

**DEPARTMENT OF THE TREASURY****Internal Revenue Service****26 CFR Part 1**

[TD 9776]

RIN 1545-BM74

**Income Inclusion When Lessee Treated as Having Acquired Investment Credit Property****AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Final and temporary regulations.

**SUMMARY:** This document contains temporary regulations that provide guidance regarding 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 temporary regulations also provide rules to coordinate the section 50(a) recapture rules with the section 50(d)(5) income inclusion rules. In addition, these temporary 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 such 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. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the Proposed Rules section in this issue of the **Federal Register**.

**DATES:**

*Effective Date:* These regulations are effective on July 22, 2016.

*Applicability Date:* For date of applicability, see § 1.50-1T(f).

**FOR FURTHER INFORMATION CONTACT:**

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**SUPPLEMENTARY INFORMATION:****Background**

These temporary regulations amend the Income Tax Regulations (26 CFR part 1) under section 50(d)(5) to provide the income inclusion rules applicable to a lessee of investment credit property when a lessor elects to treat the lessee as having acquired such 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 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 only 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.

**Explanation of Provisions***A. Scope*

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

*B. In General*

Section 1.50-1T(b) provides the 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, § 1.50-1T(b)(1) provides 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 determined under section 46 (or 50 percent of the amount of the credit in the case of the energy credit under section 48).

Under § 1.50-1T(b)(2), 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, in the case of the section 48 energy credit, 50 percent of the amount of the credit) determined under section 46. Generally, the lessee includes such 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 these temporary regulations in

§ 1.50–1T(b)(2) 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).

### C. Special Rule for Partnerships and S Corporations

Section 1.50–1T(b)(3) provides that, 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 § 1.50–1T(b)(2). The term *ultimate credit claimant* is defined in § 1.50–1T(b)(3)(ii) 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 § 1.50–1T(b)(2). Each partner or S corporation shareholder that is the ultimate credit claimant must include in gross income the amount required under § 1.50–1T(b)(2) 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 Treasury Department and the IRS believe that, 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 actually 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 basis of 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 an 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 believe 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 temporary regulations in § 1.50–1T(b)(3) provide that the gross income required to be ratably included under § 1.50–1T(b)(2) 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 rules that would apply were such gross income an item of income under section 702 or section 1366, such as section 705(a) (providing for an increase in the partner’s outside basis for items of income) or section 1367(a) (providing for an increase in the S corporation shareholder’s stock basis for items of income) do not apply.

The Treasury Department and the IRS are aware that some partnerships and S corporations have taken the position that this income is includible by the partnership or S corporation and that their partners or S corporation shareholders are 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 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.

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. 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 basis increase under section 705(a) or section 1367(a). As a result of the basis increase, these partners or S corporation shareholders claim a 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 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. 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 concluded that, under any approach, allowing

partners and S corporation shareholders a basis increase to offset the income inclusion required by § 1.50-1T(b)(2) 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.

#### *D. Coordination With the Recapture Rules*

Section 1.50-1T(c) provides that if the investment credit recapture rules under section 50(a) are triggered (including if 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 these temporary regulations in § 1.50-1T(b)(2) 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.

If 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 amount previously included in gross income under § 1.50-1T(b)(2), the lessee's (or the ultimate credit claimant's) gross income is increased. The lessee (or the ultimate credit claimant) is required to include in gross income an amount equal to the excess of the amount of the credit that is not recaptured (or 50 percent of the amount of the credit that is not recaptured in the case of the energy credit) over the amount of the total increases in gross income previously made under § 1.50-1T(b)(2). This amount is in addition to the amounts previously included in gross income under § 1.50-1T(b)(2).

If the income inclusion prior to recapture under § 1.50-1T(b)(2) exceeds 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, the lessee's (or the ultimate credit claimant's) gross income is reduced. The lessee's or ultimate credit claimant's gross income is reduced by an amount equal to the excess of the total increases in gross income previously made under § 1.50-1T(b)(2) over the amount of the credit that is not recaptured (50 percent of the amount of the credit that is not

recaptured in the case of the energy credit).

#### *E. Election To Accelerate Income Inclusion Outside of the Recapture Period*

Section 1.50-1T(d)(1) provides that a lessee or an ultimate credit claimant may 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, § 1.50-1T(d)(1) provides 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 under § 1.50-1T(b)(2) in the taxable year in which the ultimate credit claimant no longer owns a direct or indirect interest in the lessee of the investment credit property. 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 it is exiting 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 owns no direct or indirect interest in the lessee partnership or S corporation may not elect to accelerate the gross income required to be included under § 1.50-1T(b)(2) 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.

Section 1.50-1T(d)(2) provides that the election to accelerate the income inclusion must be made by the due date (including any extension of time) of the lessee's return, or, in the case of a partnership or S corporation, by the due date (including any extension of time) of the ultimate credit claimant's return for the taxable year in which the relevant event occurs (for example, the lease termination, lease disposition, or disposition of the entire interest in the

lessee partnership or S corporation). The election is made by including the remaining gross income required by these temporary regulations in the taxable year of the relevant event (for example, the lease termination, lease disposition, or disposition of the entire interest in the lessee partnership or S corporation).

#### *F. Applicability Date*

These temporary regulations apply with respect to investment credit property placed in service on or after the date that is 60 days after the date of filing of these regulations in the **Federal Register**. 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.

