AUTHENTICATED U.S. GOVERNMENT INFORMATION GPO

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9872]

RIN 1545–BM74

Income Inclusion When Lessee Treated as Having Acquired Investment Credit Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that provide guidance concerning the income inclusion rules under section 50(d)(5) of the Internal Revenue Code (Code) that are applicable to a lessee of investment credit property when a lessor of such property elects to treat the lessee as having acquired the property. These final regulations also provide rules to coordinate the section 50(a) recapture rules with the section 50(d)(5) income inclusion rules. In addition, these final regulations provide rules regarding income inclusion upon a lease termination, lease disposition by a lessee, or disposition of a partner's or S corporation shareholder's entire interest in a lessee partnership or S corporation outside of the recapture period. Accordingly, these regulations will affect lessees of investment credit property when the lessor of the property makes an election to treat the lessee as having acquired the property and an investment credit is determined under section 46 with respect to such lessee.

DATES:

Effective date: These regulations are effective on July 17, 2019.

Applicability date: For date of applicability, see § 1.50–1(f).

FOR FURTHER INFORMATION CONTACT: Barbara J. Campbell or Michael J. Torruella Costa, (202) 317–4137 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

I. Overview

This document amends the Income Tax Regulations (26 CFR part 1) to finalize rules under section 50(d)(5) of the Code. On July 22, 2016, the Department of the Treasury (Treasury Department) and the IRS published in the **Federal Register** a notice of proposed rulemaking by cross-reference to temporary regulations ((REG–102516–15) (81 FR 47739)) (proposed regulations) and final and temporary regulations ((TD 9776) (81 FR 47701)) (temporary regulations) that amended § 1.50–1 of the Income Tax Regulations. On September 23, 2016, the Treasury Department and the IRS published corrections to the temporary regulations in the **Federal Register** (81 FR 65541). (Subsequent references in this preamble to the temporary regulations are to the temporary regulations as so corrected.) The Treasury Department and the IRS received two written comments on the proposed regulations. No requests for a public hearing were made, and no public hearing was held. After consideration of the comments received, these final regulations adopt the proposed regulations without modification.

II. Section 50 Background

Section 50(d) provides special rules applicable to the investment credit determined under section 46 (investment credit property). Section 50(d)(5) provides the income inclusion rules applicable to a lessee of investment credit property when a lessor elects to treat the lessee as having acquired the property. Section 50(d)(5) provides that, for purposes of the investment credit, rules similar to former section 48(d) (as in effect prior to the enactment of the Revenue Reconciliation Act of 1990 (Pub. L. 101–508, 104 Stat 1388 (November 5, 1990))) apply.

Former section 48(d)(1) permitted a lessor of new section 38 property to elect to treat that property as having been acquired by the lessee for an amount equal to its fair market value (or, if the lessor and lessee were members of a controlled group of corporations, equal to the lessor's basis). Former section 48(d)(3) provided that if the lessor made the election provided in former section 48(d)(1) with respect to any such property, the lessee would be treated for all purposes of subpart E, part IV, subchapter A, Chapter 1, subtitle A, as having acquired such property. Section 50(a)(5)(A) replaced the term "section 38 property" with the term "investment credit property."

Under former section 48(q), if a credit was determined under section 46 with respect to section 38 property, the basis of the property was reduced by 50 percent of the amount of the credit determined (or 100 percent of the amount of the credit determined in the case of a credit for qualified rehabilitation expenditures). Former section 48(d)(5) provided specific rules coordinating the effect of the former section 48(d) election with the basis adjustment rules under former section 48(q). Because the lessee would have no basis in the property that the lessee was deemed to have acquired pursuant to the election, former section 48(d)(5)(A) provided that the basis adjustment rules under former section 48(q) did not apply. Section 50(c) replaced former section 48(q) and provides the current basis adjustment rules.

In lieu of a basis adjustment, former section 48(d)(5)(B) provided that the lessee was required to 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 50 percent of the amount of the credit allowable under section 38 to the lessee with respect to such property. In the case of the rehabilitation credit, former section 48(q)(3) provided that former section 48(d)(5)(B) was to be applied without the phrase "50 percent of."

Former section 48(d)(5)(C) provided that, in the case of a disposition of property to which former section 47 (the former recapture rules) applied, the income inclusion rules of former section 48(d)(5) applied in accordance with regulations prescribed by the Secretary. Section 50(a) replaced former section 47 and provides the current recapture rules.

The temporary regulations provide the applicable rules that the Secretary determined are similar to the rules of former section 48(d)(5). The temporary regulations are limited in scope to the income inclusion rules that apply when a lessor elects under § 1.48–4 to treat the lessee as having acquired investment credit property.

The temporary regulations provide general rules for coordinating the basis adjustment rules under section 50(c) (the successor to former section 48(q)) with the rules under § 1.48–4 pursuant to which a lessor may elect to treat the lessee of investment credit property as having acquired such property for purposes of calculating the investment credit. Similar to the rule in former section 48(d)(5)(A), which provided that the basis adjustment rules under former section 48(q) did not apply when a § 1.48–4 election was made, the temporary regulations provide that section 50(c) does not apply when the election is made. Thus, the lessor is not required to reduce its basis in the property by the amount of the investment credit (or 50 percent of the amount of the credit in the case of the energy credit under section 48) determined under section 46.

The temporary regulations require that, in lieu of a basis adjustment, and similar to the rule contained in former section 48(d)(5)(B), a lessee must include in gross income an amount

equal to the amount of the credit (or 50 percent of the amount of the credit in the case of the energy credit under section 48) determined under section 46. The lessee includes the amount ratably over the shortest recovery period applicable under the accelerated cost recovery system provided in section 168, beginning on the date the investment credit property is placed in service and continuing on each one-year anniversary date thereafter until the end of the applicable recovery period. The amount required to be included by the lessee is not subject to any limitations under section 38(c) on the amount of the credit allowed based on the amount of the lessee's income tax.

