition costs and enlargement costs.[51] In the year a qualified

[44] *Compare* I.R.C. § 38 (allowing business credits "as a credit against the tax imposed by this chapter"), *with id.* § 161 (allowing certain items as deductions "[i]n computing taxable income").

[45] *See id.* § 45D (providing, indirectly, for a 39% tax credit for investments in qualified active low-income community businesses).

[46] *See id.* § 42 (providing for a tax credit equal to a certain percentage of a taxpayer's qualified basis in certain qualified low-income housing projects).

[47] *See id.* § 23 (providing for a tax credit for "the amount of the qualified adoption expenses paid or incurred by the taxpayer").

[48] National Historic Preservation Act, Pub. L. No. 89-665, 80 Stat. 915, 915 (1966).

[49] *See* Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594, 594 (describing the Energy Policy Act as "[a]n Act [t]o ensure jobs for our future with secure, affordable, and reliable energy").

[50] I.R.C. § 47(a)(2); *see also* MACHEN, *supra* note 7, at 8 (noting that "the use of the 10 percent Rehabilitation Tax Credit is relatively uncommon").

[51] I.R.C. § 47(c)(2) (defining "qualified rehabilitation expenditure" as "any amount properly chargeable to capital account . . . for property for which depreciation is allowable . . . in connection with the rehabilitation of a qualified rehabilitated building" but excluding the "cost of acquiring any building," any "expenditure attributable to the enlargement of an existing building," and certain other expenditures).

rehabilitation expenditure is placed in service, the building's owner (in the case of a single-tier structure, discussed further below) is entitled to claim the corresponding rehabilitation credits on its tax returns.[52]

The energy credit similarly confers a tax credit of 30% of the basis of certain energy property.[53] Energy property includes numerous types of renewable energy facilities, such as fuel cells and small wind projects, but the designation is most commonly used for properties that are heated, cooled, or illuminated using solar energy.[54] The energy credit also includes a 10% credit for other technologies, including geothermal and groundwater power.[55] As mentioned above, these percentages are set to phase out within the next several years.[56] Unlike the rehabilitation credit, the energy credit is calculated as a percentage of the taxpayer's entire basis in the property, rather than only certain qualified expenditures.[57] Like the rehabilitation credit, the property's owner is entitled to

---

[52] *Id.* § 47(b)(1) ("Qualified rehabilitation expenditures with respect to any qualified rehabilitated building shall be taken into account for the taxable year in which such qualified rehabilitated building is placed in service."). As suggested by the statutory text, the rehabilitation credit's availability corresponds to the placed-in-service date separately for each qualified rehabilitation expenditure. As a practical matter, most completed projects are placed in service on a single date and this distinction is irrelevant. However, some projects do have multiple placed-in-service dates, which can even occur over multiple years. This creates a still-unresolved issue relating to the application of the Section 50(d) income rules. *See infra* Section II.C (describing issues raised in comments to the proposed Section 50(d) income regulations).

[53] I.R.C. § 48(a) (providing that the "energy percentage" which forms the basis of the energy credit is 30% in the case of: (i) qualified fuel cell property; (ii) equipment which uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat, excepting property used to generate energy for the purposes of heating a swimming pool; (iii) equipment which uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight; and (iv) qualified small wind energy property).

[54] *About Renewable Energy Tax Credits*, NOVOGRADAC & CO. LLP: RENEWABLE ENERGY TAX CREDIT RES. CTR, https://www.novoco.com/resource-centers/renewable-energy-tax-credits/retc-basics/about-renewable-energy-tax-credits [https://perma.cc/3EVV-VR5F] (last visited Sept. 17, 2017) ("The [energy credit] is a dollar-for-dollar credit for expenses invested in renewable energy properties, most often solar developments.").

[55] I.R.C. § 48(a) (providing that the "energy percentage" is 10% for certain energy property, including "equipment used to produce, distribute, or use energy derived from a geothermal deposit," "combined heat and power system property," and "equipment which uses the ground or ground water as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure").

[56] I.R.C. § 48(a)(5)(E)-(6)(B) (Supp. III 2015) (providing for reductions in the amount of energy credits that can be claimed depending on the commencement of construction of the property).

[57] The taxpayer's basis is adjusted for any government subsidies provided to the project. I.R.C. § 48(a)(4) (2012) (providing for a reduction in basis for calculating the energy credit if energy property is financed in whole or in part by subsidized energy financing or the proceeds

claim the full amount of the energy credit in the year the property is placed in service.[58]

Real estate development companies are often the parties who acquire historic buildings in order to rehabilitate, then operate or lease them as housing, entertainment, restaurants, offices, or retail space. However, due to restrictions on tax benefits from "passive" activities, real estate developers often lack the ability to utilize the rehabilitation credit themselves.[59] As a result, developers often team up with institutions, such as major corporations and banks, to utilize the credits.[60] Developers of energy credit property also sometimes partner with institutional investors to utilize credits generated by their properties.[61] In both rehabilitation and energy credit transactions, the parties will form a new limited liability company or limited partnership, which in either case is treated as a partnership for tax purposes, and that partnership will own the property.[62] Typically, the investor corporation (or, in some cases, a transaction-specific

of a tax-exempt private activity bond). However, the universe of costs included in the calculation remains much broader than the costs included in the calculation of the rehabilitation credit. *See supra* note 51 (describing the limitations on costs available in calculating the rehabilitation credit, including the exclusion for acquisition or enlargement costs).

[58] I.R.C. § 48(a)(1).

[59] *See id.* § 469 (prohibiting credits and deductions from passive activities, including real estate rental, to offset income from non-passive activities); MACHEN, *supra* note 7, at 7 ("Because of the limitations on the use of credits and losses from passive activities, the vast majority of these investors are widely held corporations.").

[60] *See supra* note 33 (citing sources that note some major institutional investors in the rehabilitation credit).

[61] *See* Teresa Garcia, *Stakeholders Say Scarce Renewable Energy Tax Equity Spurs Innovative Financing*, NOVOGRADAC J. OF TAX CREDITS, June 2014, at 67, 67 (noting that "[a]ctively engaged investors include U.S. Bank, PNC, Bank of America, Wells Fargo and JPMorgan Chase," as well as Google and Honda).

[62] The issue of what constitutes a partnership for tax purposes in the investment credit industry has been a hot topic of debate between the IRS and credit claimants in recent years. *See* Historic Boardwalk Hall, LLC v. Comm'r, 694 F.3d 425, 429 (3d Cir. 2012) (finding that a rehabilitation credit investor was not a "bona fide partner" in a partnership formed to rehabilitate the historic East Hall in Atlantic City). The IRS has promulgated a safe harbor rule under which it has agreed not to challenge partnerships that meet the safe harbor's requirements. *See* Rev. Proc. 2014-12, 2014-3 I.R.B. 415, 415 (establishing "the requirements (the Safe Harbor) under which the [IRS] will not challenge partnership allocations of § 47 rehabilitation credits by a partnership to its partners"). An S corporation is also theoretically available as a form for allocating rehabilitation credits and profits among partners. *See* I.R.C. § 50(c)(5) (providing for basis decrease of shareholders in an S corporation corresponding to the rehabilitation credit). However, it is not available for these types of investors, as an S corporation cannot have shareholders that are not individuals, estates, certain trusts, or certain tax-exempt entities. *See id.* § 1361 (defining "S corporation" as an electing corporation with no more than a hundred shareholders, all of whom are individuals or estates, none of whom are nonresident aliens, and which corporation does not have more than one class of stock).

subsidiary) will have a 99% membership interest in the partnership and will claim 99% of the tax credits and net profits.[63] The partnership will continue to own the property and distribute net operating profits accordingly for five years after the property is placed in service. At the expiration of five years, the investment credits are no longer subject to being recaptured by the IRS.[64] At that time, the investor has the option to exercise a pre-negotiated put option and sell its interest in the partnership to the developer.[65] The tax credits provide the lion's share of the investor's return, and, as a result, the developer obtains equity for the project on more favorable terms and retains more of the overall cash flow from the project than a conventional investor may offer.

As an example, suppose developer Jack Torrance and investor Wendy Torrance (no relation) form a partnership, Torrance Overlook LLC, in 2017 for the purpose of rehabilitating the historic Overlook Hotel. Jack owns a 1% membership interest and Wendy owns a 99% membership interest in the partnership. Torrance Overlook expends $5 million on qualified rehabilitation expenditures. The rehabilitated building is placed in service on January 1, 2019. Torrance Overlook reports $1 million in rehabilitation credits on its 2019 partnership tax returns. In 2019, Jack may claim $10,000 in rehabilitation credits on his tax return and Wendy may claim the other $990,000. On or shortly after January 1, 2024, Wendy may sell her interest in Torrance Overlook to Jack.

---

63 This structure is used in rehabilitation credit transactions to comply with the IRS's Safe Harbor for rehabilitation credit partnerships. *See* Rev. Proc. 2014-12, 2014-3 I.R.B. 415, 416 (requiring that the developer "have a minimum one percent interest in each material item of Partnership income, gain, loss, deduction, and credit at all times during the existence of the Partnership"); *supra* note 62 and accompanying text (describing the inception of the IRS's Safe Harbor).

64 Unsurprisingly, the five-year recapture period can only be discerned through a convoluted tracing of statutory language. The current statute provides: "If, during any taxable year, investment credit property is disposed of, or otherwise ceases to be investment credit property with respect to the taxpayer, before the close of the recapture period, then the tax under this chapter for such taxable year shall be increased" by a computable amount. I.R.C. § 50(a)(1)(A). Logically, then, if investment credit property is disposed of, or otherwise ceases to be investment credit property, after the close of the recapture period, there is no tax increase to the taxpayer. However, the statute does not define "recapture period." The currently effective regulations, which were promulgated prior to the enactment of current § 50, are similarly vague, providing: "If property described in section 48(a)(1)(E)[, i.e., qualified rehabilitation expenditures attributable to a qualified rehabilitated building,] is disposed of by the taxpayer, or otherwise ceases to be 'section 38 property,' [i.e., investment credit property,] section 47 may apply." Treas. Reg. § 1.48-12(f)(3) (2016) (as amended in 2006). Former § 47 contained the analog to current § 50(a)(1)(A), but defined "recapture period" as "the period consisting of the first full year after the property is placed in service and the 4 succeeding full years." I.R.C. § 47(a)(5)(E)(ii) (1988) (amended 1990).

65 MACHEN, *supra* note 7, at 74 (describing how "the investor typically has a put option to compel the developer to purchase the investor's interest for a specified amount after the expiration of the five-year recapture period").

The structure just described, in which the partnership between the developer and investor owns the investment credit property, often called a "single-tier" structure, is the simplest available structure with which an investor may claim investment tax credits. However, for reasons partly due to the basis adjustment and income inclusion requirements discussed below,[66] it is not the most popular.[67] Far more popular is a "two-tier" structure, often called a "master lease" or "lease pass-through" structure.[68]

In a master lease structure, the investor and the developer again form a new limited liability company or limited partnership, which in either case is treated as a partnership for tax purposes. However, rather than owning the investment credit property, the partnership leases the property from its owner once the project is completed.[69] The partnership operates the property and pays rent to the owner.[70] The Internal Revenue Code permits a lessor and lessee to agree, solely for purposes of the investment credits, to treat the lessee as having incurred all or part of the rehabilitation expenditures incurred by the lessor, so the owner elects to "pass through" the investment credits generated by the property to the lessee partnership.[71] The lessee partnership then allocates the expenditures along with net profits to the investor and the developer. After five years, the investor may sell its interest in the partnership to the developer.

Returning to the example above, Jack would form two entities: Torrance Overlook Owner LLC and Torrance Overlook Tenant LLC. Torrance Overlook Owner, of which Jack is the 100% owner, owns the Overlook Hotel. Jack also owns 1% of Torrance Overlook Tenant and Wendy owns the other 99%. Owner and Tenant enter into a master lease agreement, under which Owner will lease the Hotel to Tenant for thirty-two years.[72] Overlook Owner expends $5 million

---

66 *See infra* Section I.C (discussing the details of basis and income inclusion in investment credit transactions).

67 Other reasons besides the basis adjustment and income inclusion rules drive the decision to utilize a master lease structure. Those reasons include separating the economic expectations of investors primarily interested in cash from the expectations of a tax credit investor, the accounting benefits available for institutional investors, and insulating the tax credit investor from certain risks associated with property ownership. MACHEN, *supra* note 7, at 55 (describing the non-tax benefits available from using a lease pass-through structure).

68 *Id*. at 54; Forrest Milder, *What Do the IRS's Temporary IRS 50(d) Regulations Mean for the Renewable Energy Community?*, NOVOGRADAC J. OF TAX CREDITS, Sept. 2016, at 71, 71.

69 *See* Thomas Boccia, *Q&A: Single Tier vs. Master Lease Structure*, NOVOGRADAC & COMPANY LLP (Mar. 1, 2010), https://www.novoco.com/periodicals/articles/qa-single-tier-vs-master-lease-structure [https://perma.cc/TW8R-6642] ("[The lessee entity] will master lease the property from the landlord, will lease the space, be it to residential or commercial tenants, and pay all property operating expenses.").

70 *Id*.

71 *See* I.R.C. § 50(d)(5) (2012) (providing, by reference to former § 48(d), for the pass-through of investment tax credits from owner to lessee).

72 The length of the lease term is intended to avoid application of the "short-term lease" rules. *See* Treas. Reg. § 1.48-4 (as amended in 1972) (providing a series of special rules if the

in qualified rehabilitation expenditures, generating $1 million in rehabilitation credits. Owner places the Hotel in service on January 1, 2019. Owner makes an election under I.R.C. § 50(d)(5) to pass through the $1 million in rehabilitation credits to Tenant. In 2019, Jack may claim $10,000 in rehabilitation credits on his tax return and Wendy may claim the other $990,000. On or shortly after January 1, 2024, Wendy may exercise her option to sell her interest in Tenant to Jack.

The master lease structure has been dominant in the vast majority of large rehabilitation credit transactions in recent years,[73] and has also been popular for energy credit transactions.[74] Despite its complexity, transaction parties have believed it to offer substantial benefits over a single-tier structure.[75] However, the uncertainty surrounding Section 50(d) income has long been a main concern regarding the use of a master lease structure.

