Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201507020**
Release Date: 2/13/2015

CC:PSI:5:RBChapman
POSTN-145918-14

UILC: 50.00-00, 50.01-01

date: January 8, 2015

to: Mary Ann Waters, Senior Counsel
SB/SE Division Counsel, Area 2, CC:SB:2:RCH

from: Paul Handleman, Chief, Branch 5, Office of the Associate Chief Counsel
(Passthroughs & Special Industries), CC:PSI:5

---

subject: Form 4255 and Section 47 Rehabilitation Credits

This Chief Counsel Advice responds to your request for assistance dated December 17, 2014. This advice may not be used or cited as precedent.

ISSUES

1. What is the correct computation of the increase in tax imposed by § 50(a)(1) in the factual situation described below?

2. What, if any, is the adjustment to the carryover of the credit? How is that computed and what is the statutory basis for the computation?

3.

FACTS

On January 10, 2011, X, a calendar-year taxpayer, places property A (a qualified rehabilitated building (QRB) and certified historic structure) in service, with respect to which X made qualified rehabilitation expenditures (QREs) of $500,000. The credit determined under § 47(a) with respect to property A is $100,000. None of the credit is disallowed by § 469 for any year. X's tax liability limit under § 38(c) for 2011 is $20,000;

X therefore uses $20,000 of this credit to offset tax for taxable year 2011 and has a carryover of $80,000 that cannot be used in 2010 and is therefore a carryforward to 2012 under § 39. X's tax liability limit under § 38(c) for 2012 is $16,000; X therefore uses $16,000 of this credit to offset tax for taxable year 2012 and has a carryforward of $64,000 to 2013 under § 39. On June 2, 2013, X disposes of the property. X has no other tax credits in any taxable year.

CONCLUSIONS

1. The correct computation of the increase in tax imposed by § 50(a)(1) in the factual situation presented above is $21,600.
2. The adjustment to the carryover of the credit is reduced in the amount of $38,400, reducing the carryover from $64,000 to $25,600.
3. [redacted]
[redacted].

LAW AND ANALYSIS

Section 38(a) generally allows as a credit against tax in a given taxable year the sum of the business credit carryforwards carried to that taxable year (§ 38(a)(1)), the current year business credit (§ 38(a)(2)), and the business credit carrybacks carried to that year (§ 38(a)(3)). Section 38(b)(1) provides that the business credit includes the investment credit determined under § 46, which in turn provides that the investment credit includes the rehabilitation credit.

Section 38(c) imposes a limit, based on tax liability, on the amount of business credit allowed under § 38(a) for a taxable year. Section 39(a)(1)(A) provides generally for a one-year carryback and § 39(a)(1)(B)) for a twenty-year carryforward.

Section 50(a)(1)(A) provides that, under regulations prescribed by the Secretary, if, during any taxable year, investment credit property is disposed of, or otherwise ceases to be investment credit property with respect to the taxpayer, before the close of the recapture period, then the tax under chapter 1 for such taxable year shall be increased by the recapture percentage of the aggregate decrease in the credits allowed under § 38 for all prior taxable years which would have resulted solely from reducing to zero any credit determined under subpart D (§§ 38 through 50) with respect to such property.

Section 50(a)(1)(B) provides that the recapture percentage is 100 percent for property disposed of within one year, reduced by 20 percentage points for each additional year the property is held:

If the property ceases to be investment credit property within –	The recapture percentage is:
(i) One full year after placed in service	100
(ii) One full year after the close of the period described in clause (i)	80
(iii) One full year after the close of the period described in clause (ii)	60
(iv) One full year after the close of the period described in clause (iii)	40
(v) One full year after the close of the period described in clause (iv)	20

Section 50(a)(3) provides that in the case of a cessation described in § 50(a)(1), the carrybacks and carryforwards under § 39 shall be adjusted by reason of such cessation. Section 50(a)(5)(C) provides that the increase in tax under § 50(a)(1) shall not be treated as a tax imposed by chapter A for purposes of determining the amount of any credit allowable under that chapter; as a result, available business credits, whether from the recapture property or otherwise, may not be used to offset the increase in tax under § 50(a)(1).