Because section 50(c) replaces the old basis adjustment rules under former section 48(q), the amount the lessee is required to include in gross income under the temporary regulations corresponds to the current basis adjustment amounts required under section 50(c), rather than the former basis adjustment amounts provided in former section 48(q).

The temporary regulations include special rules for partnerships and S corporations. In the case of a partnership (other than an electing large partnership) or an S corporation for which an election is made under § 1.48–4 to treat such entity as having acquired the investment credit property, each partner or S corporation shareholder that is the ultimate credit claimant is treated as the lessee for purposes of the income inclusion rules under the temporary regulations. The term *ultimate credit claimant* is defined in the temporary regulations as any partner or S corporation shareholder that files (or that would file) Form 3468, ''Investment Credit'' (or its successor form), with such partner's or S corporation shareholder's income tax return to claim the investment credit determined under section 46 that results in the corresponding income inclusion under the temporary regulations. Each partner or S corporation shareholder that is the ultimate credit claimant must include in gross income the amount required under the temporary regulations in proportion to the amount of the credit determined under section 46 (or 50 percent of the amount of the credit in the case of the energy credit under section 48) with respect to the partner or S corporation shareholder.

The temporary regulations also coordinate the income inclusion rules with the credit recapture rules in section 50(a). The temporary regulations provide that, when the investment credit recapture rules under section 50(a) are triggered (including when there is a lease termination), causing a recapture of the credit or a portion of the credit, an adjustment will be made to the lessee's (or, as applicable, the ultimate credit claimant's) gross income for any discrepancies between the total amount included in gross income under the income inclusion requirement in the temporary regulations and the total credit allowable after recapture. The adjustment amount is taken into account in the taxable year in which the property is disposed of or otherwise ceases to be investment credit property. The temporary regulations provide rules for when the amount of the unrecaptured credit (that is, the allowable credit after taking into account the recapture amount, or 50 percent of the unrecaptured credit in the case of the energy credit) exceeds the income inclusion, and when the income inclusion exceeds the unrecaptured credit.

The temporary regulations also allow a lessee or an ultimate credit claimant to make an irrevocable election to include in gross income any remaining income required to be taken into account under § 1.50–1T(b)(2) in the taxable year in which the lease terminates or is otherwise disposed of. Similarly, the temporary regulations provide that if an ultimate credit claimant disposes of its entire interest, either direct or indirect, in a partnership (other than an electing large partnership) or an S corporation, the ultimate credit claimant may make an irrevocable election to include in gross income any remaining income required to be taken into account by the temporary regulations in the taxable year of the disposition. The availability of this election allows a lessee or an ultimate credit claimant to account for any remaining required gross income inclusion in the taxable year in which the lease terminates or is otherwise disposed of or in which an ultimate credit claimant exits its investment.

This election is available only outside of the section 50(a) recapture period, and only if the lessee or the ultimate credit claimant was not already required to accelerate the gross income required to be included under § 1.50–1T(b)(2) because of a recapture event during the recapture period. Additionally, a former partner or S corporation shareholder that no longer owns a direct or indirect interest in the lessee partnership or S corporation may not elect to accelerate the gross income required to be included under the temporary regulations at the time of a termination or disposition of the lease by the lessee partnership or S corporation. The appropriate time for a former partner or S corporation shareholder that is an ultimate credit claimant to elect income acceleration is the taxable year that it disposes of its entire interest in a lessee partnership or S corporation.

Summary of Comments and Explanation of Provisions

I. Reconsideration of the Special Rule for Partnerships and S Corporations

The temporary regulations (§ 1.50–1T(b)(3)) clarify that the gross income inclusion is not an item of partnership income or an item of S corporation income to which the rules of subchapter K or subchapter S apply. One commenter requested that the Treasury Department and the IRS reconsider the rules in § 1.50–1T(b)(3) based on a concern that the operation of the rules will decrease the amount of investment that flows into the credit programs, which will result in less cash available for projects. The commenter also expressed a related concern that requiring credit claimants to identify and track the income inclusion will add additional complexity to the investments.

As explained in the preamble to the temporary regulations, because the investment credit and any limitations on the credit itself are determined at the partner or S corporation shareholder level it is appropriate that the income inclusion occurs at the partner or shareholder level. In the case of a partnership that owns the investment credit property, a partner in a partnership is treated as the taxpayer with respect to the partner's share of the basis of partnership investment credit property under § 1.46–3(f)(1) and separately computes the investment credit based on its share of the partnership's basis in the investment credit property. 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. Each partner in the lessee partnership will separately compute the investment credit based on each partner's share of the investment credit property. The credit is therefore computed at the partner level based on partner level limitations. Section 1.704–1(b)(4)(ii), which requires allocations with respect to the investment tax credit provided by section 38 to be made in accordance with the partners' interests in the partnership, provides that allocations of cost or qualified investment (as opposed to the investment credit itself, which is

not determined at the partnership level) made in accordance with § 1.46–3(f) shall be deemed to be made in accordance with the partners' interests in the partnership.

Under similar principles, in the case of a lessor that makes an election under § 1.48–4 to treat a lessee S corporation as having acquired investment credit property, each shareholder in the lessee S corporation is the taxpayer with respect to whom the investment credit is determined under section 46. The credit is therefore computed at the S corporation shareholder level based on shareholder level limitations.