C. *Basis Adjustment and Income Inclusion*

Determinations of basis are critical to evaluating the tax consequences of any property transaction, and investment tax credit transactions are no exception. A taxpayer's "adjusted basis" in property is predominantly the taxpayer's total investment in the property.[76] The taxpayer's basis is central to determining how much taxable gain or loss it will incur when selling property,[77] and the availability of deductions for loss[78] or depreciation.[79] As described in the

lease is a "short-term lease" that limit the credit to the taxpayer's "qualified investment"). A lease term of thirty-two years exceeds 80% of the recovery period of thirty-nine years for nonresidential real property and thus would not be considered a "short-term lease." *See* MACHEN, *supra* note 7, at 58-62 (explaining the short-term lease rules as applying when the lease does not exceed 80% of the property's class life, i.e., its recovery period, and is not a net lease). The thirty-two-year lease period is also likely not so long as to exceed 80% of the useful life of the property, which would result in the lessee being treated as the owner of the building for tax purposes. *See* Rev. Proc. 2001-28, 2001-1 C.B. 1156, 1157 (requiring that, to prove a lease is a true lease, "the lessor must represent and demonstrate that a remaining useful life of the longer of one year or 20 percent of the originally estimated useful life of the property is a reasonable estimate of what the remaining useful life of the property will be at the end of the lease term").

[73] *See* MACHEN, *supra* note 7, at 54.

[74] *See* Milder, *supra* note 68, at 71.

[75] *See supra* note 67 and accompanying text (describing non-tax benefits to the use of lease pass-through structure).

[76] *See* I.R.C. § 1012(a).

[77] *Id.* § 1001(a) ("The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis.").

[78] *Id.* § 165(b) ("[T]he basis for determining the amount of the deduction for any loss shall be the adjusted basis.").

[79] *Id.* § 167(c)(1) ("The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis.").

examples below, statutory and regulatory adjustments to basis can have significant effects on after-tax returns from a transaction.[80]

For example, if Torrance Corp. acquires the Overlook Hotel for $20 million, its basis will be $20 million. If it sells the Hotel for $25 million, it will have $5 million in taxable gain to report on its income tax returns.[81] Assuming a corporate tax rate of 35% and no other intervening circumstances, Torrance Corp. will owe $1.75 million in taxes resulting from the sale. However, if, by some statutory or regulatory means, Torrance Corp.'s basis is reduced to $10 million, it would have $15 million in taxable gain from the same sale, resulting in $5.25 million in tax liability.

Moreover, for a partnership, while the partnership has basis in its assets (referred to as "inside basis"), the partners also have basis in the partnership (referred to as "outside basis"). A partner's outside basis is typically its contributions to the partnership, adjusted for income, deductions, losses, and expenditures of the partnership allocated to the partner in accordance with its ownership share of the partnership.[82] Accordingly, if a partner sells its interest in the partnership, the partner must report on its tax returns gains or losses based on its outside basis.[83]

In the case of investment tax credit transactions, an owner of investment tax credit property is required to reduce its basis in the property by the full amount of the credit (or, in the case of energy credit property, 50% of the amount of the credit).[84] Therefore, if Torrance Corp. acquires the Overlook Hotel, a certified historic structure, for $10 million and spends $20 million on qualified expenditures rehabilitating the Hotel, its basis would ordinarily be $30 million. The rehabilitation has generated $4 million in rehabilitation credits that Torrance Corp. may claim. However, when it does so, it must reduce its basis in the Hotel to $26 million.[85] If the Hotel is sold for $30 million, Torrance Corp. will incur

[80] Basis is increased, for example, by making capital improvements, restoring property after a casualty loss, and otherwise investing in an asset. Basis is decreased, for example, by casualty or theft loss deductions, depreciation deductions, postponed gain, insurance reimbursements, and accelerated expensing of assets. *See id.* § 1016(a) (providing that basis shall be adjusted "for expenditures, receipts, losses, or other items, properly chargeable to capital account"); INTERNAL REVENUE SERV., *Basis of Property*, https://www.irs.gov/publications/p17/ch13.html [https://perma.cc/27NX-Q98M] (last visited Sept. 17, 2017) (providing a table of examples of basis adjustments).

[81] In the interest of simplicity, this example ignores the tax impact of depreciation, even though these projects are almost invariably subject to depreciation.

[82] I.R.C. § 705(a).

[83] *Id.* § 741.

[84] *Id.* § 50(c)(1), (c)(3).

[85] Treas. Reg. § 1.48-12(e)(1) (as amended in 2006) ("[I]f a credit is allowed with respect to property attributable to qualified rehabilitation expenditures incurred in connection with the rehabilitation of a qualified rehabilitated building, the increase in the basis of the rehabilitated property that would otherwise result from the qualified rehabilitation expenditures must be reduced by the amount of the credit allowed.").

$1.4 million in tax liability that it would not have incurred without the basis reduction.[86] The historical background of the required basis adjustment is discussed in Subsection III.B.2.

Additionally, if a partnership is the owner of the investment tax credit property, each partner in the partnership must also reduce its outside basis.[87] Suppose Jack Torrance and Wendy Torrance form Torrance Overlook LLC, a partnership for tax purposes, to acquire and rehabilitate the Overlook Hotel. Jack contributes $300,000 to the partnership and obtains a 1% membership interest. Wendy contributes $29.7 million to the partnership and obtains a 99% membership interest. Torrance Overlook spends $10 million acquiring the Overlook Hotel and $20 million on qualified rehabilitation expenditures. The rehabilitation generates $4 million of rehabilitation credits, of which Wendy claims $3.96 million and Jack claims $40,000. Wendy's outside basis is accordingly reduced to $25.74 million and Jack's outside basis is reduced to $260,000.

Congress has provided an alternative to the basis reduction required for owners of investment tax credit property in the case of leased property. For transactions utilizing a master lease structure in which the property owner passes the investment tax credits through to the lessee, it would not make much sense for the lessee to reduce its basis in the property. Indeed, since the lessee has not paid for the property or the rehabilitation expenses (and the "pass-through" election only affects the tax credits; it does not pass through basis or have effect for any other purposes), it has no basis to reduce. Instead, the lessee is required to report income in the amount of the credit (or, in the case of the energy credit, 50% of the amount of the credit), so-called "Section 50(d) income" or "phantom income," ratably over the property's recovery period.[88]

This income inclusion rule for master lease structures, enacted simultaneously with the downward basis adjustment for owners,[89] comes to apply in a rather convoluted way, which is not unrelated to the confusion surrounding its application discussed below.[90] I.R.C. § 50(d) provides that rules similar to the rules for § 48(d), as of the day before enactment of the Revenue Reconciliation Act of 1990 shall apply.[91] Former § 48(d) provided that if an election was made to treat a lessee as having acquired the investment tax credit property, then §

[86] This result assumes Torrance Corp.'s applicable tax rate is 35%. *See* I.R.C. § 11 (providing a tax rate of 35% for so much of a corporation's income that exceeds $10 million).

[87] *Id.* § 50(c)(5).

[88] *See id.* § 50(d) (providing that rules similar to former I.R.C. § 48(d) shall apply relating to certain leased property).

[89] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 205(a)(4), 96 Stat. 324, 428 (enacting what is now known as the Section 50(d) income inclusion requirement).

[90] *See infra* Section II.A.

[91] I.R.C. § 50(d).

48(q),[92] which provided for the owner basis reduction, would not apply, and instead,

> the lessee of such property shall include ratably in gross income over the shortest recovery period which could be applicable under section 168 with respect to such property an amount equal to 50 percent of the amount of the [investment] credit allowable . . . to the lessee with respect to such property . . . .[93]

Because, under § 48(d), § 48(q) did not apply for master lease transactions, then § 48(q)(6), which provided for the basis reduction for partnership interests, also did not apply.[94]

Suppose again that developer Jack Torrance forms two entities: Torrance Overlook Owner LLC and Torrance Overlook Tenant LLC. Owner owns the Overlook Hotel. Jack owns 1% of Tenant and Wendy owns the other 99%. Owner and Tenant enter into a master lease agreement, under which Owner will lease the Hotel to Tenant for thirty-two years. Owner spends $10 million acquiring the Hotel and $20 million on qualified rehabilitation expenditures, generating $4 million in rehabilitation credits. Owner places the Hotel in service on January 1, 2019. Owner makes an election under I.R.C. § 50(d)(5) to pass through the $4 million in rehabilitation credits to Tenant. In 2019, Jack may claim $40,000 in rehabilitation credits on his tax return and Wendy may claim the other $3.96 million. Owner's basis in the Hotel remains $30 million. The transaction results in $102,564 of Section 50(d) income per year for thirty-nine years, of which Jack will be required to report $1026 per year and Wendy will be required to report the remaining $101,538.[95]

---

92 I.R.C. § 48(q)(1) (1988) (amended 1990) ("[I]f a credit is determined under section 46(a) with respect to section 38 property, the basis of such property shall be reduced by 50 percent of the amount of the credit so determined."). Note that § 48(q)(3) provided that, in the case of the rehabilitation credit, "paragraphs (1) and (2) of this subsection and paragraph (5) of subsection (d) shall be applied without regard to the phrase '50 percent of.'" *Id.* § 48(q)(3). Thus, for the rehabilitation credit, both the basis reduction under § 48(q)(1) and the income inclusion under § 48(d)(5) were in the full amount of the credit. There was some confusion surrounding this point for many years that has only recently been cleared up. *See infra* note 109 (discussing a reading of former § 48 that provided for income inclusion of only 50% of the credit amount for the rehabilitation credit).

93 *Id.* § 48(d)(5)(B).

94 *Id.* § 48(d)(5); *see also id.* § 48(q)(6).

95 Tenant's Section 50(d) income was computed by dividing the amount of total credits claimed ($4 million) by the applicable recovery period for the property (thirty-nine years). Thirty-nine years is the applicable recovery period for nonresidential real property, such as the Overlook Hotel. I.R.C. § 168(c) (2012) (providing that in the case of nonresidential real property, the applicable recovery period is thirty-nine years for purposes of the accelerated cost recovery system). The allocation of the income between Jack and Wendy is based on each of their distributive shares of such income (1% and 99%, respectively). *See id.* § 702(a) ("In determining his income tax, each partner shall take into account separately his

These critical components of investment tax credits might have been presented more clearly than by providing that "rules similar to" a repealed statute would apply.[96] However, the fact that Section 50(d) income as described above results from this application has never been in dispute.

Nevertheless, many questions remained unanswered. Chief among them was the impact of Section 50(d) income on the lessee partners' outside basis in the lessee partnership. Generally, in the case of a partnership, income is computed at the partnership level in the same manner as it would be for an individual.[97] Once computed by the partnership, each partner is allocated its share of the income and reports that share of the income on its own tax return.[98] Correspondingly, such partner's outside basis is increased by such partner's distributive share of the taxable income of the partnership.[99]

Each partner *may* be separately required to account, outside of the partnership, for its distributive share of the partnership's items of income, gain, loss, deduction, or credit, but only to the extent required by regulations.[100] The partnership allocation regulations are very complex in order to ensure that partnerships are not used as vehicles for tax avoidance,[101] but generally allocations of income and loss should track the partner's economic interest in the partnership,[102] and allocations of income and loss usually result in an increase or decrease of the partner's outside basis in the partnership.

This structure creates the two important questions that Part III of this Note seeks to address. The first question is a technical tax question: Under the Internal Revenue Code, is Section 50(d) income a partnership-level tax item, in which case it is generally subject to allocation by the partnership and gives rise to an increase in outside basis, or is it a partner-level tax item that does not give rise to an outside basis increase? The second question is normative: From a policy perspective *should* Section 50(d) income give rise to an outside basis increase?

In light of the clear textual provisions in the Internal Revenue Code, most partnerships in investment tax credit transactions treated Section 50(d) income

distributive share of the partnership's . . . other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary.").

96 *See id.* § 50(d) (providing that "rules similar to the rules of [former § 48(d)] (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) shall apply").

97 *Id.* § 703(a).

98 *Id.* § 702(a).

99 *Id.* § 705(a).

100 *Id.* § 702(a). Even so, the partner's distributive share is determined in accordance with the parties' partnership agreement, unless the agreement is silent or the agreement's allocations do not have substantial economic effect. *Id.* § 704(b).

101 *See* WILLIAM S. MCKEE ET AL., *Testing Allocations under Section 704(b)*, *in* 1 FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 11.02 (4th ed. 2007) (discussing partnership allocation rules).

102 *See id.* at 11-12.

in the same manner as other taxable income, allocating the income to their partners in accordance with each partner's partnership interests. As a result, partners took the corresponding position that Section 50(d) income inclusion increased each partner's outside basis,[103] which, in turn, led to the result that investors claimed decreased gains or increased losses upon disposition of their interest in the partnership. Developers reap benefits from this approach, as investors are willing to make larger investments in the developers' projects as a result of the benefits from the Section 50(d) income outside basis increase.

For example, turning again to Wendy Torrance, suppose, as in the previous example, that Wendy claimed $3.96 million in rehabilitation credits. Torrance Overlook Tenant LLC allocated $101,538 of Section 50(d) income per year to Wendy, and Wendy included this amount in her income reported on her tax return, beginning in 2019. Suppose further that Wendy's initial outside basis in Tenant is $4 million based on a cash contribution of $4 million to Tenant made in 2017. In 2024, Wendy may sell her interest in Tenant for $50,000.

How should Wendy treat the inclusion of Section 50(d) income and what are the consequences to her? The differences can be substantial. If Wendy's outside basis in Tenant is not increased as a result of her share of the Section 50(d) income, she would report a loss of $3.95 million. This loss could result in tax savings to Wendy of $592,500.[104] If Wendy is a corporation, the tax savings could be up to $1,382,500.[105] However, if her outside basis is increased by the amount of Section 50(d) income she reports in the years 2019 to 2023, her loss on the disposition of her interest in Tenant would be $4,457,690.[106] Her resulting tax savings could be as high as $668,654 if Wendy is an individual or $1,560,192 if Wendy is a corporation.[107] Prior to the promulgation of § 1.50-1T, which is

[103] Breed, *supra* note 8, at 54 ("Most HTC investors included Section 50(d) income in the basis of their interest in the master tenant.").