#### *G. Rev. Proc. 2014-12*

Rev. Proc. 2014-12 (2014-3 IRB 415) 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 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 § 1.50-1T(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).

#### **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 Web site at <http://www.irs.gov>.

#### Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For applicability of the Regulatory Flexibility Act, please refer to the Special Analyses section of the preamble to the cross-referenced notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

#### Drafting Information

The principal author of these temporary regulations is Jennifer A. Records, 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 continues 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) through (f) [Reserved]. For further guidance, see § 1.50–1T(a) through (f).

■ **Par. 3.** Section 1.50–1T is added to read as follows:

#### § 1.50–1T Lessee's income inclusion following election of lessor of investment credit property to treat lessee as acquirer (temporary).

(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 unrecovered 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:

*Example 1.* X, a calendar year C corporation, leases nonresidential real property from Y. The property is placed in service on July 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).

*Example 2.* The facts are the same as in *Example 1* of this paragraph (e), 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).

*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 July 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).

*Example 4.* The facts are the same as in *Example 3* of this paragraph (e), 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.

*Example 5.* (i) The facts are the same as in *Example 4* of this paragraph (e), 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).

*Example 6.* (i) The facts are the same as in *Example 3* of this paragraph (e), 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.

(g) *Expiration date.* The applicability of this section will expire on or before July 19, 2019.

**John Dalrymple,**  
*Deputy Commissioner for Services and Enforcement.*

Approved: June 1, 2016.

**Mark J. Mazur,**  
*Assistant Secretary of the Treasury (Tax Policy).*

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**DEPARTMENT OF DEFENSE**

**Department of the Navy**

**32 CFR Part 706**

**Certifications and Exemptions Under the International Regulations for Preventing Collisions at Sea, 1972**

**AGENCY:** Department of the Navy, DoD.

**ACTION:** Final rule.

**SUMMARY:** The Department of the Navy (DoN) is amending its certifications and exemptions under the International Regulations for Preventing Collisions at Sea, 1972 (72 COLREGS), to reflect that the Deputy Assistant Judge Advocate General (DAJAG) (Admiralty and Maritime Law) has determined that USS RAFAEL PERALTA (DDG 115) is a vessel of the Navy which, due to its special construction and purpose, cannot fully comply with certain provisions of the 72 COLREGS without interfering with its special function as a naval ship. The intended effect of this rule is to warn mariners in waters where 72 COLREGS apply.

**DATES:** This rule is effective July 22, 2016 and is applicable beginning June 27, 2016.

**FOR FURTHER INFORMATION CONTACT:** Commander Theron R. Korsak, (Admiralty and Maritime Law), Office of the Judge Advocate General, Department of the Navy, 1322 Patterson Ave. SE., Suite 3000, Washington Navy Yard, DC 20374–5066, telephone 202–685–5040.

**SUPPLEMENTARY INFORMATION:** Pursuant to the authority granted in 33 U.S.C. 1605, the DoN amends 32 CFR part 706.

This amendment provides notice that the DAJAG (Admiralty and Maritime Law), under authority delegated by the Secretary of the Navy, has certified that USS RAFAEL PERALTA (DDG 115) is a vessel of the Navy which, due to its special construction and purpose, cannot fully comply with the following specific provisions of 72 COLREGS without interfering with its special function as a naval ship: Annex I,

paragraph 3(a), pertaining to the location of the forward masthead light in the forward quarter of the ship, and the horizontal distance between the forward and after masthead lights; Annex I, paragraph 3(c), pertaining to placement of task lights not less than two meters from the fore and aft centerline of the ship in the athwartship direction; and Annex I, paragraph 2(f)(ii), pertaining to the vertical placement of task lights. The DAJAG (Admiralty and Maritime Law) has also certified that the lights involved are located in closest possible compliance with the applicable 72 COLREGS requirements.

Moreover, it has been determined, in accordance with 32 CFR parts 296 and 701, that publication of this amendment for public comment prior to adoption is impracticable, unnecessary, and contrary to public interest since it is based on technical findings that the placement of lights on this vessel in a manner differently from that prescribed herein will adversely affect the vessel's ability to perform its military functions.

**List of Subjects in 32 CFR Part 706**

Marine safety, Navigation (water), and Vessels.

For the reasons set forth in the preamble, the DoN amends part 706 of title 32 of the Code of Federal Regulations as follows:

**PART 706—CERTIFICATIONS AND EXEMPTIONS UNDER THE INTERNATIONAL REGULATIONS FOR PREVENTING COLLISIONS AT SEA, 1972**

■ 1. The authority citation for part 706 continues to read as follows:

**Authority:** 33 U.S.C. 1605.

■ 2. Section 706.2 is amended by:

■ a. In Table Four, paragraph 15, adding, in alpha numerical order, by vessel number, an entry for USS RAFAEL PERALTA (DDG 115); and

■ b. In Table Five, by adding, in alpha numerical order, by vessel number, an entry for USS RAFAEL PERALTA (DDG 115).

**§ 706.2 Certifications of the Secretary of the Navy under Executive Order 11964 and 33 U.S.C. 1605.**

\* \* \* \* \*

**Table Four**

\* \* \* \* \*

15. \* \* \*