The Treasury Department and the IRS have determined that the burden of income inclusion should match the benefits of the allowable credit. Therefore, because the investment credit and any limitations on the credit are determined at the partner or shareholder level, these final regulations adopt the rule from the proposed regulations that provides that the gross income required to be ratably included is not an item of partnership income for purposes of subchapter K or an item of S corporation income for purposes of subchapter S. Accordingly, the basis adjustment rules that would apply if such gross income was an item of income under section 702 or section 1366, such as section 705(a) (providing for an increase in a partner's outside basis for items of partnership income) or section 1367(a) (providing for an increase in an S corporation shareholder's stock basis for items of S corporation income), do not apply.

When the temporary regulations were issued, the Treasury Department and the IRS were aware that some partnerships and S corporations had taken the position that this income is includible by the partnership or S corporation and that their partners or S corporation shareholders were entitled to increase their bases in their partnership interests or S corporation stock as a result of the income inclusion. The Treasury Department and the IRS determined that such basis increases 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.

The investment credit rules operate to allow a taxpayer to claim the benefit of the 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. Where the taxpayer claiming the credit owns the investment credit property, the basis reduction provided in section 50(c) results in reduced cost recovery deductions over the life of the property or the realization of gain (or a reduction in the amount of loss realized) upon the disposition of the property. In the case of a lessor that elects under § 1.48–4 to treat the lessee of investment credit property as having acquired such property, § 1.50–1T(b)(2) instead requires the lessee to ratably include this amount in gross income over the life of the property.

If that lessee is a partnership or an S corporation, however, some partnerships and S corporations contend that this income inclusion is treated as an item of partnership or S corporation income that entitles their partners or S corporation shareholders to a corresponding outside basis increase under section 705(a) or section 1367(a). If these partners or S corporation shareholders were entitled to an outside basis increase equal to their share of the income inclusion, they would be able to claim an offsetting loss (or reduce the amount of gain realized) upon the disposition of their partnership interests or S corporation shares.

As noted, the Treasury Department and the IRS have concluded that the income inclusion is not properly treated as an item of partnership income or of S corporation income. Nonetheless, had the Treasury Department and the IRS determined otherwise, the Treasury Department and the IRS have decided 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. The income to be included is a notional amount, which has no current or future economic effect on the basis of assets held by a partnership or S corporation. 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 H.R. Rep. No. 1337, 83d Cong., 2d Sess. A225 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 384 (1954); H.R. Rep. No. 97–826, 97th Cong., 2d Sess. p. 17 (1982); S. Rep. No. 97–640, 97th Cong., 2d Sess. 16, 18 (1982); and Rev. Rul. 96–11 (1996–1 CB 140). Ultimately, the Treasury Department and the IRS have determined that, under any approach, allowing partners and S corporation shareholders a basis increase to offset the income inclusion required by the temporary regulations upon disposition of their partnership interests or S corporation shares is inappropriate, and that Congress did not intend to allow partners and S corporation shareholders the full benefit of the credit without any of the corresponding burden.

Additionally, the Treasury Department and the IRS are aware that one practitioner questioned whether the Supreme Court's holding in *U.S.* v. *Basye,* 410 U.S. 441 (1973), is contrary to the position taken in the temporary regulations that the notional income created under section 50(d)(5) is not an item of partnership income computed under section 703. In *Basye,* the partnership entered into a contractual arrangement whereby a portion of the payments it received for services rendered was redirected to a trust established for the benefit of the partnership's partner and non-partner physicians. The payments were not forfeitable by the partnership or recoverable by the payor upon the happening of any contingency. The Court held that because the payments represented compensation for services rendered by the partnership, the partnership was required to include them in current income and each partner was required to include his distributive share of those amounts in his income. The Court stated:

> This conclusion rests on two familiar principles of income taxation, first, that income is taxed to the party who earns it and that liability may not be avoided through an anticipatory assignment of that income, and, second, that partners are taxable on their distributive or proportionate shares of current partnership income irrespective of whether that income is actually distributed to them.

Basye at 447–448.

The Treasury Department and the IRS believe that *Basye* is inapplicable to the determination that the notional income created under section 50(d)(5) is not an item of partnership income computed under section 703. Unlike the income at issue in *Basye,* the income created under section 50(d)(5) is not ''earned'' by the partnership. It has no economic effect as it is merely a notional item created to mimic the effect of the basis adjustment under former section 48(q) with respect to a lessee. Further, treating it as a partnership income item would generate an inappropriate basis increase to the partners under section 705 that would allow them to take a non-economic loss.

II. Basis Reduction Election

The temporary regulations (§ 1.50–1T(c)) allow a lessee or an ultimate

credit claimant, under certain circumstances, to elect to accelerate the income inclusion outside of the section 50(a) recapture period (income acceleration election). This income acceleration election is available in the taxable year in which the lease terminates or is otherwise disposed of or when an ultimate credit claimant disposes of their entire interest in the partnership or the S corporation. One commenter requested that the final regulations permit the lessor and lessee of investment credit property, together with the ultimate credit claimant, to make an irrevocable ''basis reduction election.'' This election would allow the lessor of investment credit property to reduce the basis of the property by the remaining amount of the ultimate credit claimant's income inclusion in lieu of requiring the ultimate credit claimant to continue to account for the income inclusion or make the income acceleration election. The commenter suggested that the ''basis reduction election'' be permitted after the recapture period when a lease termination occurs or when an ultimate credit claimant disposes of their entire interest in the partnership or S corporation. The commenter requested that the Treasury Department and the IRS adopt the ''basis reduction election'' based on policy considerations the Treasury Department and the IRS took into account when incorporating the income acceleration election in the temporary regulations.