The rule in § 50(a)(1) was enacted in largely the same form as § 47(a)(5) by the Economic Recovery Tax of 1981 (ERTA), Pub. L. 97-34, § 211(g)(1), when recapture rules were developed for property subject to the accelerated cost recovery system (ACRS). For property placed in service before the effective date of ERTA (and for non-recovery property placed in service thereafter), the increase in tax was computed under § 47(a)(1).[1] Section 47(a)(5) was recodified as § 50(a)(1)(A) by the Revenue Reconciliation Act of 1990, Pub. L. 101-508, § 11813(a), which applies to all investment credit property placed in service after December 31, 1990.

The unambiguous language of § 50(a)(1)(A) requires the following mechanical computational steps. First, the statute requires computation of the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from reducing to zero any credit determined under subpart E with respect to the recapture property. The computation of this aggregate decrease requires three steps: (a) Compute the amount of credits that were actually allowed under § 38 in all taxable years prior to the recapture year; (b) recompute the amount of credits that would have been allowed under § 38 in all taxable years prior to the recapture year had

there been no credit determined from the recapture property; and (c) subtract the amount in step (b) from the amount in step (a). This difference is the aggregate decrease in the credits allowed under § 38 for all prior taxable years which would have resulted solely from reducing to zero any credit determined under this subpart with respect to such property (the "aggregate decrease"). Second, once the aggregate decrease is determined, § 50(a)(1)(A) requires the aggregate decrease be multiplied by the recapture percentage. The product of this multiplication is the increase in tax required by § 50(a)(1)(A).

Issue 1: What is the correct computation of the increase in tax imposed by § 50(a)(1) in the factual situation presented above?

Applying the mechanical computational rules of § 50(a)(1) to the factual situation you asked about results in an increase in tax of $21,600. Section 50(a)(1)(A) requires the computation of the aggregate decrease in the credits allowed under § 38 for all prior taxable years which would have resulted solely from reducing to zero any credit determined under this subpart with respect to property disposed of during the recapture period. The increase in tax is the product of the aggregate decrease and the recapture percentage.

Although the rules for computing the increase in tax under § 50(a)(1) differ considerably from the rules under former § 47(a)(1), the identical phrase, "aggregate decrease in the credits allowed under section 38 for all prior taxable years," appears in paragraphs (1) and (2) of § 50(a) and also appeared in paragraphs (1) and (5) of former § 47(a).

Section 1.47-1(a)(1)(i), promulgated under former § 47(a)(1),[2] provides that the aggregate decrease is the total decrease, in each prior taxable year, in "the credits allowed for the credit year and any other taxable year affected by the reduction in credit earned for the credit year." The distinction between "credit earned" and "credits allowed" implies that the aggregate decrease measures the difference in credits used to offset tax liability with and without the relevant hypothetical condition.

The regulations also provide examples of how to compute the hypothetical aggregate decrease in the credits allowed under section 38 for all prior taxable years. In § 1.47-1(d) Example 3, the taxpayer earned credits of $2,520 ($840 for each of three properties) and was allowed a credit of $1,520 against its liability for 1962 tax, $100 against 1963 tax, and $100 against 1964 tax. The taxpayer disposed of one of the three properties three years and eleven months after placing it in service. Due to the disposition, the example recomputes the qualified investment for that property to be zero and the credit earned to be $1,680, of which the taxpayer would have used $1,520 for 1962, $100 for 1963, and $60 for 1964. The aggregate decrease, the difference

between credits actually allowed in all prior years and the credits that would have been allowed in those prior years, is $40.

