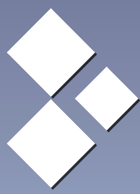
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Guidance on 50(d) Income Will Make a Major Impact

JEROME BREED, BRYAN CAVE LLP

Even after the Internal Revenue Service (IRS) issued Revenue Procedure 2014-12, the historic tax credit (HTC) community remained uncertain about the treatment of Internal Revenue Code (IRC) Section 50(d) income and its effect on pricing HTC investments. While 50(d) income appears at first blush to be a technical tax concept, it has an enormous effect on the investor's yield from HTC investments.

What is 50(d) income? In a master lease pass-through transaction, the owner of a rehabilitated building elects to forgo claiming HTC and instead, to pass-through the HTC to a master tenant. If the pass-through election is not made and the property owner/lessor claims the HTC, the basis of the historic property is reduced by the amount of the HTC and each partner of the property owner entity reduces its capital account and the basis of its partnership interest by its share of the HTC. When a pass-through election is made and the project owner does not claim the HTC, no basis reduction is required at the property owner level and the master tenant does not own any property whose basis can be reduced.

In an attempt to make the federal income tax consequences in a pass-through transaction match a single-tier deal, Code Section 50(d) requires the owner of the master tenant to recognize "phantom income" in an amount equal to the "excess depreciation" claimed by the owners of the property due to the fact that the basis of the HTC building was not reduced. An example may be helpful.

If the qualified rehabilitation expenditures of a commercial HTC property are $3,900,000, and the owner of the project claims HTCs, the property owners would be entitled to claim $780,000 of HTC and must reduce the basis of the property by $780,000. After the reduction, the property owner would claim $80,000 of annual depreciation ($3,900,000 - $780,000 = $3,120,000 ÷ 39 years = $80,000 annual depreciation). If the HTC is passed-through to the master tenant, the property's basis is not reduced, and the annual depreciation deduction claimed by the property owner would be $100,000 ($3,900,000 ÷ 39 years). The excess $20,000 ($100,000 - $80,000) depreciation deduction is the amount of the 50(d) income that partners of the master tenant must recognize each year for 39 years.

Taxpayers have been uncertain about the tax consequences of receipt of 50(d) income. Most HTC investors included Section 50(d) income in

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the basis of their interest in the master tenant. As a result, when the investor sold its interest in the master tenant, it recognized a loss. The new guidance, issued as temporary and proposed Treasury Regulation Section 1.50-1T, concludes that each "ultimate credit claimant" (that is, the first non-partnership that owns a direct or indirect interest in the master tenant), with respect to a lease of HTC property must take into income its portion of the amount of HTC claimed, based on Treas. Reg. Section 1.50-1T(b)(3). Treasury concluded that the burden of 50(d) income inclusion should be matched to the taxpayer that claimed the HTC. In Treasury's view, because HTC is calculated at the ultimate credit claimant level based upon its share of QREs, the master tenant partnership does not allocate Section 50(d) income to the claimant. As a result, the claimant does not increase the basis of its interest in the master tenant by the amount of Section 50(d) income and the investor would likely recognize a gain rather than a loss on disposition of its master tenant interest.

Since most investors dispose of their interest shortly after the end of the five-year recapture period, 34/39ths of the HTC Section 50(d) income for a commercial building would not have been reported at the time of disposition. If the entire amount of the unreported Section 50(d) income is accelerated on disposition, the inclusion of such a large amount of income in Year 6 significantly reduces the investor's yield. Thankfully, the new guidance provides that, absent an election to accelerate the unreported Section 50(d) income into the taxable year of disposition, the investor reports Section 50(d) income over the remaining 34 years regardless of when it disposes of its interest in the master tenant, so long as the disposition occurs after the end of the recapture period. While on a present-value basis, deferring taxable income for 34 years improves yield, the investor must establish a dependable and accurate reporting structure to keep track of the unreported deferred income.

The new guidance is applicable to buildings placed in service on or after Sept. 19, a date approximately 60 days after the date that the guidance was released. In most HTC transactions, the rehabilitated building is placed in service well after 60 days from the closing date. Accordingly, many recently closed transactions, negotiated under the old rules, will now be subject to the new guidance. Affected taxpayers may want to revisit such recently closed transactions to reprice the transaction and restructure any tax credit adjusters. While examples that apply the rules contained in the new guidance to specific fact situations reference a July 1, 2016, placed-in-service date, we understand that IRS representatives have stated that pre-effective date used in the guidance examples was an error that will be corrected. The examples should not be interpreted as a statement that the IRS will apply new rules to buildings placed in service before the effective date.

Participants in new HTC transactions face a number of questions. Transactions closed after the publication of this article will negotiate and price their deal under the new rules. The participants must decide, however, whether to use the master lease pass-through structure or a simpler single-tier structure. Factors that will guide the decision include whether (1) an enhanced SNDA is available from the lender, (2) the reduced value of a master tenant interest is relevant in exit planning (3) cash flow sharing and loss allocation differences between the two structures are important, and (4) whether the investor is willing to accept the receipt of phantom income for an extended period of time.

For participants in recently closed transactions, a different set of questions arise. First, will all of the buildings be placed in service before or after Sept. 19, 2016, the effective date of the new guidance? If the rehabilitated property is placed in service in phases or contains multiple buildings that are completed before and after Sept. 19, will the investor require that the

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master tenant apply the new rules to all phases or all buildings included in the project?

For master tenants in closed deals which are rehabilitating buildings that will be placed in service after Sept. 19, should the guarantees, pricing, adjusters, exit strategy and other arrangements be renegotiated? In most cases, it would be advisable to review and renegotiate the terms of the investment after the investor determines whether it will make the acceleration election.

For projects that were placed in service before Sept. 19, and as to which the taxpayer has filed a federal income tax return that included 50(d) income in basis, the participants must decide whether to change the accounting method previously applied to the transaction. 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. On the other hand, Revenue Procedure 2014-12 specifically excluded the treatment of 50(d) income from required compliance with Code Section 704 guidance, a clear indication that the law was not settled before the issuance and effective date of the new guidance. While investors may prefer following the new guidance in these situations, developers can be expected to resist repricing deals that technically are not subject to Treasury Regulations Section 1.50-1T. Taxpayers should consult with counsel, the accountants who will prepare the tax returns and should consider raising the issue with their auditors.

With the issuance of the new guidance, the significant federal income tax uncertainties hanging over the industry have been resolved. Investors and developers can now be confident in their knowledge of the applicable rules and pricing methodology. This confidence should be reflected in an increase in the pool of potential investors as well as an increase in the number of transactions closed.❖

Jerome Breed practices in the Washington, D.C. office of the law firm of Bryan Cave LLP. Mr. Breed focuses his practice on tax planning and the structuring of low-income housing, historic rehabilitation and new markets tax credit transactions. Mr. Breed has closed many low-income housing, historic rehabilitation and new markets tax credit transactions that permit his clients to maximize tax benefits and investment returns, all within the framework of the client's business goals. He has substantial experience in the taxation of community development and new markets credit investments.

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