As previously noted, the investment credit rules operate to allow a taxpayer to claim the benefit of the 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. In the case of a lessee, in lieu of a basis adjustment, and similar to the rule contained in former section 48(d)(5)(B), the lessee (or an ultimate credit claimant) must include in gross income an amount equal to the amount of the credit (or 50 percent of the amount of the credit in the case of the energy credit under section 48) determined under section 46. The Treasury Department and the IRS did consider the administrative convenience and reduced reporting burden for taxpayers when permitting the income acceleration election. The Treasury Department and the IRS also determined that such an election is consistent with the applicable rules in former section 48(d)(5)(B), because a lessee (or an ultimate credit claimant) that benefitted from the credit is the appropriate party to recognize the gross income inclusion described in the statute.

The Treasury Department and the IRS have determined that the suggested ''basis reduction election'' is inconsistent with the applicable rules in former section 48(d)(5)(B) because the election would allow the lessee or ultimate credit claimant that recognized the benefit of the credit to transfer the burden of the offsetting income inclusion to the lessor. The suggested ''basis reduction election'' would essentially permit participants in investment credit leasing transactions to unwind the transactions after the section 50(a) recapture period. For these reasons, the Treasury Department and the IRS do not adopt this recommendation in the final regulations.

III. Amount of Credit Included Ratably in Gross Income

The temporary regulations (§§ 1.50–1T(b)(2) and (3)) require a lessee or an ultimate credit claimant to include ratably in gross income, over the shortest recovery period which could be applicable under section 168 with respect to that property, an amount equal to the amount of the credit (or 50 percent of the amount of the energy credit under section 48). The temporary regulations made applicable the rule in former section 48(d)(5) that required the lessee of investment credit property to recognize the gross income inclusion over the shortest applicable recovery period under section 168. One commenter suggested that the final regulations allow a lessee or ultimate credit claimant to calculate the income inclusion based on the depreciation methods and conventions applicable to the underlying investment credit property. The commenter described an example where an owner-lessor of investment credit property elects to depreciate rental property over 40 years instead of over the usual 27½ year recovery period, and the lessee or ultimate credit claimant reports the offsetting income inclusion over the same 40-year period instead of the shortest recovery period. The commenter suggested that the approach is equitable and can be justified under the ''rules similar to'' language in section 50(d)(5), which provides that for purposes of the investment credit, rules similar to former section 48(d) apply.

The Treasury Department and the IRS have determined that the applicable rules from the temporary regulations (§ 1.50–1T(b)(2) and (3)) are the correct interpretation of the language in section 50(d)(5). A rule that permits a lessee or ultimate credit claimant to calculate the income inclusion based on the depreciation methods and conventions applicable to the underlying investment credit property is dissimilar to the rule in former section 48(d)(5)(B), because it contradicts the plain language of the statute. Adopting a rule that would allow a lessor or an ultimate credit claimant to recognize the income inclusion over a longer recovery period would facilitate an inappropriate income deferral, and create additional reporting and monitoring burden. For these reasons, the Treasury Department and the IRS are not adopting this recommendation in the final regulations.

IV. Request for Comments in the Proposed Regulations

The preamble to the proposed regulations included a specific request for comments regarding whether guidance is needed to address the applicability of the income inclusion rules under section 50(d)(5) to trusts, estates, and/or electing large partnerships. No comments were received in response to this request. However, the Treasury Department and the IRS are aware that, given the reference to electing large partnerships, some questioned how the temporary regulations would interact with the centralized partnership audit regime enacted as part of the Bipartisan Budget Act of 2015. Such guidance is beyond the scope of these final regulations.

V. Effective and Applicability Dates

The temporary regulations were effective on July 22, 2016, and applicable to investment credit property placed in service on or after the date that is 60 days after the date of filing in the **Federal Register** (September 19, 2016). The preamble to the temporary regulations states that the effective date of the regulations should not be construed to create any inference concerning the proper interpretation of section 50(d) prior to the effective date of the regulations. Both commenters requested that the final regulations clarify the treatment of pre-effective date transactions.

Both commenters also requested that the effective date be modified to limit the application of the rules for investment partnership transactions entered into in prior years. Both commenters noted that different portions of a project could be placed in service both before and after the effective date, because some historic rehabilitation projects involve multiple placed in service dates (for example, if a project involves renovating multiple buildings over a period of years). One commenter proposed to deem an entire project as placed in service on the first

placed in service date when contemporaneous evidence shows that the project will include more than one building. The other commenter suggested that the effective date be based on timing of investment in the investment partnership, rather than the placed in service date.

The Treasury Department and the IRS do not adopt these recommendations in the final regulations. These final regulations are effective on July 17, 2019, and are applicable to investment credit property placed in service on or after September 19, 2016. Section 7805(b)(1)(B) provides that a final regulation may apply to a taxable period ending on or after the date on which a proposed or temporary regulation to which the final regulation relates was filed with the **Federal Register**. The applicability date of the rules in the final regulations is September 19, 2016, the same date as the applicability date of the rules as set forth in the temporary regulations. Those regulations were issued as temporary regulations to address investment credit transactions in which partnerships and S corporations treated the income inclusion as an item of partnership or S corporation income that entitled their partners or S corporation shareholders to a corresponding outside basis increase under section 705(a) or section 1367(a). Such a basis increase would allow these partners or S corporation shareholders to claim an inappropriate loss (or reduce the amount of gain realized) upon the disposition of their partnership interests or S corporation shares. Revising the rules in accordance with commenters' suggestions would conflict with the purpose of these regulations. Accordingly, the applicability date of the final regulations corresponds to the applicability date of the temporary regulations. Similar to the temporary regulations, the applicability date of these final regulations should not be construed to create any inference concerning the proper interpretation of section 50(d) prior to the applicability date of these regulations.

