# Rehabilitation Credit:
# *Lessee's Ability to Claim the Rehabilitation Credit*

The Internal Revenue Code and Department of the Treasury Regulations provide rules that allow lessees of a building to claim the rehabilitation credit provided certain requirements are met.

Lessees may be able to claim the rehabilitation credit in the case of a long-term lease, and also in the case of a lessor's election pursuant to Treasury Regulation §1.48-4(a)(1) to treat a lessee as the purchaser of the building for purposes of claiming the rehabilitation credit.

This information is intended to provide a basic understanding of a lessee's ability to claim the rehabilitation credit. The information does not constitute legal authority and may not be relied upon as such. The information does not amend, modify, or add to the Income Tax Regulations or any other legal authority.

Most of the Department of the Treasury regulations governing the rehabilitation credit are contained in Treasury Regulation § 1.47-7 and § 1.48-12. Furthermore, the provisions of the Internal Revenue Code including the investment credit, general business credit, at-risk rules, passive activity limitation, and alternative minimum tax can affect a taxpayer's ability claim the rehabilitation credit.

**Long-Term Lease Rules**

*Expenditures Made by a Lessee of the Building*

Internal Revenue Code § 47(c)(2) defines the term Qualified Rehabilitation Expenditure (QRE). An expenditure must be a QRE to be taken into account in determining the rehabilitation credit. Internal Revenue Code § 47(c)(2)(B)(vi) does not exclude from the definition of QRE any expenditure of a lessee of a building if on the date the rehabilitation is completed, the remaining term of the lease is greater than the recovery period determined under Internal Revenue Code § 168(c). Under current law, the recovery period is 39 years for non-residential real property and 27.5 years for residential rental property. If a lessee's expenditures are QREs, the lessee can claim the rehabilitation credit provided all the requirements of the Internal Revenue Code and regulations are met. One noteworthy requirement is the "substantial rehabilitation test."

*Substantial Rehabilitation Test*

Internal Revenue Code § 47(c) requires a building to be "substantially rehabilitated," and Internal Revenue Code § 47(c)(1)(B) defines the term "substantially rehabilitated." A building is treated as having been substantially rehabilitated only if the QREs during the 24-month measuring period selected by the taxpayer exceed the greater of the adjusted basis of the building (and its structural components) or $5,000.

Treasury Regulation § 1.48-12(b)(2) describes the "substantial rehabilitation test" and also includes special rules for lessees in Treasury Regulations § 1.48-12(b)(2)(ii), (iii), and (vi).

Treasury Regulation § 1.48-12(b)(2)(ii)(B) provides a special rule for determining the date used to determine the adjusted basis of a building if a lessee rehabilitates a building. Generally, the date a lessee uses is the date that the owner would have used if the owner was the taxpayer. If the building is sold subject to the lease prior to the date that the lessee has substantially rehabilitated the building, the lessee's adjusted basis is determined as of the later of the first day of the new lessor's holding period or the first day of the 24-month period selected by the lessee.

This can be illustrated by the following example:

*Taxpayer X owns property and leases it to taxpayer A for 40 years. Taxpayer X has an*

*adjusted basis of $500,000 in the property and does not wish to spend any money on rehabilitating the building.*
*Taxpayer A must spend more than $500,000 during a 24-month measuring period to be eligible for the rehabilitation credit. If during the rehabilitation project, but before Taxpayer A spends more than $500,000, Taxpayer X sells the building to Taxpayer Z for $750,000, Taxpayer A must now spend more than $750,000 to be eligible for the rehabilitation credit.*

Treasury Regulation § 1.48-12(b)(2)(iii)(B) provides a special rule for determining the adjusted basis of the building. In the case of a building that is leased to one or more tenants in whole or in part, adjusted basis is determined by adding the adjusted basis of the lessor in the building and the adjusted bases of the lessees in the leasehold and any leasehold improvements that are structural components of the building. The lessee is responsible for establishing the lessor's basis when determining if the substantial rehabilitation test has been met. Generally, the lessor will provide the lessee with this information. In the event the lessor does not provide the required basis information, the lessee must show that their QREs incurred during the 24-month test period exceeded the fair market value of the building on the relevant date.