[104] This assumes Wendy is an individual taxpayer who is taxed at long-term capital gain rates of 15% and has sufficient long-term capital gains to utilize the long-term capital losses resulting from the transaction. *See* I.R.C. § 1(h)(C) (providing for an individual long-term capital gain tax rate of 15% for high-income individual taxpayers); *id.* § 1211 (limiting the use of deductions for capital losses).

[105] The highest corporate marginal tax rate is currently 35%, regardless of whether the income is treated as long-term capital gain or not. *See id.* § 11 (providing for the corporate income tax rate of 35% of so much of the taxable income as exceeds $10 million). The calculated tax savings also assumes Wendy, as a corporation, has sufficient long-term capital gains to utilize the long-term capital losses resulting from the transaction. *See id.* § 1211 (limiting the use of deductions for capital losses).

[106] This computation is based on five years of Section 50(d) income of $101,538 per year, totaling $507,690. This is added to Wendy's $4 million basis for a sum of $4,507,690 in adjusted basis. Subtracting the sale proceeds of $50,000 results in a total loss of $4,457,690.

[107] *See supra* notes 104-05 and accompanying text (discussing individual and corporate tax rates).

discussed below, the latter method had been the dominant interpretation of § 50(d),[108] but it was never certain that this was the correct interpretation.

Other questions lingered as well. Among these was the actual calculation of Section 50(d) income for rehabilitation credit transactions. A number of legislative reports, statutory amendments, and reports from the Joint Committee on Taxation suggested that the amount of Section 50(d) income for the rehabilitation credit was, like the energy credit, actually only 50% of the amount of the credit, not the full amount.[109] Another question concerned how investors should (or should not) report Section 50(d) income if they exit the lessee partnership prior to the end of the property's applicable recovery period.[110] Some, though not many, investors believed their obligation to report Section 50(d) income concluded when they exited the partnership.[111] Others took the position that they would simply continue to report the Section 50(d) income for the remaining years of the property's recovery period.[112] Some investors were concerned, however, that they might be required to accelerate the Section 50(d) income and report all of it in the year they exit the partnership.[113] For Wendy Torrance, the latter would mean she would be required to report $3,452,310 of Section 50(d) income in 2024.[114] The next Part of this Note discusses the tortured history and eventual resolution of the questions described above.

---

[108] *See* Breed, *supra* note 8, at 54.

[109] This issue is not a primary topic of this Note, but is representative of the confusing state of the law generally surrounding Section 50(d) income. For a detailed discussion of the legislative confusion regarding the amount of Section 50(d) income for the rehabilitation credit, see MACHEN, *supra* note 7, at 67-71 (describing interpretations of the statute and regulations suggesting only 50% of the rehabilitation credit should be included in income). The Chief Counsel of the IRS finally confirmed the correct interpretation in 2015. I.R.S. Chief Couns. Mem. 201505038 (Jan. 30, 2015) (concluding "the taxpayer must include ratably in gross income an amount equal to 100 percent of the amount of the taxpayer's credit" in this situation).

[110] Notably, this issue has little impact on energy credit transactions. Most energy credit property has a recovery period of five years, so Section 50(d) income has been fully recognized by the expiration of the five-year recapture period.

[111] *Section 50(d) Regulations Address Income Inclusion for Certain Investment Tax Credit Claimants*, *supra* note 6, at 3 ("Before these new rules, some lessee partnerships treated the Section 50(d) income as remaining at the partnership level even after a partner exited.").

[112] *Id.* (noting that only "some" lessee partnerships believed their Section 50(d) income obligation ended upon disposition).

[113] *See* I.R.S. Priv. Ltr. Rul. 89-43-074 (Aug. 2, 1989) (addressing a concern that Section 50(d) income would accelerate upon expiration or termination of the lease); Breed, *supra* note 8, at 54-55 (noting that, "[t]hankfully," Treasury Regulation § 1.50-1T does not require acceleration of unrealized Section 50(d) income).

[114] $3,452,310 represents Wendy's Section 50(d) income for the years 2024 through 2058 that would have been unrecognized upon her exiting Torrance Overlook Tenant LLC in 2024.

II. TREASURY REGULATION § 1.50-1T

A. *History*

Questions surrounding the treatment of Section 50(d) income have lingered since the early days of the investment credit. As early as 1987, the IRS proposed regulations under former § 48 attempting to clarify some of the statutory ambiguities.[115] Ultimately, those regulations were never promulgated in final form, but they offer insight into the thinking of the IRS at that time. Consistent with the statute, the proposed regulations provided that the basis adjustment required for property owners claiming the investment credit did not apply when the taxpayer elected to pass the credit through to a lessee.[116] They further confirmed that the lessee was required to include (what we now refer to as) Section 50(d) income ratably over the property's recovery period.[117] The proposed regulations also confirmed that, in a single-tier transaction, an owner that is a partnership must have its partners reduce their basis in the owner partnership.[118]

The main novelty of the proposed regulations concerned the treatment of Section 50(d) income upon disposition of the property. If a disposition occurred prior to the end of the five-year recapture period, thus triggering a recapture of a portion of the investment credit, and the amount of reported Section 50(d) income exceeded the unrecaptured credit, the lessee's income would be reduced by the difference.[119] Conversely, if the unrecaptured credit exceeded the reported

---

[115] *See* Prop. Treas. Reg. § 1.48-4(n)-(p), 1.48-7, 1.196-1, 1.312-15(a)(4), 1.705-1(a)(3)(ii), 52 Fed. Reg. 35,438, 35,438-47 (Sept. 21, 1987) (providing proposed regulations under § 48).

[116] Prop. Treas. Reg. § 1.48-4(n), 52 Fed. Reg. at 35,439 ("[T]he lessor is not required under section 48(q) to reduce the basis of such property.").

[117] *Id.* ("[I]f 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 . . . the amount of the credit allowable under section 38 with respect to such property.").

[118] Prop. Treas. Reg. § 1.48-7(c), 52 Fed. Reg. at 35,443 ("In the case of a reduction in the basis of section 38 property by a partnership . . ., there shall be a corresponding reduction in the basis of each partner's interest in the partnership . . . .").

[119] Prop. Treas. Reg. § 1.48-4(n), 52 Fed. Reg. at 35,439 ("[I]f section 47 requires an increase in the lessee's tax . . . 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)(1) of this section over . . . the portion of the credit that is not recaptured for the taxable year in which the early disposition, etc., occurred."). This particular provision would rarely be applicable for rehabilitation credit property. Since buildings have a recovery period of either twenty-seven-and-a-half years (for residential rental property) or thirty-nine years (for nonresidential real property), the amount of Section 50(d) income reported by the astute taxpayer would never exceed the unrecaptured credit. If a recapture event occurred in year two, requiring a recapture of 80% of the credit, 20% would

Section 50(d) income, the lessee would have to include the difference in income in the year of the disposition.[120] While the proposed regulations were silent as to the treatment of a disposition *after* the expiration of the recapture period, and while the regulations never went into effect, there was concern that the IRS would take an equivalent position for post-recapture period dispositions, i.e., that the lessee would be required to accelerate inclusion of Section 50(d) income in the year of disposition. The regulations were also silent as to the treatment of Section 50(d) income among partners in a lessee partnership. Ultimately, these proposed regulations were fully withdrawn in 2016.[121]

Taxpayers did not give up on their mission to figure out how to treat Section 50(d) income in the case of lease pass-through transactions. In 1989, the IRS issued a private letter ruling to a taxpayer concerning a number of rehabilitation credit issues.[122] Among the taxpayer's questions was whether the lessee, in its rehabilitation credit lease pass-through transaction, was required to accelerate its Section 50(d) income if there is a termination of or failure to renew its leases.[123] The IRS, in a conclusory statement, determined that a termination or failure to renew the lease after the recapture period had ended "will not affect the pass through of any rehabilitation credit to Lessee because the credit recapture period has ended."[124] Though seeming to dodge the question, the ruling later summarizes its conclusion, holding that "[t]here will not be any acceleration of the amount Lessee will be required to amortize into income if either of the [leases are] terminated after" the expiration of the recapture period.[125] While one could read the letter ruling as suggesting, by extension, that Section 50(d) income should follow a partner leaving a partnership, the lessee in the ruling was a corporation,[126] so the ruling did not request or address basis adjustments by lessee partnerships. While the ruling gave some comfort to industry participants that they would not be required to accelerate Section 50(d)

remain unrecaptured, but only 3.64% of the credit for residential rental property or 2.56% of the credit for nonresidential property would have been reported in Section 50(d) income at that time. Similarly, if a recapture event occurred in year five, requiring a recapture of only 20% of the credit, and leaving 80% unrecaptured, the taxpayer would have reported Section 50(d) income at that point only of 14.55% of the credit for residential rental property or 10.26% of the credit for nonresidential property, far less than 80%.

[120] *Id.* at 35,440.

[121] Income Inclusion when Lessee Treated as Having Acquired Investment Credit Property, 81 Fed. Reg. 47,739, 47,740 (July 22, 2016).

[122] I.R.S. Priv. Ltr. Rul. 89-43-074 (Aug. 2, 1989).

[123] *Id.*

[124] *Id.*

[125] *Id.*

[126] *Id.* (noting that "[l]essee is a State Y corporation").

income upon disposition, they were not able to rely on the ruling or refer to it as precedent.[127]

After 1989, there were scant new developments concerning Section 50(d) income. In 1990, the operative provisions of the Internal Revenue Code were restructured and, in many ways, substantively altered, by organizing them under the provisions we have today.[128] However, the treatment of Section 50(d) income remained substantively the same through the new § 50(d)(5)'s reference to the application of "rules similar to . . . [former §] 48(d) (relating to certain leased property)."[129] Taxpayers and their counsel were left to speculate about how these issues would eventually be resolved, sometimes allocating the risks amongst transaction parties through complex contractual arrangements. But there was little guidance from Congress or the IRS.

In early 2014, taxpayers finally received what was perceived as a hint regarding the resolution of the Section 50(d) income issue. The IRS published Revenue Procedure 2014-12[130] in response to significant taxpayer concern over the Third Circuit's decision in *Historic Boardwalk Hall, LLC v. Commissioner*.[131] In that case, the Third Circuit held that an investor in a rehabilitation credit partnership was not a true partner due to a host of guarantees and income-allocation arrangements, and thus the investor was not entitled to claim any rehabilitation credits generated by the partnership.[132] The decision shook the rehabilitation credit industry, halting transactions and tightening investors' pocketbooks. The pain was only remedied by the promulgation of Revenue Procedure 2014-12, which, while providing significant guidance for parties structuring rehabilitation credit transactions, had very little to say about Section 50(d) income. It stated only that "this revenue procedure does not address how a Partnership is required to allocate the income inclusion required by § 50(d)(5)."[133] The revenue procedure further stated, "[s]olely for purposes of determining whether a Partnership meets the requirements of this section 4.07 [requiring that partnership allocations satisfy I.R.C. § 704(b)], the Partnership's

---

[127] *Id.* ("This ruling is directed only to the Parties who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent."); *see also* I.R.C. § 6110(k)(3) (2012) ("Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent.").

[128] Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11813, 104 Stat. 1388, 1388-536 to 1388-556.

[129] *Id.* § 11813, 104 Stat. at 1388-550.

[130] Rev. Proc. 2014-12, 2014-3 I.R.B. 415, 415-19 (providing guidance as to the allocation of rehabilitation tax credits by partnerships).

[131] 694 F.3d 425, 429 (3d Cir. 2012) (finding that a rehabilitation credit investor was not a "bona fide partner" in a partnership formed to rehabilitate the historic East Hall in Atlantic City).

[132] *See id.* at 463.

[133] Rev. Proc. 2014-12, 2014-3 I.R.B. 415, 416.

allocation to its partners of the income inclusion required by § 50(d)(5) shall not be taken into account."[134]

Many in the investment tax credit industry viewed the language "how a Partnership is required to allocate" and "the Partnership's allocation to its partners" of Section 50(d) income as a clear indication that Section 50(d) income *was*, in fact, a partnership tax item that a partnership was required to allocate. After all, a partnership can only allocate partnership-level tax items, so practitioners believed the IRS would only have used that language if it intended to eventually hold that Section 50(d) income was a partnership tax item. Alternatively, practitioners could have viewed this language as the IRS suggesting Section 50(d) income was not a partnership-level item, and therefore should be ignored for purposes of § 704(b). However, this was not the dominant view among practitioners, who were hopeful that future guidance would only need to confirm the specific details of Section 50(d) income as a partnership tax item.

Based on this and other statements from the IRS, those in the industry did not expect the ultimate resolution to be that Section 50(d) income was not at all a partnership tax item, though most industry practitioners expected that the IRS would somehow determine that Section 50(d) income would not give rise to a partnership basis increase.[135] A few months after Revenue Procedure 2014-12 was finalized, the IRS published its Priority Guidance Plan for 2014-2015, which announced "317 projects that are priorities for allocation of the resources of our offices during the twelve-month period from July 2014 through June 2015 . . . ."[136] Among these high-priority projects was "[g]uidance concerning the interaction of the rules in §50(d)(5) and subchapter K."[137] At long last, taxpayers anticipated receiving definitive guidance as to the treatment of Section 50(d) income. Industry participants were proactive during this period in holding meetings with and writing letters to the IRS illustrating their positions.[138]

---

[134] *Id.* at 417.

[135] As noted, industry participants were involved in discussions with IRS personnel during the regulation drafting process, and the IRS even disclosed publicly in advance of the regulations' promulgation that it intended to prevent a basis increase in the impending regulations. Matthew R. Madara, *Proposed Investment Tax Credit Guidance Nearing Completion*, 151 TAX NOTES 1484, 1484 (2016) (reporting that a drafter of the regulations spoke at an investment tax credit conference in June 2016 and stated that "there are concerns that allowing section 50(d)(5) income to provide a corresponding basis increase is inconsistent with congressional intent because the basis increase would effectively negate the section 50(d) income").

[136] DEP'T OF THE TREASURY, 2014-2015 PRIORITY GUIDANCE PLAN 1 (2014) (announcing that promulgating regulations under § 50 was a priority item for the IRS).

[137] *Id.* at 14. Subchapter K of the Internal Revenue Code provides the laws concerning partnership taxation.