VI. Revenue Procedure 2014–12

As explained in the Effect on Other Documents section of TD 9776, the temporary regulations modified Revenue Procedure 2014–12 (2014–3 IRB 415). Because these final regulations remove the temporary regulations from the **Federal Register**, this Treasury decision includes an identical modification to Rev. Proc. 2014–12 in the Effect on Other Documents section. Rev. Proc. 2014–12 establishes the requirements under which the IRS will not challenge partnership allocations of section 47 rehabilitation credits by a partnership to its partners. Section 3 states that Rev. Proc. 2014–12 does not address how a partnership is required to allocate the income inclusion required by section 50(d)(5). Furthermore, section 4.07 of Rev. Proc. 2014–12 provides that, solely for purposes of determining whether a partnership meets the requirements of that section, the partnership's allocation to its partners of the income inclusion required by section 50(d)(5) shall not be taken into account.

Because § 1.704–1(b)(4)(ii) provides that allocations of cost or qualified investment, and not the investment credit itself (which is not determined at the partnership level), made in accordance with § 1.46–3(f) shall be deemed to be made in accordance with the partners' interests in a partnership, this Treasury decision modifies Rev. Proc. 2014–12 by changing all references to allocations of section 47 rehabilitation credits to refer instead to allocations of qualified rehabilitation expenditures under section 47(c)(2). Additionally, because § 1.50–1(b)(3) provides that the gross income required to be included under section 50(d)(5) is not an item of partnership income to which the rules of subchapter K apply, this Treasury decision modifies Rev. Proc. 2014–12 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).

VII. Recapture of the Rehabilitation Credit

These regulations finalize the rules described in § 1.50–1T(c) that coordinate the credit recapture rules in section 50(a) with the income inclusion rules in § 1.50–1T(b)(2) and (3). These final regulations incorporate the rule from the temporary regulations requiring the lessee or ultimate credit claimant to make an adjustment to gross income for any discrepancies between the total amounts included in gross income under the income inclusion rules and the total unrecaptured credit. When the temporary regulations were published in 2016, section 47(a) provided that the rehabilitation credit was 20% of the qualified rehabilitation expenditures (QREs) with respect to a certified historic structure. Section 47(a) was amended by section 13402 of the Tax Cuts and Jobs Act, Public Law 115–97, 131 Stat. 2054, 2134 (TCJA). Section 47(a)(1) now provides that for any taxable year during the 5-year period beginning in the taxable year in which the qualified rehabilitated building is placed in service, the rehabilitation credit for the year is an amount equal to the ratable share. Section 47(a)(2) defines the ratable share as 20 percent of the qualified rehabilitation expenditures with respect to the qualified rehabilitated building, as allocated ratably to each year during the period. The TCJA did not amend section 47(b), which provides that qualified rehabilitation expenditures with respect to any qualified rehabilitated building are taken into account for the taxable year in which the building is placed in service. These final regulations adopt the rules from the temporary regulations, but the Treasury Department and the IRS request comments addressing whether additional guidance under section 50(a) is needed to coordinate recapture of the rehabilitation credit.

Effect on Other Documents

Rev. Proc. 2014–12 (2014–3 IRB 415) is modified by: (1) Changing all references to allocations of section 47 rehabilitation credits to refer instead to allocations of qualified rehabilitation expenditures under section 47(c)(2); and (2) 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).

Statement of Availability of IRS Documents

Rev. Proc. 2014–12 (2014–3 IRB 415) is published in the Internal Revenue Bulletin (or Cumulative Bulletin) and is available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by visiting the IRS website at *http://www.irs.gov.*

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Department of the Treasury and the Office of Management and Budget regarding review of tax regulations. Therefore, a regulatory impact assessment is not required. Because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses. No comments were received from the Small Business Administration.

Drafting Information

The principal authors of these temporary regulations are Barbara J. Campbell and Michael J. Torruella Costa, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by removing the entry for § 1.50–1T to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** Section 1.50–1 is revised to read as follows:

§ 1.50–1 Lessee's income inclusion following election of lessor of investment credit property to treat lessee as acquirer.

(a) *In general.* Section 50(d)(5) provides that, for purposes of computing the investment credit, rules similar to the rules of former section 48(d) (relating to certain leased property) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990 (Pub. L. 101–508, 104 Stat. 1388 (November 5, 1990))) apply. This section provides rules similar to the rules of former section 48(d)(5) that the Secretary has determined shall apply for purposes of determining the inclusion in gross income required when a lessor elects to treat a lessee as having acquired investment credit property.

(b) *Coordination with basis adjustment rules.* In the case of any property with respect to which an election is made under § 1.48–4 by a lessor of investment credit property to treat the lessee as having acquired the property—

(1) *Basis adjustment.* Section 50(c) does not apply with respect to such property.

(2) *Amount of credit included ratably in gross income*—(i) *In general.* A lessee of the property must include ratably in gross income, over the shortest recovery period which could be applicable under section 168 with respect to that property, an amount equal to the amount of the credit determined under section 46 with respect to that property. The ratable income inclusion under this paragraph begins on the date the investment credit property is placed in service and continues on each one year anniversary date thereafter until the end of the applicable recovery period. The lessee will include in gross income the amount of its credit determined under section 46 regardless of limitations on the amount of the credit allowed under section 38(c) based on the amount of the lessee's income tax.