In Example 4, the taxpayer earned an investment credit of $840 for 1962, which was allowed in full for 1962. In 1963, the taxpayer earned an investment credit of $400 but had no tax liability. In 1964, the taxpayer earned an investment credit of $400 but had no tax liability. In 1965 its liability for tax was $200 and its credit earned was zero. In 1966, a little over three years after placing the 1962 credit property in service, the taxpayer sold the property. The example recomputes the qualified investment for the property to be zero and the taxpayer's recomputed credit earned for 1962 to be zero. The example states:

> If such zero recomputed credit earned had been taken into account in place of the $840 original credit earned, the entire $400 unused credit from 1963 (including the $200 portion which was originally allowed as a credit for 1965) and the $400 unused credit for 1964 would have been allowed as investment credit carrybacks against X Corporation's liability for tax of $840 for 1962[.]

Therefore, the example concludes that the aggregate decrease, and therefore the increase in tax under former § 47(a)(1), is "the $240 aggregate reduction in the credits allowed by section 38 for the taxable years 1962 and 1965 (that is, $1,040 credit allowed minus $800 which would have been allowed)."

Examples 3 and 4 make clear that the aggregate decrease in the recapture rules is the excess of (i) the total amount by which the credits allowable under § 38 were actually allowed to reduce tax liability for all prior taxable years, over (ii) the total amount by which the credits allowable under § 38 would have been allowed to reduce tax liability for all prior taxable years had the hypothetical condition (stated in the phrase beginning "which would have resulted") obtained. The examples under § 1.47-1(b)(3) reflect the same meaning of the aggregate decrease, as does Revenue Ruling 72-221, 1972-1 C.B. 15.

The hypothetical condition required in § 50(a)(1)(A) is to reduce to zero the credit determined under subpart E with respect to the investment credit property disposed of within the recapture period or that otherwise ceases to be investment credit property. If, in the example you have asked about, the credit determined under § 47 with respect to property A were reduced to zero, the amount of credits used to reduce tax liability for 2011 would be zero the amount of credits used to reduce tax liability for 2012 would likewise be zero.

In your example, taxpayer X was actually allowed, under § 38(a), rehabilitation credits that reduced tax liability in the amount of $20,000 for taxable year 2011 and $16,000 for taxable year 2012. Reducing to zero the credit determined under § 47 for the recapture property, the decrease in the amount of credits used to reduce tax liability for 2011 would be $20,000 and the decrease in the amount of credits used to reduce tax liability for 2012 would be $16,000. The aggregate decrease in the amount of credits used to reduce tax liability for all taxable years prior to the year of disposition would therefore be $36,000.

The increase in tax is the product of the aggregate decrease and the recapture percentage. Because the period of time between when property A was placed in service and when property A was disposed of was greater than two but less than three full years, the recapture percentage is 60 percent. Therefore, the increase in tax mandated by § 50(a)(1)(A) is 60 percent of $36,000, or $21,600.

If, in the situation you have described, Taxpayer X had carryovers under § 39 other than the rehabilitation credit determined with respect to the property disposed of, those amounts might be taken into account in computing the aggregate decrease described in § 50(a)(1)(A). Consider, for example, the same facts you have described, except that Taxpayer X had earned a low-income housing credit under § 42 in 2011 in the amount of $12,000, which the taxpayer had never used to reduce tax liability. Reducing to zero the credit determined under § 47 for the recapture property, the decrease in the amount of credits used to reduce tax liability for 2011 would be $8,000 because Taxpayer X would have been able to use (as a replacement for the rehabilitation credit hypothetically reduced to zero) the $12,000 low-income housing credit to reduce tax liability (assuming no recapture with respect to the low-income housing credit); and the decrease in the amount of credits used to reduce tax liability for 2012 would be $16,000. The aggregate decrease in the amount of credits used to reduce tax liability for all taxable years prior to the year of disposition would therefore be $24,000 and the increase in tax would be $14,400. Because both the rehabilitation credit and the low-income housing credit are "specified credits" under § 38(c)(4)(B)(i) and (viii), this result would obtain whether or not, and to whatever extent, the limitation in § 38(c)(1)(A) might otherwise have applied. However, if the replacement credit were not a specified credit, then Taxpayer X would have to separately compute the amount that would have replaced the rehabilitation credit in 2011 taking into account the limitation in § 38(c)(1)(A).