[138] *See, e.g.*, Letter from John Leith-Tetrault, President, Nat'l Tr. Cmty Inv. Corp., to Paul F. Handleman, Esq., Chief, Ineternal Revenue Serv. Office of Chief Counsel (Sept. 18, 2015) [hereinafter Leith-Tetrault, Sept. 2015], http://historiccredit.com/wp-content/uploads/2015/

The first guidance came in January 2015. The IRS released a memorandum interpreting § 50 and the applicable regulations, concluding that the amount of Section 50(d) income to be included in rehabilitation credit transactions is 100% of the credit, whereas the amount for energy credit transactions is 50% of the credit.[139] Although it was helpful to have the issue clarified (albeit through nonprecedential guidance), taxpayers were not surprised by this outcome.

The second guidance came in July 2016, after industry participants spent years on the edges of their seats. The IRS proposed permanent regulations[140] and promulgated temporary regulations[141] concerning the allocation of Section 50(d) income by lessee partnerships and S corporations, and the proper treatment of Section 50(d) income upon disposition after the expiration of the five-year recapture period. A technical correction to the temporary and proposed regulations was released a few weeks later.[142] The new regulations became effective on July 22, 2016, and applicable to property placed in service on or after September 19, 2016.[143] The comment period for the proposed regulations closed on October 20, 2016, with two public comments having been

10/SignedIRS50dLetterFinal3.pdf [https://perma.cc/PA8L-ALSE] (providing additional commentary on issues discussed in a recent meeting with IRS counsel); Letter from John Leith-Tetrault, Chairman, Historic Tax Credit Coal., to Curtis Wilson, Assoc. Chief Counsel, Internal Revenue Serv., and Craig Gerson, Attorney Advisor, Dep't of the Treasury (Dec. 3, 2014) [hereinafter Leith-Tetrault, Dec. 2014], http://historiccredit.com/ wp-content/uploads/2015/01/IRS-50d-Followup-Letter-12-3-14.pdf [https://perma.cc/F9ZS-XRBP] (providing proposed language and highlighting discussion points from a recent meeting with Treasury attorneys); Letter from John Leith-Tetrault, Chairman, Historic Tax Credit Coal., to Internal Revenue Serv. (Aug. 20, 2014) [hereinafter Leith-Tetrault, Aug. 2014], http://historiccredit.com/wp-content/ uploads/2015/01/Aug-20-Section-50d-Letter-to-IRS-HTCC.pdf [https://perma.cc/N6NX-98NH] (requesting formal guidance on the allocation of Section 50(d) income and noting specifically that "Revenue Procedure [2014-12] . . . explicitly stated that Section 50(d) income is a partnership tax item").

[139] *See supra* note 109 and accompanying text (citing to the tortured legislative history of this interpretive question).

[140] Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,701-06 (July 22, 2016) (providing proposed regulations under § 50).

[141] Temp. Treas. Reg. § 1.50-1T (2016) (providing temporary regulations under § 50). The proposed and temporary regulations are identical.

[142] Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 65,541, 65,541 (Sept. 23, 2016) (correcting certain provisions of the § 1.50-1T regulations that were found to be misleading or confusing).

[143] Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,706 (July 22, 2016). Because the regulations were issued as temporary and proposed regulations, the temporary regulations became, and will remain, effective for three years, while the proposed regulations are not yet finalized. *See* I.R.C. § 7805(e) (2012) ("Any temporary regulation shall expire within 3 years after the date of issuance of such regulation."). Some have criticized this practice as a vehicle for the IRS to unfairly surprise taxpayers with new, immediately effective regulations without statutorily required notice and comment. *See* Naftali Z. Dembitzer, *Beyond the IRS Restructuring and Reform Act of 1998: Perceived Abuses of the Treasury Department's Rulemaking Authority*, 52 TAX L. 501, 509-10 (1999).

submitted.[144] The next sections will discuss the substance and impact of these new regulations and analyze their conclusions in light of legislative and judicial history.

B. *The Regulations*

The new regulations provide clarity for the first time regarding basis adjustment rules and the recognition of Section 50(d) income for lease pass-through transactions. The regulations confirm that, if the lessor and lessee have agreed to treat the lessee as having acquired the property (and thus being entitled to the investment credits), the lessor does not need to adjust its basis for the amount of the credits.[145] They further confirm that Section 50(d) income is equal to the amount of the credit (or, for energy credit property, 50% of the credit) and is included ratably over the property's shortest applicable recovery period.[146]

With respect to lessees that are partnerships or S corporations, the regulations provide that Section 50(d) income is *not* an item of partnership income or S corporation income to be allocated by the partnership or S corporation.[147] Instead, any partner or shareholder that is an "ultimate credit claimant" must report Section 50(d) income in proportion to their share of the credit.[148] The "ultimate credit claimant" is any partner or shareholder that files Form 3468 in order to claim the investment credit on its tax returns.[149] As detailed above, this provision is not merely administrative; since Section 50(d) income is assessed at the partner level and not the partnership level, the partners may not increase their outside basis in the partnership by the amount of Section 50(d) income claimed. This results in significant financial ramifications for the partners when they dispose of their partnership interests.[150]

With respect to recapture events, the regulations take a position similar to that taken by the 1987 proposed regulations. If there is a recapture event in a lease pass-through transaction, the lessee must include in gross income the difference between any unrecaptured credits and the Section 50(d) income reported to date.[151] This serves to fully accelerate Section 50(d) income in the event of recapture, since any recaptured credits will result in an increase in the lessee's tax in that amount, and any unrecaptured credits not previously reported as

[144] *See Income Inclusion When Lessee Treated as Having Acquired Investment Credit Property (REG-102516-15)*, REGULATIONS.GOV, https://www.regulations.gov/docket?D=IRS-2016-0031 [https://perma.cc/JQ5V-MPEK] (last visited Sept. 17, 2017).

[145] Temp. Treas. Reg. § 1.50-1T(b)(1) (2016) ("Section 50(c) does not apply with respect to such property.").

[146] Temp. Treas. Reg. § 1.50-1T(b)(2).

[147] Temp. Treas. Reg. § 1.50-1T(b)(3)(i).

[148] *Id.*

[149] Temp. Treas. Reg. § 1.50-1T(b)(3)(ii).

[150] *See supra* Section I.C (describing the financial impact of Section 50(d) income inclusion and basis adjustments).

[151] Temp. Treas. Reg. § 1.50-1T(c)(1).

Section 50(d) income must be included in income in the year of recapture. Conversely, if there is a recapture event and previously reported Section 50(d) income exceeds the amount of any unrecaptured credits (an unlikely event in either rehabilitation credit or energy credit transactions),[152] the lessee is entitled to reduce its income by the amount of the difference.[153] As these recapture provisions largely mirror the proposed regulations from 1987,[154] they have not engendered much controversy.

Because Section 50(d) income is assessed at the partner level, and not the partnership level, the disposition of a partner's interest after the recapture period does not affect income recognition under the new regulations (except for the acceleration option discussed below); the unreported income will continue to follow that partner and is required to be recognized over the remaining recovery period of the underlying property, potentially decades after the partner has disposed of its partnership interest and the lessee has disposed of its interest in the property. In such a situation, however, the new regulations do offer an option for the lessee or the ultimate credit claimant to accelerate any unrecognized Section 50(d) income and include it as income in the year of disposition.[155] While some investors were optimistic that Section 50(d) income was a partnership tax item that could be escaped by leaving the partnership,[156] the determination that the Section 50(d) income continued to follow the exiting investor did not come as much of a surprise to most industry participants.[157] Moreover, the option to accelerate the Section 50(d) income, which did come as a surprise to industry participants,[158] allowed some flexibility for taxpayers that did not want to continue to have to track and account for phantom sources of income decades after disposing of their interests in a project.

---

[152] *See supra* text accompanying note 119 (describing how the lengthy recovery period for rehabilitation credit property essentially forecloses the possibility of unrecaptured credit exceeding previously reported Section 50(d) income). For energy credit property, as well, which generally has a five-year recovery period, the amount of unrecaptured credit should dovetail exactly with the amount of Section 50(d) income included up to that point. The result would be, like rehabilitation credit transactions, that the reported Section 50(d) income would never exceed the unrecaptured credit.

[153] Temp. Treas. Reg. § 1.50-1T(c)(2).

[154] *See* Prop. Treas. Reg. § 1.48-4(n), 52 Fed. Reg. 35,438, 35,439-40 (Sept. 21, 1987).

[155] Temp. Treas. Reg. § 1.50-1T(d)(1).

[156] *See Section 50(d) Regulations Address Income Inclusion for Certain Investment Tax Credit Claimants*, *supra* note 6, at 3 ("Before these new rules, some lessee partnerships treated the Section 50(d) income as remaining at the partnership level even after a partner exited.").

[157] *Cf.* Leith-Tetrault, Sept. 2015, *supra* note 138, at 3 (acknowledging, prior to the promulgation of § 1.50-1T, that prior guidance implied Section 50(d) income must continue to be reported for the remainder of the recovery period).

[158] The IRS had disclosed that acceleration was an issue under consideration late in the process, but not that optional acceleration was under consideration. *See* Madara, *supra* note 135, at 1484 (reporting that regulation drafter publicly stated "acceleration is another major issue the IRS has considered during the guidance process").

The IRS's comments, included as part of the explanation accompanying the proposed regulations, are as notable as the regulations themselves. The regulations purport to interpret and determine which rules "are similar to the rules of former section 48(d)(5)."[159] Of course, the new regulations bear little resemblance to anything ever promulgated under former § 48(d).[160] The explanation goes into some detail regarding the premise for its conclusion that Section 50(d) income should be treated as a partner-level and not a partnership-level tax item.[161] The explanation then, in very strong terms, chides taxpayers that have taken a contrary position.[162] It argues that basis increases by partners in the partnership resulting from Section 50(d) income inclusion are "inconsistent with Congressional intent as they thwart the purpose of the income inclusion requirement in former section 48(d)(5)(B) and confer an unintended benefit upon partners and S corporation shareholders of lessee partnerships and S corporations that is not available to any other credit claimant."[163] It then states that *even if* the IRS had determined Section 50(d) income were a partnership tax item, allowing a basis increase would *still* be inconsistent with statutory purpose.[164] It calls the basis increase "inappropriate" for allowing partners and

[159] Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,701 (July 22, 2016) (citing I.R.C. § 50(d)(5) (2012)).

[160] The only resemblance to existing rules or regulations are the provisions, none of which were ever in dispute from the statutory text, providing that the owner need not adjust its basis in a lease pass-through transaction and that the lessee must ratably include Section 50(d) income over the applicable recovery period. Temp. Treas. Reg. § 1.50-1T(b)(1)-(2) (providing § 50(c) does not apply to such property and that the lessee must include the amount of the credit in income ratably over the shortest recovery period under § 168); *cf.* I.R.C. § 48(d)(5) (1988) (amended 1990) (providing that, for property utilizing a lease pass-through election: (1) there would be no basis adjustment for the owner; (2) Section 50(d) income must be included ratably over the applicable recovery period; and (3) the Treasury Secretary could prescribe regulations for cases in which there is a disposition causing a recapture of the tax credits); Treas. Reg. § 1.48-4 (as amended in 1972) (providing regulations under former § 48(d) relating to the investment tax credit lease pass-through, but providing no regulations relating to Section 50(d) income).

[161] *See* Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. at 47,702-03 (describing the foundation for conclusions regarding Section 50(d) income in the case of lessee partnerships and S corporations); *infra* Section III.B (discussing the arguments for and against the IRS's determinations in § 1.50-1T).

[162] *See* Milder, *supra* note 68, at 72 ("While the IRS may have included this discussion purely to establish the legitimacy of its position, the wording is a bit stronger than that.").

[163] Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. at 47,702.

[164] *Id.* ("Nonetheless, had the Treasury Department and the IRS determined otherwise, the Treasury Department and the IRS believe that in addition to being inconsistent with the purpose of section 48(d)(5)(B), allowing a basis increase for the income inclusion would also be inconsistent with the purpose of sections 705 and 1367.").

S corporation shareholders to claim the full benefit of the investment tax credit "without any of the corresponding burden."[165]

However, despite the strong condemnations expressed with respect to the basis increases, the regulations provide that they will be applicable only to property placed in service on or after September 19, 2016, and "should not be construed to create any inference concerning the proper interpretation of section 50(d)(5) prior to the effective date of the regulations."[166] Thus, while it is clear how the IRS will view properties placed in service on or after September 19, 2016, taxpayers involved in past transactions who are still subject to audit remain, except for the IRS's strong admonishments mentioned above, in the dark with respect to how the IRS will evaluate such transactions.

C. *Impact*

The regulations under § 1.50-1T had an immediate effect on participants in the investment tax credit industry. Most taxpayers had been reporting basis increases in the lessee partnerships for the allocation of Section 50(d) income prior to the publication of the regulations.[167] Of course, that practice had to immediately cease for investment credits generated by properties placed in service on or after September 19, 2016. Moreover, parties had to figure out how to address investments that had already closed prior to the promulgation of the new regulations on the assumption that Section 50(d) income allowed a basis increase, but would now be subject to the regulations because they would be placed in service on or after September 19, 2016.[168] Further, parties had to grapple with the technicalities arising from projects that have been placed in service in multiple phases, some before and some after the initial applicability date of the regulations.[169]

One of the major concerns for a broader swath of taxpayers is whether the IRS will assess deficiencies against them for transactions that predate the regulations if the IRS determines the transactions were inconsistent with congressional intent and statutory purpose.[170] Such a position would seem unfair

165 *Id.* at 47,703.

166 *Id.*

167 Breed, *supra* note 8, at 55 ("Most HTC investors included Section 50(d) income in the basis of their interest in the master tenant."); Milder, *supra* note 68, at 71 ("Virtually all [energy credit] tenant partnerships have treated the 50(d) income as a partnership item which is allocated among its partners, increasing their capital accounts and their bases in their partnership interests.").

168 *See* Breed, *supra* note 8, at 55 ("Affected taxpayers may want to revisit such recently closed transactions to reprice the transaction and restructure any tax credit adjusters.").

169 *See id.* at 55, 59 (describing questions affecting recently closed transactions with multiple structures or multiple phases).