(ii) *Special rule for the energy credit.* In the case of any energy credit determined under section 48(a), paragraph (b)(2)(i) of this section applies only to the extent of 50 percent of the amount of the credit determined under section 46.

(3) *Special rule for partnerships and S corporations*—(i) *In general.* For purposes of paragraph (b)(2) of this section, if the lessee of the property is a partnership (other than an electing large partnership) or an S corporation, the gross income includible under such paragraph is not an item of partnership income to which the rules of subchapter K of Chapter 1, subtitle A of the Code apply or an item of S corporation income to which the rules of subchapter S of Chapter 1, subtitle A of the Code apply. Any partner or S corporation shareholder that is an ultimate credit claimant (as defined in paragraph (b)(3)(ii) of this section) is treated as a lessee that must include in gross income the amounts required under paragraph (b)(2) of this section in proportion to the credit determined under section 46 with respect to such partner or S corporation shareholder.

(ii) *Definition of ultimate credit claimant.* For purposes of this section, the term *ultimate credit claimant* means any partner or S corporation shareholder that files (or that would file) Form 3468, "Investment Credit," with such partner's or S corporation shareholder's income tax return to claim an investment credit determined under section 46 with respect to such partner or S corporation shareholder.

(c) *Coordination with the recapture rules*—(1) *In general.* If section 50(a) requires an increase in the lessee's or the ultimate credit claimant's tax or a reduction in the carryback or carryover of an unused credit (or both) as a result of an early disposition (including a lease termination), etc., of leased property for which an election had been made under § 1.48–4, the lessee or the ultimate credit claimant is required to include in gross income an amount equal to the excess, if any, of the amount of the credit that is not recaptured over the total increases in gross income previously made under paragraph (b)(2) of this section with respect to the property. Such amount is in addition to the amounts the lessee or the ultimate credit claimant previously included in gross income under paragraph (b)(2) of this section.

(2) *Income inclusion exceeds unrecaptured credit.* If section 50(a) requires an increase in the lessee's or ultimate credit claimant's tax or a reduction in the carryback or carryover of an unused credit (or both) as a result of an early disposition (including a lease termination), etc., of leased property for which an election had been made under § 1.48–4, the lessee's or the ultimate credit claimant's gross income shall be reduced by an amount equal to the excess, if any, of the total increases in gross income previously included under paragraph (b)(2) of this section over the amount of the credit that is not recaptured.

(3) Special rule for the energy credit. In the case of any energy credit determined under section 48(a), paragraphs (c)(1) and (2) of this section apply by substituting the phrase "50 percent of the amount of the credit that is not recaptured" for the phrase "the amount of the credit that is not recaptured."

(4) *Timing of income inclusion or reduction following recapture.* Any adjustment required by paragraphs (c)(1) and (2) of this section is taken into account in the taxable year in which the property is disposed of or otherwise ceases to be investment credit property.

(d) Election to accelerate income inclusion outside of the recapture period—(1) *In general.* If after the recapture period described in section 50(a), but prior to the expiration of the recovery period described in paragraph (b)(2) of this section, there is a lease termination, the lessee otherwise disposes of the lease, or a partner or S corporation shareholder that is an ultimate credit claimant disposes of its entire interest, either direct or indirect, in a lessee partnership (other than an electing large partnership) or S corporation, the lessee, or, in the case of a partnership or S corporation, the ultimate credit claimant may irrevocably elect to take into account the remaining amount required to be included in gross income under this section in the taxable year of the disposition or termination.

(2) *Exceptions.* The election provided under paragraph (d)(1) of this section is not available to—

(i) Lessees or ultimate credit claimants required by paragraph (c) of this section to account for the remaining amount required to be included in gross income after accounting for recapture in

the taxable year in which the property was disposed of or otherwise ceased to be investment credit property under section 50(a); or

(ii) Former partners or S corporation shareholders that own no interest, either direct or indirect, in a lessee partnership or S corporation at the time of a lease termination or disposition.

(3) *Manner and time for making election.* The election under paragraph (d)(1) of this section is made by including the remaining amount required to be included under this section in gross income in the taxable year of the lease termination or disposition or the disposition of the ultimate credit claimant's entire interest, either direct or indirect, in a partnership or S corporation. The election must be made on or before the due date (including any extension of time) of the lessee's income tax return, or, in the case of a partnership or S corporation, the ultimate credit claimant's income tax return for the taxable year in which the lease termination or disposition or the disposition of the ultimate credit claimant's entire interest, either direct or indirect, in a partnership or S corporation occurs.

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

(1) *Example 1.* X, a calendar year C corporation, leases nonresidential real property from Y. The property is placed in service on October 1, 2016. Y elects under § 1.48–4 to treat X as having acquired the property. X's investment credit determined under section 46 for 2016 with respect to such property is $9,750. The shortest recovery period that could be available to the property under section 168 is 39 years. Because Y has elected to treat X as having acquired the property, Y does not reduce its basis in the property under section 50(c). Instead, X, the lessee of the property, must include ratably in gross income over 39 years an amount equal to the credit determined under section 46 with respect to such property. Under paragraph (b)(2) of this section, X's increase in gross income for each of the 39 years beginning with 2016 is $250 ($9,750/39 year recovery period).

(2) *Example 2.* The facts are the same as in *Example 1* in paragraph (e)(1) of this section, except that instead of nonresidential real property, X leases from Y solar energy equipment for which an energy credit under section 48 is determined under section 46. X's investment credit determined under section 46 for 2016 with respect to the property is $9,750. The shortest recovery period that could be available to the property under section 168 is 5 years. X, the lessee of the property, must include ratably in gross income over 5 years an amount equal to 50% of the credit determined under section 46 with respect to such property. Under paragraph (b)(2) of this section, X's increase in gross income for each of the 5 years beginning with 2016 is $975 ($4,875/5 year recovery period).

