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New Tax Rules Curtail Benefits Of Pass-Through Leases

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The Internal Revenue Service recently released new proposed and temporary regulations addressing certain investment tax credit issues in a so-called "pass-through lease" structure. A pass-through lease is a structure in which the lessor of an investment tax credit-eligible asset makes an election to pass through the investment tax credit to the lessee of the asset, which lessee is frequently a partnership. The term "inverted lease" is sometimes used to refer to a pass-through lease structure in which each of the lessor and the lessee is a partnership, and the lessor and lessee partnerships are related to each other. The new regulations apply an "aggregate" treatment to partnerships (and S corporations) to ensure that any investment tax credit is appropriately taxable to the taxpayer that used the credit.

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As discussed in more detail below, if a partner in a partnership that claimed an investment tax credit transfers its partnership interest during the deemed income period, these new regulations require the remaining income inclusion to be accelerated and to be recognized by the transferor. Further, under these regulations, the deemed income inclusion occurs at the partner level such that it does not result in an increase to the partners' outside basis.

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Although these temporary regulations are primarily directed at the structuring of historic tax credit transactions, the temporary regulations do have a limited effect with respect to solar transactions where the credit is passed through to a partnership (particularly the outside basis adjustment in the case of partnership lessees, as discussed below).

The context of the new regulations is that the investment tax credit recapture period is five years for each of the historic and energy tax credits. Recapture refers to the imposition of additional tax to recover the benefit of an investment tax credit where an asset for which the investment tax credit was claimed is either transferred (or an interest in a partnership that owns the asset is transferred) or removed from service during that five-year recapture period (i.e., the first five years from the date the asset was first placed in service).[1]

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Further, Congress determined that claiming the investment tax credit should come at a cost. In a typical transaction, that cost is the reduction of the basis of the eligible asset by either the amount of the credit for historic investment tax credits,[2] or half of the amount of the credit in the case of energy investment tax credits.[3] However, that construct does not work when the lessor makes an

election to pass through the investment tax credit to a lessee, as the lessee is not the owner of the asset and, therefore, has no basis in the tax credit-eligible asset. Thus, in the case of a pass-through lease, rather than reducing the basis of the asset by the full amount of the credit in a historic tax credit transaction (or half of the credit in an energy tax credit transaction), the lessee includes the comparable amount in income pro rata over the depreciable life of the eligible asset.[4]

For energy investment tax credits, the depreciable life of the eligible asset is the same as the recapture period — that is, five years. However, for historic investment tax credits, there is a divergence between the five-year recapture period and the 39-year depreciable life of the real estate to which the credits relate. Therefore, in a historic tax credit transaction, after the recapture period but before the end of the deemed income inclusion period (e.g., in the sixth year), a partner in a lessee could sell its partnership interest and avoid recapture.[5]

Many partners in historic tax credit inverted lease transactions had taken a beneficial tax reporting position with respect to the remaining income inclusion: the transferor partner avoided the income inclusion over the remainder of the 39-year depreciable life of the historic building (i.e., the income was allocated to whomever the partners were after the transfer). This created an incentive for such partners to exit the partnership shortly after the recapture period.

In addition, the lessee partnerships had taken the reporting position that the deemed income inclusion occurred at the partnership level such that it resulted in an increase to the partners' outside basis under Section 705 of the Internal Revenue Code. Outside basis is what determines if a partner has a gain or loss upon the sale of its partnership interest. This increase in outside basis resulted in the partner recognizing a loss (typically characterized as capital) upon the sale of its partnership interest. Therefore, the after-tax cost of the deemed income inclusion that Congress intended as the quid pro quo for claiming the investment tax credit was substantially mitigated, assuming the partner had sufficient capital gains to absorb the capital loss.

The new regulations preclude each of these reporting positions. First, if a partner that claimed the investment tax credit transfers its partnership interest during the deemed income period (i.e., 39 years for the historic investment tax credit and five years for the energy investment tax credit), the remaining income inclusion is accelerated and must be recognized by the transferor.[6]

Second, the regulations provide that the deemed income inclusion occurs at the partner level, such that it does not result in an increase to the partners' outside basis. Therefore, the capital loss gambit is precluded. This aspect will change the financial modeling of both historic and energy investment tax credit inverted leases and make them somewhat less attractive to tax equity investors.

The regulations are on their face prospective; they are effective for transactions involving assets placed in service 60 days after the regulations are published in the Federal Register. However, the Treasury decision explaining the regulations makes it clear that the rules in the regulations are based on existing tax policy and certain statutory provisions.[7]

Further, the Treasury decision provides, "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." This language is somewhat boilerplate, but when combined with the tax policy and statutory rationales for the tax accounting rules adopted in the regulations, it could be a harbinger that the IRS intends to challenge the inverted lease reporting positions that were addressed by these regulations. Parties to existing transactions involving these reporting positions may want to review the

documentation to determine whether a successful IRS challenge would result in an indemnity. Further, financial statement preparers may want to consider if a reserve for the tax benefits that result from these reporting positions is merited under ASC 740 (formerly FIN 48).

The regulations also implicitly confirm that an inverted lease (i.e., a pass-through lease between related partnerships) is viable for solar projects and other energy investment tax credit assets. This implication is consistent with the IRS issuing private letter rulings permitting late elections to be made in energy inverted leases. However, there is still not any official structuring guidance for energy inverted lease transactions. IRS Revenue Procedure 2014-12 provides structuring guidance for historic tax credit inverted leases, but even that guidance leaves many questions unanswered, such as what level of relatedness is permissible between the lessor and lessee partnerships.

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[1] See, generally, I.R.C. § 50(a)(1).

[2] See I.R.C. § 50(c)(1).

[3] I.R.C. § 50(c)(3).

[4] I.R.C. § 50(d)(5) (referencing old § 48(d)).

[5] In contrast, this issue does not arise in an energy investment tax credit inverted lease transaction because the recapture period and the deemed income inclusion period are each five years. As parties are generally adverse to the cost of recapture, by the time there is a transfer, the deemed income inclusion period is also over.

[6] If the transfer occurs during the five-year recapture period, which would be an extremely rare occurrence, the new regulations have a provision to avoid a double detriment to the transferor.

[7] For example, the Treasury decision provides, “The Treasury Department and the IRS believe 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.”

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