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TAX ALERT

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Master tenant HTC transactions: IRS treatment of 50(d) income

The historic tax credit industry has long expected guidance from the Internal Revenue Service (IRS) addressing how income is required to be recognized under Internal Revenue Code (Code) Section 50(d) when a "master tenant" structure is used in a transaction generating federal historic tax credits under Code Section 47 (HTCs). On July 22, 2016, the IRS released Temporary Treasury Regulation Section 1.50-1T that address several of the previously unanswered questions.[1] The regulations are effective for projects placed into service after Sept. 19, 2016. The regulations state that they "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."

In large part, the guidance is negative, meaning that the use of a master tenant structure is likely to result in significant taxable income to a federal HTC investor (federal investor). Generally, the regulations eliminate some of the benefits of using a master tenant structure versus a single-tier structure. That said, a master tenant structure may still be attractive in certain situations, depending upon (i) the identity and economic goals of the developer and the federal investor, (ii) whether other tax credits such as new markets tax credits or low-income housing tax credits are

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part of the transaction, (iii) whether the developer is uncomfortable with the federal investor being a member of the owner entity, and (iv) whether the lenders to the transaction are willing to provide an SNDA[2] but not a foreclosure forbearance agreement.

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In summary, the new 50(d) regulations:

- Provide income inclusion rules under Code Section 50(d)(5) generally
- Provide special income inclusion rules for partners of the master tenant who claim the credit (called "ultimate credit claimants" in the regulations"), principally being the federal investor assuming the federal investor has a 99 percent partnership interest in the master tenant
- Provide an election to accelerate Code Section 50(d) income upon a lease termination or the disposition of a partner's *entire* interest in master tenant after the end of the five-year HTC recapture period
- Coordinate HTC recapture rules with the Code Section 50(d) rules

Analysis

General 50(d) Rules

The owner entity (the landlord) of a HTC property that uses a long-term master lease may make an election to treat the lessee of the property (the master tenant) as having acquired the property for purposes of the federal HTC. In that situation, the HTC emanates from the master tenant and the landlord is not required to reduce the property's basis under Code Section 50(c) by the amount of the HTCs. The benefit of not having to reduce the depreciable basis of the property, along with the flexibility afforded by using a master tenant structure,[3] has made the use of master tenant HTC transactions popular in the past.

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Under Section 1.50-1T(b)(2) of the new regulations, the master tenant must include in gross income an amount equal to *100 percent* of the amount of the HTCs. Previously some industry participants believed that only 50 percent of the HTC had to be recognized, although in informal guidance released more than a year ago, the IRS stated that 100 percent of the HTC amount was recognized under Code Section 50(d). Code Section 50(d) income is not affected by any limits on a partner's ability to actually use the HTCs.

Unless an election is made (discussed below), the "ultimate credit claimant"[4] must take into income the 50(d) income ratably over the shortest applicable ACRS depreciation period under Code Section 168. Generally, these recovery periods are 39 years for nonresidential real property and 27.5 years for residential real property, both beginning on the date of placement in service.

Effect on partners of the master tenant

Most master tenant entities are structured as partnerships. Special "look through" rules apply for partners of the master tenant partnership, causing the 50(d) income event to occur at the partner level. Each partner that is an ultimate credit claimant is treated as a proportionate lessee, which in most cases is the federal investor for 99 percent of the HTCs and an affiliate of the developer for one percent of the HTCs. Thus, each credit-claiming partner must include in gross income its proportionate share of the 50(d) income. The regulations state that the income inclusion is a *partner, not a partnership, item*. This means that the 50(d) income recognized by a partner of the master tenant does not increase the partner's outside basis in its partnership interest or its capital account. Practically, this means that being required to recognize the 50(d) income is not merely a "timing issue" or a "quality of income issue" because the federal investor will not recognize less capital gain, or a larger capital loss, due to the 50(d) income if and when the federal investor exits the master tenant. The regulations also supersede some arguably inconsistent portions of the federal HTC Safe Harbor under Revenue Procedure 2014-12 (the Safe Harbor).[5]

Federal HTC partner's exit and election to accelerate 50(d) income

The regulations allow for either the master tenant or its partners to make elections to accelerate remaining 50(d) income into certain situations. Either the master tenant or any ultimate credit claimant (e.g., the federal

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investor) may make an acceleration election in the taxable year in which the master lease terminates. Similarly, an ultimate credit claimant may make an election in the taxable year that the ultimate credit claimant exits the partnership, for example under a put provision permitted by the Safe Harbor. These elections can only be made after of the five-year recapture period and only can be made if the lessee or the ultimate credit claimant was not required to accelerate gross income because of a recapture event during the recapture period.

While the regulations do not explicitly state what happens to the 50(d) income if the acceleration election is not made but the lease terminates, the federal investor puts out of the deal, the master tenant entity is no longer a "partnership," or the master tenant entity liquidates or dissolves, an example in the regulations is helpful to determining what happens. Because the IRS views the 50(d) income as not being a partnership item under the example if an acceleration election is not made, each ultimate credit claimant nevertheless continues to recognize one year's worth of 50(d) income through the end of the 39-year or 27.5-year depreciation period even if the ultimate credit claimant is no longer a partner of the master tenant, the lease terminates, or the master tenant partnership no longer exists.

Coordination of 50(d) income with HTC recapture provisions

If there is an HTC recapture event during the five-year HTC recapture period, including a premature termination of the master lease, the regulations provide that a corresponding adjustment will be made to the master tenant's or ultimate credit claimant's 50(d) income in the year of the HTC recapture. As adjusted for recaptured HTCs, the remaining 50(d) income is includable in income of each ultimate credit claimant in the year the recapture occurs.

Conclusion

Structuring HTC transactions take careful planning by developers, investors, and lenders and their counsel. Porter Wright's tax credit attorneys are experienced with structuring HTC transactions and all other facets of HTC transactions. Please contact Mark Snider, Dave Tumen or any member of Porter Wright's Tax Credit Practice Group if you would like to discuss the regulations further.

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1. The same text is concurrently both a *temporary* Treasury Regulation and a *proposed* Treasury Regulation. The new regulations also apply to other investment tax credits, including energy credits, with some differences.

2. An SNDA is a subordination, non-disturbance and attornment agreement under which, generally, the master lease is preserved in certain situations, even if the landlord defaults on its loan and the lender forecloses.

3. Flexibility is afforded by allowing the developer or sponsor to own a large percentage of the landlord entity, allowing depreciation to be received largely by the developer and flexibility in splitting cash flow between the landlord and master tenant entities to the extent permitted by the Safe Harbor. In addition, the use of a master tenant structure has provided more flexibility in *splitting* federal and state HTCs between different investors or splitting of federal HTCs and other tax credits.

4. Defined as "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."

5. The Safe Harbor contains references to *allocations* of HTCs to partners and states that the Safe Harbor "does not address how a [p]artnership is required to 'allocate' the income inclusion required by Section 50(d)(5)." Because the new regulations state that the HTCs and 50(d) income are partner items and are items allocated by the partnership, limited revisions to the Safe Harbor are made by the new regulations.

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