(3) *Example 3.* A and B, calendar year taxpayers, form a partnership, the AB partnership, that leases nonresidential real property from Y. The property is placed in service on October 1, 2016. Y elects under § 1.48–4 to treat the AB partnership as having acquired the property. A's investment credit determined under section 46 for 2016 is $3,900 and B's investment credit determined under section 46 for 2016 is $7,800 with respect to the property. The shortest recovery period that could be available to the property under section 168 is 39 years. Because Y has elected to treat the AB partnership as having acquired the property, Y does not reduce its basis in the building under section 50(c). Instead, A and B, the ultimate credit claimants, must include the amount of the credit determined with respect to A and B under section 46 ratably in gross income over 39 years, the shortest recovery period available with respect to such property. Therefore, A and B must include ratably in gross income over 39 years under paragraph (b)(2) of this section an amount equal to $3,900 and $7,800, respectively. Under paragraph (b)(2) of this section, A's increase in gross income for each of the 39 years beginning with 2016 is $100 ($3,900/39 year recovery period) and B's is $200 ($7,800/39 year recovery period). Because the gross income A and B are required to include under paragraph (b)(2) of this section is not an item of partnership income, the rules under subchapter K applicable to items of partnership income do not apply with respect to such income. In particular, A and B are not entitled to an increase in the outside basis of their partnership interests under section 705(a) and are not entitled to an increase in their capital accounts under section 704(b).

(4) *Example 4.* The facts are the same as in *Example 3* in paragraph (e)(3) of this section, except that on January 1, 2019, the lease between AB partnership and Y terminates (Y retains ownership of the property), which is a recapture event under section 50(a). A's and B's income tax for 2019 is increased under section 50(a) by $2,340 and $4,680, respectively (60% of $3,900 and $7,800, respectively, assuming that the aggregate decrease in the credits allowed under section 38 was the full amount of the investment credits determined as to A and B under section 46). Therefore, the amount of the unrecaptured credit as to A and B is $1,560 and $3,120, respectively (40% of $3,900 and $7,800, respectively). The amounts that A and B previously included in gross income under paragraph (b)(2) of this section are $300 ($100 for each of 2016, 2017, and 2018) and $600 ($200 for each of 2016, 2017, and 2018), respectively. A and B are required under paragraph (c)(1) of this section to include in gross income an amount equal to the excess of the credit that is not recaptured ($1,560 and $3,120, respectively) over the total increases in gross income previously made under paragraph (b)(2) of this section with respect to the property ($300 and $600, respectively). Therefore, A and B must include in gross income $1,260 and $2,520, respectively, in the taxable year of the lease termination (2019) in addition to the recapture amounts described above.

(5) *Example 5.* (i) The facts are the same as in *Example 4* in paragraph (e)(4) of this section, except that instead of nonresidential real property, the AB partnership leases from Y solar energy equipment for which an energy credit under section 48 is determined under section 46. Because the shortest recovery period that could be available to the property under section 168 is 5 years, A and B are required under paragraph (b)(2)(ii) of this section to include ratably in gross income over 5 years an amount equal to 50% of the credit determined under section 46 with respect to such property (50% of $3,900/5, or $390, per year for A, and 50% of $7,800/5, or $780, per year for B).

(ii) The January 1, 2019 lease termination requires A's and B's income tax for 2019 to be increased under section 50(a) by $2,340 and $4,680, respectively (60% of $3,900 and $7,800, respectively). Therefore, the amount of the unrecaptured credit as to A and B is $1,560 and $3,120, respectively (40% of $3,900 and $7,800, respectively). Under paragraph (b)(2)(ii) of this section, the amounts A and B previously included in gross income are $1,170 ($390 for each of 2016, 2017, and 2018) and $2,340 ($780 for each of 2016, 2017, and 2018), respectively. A and B are entitled to a reduction in gross income under paragraph (c)(2) of this section equal to the excess of the total increases in gross income made under paragraph (b)(2)(ii) of this section ($1,170 and $2,340, respectively) over 50% of the amount of the credit that is not recaptured ($780 and $1,560, respectively). Therefore, A and B are entitled to a reduction in gross income in the amount of $390 and $780, respectively, in the taxable year of the lease termination (2019).

(6) *Example 6.* (i) The facts are the same as in *Example 3* in paragraph (e)(3) of this section, except that on December 1, 2021, A sells its entire interest to C, and on January 1, 2022, the lease between AB partnership and Y terminates. At the time of the lease termination, B is still a partner in the AB partnership. There is no recapture event under section 50(a) because both the lease termination and the disposition of A's interest in the partnership occurred outside of the recapture period.

(ii) At the time that A sold its interest in the AB partnership to C, A had previously included $500 ($100 for each of 2016–2020) in gross income under paragraph (b)(2) of this section. Under paragraph (b)(2) of this section, A must continue to include the remaining $3,400 (including $100 in 2021) in gross income ratably over the remaining portion of the applicable recovery period of 39 years. Alternatively, under paragraph (d)(1) of this section, A may irrevocably elect to include the remaining $3,400 in gross income in the taxable year that A sold its entire interest in the AB partnership to C (2021). Pursuant to paragraph (d)(2) of this section, A cannot make this election in the taxable year of the lease termination (2022).

(iii) At the time of the lease termination, B had previously included $1,200 ($200 for each of 2016–2021) in gross income under paragraph (b)(2) of this section. Under

paragraph (b)(2) of this section, B must continue to include the remaining $6,600 required in gross income ratably over the remaining portion of the applicable recovery period of 39 years. Alternatively, under paragraph (d)(1) of this section, B may irrevocably elect to include the remaining $6,600 in gross income in the taxable year of the lease termination (2022).