170 *See id.* at 55 ("While nothing in the new guidance explicitly permits taxpayers to elect an early application of the rules, Treasury's explanatory discussion can be read to indicate that, in Treasury's view, the position taken in the new guidance was always the law."); Milder,

considering the IRS's previous indications that Section 50(d) income was a partnership tax item or the law was unsettled.[171]

The regulations may make investment tax credits less valuable to investors, thus reducing the amount investors are willing to contribute to projects and the amount of equity available for investments in historic rehabilitations and renewable energy projects.[172] If corporate tax rates are reduced in the coming years, the demand for investment tax credits may further erode.[173] On the other hand, the increased certainty provided by the regulations may increase the pool of investors willing to participate in investment tax credit transactions.[174] Moreover, a reduction in corporate tax rates would reduce the cost of Section 50(d) income, so conditions may be such that investments in investment tax credits are not substantially reduced at the end of the day.

The regulations prompted strong responses from industry participants. The American Bankers Association (the "ABA"), which represents the $16 trillion American banking industry, and the Historic Tax Credit Coalition (the "HTCC"), which represents rehabilitation tax credit industry participants including investors, developers, law firms, accountants, and consultants, both submitted comments on the proposed regulations.[175] The ABA objected

supra note 68, at 74 ("Many practitioners fear that an aggressive IRS auditor might cite this language as indicating that facilities placed-in-service years before Sept. 19[, 2016,] should be subject to the 'spirit' of the Regulations if not their explicit rules.").

[171] *See, e.g.*, Rev. Proc. 2014-12, 2014-3 I.R.B. 415, 416 (providing that "this revenue procedure does not address how a Partnership is required to allocate the income inclusion required by § 50(d)(5)" and thus implying that the income inclusion *is* in fact a partnership item to be allocated by the partnership in the first place); *see also* Breed, *supra* note 8, at 55 ("Revenue Procedure 2014-12 specifically excluded the treatment of [Section] 50(d) income from required compliance with . . . Section 704 guidance, a clear indication that the law was not settled before the issuance and effective date of the new guidance.").

[172] *See* Breed, *supra* note 8, at 55 (noting that the decision to use a lease pass-through structure will be affected by "the reduced value of a master tenant interest").

[173] *See* Tax Policy Center Staff, *The Implications of What We Know and Don't Know About President Trump's Tax Plan*, TAX POL'Y CTR. 3 (July 12, 2017), http://www.taxpolicycenter.org/sites/default/files/publication/142616/2001405-the-implications-of-what-we-know-and-dont-know-about-president-trumps-plan_1.pdf [https://perma.cc/YL44-EUG8] (noting that President Trump's tax proposals include cutting the corporate tax rate to 15%).

[174] Breed, *supra* note 8, at 59 (stating that confidence in the understanding of applicable rules "should be reflected in an increase in the pool of potential investors as well as an increase in the number of transactions closed").

[175] *See generally* Letter from John Kinsella, Vice President, Tax Policy, Am. Bankers Ass'n, to Internal Revenue Serv. (Oct. 20, 2016), https://www.regulations.gov/content Streamer?documentId=IRS-2016-0031-0005&attachmentNumber=1&disposition=attachment&contentType=pdf [https://perma.cc/7PCB-YLCE]; Letter from John Leith-Tetrault, President, Historic Tax Credit Coal., to Jennifer Records, Internal Revenue Serv. (Oct. 19, 2016), https://www.regulations.gov/content Streamer?documentId=IRS-2016-

vehemently to the overall conclusion that Section 50(d) income should be a partner tax item, stressing that "the operation of these rules will decrease the amount of investment that flows into these credit programs and as a result, there will be less cash available for rehabilitation and energy projects. This seems to be at odds with the public policy objectives."[176] The ABA expressed further concern regarding the ambiguity with respect to whether the regulations would be applied only prospectively or also retrospectively, and requested that they only be applied prospectively.[177] It also requested modification of the applicability date so as to cover only investments made after September 19, 2016, and, thus, exempt transactions that had been closed but not placed in service prior to that date, or that have multiple placed-in-service dates.[178]

The HTCC's comments took a less strident view of the regulations. The HTCC instead requested that, rather than accelerate Section 50(d) income upon disposition, taxpayers could elect to reduce the basis in the investment credit property.[179] Such a position would shift the burden of the Section 50(d) income away from the lessee and to the lessor, but might, in theory, be revenue-neutral for the government.[180] It could even result in increased revenue by shifting the

0031-0004&attachmentNumber=1&disposition=attachment&contentType=pdf [https://perma.cc/ZG4E-ULX6].

[176] Kinsella, *supra* note 175, at 2.

[177] *Id.* at 3 ("[W]e have concerns that this ambiguity may create an uncertain environment for IRS auditors or others who are evaluating the investments.").

[178] *See id.* ("[I]nvestment partnership transactions entered into as early as 2014 may be impacted solely based upon an arbitrary September 19, 2016 deadline.").

[179] Leith-Tetrault, *supra* note 175, at 1 ("[W]e ask that the Service include in the regulations a provision permitting the lessor and lessee . . . to reduce the basis of the investment credit property by the amount of the unrealized Code §50(d)(5) income in lieu of requiring the ultimate credit claimant to continue to report its allocable share of such income."). The HTCC had previously proposed this idea, and also suggested as an alternative that Section 50(d) income could track the allocation of income rather than the investment tax credit. Leith-Tetrault, Sept. 2015, *supra* note 138, at 5 ("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."). The result would be that transactions could be structured to "flip" the income, which would then include the Section 50(d) income, from the investor to the developer. Presumably because the IRS found that Section 50(d) income was not a partnership tax item, and because this method would allow investors to escape the Section 50(d) income burden, the IRS did not adopt this method. *See* Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,703 (July 22, 2016).

[180] Leith-Tetrault, *supra* note 175, at 2 ("While the proposed election would result in someone other than the ultimate credit claimant bearing the 'burden' of the credit, we believe such an approach will provide more flexibility in structuring equity transactions without any loss of revenue to the government.").

Section 50(d) income burden to taxpayers with higher marginal tax rates.[181] Given the IRS's strong objections to taxpayers obtaining the benefit of investment tax credits without any of the corresponding burden,[182] it does not seem very likely that the IRS would adopt a proposal that allows wealthy corporations and banks to shift the tax burden away from themselves while retaining the tax credits.

The HTCC also requested modifications to the applicability date so that the regulations would only be applicable to properties with a binding lease executed on or after September 19, 2016, to avoid burdening previously negotiated and closed transactions with unexpected changes to their economic expectations.[183] The HTCC, like the ABA, further sought clarity with respect to transactions with multiple placed-in-service dates, confirmation that the IRS would not pursue actions against preexisting transactions based on the explanatory language, and conformity of Section 50(d) income treatment to depreciation conventions on the same property.[184] Unfortunately for the ABA and HTCC, the IRS has allegedly failed to adequately consider comments from the public when finalizing regulations, an issue which could be an ongoing concern.[185]

After years of uncertainty, the IRS has finally provided key guidance to investment tax credit industry participants regarding Section 50(d) income. For better or for worse, the IRS's position is now that Section 50(d) income is assessed at the partner level and cannot serve to increase a partner's basis in a lessee partnership. However, key questions remain, as highlighted by both the ABA and HTCC comments. The next Part analyzes some of these remaining questions.

III. APPLICATION OF § 1.50-1T

As noted above, while the new regulations codified at § 1.50-1T answer the primary outstanding questions concerning Section 50(d) income, some questions remain unanswered. The HTCC and ABA comments highlight several issues,

[181] *Id.* ("[S]ince the ultimate members of lessor entities frequently are individuals, the reduction in depreciation deductions at higher individual tax rates actually could result in an overall increase in taxes . . . .").

[182] Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,703 (July 22, 2016) ("Congress did not intend to allow partners and S corporation shareholders the full benefit of the credit without any of the corresponding burden.").

[183] Leith-Tetrault, *supra* note 175, at 2.

[184] *Id.* at 2-3 (proposing language that would clarify the regulations' applicability to transactions with multiple phases or buildings, provide conventions conforming Section 50(d) income to depreciation conventions, and confirm non-applicability to pre-effective date transactions "[i]n the interests of avoiding future disputes and stabilizing the equity markets").

[185] Dembitzer, *supra* note 143, at 508-09 (citing Georgia Fed. Bank v. Comm'r, 98 T.C. 105, 118 (1992)) (asserting that the court in *Georgia Federal Bank* "was not convinced that the Treasury adequately considered the 'vital relevant comments' it received from practitioners").

but this Part will focus on two in particular that have the greatest impact. The first question is a more technical one: What do the regulations mean for the thousands of extant transactions in which the partners of a lessee partnership reported an increase in their basis in the lessee partnership as a result of an allocation of Section 50(d) income? The second one is broader: Did the IRS reach the best conclusion regarding whether Section 50(d) income constitutes a partner or partnership tax item?

A. *Retroactive Application*

During and after the development of the § 1.50-1T regulations, the HTCC repeatedly insisted that any new guidance be clear that it applied only prospectively and that the IRS would not challenge contrary positions taken by taxpayers in good faith prior to the promulgation of the regulations.[186] To date, that request has fallen on deaf ears as the § 1.50-1T regulations are notably ambiguous as to the treatment of pre-effective date transactions.[187] Billions of dollars of investment tax credits have been claimed that remain subject to audit,[188] and a large majority of taxpayers in those transactions took positions contrary to the new regulations.[189] What does the future hold for these taxpayers? Generally, the IRS does not apply new regulations retroactively when doing so harms the taxpayer, but this is not an official policy.[190] Furthermore, it

---

[186] *See* Leith-Tetrault, *supra* note 175, at 3 ("In the interests of avoiding future disputes and stabilizing the equity markets, the Coalition reiterates its request that the regulations provide (perhaps in the preamble) that the Service does not intend to challenge good faith tax positions taken by taxpayers in pre-effective date transactions that do not conform to the partner-level approach reflected in the regulations."); Leith-Tetrault, Sept. 2015, *supra* note 138, at 5 ("We continue to request that any change to the treatment of [Section] 50(d) income not apply to transactions which met certain requirements prior to the publication of the regulations, as discussed in our previous letter."); Leith-Tetrault, Dec. 2014, *supra* note 138, at 2-3 (proposing specific language relating to the effective date of new regulations, including a statement that the IRS would not challenge prior contrary treatments by taxpayers except in limited circumstances); Leith-Tetrault, Aug. 2014, *supra* note 138, at 17 ("[T]he Coalition believes . . . that any such change should be prospective in application only.").

[187] *See* discussion *supra* Section II.B (discussing the text of the § 1.50-1T regulations, including the applicability date).

[188] *See* NAT'L PARK SERV., *supra* note 27, at 5 (reporting that, from fiscal years 2012 through 2016, the maximum amount of rehabilitation credits available based on approved projects exceeds $6.3 billion).

[189] *See* sources cited *supra* note 167 (noting that almost all investors took the position that Section 50(d) income increased basis in the lessee partnership).

[190] John S. Nolan & Victor Thuronyi, *Retroactive Application of Changes in IRS or Treasury Department Position*, 61 TAXES 777, 778 (1983) ("In practice, administrative interpretations in regulations and revenue rulings are generally applied with retroactive effect if the change benefits taxpayers, and prospectively if they operate to the detriment of taxpayers."); Sheryl Phillabaum, *To What Extent Can Taxpayers Rely on IRS Regulations and Rulings to Predict Future IRS Conduct?*, 25 GONZ. L. REV. 281, 289 (1989-90) ("Although

is general IRS policy to limit new regulations to prospective effect where there is a prior regulation or revenue ruling (for example, Revenue Procedure 2014-12 or the cases cited in Section III.B) on which the taxpayer may have relied.[191] However, only the IRS knows whether it intends to challenge taxpayers' positions in such transactions.

If the IRS does choose to apply its new regulations (or their underlying logic) retroactively, the situation for taxpayers is grim. The IRS has relatively broad discretion to issue regulations that apply retroactively.[192] When regulations are applied retroactively, their application is subject to review for an abuse of discretion,[193] which is rarely found.[194] The courts will generally only find the IRS abused its discretion in limited circumstances in the following specific cases:

> (1) where retroactivity would work a change in settled law relied on by the taxpayer and implicitly approved by Congress;
> (2) where retroactivity would lead to a result in a particular case that would be unduly harsh; or
> (3) where retroactivity would lead to inequality of treatment between similarly situated taxpayers.[195]

Taxpayers in investment tax credit transactions will find it difficult to meet this heavy burden. As to the first possibility, the taxpayer would have to establish that the treatment of Section 50(d) income as a partnership item was "settled law." This is hardly the case. Settled law may not consist of governmental silence, informal publications, the IRS's acquiescence in a Tax Court decision, or conflicting judicial interpretations of the law.[196] Settled law consists of

---

the Commissioner has broad powers to change regulations and apply the change retroactively, the practice is to make any changes in the regulations which would be detrimental to the taxpayer apply only prospectively.").

[191] Nolan & Thuronyi, *supra* note 190, at 778 ("The IRS policy is that a change of position will be limited to prospective effect only if there has been a prior regulation or revenue ruling on which taxpayers presumably relied.").

[192] *See* I.R.C. § 7805(b) (2012) (permitting the Treasury Secretary to issue regulations retroactively if they are issued shortly after enactment of the applicable statute, to prevent abuse, to correct procedural defects in prior regulations, with congressional authority, or by election).

[193] Auto. Club of Mich. v. Comm'r, 353 U.S. 180, 184 (1957) (holding that a retroactive regulation "may not be disturbed unless, in the circumstances of [the] case, the Commissioner abused the discretion vested in him"); Bryan T. Camp, *The Retroactivity of Treasury Regulations: Paths to Finding Abuse of Discretion*, 7 VA. TAX REV. 509, 510-11 (1988) (discussing the abuse of discretion standard).

[194] Phillabaum, *supra* note 190, at 289 ("[C]ourts have taken the approach that any retroactive application of a regulation may be reviewed for abuse of discretion, although such abuse is rarely found.").

[195] Camp, *supra* note 193, at 511 (citing Anderson, Clayton & Co. v. United States, 562 F.2d 972, 981 (5th Cir. 1977)).

[196] *Id.* at 515-16.