<u>Issue 2: What, if any, is the adjustment to the carryover of the credit? How is that computed and what is the statutory basis for the computation?</u>

Section 50(a)(3) provides that in the case of a cessation described in § 50(a)(1), the carrybacks and carryforwards under § 39 shall be adjusted by reason of such cessation. Under § 50(a)(3), X's credit carryforward is reduced by 60 percent of $64,000, or $38,400, to $25,600.

Unlike § 50(a)(1), which provides specific and mechanical rules for computing the increase in tax, § 50(a)(3) says merely that carryforwards and carrybacks under § 39 shall be adjusted. If, in the example you have asked about, taxpayer X had used all $100,000 of credits to reduce tax liability, X would have an increase in tax of $60,000 and would retain the benefit of $40,000 of credits. Assuming, as we do, that Congress intended that the taxpayer retain the eventual benefit of the same amount of credits based on principles of horizontal equity, the only way to accomplish parity, given the strict rule of § 50(a)(1), is to reduce the carryforwards and carrybacks under § 39 by the same percentage used to compute the § 50(a)(1) increase in tax. Therefore, where § 50(a)(1) mandates that taxpayer X repay $21,600 of $36,000 credits previously allowed against tax, thus effectively retaining the benefit of only $14,400 of previously allowed credits, permitting taxpayer X to retain $25,600 of carryovers produces parity by leaving the taxpayer, in effect, with $40,000 of allowable credits, $14,400 of which has already been used and $25,600 of which has yet to be used.

Taxpayer X may use this $25,600 credit amount against the tax imposed by chapter 1 for 2013 or thereafter. If, in the factual scenario you have asked about, Taxpayer X had tax liability under § 1 or § 11 for 2013 in the amount of $25,600, Taxpayer X would be able to use $25,450 of the credit under § 38(a)(1) after applying the limitation under § 38(c).

Please call Robert Chapman (202) 317-5116 if you have any further questions.

---

[1] Former § 47(a)(1), as in effect until 1990 (and applicable, with respect to property placed in service after December 31, 1981, only to property other than "recovery property" as that term was then defined in former § 168(c)), provided that if in any taxable year property was disposed of or otherwise ceased to be § 38 property before the close of the estimated useful life the taxpayer used to compute the investment credit, then there was an increase in tax. Former § 47(a)(1) defined the increase in tax as an amount equal to the aggregate decrease in the investment credit allowed for all prior years that would have resulted solely from substituting, in determining qualified investment, the actual useful life of the property for the estimated useful life used to compute the investment credit. For this purpose, the actual useful life of the property was the period beginning when it was placed in service and ending when it was disposed of or otherwise ceased to be § 38 property.

Computing the increase in tax under former § 47(a)(1) required the following steps. First, the statute required a determination of the period of time between the placed-in-service date and the disposition or other cessation. This period, or the actual useful life, would determine the "applicable percentage," under former § 46(c)(2), which provided for the following applicable percentages.

If the useful life is —	The applicable percentage is —
3 years or more but less than 5 years	$33\ {}^{1}/_{3}$
5 years or more but less than 7 years	$66\ {}^{2}/_{3}$
7 years or more	100

The basis of the § 38 property was multiplied by the applicable percentage to determine the "qualified investment," as defined in § 46(c)(1). The qualified investment was then multiplied by the credit percentage to derive the amount of the recomputed credit earned. The amount of § 38 credits that would have been used to reduce tax liability in all prior years, taking into account the recomputed credit, was subtracted from the amount of § 38 credits that were actually used to reduce tax liability in all prior years. The difference, the aggregate decrease, was the increase in tax.

[2] In 1985, regulations were proposed that would have limited § 1.47-1(a)(1) to non-recovery property. Special rules for recovery property were contemplated to be included in § 1.47-1(a)(3), which was reserved in the proposed regulation. 50 Fed. Reg. 51874 (December 20, 1985). These regulations were never finalized.