(f) *Applicability date.* This section applies to property placed in service on or after September 19, 2016.

§ 1.50–1T [Removed]

■ **Par. 3.** Section 1.50–1T is removed.

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

Approved: June 21, 2019.

David J. Kautter,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2019–15497 Filed 7–17–19; 4:15 pm]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Alcohol and Tobacco Tax and Trade Bureau

27 CFR Part 9

[Docket No. TTB–2018–0009; T.D. TTB–156; Ref: Notice No. 178]

RIN 1513–AC43

Establishment of the Crest of the Blue Ridge Henderson County Viticultural Area

AGENCY: Alcohol and Tobacco Tax and Trade Bureau, Treasury.

ACTION: Final rule; Treasury decision.

SUMMARY: The Alcohol and Tobacco Tax and Trade Bureau (TTB) establishes the approximately 215-square mile ‘‘Crest of the Blue Ridge Henderson County’’ viticultural area in Henderson County, North Carolina. The Crest of the Blue Ridge Henderson County viticultural area is not located within any other established viticultural area. TTB designates viticultural areas to allow vintners to better describe the origin of their wines and to allow consumers to better identify wines they may purchase.

DATES: This final rule is effective August 19, 2019.

FOR FURTHER INFORMATION CONTACT: Karen A. Thornton, Regulations and Rulings Division, Alcohol and Tobacco Tax and Trade Bureau, 1310 G Street NW, Box 12, Washington, DC 20005; telephone 202–453–1039, ext. 175.

SUPPLEMENTARY INFORMATION:

Background on Viticultural Areas

TTB Authority

Section 105(e) of the Federal Alcohol Administration Act (FAA Act), 27 U.S.C. 205(e), authorizes the Secretary of the Treasury to prescribe regulations for the labeling of wine, distilled spirits, and malt beverages. The FAA Act provides that these regulations should, among other things, prohibit consumer deception and the use of misleading statements on labels and ensure that labels provide the consumer with adequate information as to the identity and quality of the product. The Alcohol and Tobacco Tax and Trade Bureau (TTB) administers the FAA Act pursuant to section 1111(d) of the Homeland Security Act of 2002, codified at 6 U.S.C. 531(d). The Secretary has delegated various authorities through Treasury Department Order 120–01, dated December 10, 2013 (superseding Treasury Order 120–01, dated January 24, 2003), to the TTB Administrator to perform the functions and duties in the administration and enforcement of these laws.

Part 4 of the TTB regulations (27 CFR part 4) authorizes the establishment of definitive viticultural areas and regulates the use of their names as appellations of origin on wine labels and in wine advertisements. Part 9 of the TTB regulations (27 CFR part 9) sets forth standards for the preparation and submission of petitions for the establishment or modification of American viticultural areas (AVAs) and lists the approved AVAs.

Definition

Section 4.25(e)(1)(i) of the TTB regulations (27 CFR 4.25(e)(1)(i)) defines a viticultural area for American wine as a delimited grape-growing region having distinguishing features, as described in part 9 of the regulations, and a name and a delineated boundary, as established in part 9 of the regulations. These designations allow vintners and consumers to attribute a given quality, reputation, or other characteristic of a wine made from grapes grown in an area to the wine's geographic origin. The establishment of AVAs allows vintners to describe more accurately the origin of their wines to consumers and helps consumers to identify wines they may purchase. Establishment of an AVA is neither an approval nor an endorsement by TTB of the wine produced in that area.

Requirements

Section 4.25(e)(2) of the TTB regulations (27 CFR 4.25(e)(2)) outlines the procedure for proposing an AVA and provides that any interested party may petition TTB to establish a grape-growing region as an AVA. Section 9.12 of the TTB regulations (27 CFR 9.12) prescribes standards for petitions for the establishment or modification of AVAs. Petitions to establish an AVA must include the following:

- Evidence that the area within the proposed AVA boundary is nationally or locally known by the AVA name specified in the petition;
- An explanation of the basis for defining the boundary of the proposed AVA;
- A narrative description of the features of the proposed AVA affecting viticulture, such as climate, geology, soils, physical features, and elevation, that make the proposed AVA distinctive and distinguish it from adjacent areas outside the proposed AVA boundary;
- The appropriate United States Geological Survey (USGS) map(s) showing the location of the proposed AVA, with the boundary of the proposed AVA clearly drawn thereon; and
- A detailed narrative description of the proposed AVA boundary based on USGS map markings.

Crest of the Blue Ridge Henderson County Petition

TTB received a petition from Mark Williams, the executive director of Agribusiness Henderson County, and Barbara Walker, the county extension support specialist for North Carolina Cooperative Extension, on behalf of local vineyards and winery operators, proposing the establishment of the ‘‘Crest of the Blue Ridge Henderson County’’ AVA in Henderson County, North Carolina. The proposed Crest of the Blue Ridge Henderson County AVA covers approximately 215 square miles and is not located within any other AVA. There are 14 commercial vineyards covering a total of approximately 70 acres within the proposed AVA, as well as two bonded wineries. According to the petition, an additional 55 acres of vineyards are planned for planting in the next five years.

According to the petition, the distinguishing features of the proposed AVA are its climate and topography—specifically its elevation. Elevation can influence such climatic factors as temperature, length of growing season, and precipitation. The petition describes the Crest of the Blue Ridge Henderson County AVA as straddling the Eastern Continental Divide, colloquially known as the Crest of the Blue Ridge. The crest separates two