"almost nothing short of a prior regulation which is on point, which applies to the disputed transaction or calculation in some substantive way, and which, by the passage of time and reenactments of the [Internal Revenue] Code, has been implicitly approved by Congress."[197]

Taxpayers might conceivably argue that the IRS's statements in Revenue Procedure 2014-12 implying that Section 50(d) income was a partnership tax item makes it settled law,[198] but it is far from clear that the statement is definitive or binding enough to be settled law.[199] Moreover, there is little support to argue that Congress has implicitly approved the statement by the passage of time and reenactments of the Internal Revenue Code, since Revenue Procedure 2014-12 has only been on the books for three years and Congress has not reenacted the Internal Revenue Code in that time. Additionally, it is likely the IRS has authority to retroactively change Revenue Procedure 2014-12 if it were erroneous on that point.[200] In fact, the IRS modified Revenue Procedure 2014-12 accordingly when it issued the § 1.50-1T regulations.[201]

---

[197] *Id.* at 516. *But see id.* at 516-18 (discussing a contrary case in which an informal publication was sufficient).

[198] Rev. Proc. 2014-12, 2014-3 I.R.B. 415, 416 (providing that "this revenue procedure does not address how a Partnership is required to allocate the income inclusion required by § 50(d)(5)"). Indeed, this argument was made during the process of developing the regulations. *See* Leith-Tetrault, Aug. 2014, *supra* note 138, at 1 ("The Revenue Procedure thus explicitly stated that Section 50(d) income is a partnership tax item . . . .").

[199] *Cf.* Gehl Co. v. Comm'r, 795 F.2d 1324, 1333 (7th Cir. 1986) (holding a pamphlet that amounted to "an express promise that the Commissioner will not in the future exercise his discretion to apply adverse changes retroactively" was sufficient to constitute settled law); Camp, *supra* note 193, at 517 (discussing the *Gehl* case).

[200] *See* Dixon v. United States, 381 U.S. 68, 76 (1965) (holding that taxpayer was not protected in relying on the published acquiescence of the IRS on an issue that the IRS subsequently retroactively revoked due to a mistake in the underlying law); Phillabaum, *supra* note 190, at 296 (noting, with respect to *Dixon*, that "[t]he Court concluded that the Commissioner had not abused his discretion by correcting a mistake of law and the taxpayer had no right to rely on the erroneous decision"). *But see* Nolan & Thuronyi, *supra* note 190, at 780 (doubting the theoretical underpinnings of the IRS's authority to retroactively modify a revenue ruling).

[201] Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,703-04 (July 22, 2016) ("Rev. Proc. 2014–12 (2014–3 IRB 415) is modified by . . . deleting the sentences in section 3 and section 4.07 that refer to allocation by a partnership of the income inclusion required under section 50(d)(5)."). As with the regulations, though, it is not clear that the modification is retroactive. The applicability date of this modification presumably would dovetail with the applicability date of the new regulations as a whole. As a general matter, the IRS usually only modifies revenue procedures prospectively. Mitchell Rogovin & Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View from Within*, 46 DUQ. L. REV. 323, 338 (2008) ("[A]s statements of the administrative procedures the Service follows, revenue procedures are not generally revoked, but instead modified prospectively.").

Beyond all that, the period during which taxpayers might justifiably have relied is short: Revenue Procedure 2014-12 was first released in December 2013, and the § 1.50-1T regulations were promulgated in July 2016. Furthermore, knowledgeable taxpayers and those with sophisticated counsel were aware by August 2014 that definitive guidance on Section 50(d) income was impending.[202] Finally, taxpayers would find it difficult to argue that they relied on Revenue Procedure 2014-12 if they were already reporting Section 50(d) income as a partnership item prior to December 2013.

Taxpayers may also argue that certain judicial interpretations regarding investment tax credits were enough to create settled law.[203] As discussed further below, courts have held that investment tax credits are partnership tax items, and have further held that taxpayers should not be barred from receiving unintended benefits from the tax code if they are otherwise clearly provided for by the statutory text.[204] While informative, these cases stop well short of creating settled law for the treatment of Section 50(d) income by lessee credit claimants, an issue far from anything considered by those courts.[205] As to the second possibility for proving abuse of discretion, the "unduly harsh" test has never been fully defined but is unlikely to apply, as the little case law applying it suggests the circumstances must be very extreme, such as a tax liability so great as to "wipe [the taxpayer] out of existence."[206] The third possibility, the "inequality of treatment" test, would be highly dependent on the positions the IRS takes in the future with respect to different investors.[207]

Of course, the inequality of treatment test assumes that such treatment would constitute a *retroactive* application of a new regulation. It is possible that, "even though a regulation affects past years, it is not retroactive (and hence not reviewable for abuse of discretion) because the regulation merely interprets what

---

[202] *See* DEP'T OF THE TREASURY, *supra* note 136, at 14 (disclosing in August 2014 that definitive guidance concerning Section 50(d) income was on the IRS's priority list for the following year).

[203] *See infra* Section III.B (discussing case law holding that investment credits are partnership tax items).

[204] *See infra* notes 230-32, 235-38, 240-42 (describing such cases and holdings).

[205] *See* Camp, *supra* note 193, at 516 (defining "settled law" as "almost nothing short of a prior regulation which is on point, which applies to the disputed transaction or calculation in some substantive way, and which, by the passage of time and reenactments of the Code, has been implicitly approved by Congress").

[206] *See id.* at 521-25.

[207] The "unequal treatment" theory is narrowly construed; it does not permit taxpayers to argue for a particular treatment just because the IRS has (maybe erroneously) treated another taxpayer a certain way. *See* Nolan & Thuronyi, *supra* note 190, at 782 ("It is not surprising that the application of this principle has generally been narrowly limited."). Bryan Camp also discusses a largely untested theory in which the courts may focus on a "notice" rationale exonerating taxpayers in highly technical areas of tax law. However, the theory is largely dependent on the existence of settled law or policy. Camp, *supra* note 193, at 527-32.

the statute has in fact meant all along."[208] In light of the IRS's explicit disagreement with taxpayers that previously claimed a basis increase from Section 50(d) income, that appears to be its line of reasoning.[209] However, this standard is not always applied equally if there would be great inequity to the taxpayer.[210] Even if the IRS claims that its new regulations were merely clarifying prior law and that it never gave express permission for any taxpayer to treat Section 50(d) income as a partnership tax item, its awareness and apparent tolerance of the prevalent practice of doing so prior to July 2016 may bar retroactive application.[211]

While the IRS deliberately left open the interpretation of § 50 prior to July 22, 2016,[212] it also laid the groundwork for the claim that its interpretation is correct,[213] thus preserving its own flexibility to apply § 1.50-1T, or a modified version of § 1.50-1T, or any other reasonable interpretation of its choosing in past cases. Even if the IRS does not explicitly rely on its new regulations in challenging a transaction, a court may still use the regulations as guidance to interpret the statute.[214] The IRS's particular choice of language regarding the regulations' applicability seems relatively unique, and does not appear to have

[208] Camp, *supra* note 193, at 511 (citing Chock Full O' Nuts Corp. v. United States, 453 F.2d 300, 303 (2d Cir. 1971)). *But see* Richard M. Ireland, Jr., *Retroactivity and IRC § 7805—A Plea to the IRS to Exercise Its Discretion to Limit Its Discretion*, 28 LOY. L. REV. 483, 487 (1982) ("[T]he presumption is that a change in a regulation will be retroactive, since the new regulation is merely expressing the meaning of the statute that has existed since its enactment. . . . However, where the original regulation is a reasonable interpretation of the statute, a court may be unwilling to apply the new regulation retroactively, applying instead the regulation then in effect.").

[209] Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,702 (July 22, 2016) (arguing that basis increases from Section 50(d) income inclusion are "inconsistent with Congressional intent as they thwart the purpose of the income inclusion requirement").

[210] *See* Farmers' & Merchs.' Bank v. United States, 476 F.2d 406, 409 (4th Cir. 1973) (holding that retroactive application of a revenue ruling purportedly clarifying a computation procedure was "too inequitable to be permissible"); Ireland, *supra* note 208, at 505 (discussing *Farmers'*).

[211] *See Farmers' & Merchs.' Bank*, 476 F.2d at 409 ("[The IRS] was quite aware of this practice and unequivocally tolerated it with full knowledge of its prevalence."). Notably, the revenue ruling at issue in *Farmers'* explicitly stated that it "will not be applied by the Service to deductions claimed for taxable years ending on or before November 30, 1968," but the IRS sought to apply it retroactively to the taxpayer's 1964 tax return, on which the taxpayer sued for a refund in 1972. *Id.* at 406-09.

[212] Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. at 47,703 ("The temporary regulations should not be construed to create any inference concerning the proper interpretation of section 50(d)(5) prior to the effective date of the regulations.").

[213] *Id.* at 47,702-03 (discussing the rationale for the regulations).

[214] *See* Laurent v. PricewaterhouseCoopers LLP, 794 F.3d 272, 288 (2d Cir. 2015) (providing that new regulations are not dispositive but may be helpful in guiding a court ruling on cases predating such regulations).

been litigated,[215] though it is not uncommon for IRS regulations to have unclear effective dates.[216] That ambiguity may provide an avenue for disputing an IRS challenge if the taxpayer can argue it was misled about the IRS's intention to apply the new rules retroactively.[217] If it chooses to challenge prior transactions, the IRS could argue it is applying § 1.50-1T retroactively or it is simply applying the same logic to interpret the statute. The taxpayer's best defense in either case would be that it acted in good faith, without utilizing abusive practices, and would suffer unduly harsh consequences if its position were held invalid.[218]

B. *Validity of Regulations*

Of course, the issue of applicability is irrelevant either retroactively or prospectively if the regulation is an improper interpretation of the statute. Treasury regulations generally are legally binding and valid, even if they merely interpret a statute.[219] They are afforded deference by the courts as long as they are reasonable and are not clearly precluded by the statute.[220] Section 50(d) and

[215] *Compare* Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. at 47,703 ("The temporary regulations should not be construed to create any inference concerning the proper interpretation of section 50(d)(5) prior to the effective date of the regulations."), *with* Prop. Treas. Reg. § 1.411(a)(13)-1, (b)-1, (b)(5)-1, 79 Fed. Reg. 56,442, 56,457 (Sept. 19, 2014) ("In addition, the regulations should not be construed to create any inference concerning the proper interpretation of sections 411(a)(13) and 411(b)(5) prior to the effective date of the regulation."). No other proposed regulations from the IRS have utilized such language, and searches have revealed no litigation on point.

[216] *See* Dembitzer, *supra* note 143, at 518-19 (noting instances where regulations have been accompanied by confusing or unclear preamble statements concerning effective dates).

[217] *See* Elkins v. Comm'r, 81 T.C. 669, 681 (1983) ("The Secretary's discretion to apply his regulations retroactively is very broad, but its counterpart is the responsibility to provide taxpayers with adequate guidance as to the extent to which his power will be exercised, or at the very least to avoid misleading them."). The unique factual circumstances of *Elkins*, though, make for a difficult analogy to § 1.50-1T because § 1.50-1T does not present an equivalent opportunity for reliance unless there is a significant change in the regulations before they become final.

[218] Nolan & Thuronyi, *supra* note 190, at 782.

[219] United States v. Mead Corp., 533 U.S. 218, 229 (2001) (citing Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 845 (1984)) ("Congress would expect the agency to be able to speak with the force of law when it addresses ambiguity in the statute or fills a space in the enacted law, even one about which 'Congress did not actually have an intent' as to a particular result."). The Supreme Court confirmed that *Chevron* applies to tax regulations in *Mayo Foundation for Medical Education & Research v. United States*, 562 U.S. 44 (2011), when it said "the principles underlying *Chevron* apply with full force in the tax context," *id.* at 45.

[220] United States v. Cleveland Indians Baseball Co., 532 U.S. 200, 219 (2001) ("[W]e defer to the Commissioner's regulations as long as they implement the congressional mandate in some reasonable manner. We do this because Congress has delegated to the [Commissioner], not to the courts, the task of prescribing all needful rules and regulations for the enforcement

its predecessor, former § 48(d), are themselves silent as to whether Section 50(d) income should be treated as a partnership tax item. As a result, in order to determine whether § 1.50-1T is a reasonable interpretation of § 50(d) and former § 48(d), we must look to other textual and policy sources.

1. Textual Sources: The Case Against § 1.50-1T

As a textual matter, there is significant support for treating Section 50(d) income as a partnership tax item that can serve to increase a partner's basis in the partnership. As discussed in Section I.C, income at the partnership level is computed the same as it would be for an individual, with no exception for Section 50(d) income or any category that would encompass Section 50(d) income.[221] Once computed by the partnership, the basis of a partner's interest in a partnership is increased by such partner's distributive share of the taxable income of the partnership.[222] Section 50(d) income is taxable income, so there is no apparent textual reason to treat it differently.

As a theoretical matter, the basis adjustment serves to ensure that such items of income are only taxed once, when they are allocated to the partner.[223] If no basis adjustment is allowed, then the partner is effectively taxed twice: once when the income is allocated to it and again when it disposes of its partnership interest.[224] The purpose of the basis adjustment:

> is to keep track of a partner's "tax investment" in the partnership, with a view toward preventing double taxation or exclusion from taxation of income items upon ultimate disposition of the partnership interest. . . . If a partner's basis were not increased by his share of the partnership's income, he would be taxed on such income a second time upon the sale or other

of the Internal Revenue Code." (internal citations and quotation marks omitted)). For a detailed discussion of judicial deference to tax rules, see generally Leandra Lederman, *The Fight over "Fighting Regs" and Judicial Deference in Tax Litigation*, 92 B.U. L. REV. 643 (2012); and James M. Puckett, *Embracing the Queen of Hearts: Deference to Retroactive Tax Rules*, 40 FLA. ST. U. L. REV. 349 (2013). At least one scholar has argued a different standard should be applied for retroactive tax regulations. *See* Andrew Pruitt, *Judicial Deference to Retroactive Interpretative Treasury Regulations*, 79 GEO. WASH. L. REV. 1558, 1563 (2011) (arguing traditional *Chevron* deference "is both normatively and doctrinally the wrong standard for judicial review of I.R.C. § 7805(b) regulations").

[221] I.R.C. § 703(a) (2012).

[222] *Id.* § 705(a).

[223] *See* Rev. Rul. 96-11, 1996-1 C.B. 140 ("Generally, the basis of a partner's interest in a partnership is adjusted to reflect the tax allocations of the partnership to that partner. This ensures that the income and loss of the partnership are taken into account by its partners only once.").

[224] S. REP. NO. 83-1622, at 384 (1954) ("The adjustments to the basis of a partner's interest are necessary to prevent unintended benefit or detriment to the partners. . . . Otherwise, the partner would eventually incur a capital gain with respect to such amounts."); H.R. REP. NO. 83-1337, at A225 (1954) ("The adjustments to the basis of a partner's interest are necessary to prevent unintended benefit or detriment to the partners.").

> disposition of his interest. Conversely, if his basis were not reduced by his share of partnership loss, such loss would benefit him a second time by reducing his gain (or increasing his loss) upon a subsequent sale or other disposition of his interest.[225]

Whether Section 50(d) income is notional or not, barring the basis adjustment serves to double-tax the partner by ignoring the partner's tax investment in its reported Section 50(d) income. There is no sensible reason why Section 50(d) income should be an exception from the general rule that partnership income should only be taxed once.

Each partner *may* be separately required to account for its distributive share of the partnership's items of income, gain, loss, deduction, or credit, but only to the extent required by regulations.[226] The regulations in fact provide that "[i]tems of income, gain[,] loss, deduction, or credit of the partnership" as well as "[o]ther amounts determinable at the partnership level with respect to partnership assets, investments, transactions and operations necessary to enable the partnership or the partners to determine . . . [t]he investment credit" are partnership-level tax items.[227] While not directly addressing Section 50(d) income, it would be aberrational to treat Section 50(d) income as a partner-level tax item while all of these other comparable items are assessed at the partnership level, including the assets themselves that give rise to the investment tax credits.

The default method in the case of a partnership is to treat income and other items at the partnership level. The Supreme Court has stated that, for the purpose of calculating income, "the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded."[228] This remains true even if no actual income is distributed to the partner,[229] which it would not be in the case of "phantom" income such as Section 50(d) income.

Additionally, the Tax Court has repeatedly held that for purposes of investment tax credits, the partnership is to be treated as an entity, and tax items are to be assessed at the partnership level. The Tax Court has held:

> Although the operative term used when determining the amount of investment credit is "taxpayer" and not "person" . . ., it is clear that an entity rather than an aggregate approach is contemplated. . . . [T]he

[225] MCKEE ET AL., *supra* note 101, at ¶ 6.02[2].

[226] I.R.C. § 702(a). Even so, the partner's distributive share is determined in accordance with the parties' partnership agreement, unless the agreement is silent, or the agreement's allocations do not have substantial economic effect. *Id.* § 704(b).

[227] Treas. Reg. § 301.6231(a)(3)-1(a) (as amended in 1986).

[228] United States v. Basye, 410 U.S. 441, 448 (1973).

[229] *Id.* at 453 ("For it is axiomatic that each partner must pay taxes on his distributive share of the partnership's income without regard to whether that amount is actually distributed to him."); *see* Treas. Reg. § 1.702-1(a) (1960) ("Each partner is required to take into account separately in his return his distributive share, *whether or not distributed*, of each class or item of partnership income, gain, loss, deduction, or credit." (emphasis added)).

> operative term includes a partnership. It is the partnership which places the property in service under section 46(c)(1). Therefore, the focus of the investment credit provisions is initially on the partnership as an entity, and the investment credit is a partnership item for which each partner must report a distributable share.[230]

Other judicial decisions have also taken the entity approach of treating investment tax credits at the partnership level over the continued objections of the IRS; such cases have even overruled the IRS's attempts to regulate to the contrary.[231] Moreover, the Court of Federal Claims has explicitly held that "[a]n investment credit is a partnership item, and the IRS has determined that entitlement to the credit is more appropriately determined at the partnership level."[232] With all of these other matters surrounding investment tax credits being determined at the partnership level, it appears illogical that the IRS should invent a sui generis approach in order to assess Section 50(d) income at the level of the "ultimate credit claimant"[233] and cause the taxpayer to be double-taxed on its Section 50(d) income.

The IRS has objected to Section 50(d) income causing a partnership basis increase partly on the ground that it confers "an unintended benefit upon partners and S corporation shareholders of lessee partnerships and S corporations that is not available to any other credit claimant."[234] However, the Internal Revenue Code does not necessarily bar the receipt of an unintended benefit. Courts have been extremely hesitant to overrule tax statutes on policy grounds, even in the face of unintended consequences.[235] In *Gitlitz v. Commissioner*,[236] the Supreme Court addressed a similar issue where an S corporation realized $2 million of

---

[230] Southern v. Comm'r, 87 T.C. 49, 54 (1986).

[231] *See* Holloman v. Comm'r, 551 F.2d 987, 990 (5th Cir. 1977) (treating a minority partner as separate from the partnership for purposes of determining whether property was "used section 38 property"); Siller Bros., Inc. v. Comm'r, 89 T.C. 256, 261 (1987) (finding that the early termination of a partnership caused a recapture of investment tax credits in the hands of the partner that received the investment credit property); Moradian v. Comm'r, 53 T.C. 207, 213-14 (1969) (holding acquisition by wife of 50% interest in partnership that owned investment credit property, where husband held other 50% partnership interest, did not disallow investment tax credit on grounds that partnership was not "same or related to" prior partnership between husband and an unrelated third party).

[232] Rothstein v. United States, 81 A.F.T.R.2d 98-2132, 98-2133 (Fed. Cl. 1998).

[233] Temp. Treas. Reg. § 1.50-1T(b)(3)(i) (2016) (defining ultimate credit claimant).

[234] Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,702 (July 22, 2016).

[235] *See, e.g.*, Crooks v. Harrelson, 282 U.S. 55, 60 (1930) ("[T]he principle is to be applied to override the literal terms of a [tax] statute only under rare and exceptional circumstances. . . . [T]o justify a departure from the letter of the law upon that ground, the absurdity must be so gross as to shock the general moral or common sense."); Babin v. Comm'r, 23 F.3d 1032, 1039 (6th Cir. 1994) (denying relief to insolvent partner even though harsh consequences would not have been imposed had he engaged in the same conduct as a sole proprietor).

[236] 531 U.S. 206 (2001).

income from the discharge of its indebtedness.[237] However, the corporation was insolvent, so it was permitted to exclude the income from its gross income.[238] Moreover, despite the fact that the corporation excluded the income from its gross income, the Internal Revenue Code permitted the shareholders to increase their basis in the corporation's stock by their pro rata share of the income excluded.[239] The Court held the income was an "item of income" to the corporation's shareholders despite being excludable from the gross income of the corporation.[240] The result created a double benefit for the shareholders, who did not have to include their share of the discharge of indebtedness income on their own tax returns, but were afforded an increase in the basis of their stock that enabled other benefits.[241] Responding to this concern of a "double windfall," the Court held that "[b]ecause the [Internal Revenue] Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern."[242]

It would appear then, that in the case of § 1.50-1T, the IRS is seeking to overrule the benefit afforded by the plain text of the statute in violation of the principles set forth in *Gitlitz*. Section 50(d) income is without question an item of "taxable income" that would, but for the choice of the partnership entity, be assessed to the lessee in a lease pass-through transaction, so § 1.50-1T's mandate to assess it at the partner level and disallow the outside basis increase runs counter to the plain text of the Internal Revenue Code.[243] The IRS claims, despite provisions of the Internal Revenue Code that suggest the contrary, that Congress intended the basis adjustment rules to retain parity between inside basis and outside basis.[244] However, the IRS fails to cite any evidence that Congress did

[237] *Id.* at 210.

[238] *Id.* ("Because it was insolvent even after the discharge of indebtedness was added to its balance sheet, P. D. W. & A. excluded the entire discharge of indebtedness amount from gross income under 26 U.S.C. §§ 108(a) and 108(d)(7)(A)."); *see also* I.R.C. § 108 (2012) (permitting exclusion of discharge of indebtedness income if the taxpayer is insolvent).

[239] *See* I.R.C. §§ 1366-1367.

[240] *Gitlitz*, 531 U.S. at 212 ("[E]xcluded discharged debt is indeed an 'item of income,' which passes through to the shareholders and increases their bases in the stock of the S corporation.").

[241] *Id.* at 220 ("They would be exempted from paying taxes on the full amount of the discharge of indebtedness, and they would be able to increase basis and deduct their previously suspended losses.").

[242] *Id.*

[243] I.R.C. § 705(a) ("The adjusted basis of a partner's interest in a partnership shall . . . [be] increased by the sum of his distributive share for the taxable year and prior taxable years of . . . taxable income of the partnership as determined under section 703(a).").

[244] *See* Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,702 (July 22, 2016) ("In general, Congress intended for sections 705 and 1367 to preserve inside and outside basis parity for partnerships and S corporations so as to prevent any unintended tax benefit or detriment to the partners or shareholders."); *see also* I.R.C. § 743(a) (creating a basis disparity between inside and outside basis for transferees of a partnership interest); Tony Nitti, *Tackling*

so intend.[245] Even the IRS's own regulations acknowledge that certain provisions of the partnership tax statutes "could, in some circumstances, produce tax results that do not properly reflect income," but such results would not prohibit partnership treatment if the partnership is bona fide, has a substantial business purpose, and satisfies substance over form principles, none of which are generally at issue when only discussing Section 50(d) income.[246] If a contrary result is truly desirable, Congress should be the body to enact it, not the IRS.[247]

2. Policy Sources: The Case For § 1.50-1T

Viewed more as a policy matter, however, it is difficult to disagree with the IRS's conclusions in § 1.50-1T. It is important first to note the origin of the downward basis adjustment for owners claiming the investment tax credit. That basis adjustment has not always been part of the law. Between 1964 and 1982, taxpayers were not required to adjust their basis in investment credit property when they claimed the credits arising from that property.[248] Scholarly criticism of this structure hit a crescendo with the introduction of the Accelerated Cost Recovery System ("ACRS"), which, compared to prior law, provided for substantially more accelerated depreciation deductions for depreciable property.[249] Scholars noted that ACRS, combined with the investment tax credit, particularly at high tax brackets, created tax benefits more generous than an

---

the Dreaded Section 754 Adjustment, FORBES: TAX GEEK TUESDAY (Mar. 11, 2014), http://www.forbes.com/sites/anthonynitti/2014/03/11/tax-geek-tuesday-tackling-the-dreaded-section-754-adjustment/#648096fa35c0 [https://perma.cc/F6QY-V6VC] (discussing the disparity created by § 743(a)).

[245] None of the congressional sources cited by the IRS mention inside and outside basis parity. *See* H.R. REP. NO. 97-826, at 17 (1982); S. REP. NO. 97-640, at 16, 18 (1982); S. REP. NO. 83-1622, at 384 (1954); H.R. REP. NO. 83-1337, at A225 (1954). *But see* Rev. Rul. 96-11, 1996-1 C.B. 140 ("[T]he proper inquiry is whether the transaction has a permanent effect on the partnership's basis in its assets, without a corresponding current or future effect on its taxable income.").

[246] Treas. Reg. § 1.701-2(a)(3) (as amended in 1995). For a discussion of bona fide partnership, business purpose, and substance over form issues in the context of investment credit transactions, see generally Historic Boardwalk Hall, LLC v. Comm'r, 694 F.3d 425 (3d Cir. 2012) (prohibiting investor from claiming rehabilitation credits where investor was not a bona fide partner).

[247] *Cf.* Crooks v. Harrelson, 282 U.S. 55, 60 (1930) ("Laws enacted with good intention, when put to the test, frequently, and to the surprise of the law maker himself, turn out to be mischievous, absurd or otherwise objectionable. But in such case the remedy lies with the law making authority, and not with the courts.").

[248] *See* S. REP. NO. 97-494, pt. 2, at 122 (1982) (noting that the basis adjustment was repealed in 1964).

[249] *See, e.g.*, Calvin H. Johnson, *Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation*, 61 TEX. L. REV. 1013, 1014 (1983) (referring to the effects of ACRS as a "negative tax").

immediate deduction for the full amount of the property, and even criticized it as a "negative tax."[250] Moreover, an analyst for the Treasury Department, Seymour Fiekowsky, noted, even before the enactment of ACRS, that the investment tax credit, absent a downward basis adjustment, created more generous benefits than a direct cash grant.[251] He described the issue as follows:

> [I]f the Commerce Department had paid $3 million toward the purchase of $30 million of equipment, the purchaser of the equipment would be treated under the tax laws . . . as having only $27 million in private resources recoverable as depreciation. However when that same subsidy is conveyed as a credit against income tax, the investor is permitted to take tax depreciation deductions with respect to the $3 million of subsidy as well as the $27 million paid with his own (or borrowed) funds.[252]

Congress responded in 1982 by requiring a downward basis adjustment in the amount of 50% of the investment tax credit,[253] citing the concerns regarding overly generous benefits resulting from combining ACRS depreciation with the investment tax credit.[254] The predecessor to the current Section 50(d) income provision was enacted simultaneously with the downward basis adjustment; notably, the legislative history lacks any insightful explanation of the requirement.[255]

Section 50(d) income is meant to serve as a substitute for a basis *decrease* under § 50(c) (which also requires a basis decrease of partners' interest in an

---

[250] *See id.* at 1021-25.

[251] Seymour Fiekowsky, *Accounting for Tax Subsidies with Special Reference to Cost of Service, or "Fair Rate of Return", Utility Regulation* 32 (U.S. Dep't of the Treasury, OTA Paper No. 27, May 1979) ("Clearly, a 10 percent investment tax credit so structured is worth more, i.e., displaces more privately financed rate base, than a 10 percent cash subsidy.").

[252] *Id.*

[253] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 205(a)(1), 96 Stat. 324, 427.

[254] S. REP. NO. 97-494, pt. 2, at 122 (1982) ("Cost recovery deductions for most personal property allowed currently under ACRS in combination with the regular investment tax credit generate tax benefits which have a present value that is more generous than the tax benefits that would be available if the full cost of the investment could be deducted in the year when the investment was made; i.e., more generous than the tax benefits of expensing.").

[255] § 205(a)(4), 96 Stat. at 429 (enacting the income inclusion requirement now known as Section 50(d) income); STAFF OF J. COMM. ON TAXATION, 97TH CONG., SUMMARY OF THE REVENUE PROVISIONS OF H.R. 4961 (THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982) 12 (Comm. Print 1982) (providing only a reiteration of the mechanical operation of what is now the Section 50(d) income inclusion requirement). Prior to the enactment of the Section 50(d) income requirement, the lessee was instead required to reduce its deductions for rent payments to the lessor. *See* Revenue Act of 1962, Pub. L. No. 87-834, § 2(b), 76 Stat. 960, 969-70. It is worth noting that, in the case of a lessee partnership, such a regime would result in an increase in the partnership's taxable income, and thus an increase in each partner's outside basis attributable to its distributive share of such income. *See supra* notes 97-99 and accompanying text.

owner partnership),[256] so allowing a basis *increase* to result from Section 50(d) income produces a clearly inconsistent result. Mirroring Fiekowsky's analysis, the investment tax credit continues to provide overly generous benefits because the government has provided the project with a subsidy, and not only is the owner not required to decrease its basis in the property and its resulting depreciation deductions, but the Section 50(d) income is being offset at the lessee level through a step-up in outside basis.

It is fair to say, as the IRS does, "that the burden of income inclusion should match the benefits of the allowable credit."[257] Furthermore, it seems fundamentally unfair and incorrect that the Internal Revenue Code should "confer an unintended benefit upon partners and S corporation shareholders of lessee partnerships and S corporations that is not available to any other credit claimant."[258] The IRS has interpreted its authority as permitting it to recast partnerships "formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of" the partnership provisions of the Internal Revenue Code, in order to achieve results consistent with the intent of such provisions.[259] Accordingly, the IRS would presumably argue that it can use that authority here to recharacterize the transaction if the principal purpose of the use of a partnership was to minimize

---

256 I.R.C. § 50(c) (2012) (providing that "the basis of [investment credit] property shall be reduced by the amount of the [investment tax] credit" and that "[t]he adjusted basis of . . . a partner's interest in a partnership . . . shall be appropriately adjusted to take into account adjustments made under this subsection in the basis of property held by the partnership").

257 Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,702 (July 22, 2016).

258 *Id.* The HTCC points out that the same benefit is available, not just to partnerships, but also to S corporations and corporate subsidiaries filing consolidated returns. Leith-Tetrault, Dec. 2014, *supra* note 138, at 1 ("If a corporation formed a subsidiary to act as the lessee in such a transaction, . . . and the subsidiary was part of a consolidated group filing a consolidated return, the basis of the subsidiary's stock would be increased by its share of taxable income under Treas. Reg. § 1.1502-32. As is the case with a partnership, there currently is no statutory exclusion for Section 50(d) income. The same result would occur under . . . § 1367(a)(1)(A) in the case of an S corporation."). The IRS apparently did not find this argument convincing. Of course, the Internal Revenue Code still finds plenty of occasions to provide intentional benefits to partnerships and S corporations that are not available to C corporations, such as pass-through taxation.

259 Treas. Reg. § 1.701-2(b) (as amended in 1995). However, there is a significant discrepancy between Congress's expression of its intent with respect to the partnership basis provisions and the IRS's interpretation of Congress's intent with respect to such provisions. *Compare* H.R. REP. NO. 83-1337, at A225 (1954) (expressing Congress's intent "to prevent any unintended tax benefit or detriment to the partners. . . . [and avoid] a capital gain with respect to such amounts"), *with* Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,702 (July 22, 2016) (interpreting Congress's intent as "to preserve inside and outside basis parity"). This could be a point of controversy if the IRS relied on the anti-abuse regulations in Treas. Reg. § 1.701-2 to recharacterize a partnership for purposes of adjusting basis.

the impact of Section 50(d) income. Thus, from such policy perspectives, Section 50(d) income should not be permitted to provide a basis increase for partners in a partnership.

According to the IRS, the structure of the investment tax credit essentially provides the taxpayer with the benefit of the time value of money: the credit is claimed in the year the project is placed in service, but the IRS recoups the credit (or, in the case of the energy credit, 50% of the credit) later on through a basis reduction under § 50(c) (for owner claimants) or through the inclusion of Section 50(d) income (for lessee claimants).[260] It certainly frustrates that system if partners in a lessee partnership can escape that recoupment by increasing their bases in the partnership.[261]

The IRS further claims the basis increase is inconsistent with the overall purpose of an increase for a partner of its basis in a partnership.[262] While the purpose of those rules is, on the one hand, to prevent unintended detriment to a partner by, for example, double-taxing that partner, the rules are also intended to "prevent unintended benefit" to a partner.[263] For this reason, then, it might be appropriate not to follow *Gitlitz*'s command to allow an unintended benefit if it is otherwise clearly dictated by the Internal Revenue Code. However, the legislative history for § 705 provides that it is the *operation* of the basis adjustment rules that is supposed to prevent unintended benefit or detriment to the partners.[264] As a result, it would seem to undermine Congressional intent to

---

[260] Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. at 47,702 ("The investment credit rules operate to allow a taxpayer to claim the immediate benefit of the full amount of the allowable credit in exchange for the recoupment of that amount (or 50 percent of that amount in the case of the section 48 energy credit) over time."). This is not technically correct. The IRS only recoups the amount of the credit multiplied by the taxpayer's marginal tax rate.

[261] *Id.* (arguing that a partnership basis increase is "inconsistent with the purpose of section 48(d)(5)(B)"); *see also* Treas. Reg. § 1.701-2(e) (permitting the IRS to treat a partnership as an aggregate of its partners "to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder" unless the Code or regulations clearly contemplate entity treatment).

[262] *See* I.R.C. § 705(a) (2012) ("The adjusted basis of a partner's interest in a partnership shall [be] . . . increased by the sum of his distributive share for the taxable year and prior taxable years of . . . taxable income of the partnership.").

[263] S. REP. NO. 83-1622, at 384 (1954) ("The adjustments to the basis of a partner's interest are necessary to prevent unintended benefit or detriment to the partners."); H.R. REP. NO. 83-1337, at A225 (1954).

[264] *See* S. REP. NO. 83-1622, at 384 ("The adjustments to the basis of a partner's interest are necessary to prevent unintended benefit or detriment to the partners."); H.R. REP. NO. 83-1337, at A225. Presumably, the reference to "unintended benefit" refers to the requirement that partners decrease their bases in the partnership for distributions and losses taken by the partnership, I.R.C. § 705(a)(2), which prevents the partner from receiving both the benefit of the distribution or tax loss and the benefit of a non-decreased basis for purposes of computing gain or loss on disposition. *See supra* note 225 and accompanying text.

rule, as § 1.50-1T does, that the basis adjustment rules are to be *ignored* in order to prevent an unintended benefit.

Moreover, the Supreme Court's decision in *Gitlitz* has faced heavy criticism.[265] Congress quickly reacted by amending the statute at issue. In so doing, it adopted language used by Justice Breyer in his dissent, stating: "As a general matter, the Committee believes that where . . . the plain text of a provision of the Internal Revenue Code produces an ambiguity, the provision should be read as closing, not maintaining, a loophole that would result in an inappropriate reduction of tax liability."[266] Arguably, then, we should similarly read Congress's silence in § 50(d) as reflecting its intent not to open a tax loophole.

The complex rules that govern partnership allocations are intended to ensure that tax consequences match economic consequences:

> If a partner will benefit economically from an item of partnership income or gain, that item must be allocated to him so that he bears the correlative tax burden. Conversely, if a partner will suffer the economic burden of an item of partnership loss or deduction, he must be allocated the associated tax benefit. In other words, tax must follow economics.[267]

The IRS claims, shakily relying on legislative history, that the partnership basis increase and decrease serves to preserve parity between the partners' bases in the partnership and the partnership's basis in its assets.[268] For example, if a partner contributes cash to a partnership, the partner has a basis in the partnership in the amount of that contribution, and the partnership has a basis of equal amount in the cash (or property it purchases with the cash). Unlike standard items of income and deduction that tie to specific goods or cash flows, the

---

[265] *See, e.g.*, Ann M. Tabor, Gitlitz v. Commissioner*: Windfall for Shareholders of an Insolvent S Corporation*, 46 S.D. L. REV. 648, 648 (2001) (referring to the *Gitlitz* decision as "controversial" and examining its background and analysis); *see also* Gitlitz v. Comm'r, 531 U.S. 206, 222-23 (Breyer, J., dissenting) (arguing for reliance on policy and congressional intent where permissible).

[266] H.R. REP. NO. 107-251, at 52 (2002); *see also Gitlitz*, 531 U.S. at 223 (Breyer, J., dissenting) ("[O]ther things being equal, we should read ambiguous statutes as closing, not maintaining, tax loopholes. Such is an appropriate understanding of Congress' likely intent.").

[267] MCKEE ET AL., *supra* note 101, at ¶ 11.02[1].

[268] *See* Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,702 (July 22, 2016) ("In general, Congress intended for sections 705 and 1367 to preserve inside and outside basis parity for partnerships and S corporations so as to prevent any unintended tax benefit or detriment to the partners or shareholders."). The IRS speaks here of congressional intent, but cites to legislative history that does not speak of preserving parity between inside basis (the partnership's basis in its assets) and outside basis (the partners' bases in the partnership). *See* sources cited *supra* note 245 and accompanying text. As noted above, the Code itself provides for disparities between inside and outside basis, so it is unclear what is driving the IRS's reliance on preserving inside and outside basis parity. *See supra* note 244 and accompanying text.

investment tax credit is a special benefit with no economic correlative.[269] Similarly, Section 50(d) income does not tie to specific goods or cash flows.[270] Section 50(d) income "has no current or future economic effect on the basis of assets held by a partnership," because it has no cash or property correlative.[271] To illustrate this point, it may be conceived that an outside basis increase usually results under § 705 because there has been income and value created within the partnership. For example, if Torrance Overlook Tenant LLC has assets that have appreciated in value and sells those assets at a gain, the transaction creates tax-paid value in the partnership. While Wendy and Jack must report their share of the gain from the sale, they also get an outside basis increase to reflect taxation of that increase in value.[272] As a result, it may be sensible that Section 50(d) income, which does not reflect an increase in value, but instead is imposed to offset a downward basis adjustment not required of the lessor, not result in a basis adjustment the way standard items of income and deduction do.

Additionally, in contradiction to the judicial precedent establishing that the investment tax credit is a partnership tax item,[273] the IRS has itself established regulations providing that, in the case of an owner of investment credit property claiming the credit, each partner in a partnership computes the credit separately.[274] Notably, there is no parallel provision in the regulations pertaining to lease pass-through transactions,[275] though the IRS apparently views the lessee

[269] *See* Treas. Reg. § 1.704-1(b)(4)(ii) (1960) ("Allocations of tax credits and tax credit recapture are not reflected by adjustments to the partners' capital accounts . . . . Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(b)(1) of this section.").

[270] *See* Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. at 47,702 (referring to Section 50(d) income as "notional amount").

[271] *Id.*; *see* MCKEE ET AL., *supra* note 101, at ¶ 11.02[2][c][viii], n.211 ("Although no provision of law prevents this income inclusion from increasing outside basis under § 705 where a partnership is the lessee, such a basis increase is unwarranted given that the income amortization will have no effect on § 704(b) capital accounts and substitutes for a downward basis adjustment that would have occurred if the partnership had actually owned the leased property.").

[272] This example has some intuitive theoretical appeal, but the purpose of § 705's basis adjustment is to track the partners' tax investment in the partnership, not the value inside the partnership. *See supra* note 225 and accompanying text.

[273] *See* cases cited *supra* notes 230-32 (holding that the investment tax credit is treated as a partnership-level tax item).

[274] *See* Treas. Reg. § 1.46-3(f)(1) (as amended in 1993) ("[E]ach partner shall take into account separately . . . his share of the basis of partnership new section 38 property and his share of the cost of partnership used section 38 property placed in service by the partnership during such partnership taxable year. Each partner shall be treated as the taxpayer with respect to his share of the basis of partnership new section 38 property and his share of the cost of partnership used section 38 property."); Treas. Reg. § 1.704-1(b)(4)(ii) (2016) (requiring allocations with respect to the investment tax credit to be made in accordance with the partners' interests in the partnership).

[275] *See* Treas. Reg. § 1.48-4 (as amended in 1972) (providing regulations relating to the election of a lessor of new section 38 property to treat its lessee as purchaser).

in the same manner.[276] This provides further support for § 1.50-1T's treatment of Section 50(d) income as a partner-level tax item, as it would match the treatment of the investment tax credit itself.

Ultimately, if the issue were being decided on a neutral playing field, the advantage would likely go against the IRS's interpretation in § 1.50-1T. The argument in favor of treating Section 50(d) income as a partnership tax item and allowing a basis increase simply finds greater support from the text and legislative history of the Internal Revenue Code and judicial precedent. However, given the substantial deference that is afforded to IRS regulations,[277] the IRS's policy arguments codified in § 1.50-1T, despite their notable holes,[278] would likely succeed if challenged in court. On the other hand, though, given the relative strength of the arguments and the substantial amount of capital at stake, which likely relied on longstanding IRS acquiescence and other IRS pronouncements and judicial precedent, the IRS should confirm that it would not apply its arguments retroactively to projects closed prior to the applicability date of the regulations.

CONCLUSION

The phantom has finally been calmed with respect to Section 50(d) income. After years of uncertainty, the Section 50(d) income specter that once frightened practitioners and industry participants is now a much friendlier ghost that investors and developers can adequately account for when planning and negotiating transactions. Though there is still potential for some paranormal activity for projects placed in service prior to September 19, 2016, that remain subject to audit, industry participants on the whole are still likely pleased to have guidance on the state of the law. The IRS has made its case that Section 50(d) income should be treated as a partner-level tax item and should not afford a basis increase for partners in the partnership. Despite its flaws, that argument likely has enough logical and policy appeal to avoid becoming a ghost of Christmas past.

[276] *See* Prop. Treas. Reg. § 1.50-1T, 81 Fed. Reg. 47,701, 47,702 (July 22, 2016) ("Similarly, in the case of a lessee partnership where the lessor makes an election under § 1.48-4 to treat the partnership as having acquired investment credit property, each partner in the lessee partnership is the taxpayer with respect to whom the investment credit is determined under section 46.").

[277] *See* sources cited *supra* notes 219-20 (describing the standard of deference afforded to regulations from the IRS).

[278] *See supra* notes 258-59, 264, 268, 275 and accompanying text (identifying flaws in the IRS's arguments).