Treasury Regulation § 1.48-12(b)(2)(vi), allows the taxpayer to take into account the QREs incurred during the same rehabilitation process by any other person who has an interest in the building. Thus, for example, to determine whether a building has been substantially rehabilitated, a lessee may include the expenditures of the lessor and of other lessees; a condominium owner may include the expenditures incurred by other condominium owners; and an owner may include the expenditures of the lessees.

After taking these special rules into account, the QREs must exceed the greater of the aggregate adjusted basis of all parties who have an interest in the building (i.e., the adjusted basis of the lessor in the building and the adjusted bases of the lessees in the leasehold and any leasehold improvements that are structural components of the building) or $5,000. Treasury Regulation § 1.48-12(b)(2).

As a result of these special rules, the property owner (lessor) and several lessees could all qualify for the rehabilitation credit as long as the aggregate rehabilitation expenditures of all parties are considered when determining if the project meets the substantial rehabilitation test. The amount of credit each party would claim would be based on the amount each party expended during the rehabilitation.

This can be illustrated in the following example:

*Taxpayer X owns a building and leases space in the building to Taxpayer A, Taxpayer B and Taxpayer C. Each lessee has a lease term is in excess of 39 years. The adjusted basis of the building before rehabilitation is $75,000. Taxpayers X, B and C spend a total of $80,000 to substantially rehabilitate the building. A $16,000 ($80,000 x 20%) rehabilitation credit has been generated. If Taxpayer X spent $25,000, Taxpayer B spent $10,000 and Taxpayer C spent $45,000, they will each be entitled to claim a portion of the allowable rehabilitation credit -*
*$5,000 for Taxpayer X, $2,000 for Taxpayer B and $9,000 for Taxpayer C.*

Treasury Regulations § 1.48-12(b)(2)(x) provides examples that further illustrate the application of the substantial rehabilitation test.

**Lessor's Election Rules**

Internal Revenue Code § 50(d)(5) and Treasury Regulation § 1.48-4(a)(1) permit a lessor of property (or portion of the property) to elect to treat a lessee of the property (or a portion of the property) as having purchased the property for purposes of the rehabilitation credit. The lessee of the building (or a portion of the building) is allowed to take the lessor's

QREs into account for claiming the rehabilitation credit provided all requirements are met.

Treasury Regulation § 1.48-4(a)(1) provides the requirements for the time and manner for making an election to treat the lessee as having purchased the building for purposes of the
rehabilitation credit.

The lessor of the property is required to provide the lessee of the property with all the information needed to complete Form 3468 Investment Credit.

*Property Requirements*

Treasury Regulation § 1.48-4(a)(1) describes the following conditions that must be satisfied for a lessor to treat the lessee as purchaser of the property:

(1) The property must be "section 38 property" in the hands of the lessor; that is, it must be property with respect to which depreciation is allowable to the lessor and it must satisfy the other requirements set forth under § 1.48-1 of the Treasury Regulations, "Definition of section 38 property".
(2) The property must be "new section 38 property" in the hands of the lessor (within the meaning of § 1.48-2), and the original use of such property must commence with the lessor.
(3) The property must be such that it would have constituted "new section 38 property" to the lessee if such lessee had actually purchased the property.
(4) A statement of election to treat the lessee as a purchaser must be made. Treasury Regulation 1.48-4.
(5) The lessor cannot be a mutual savings bank, cooperative bank, or an entity described in Treasury Regulation § 1.48-4(a)(1)(v).

A tax-exempt entity generally cannot pass the rehabilitation credit to its lessee(s) because Treasury Regulation § 1.48-4(a)(1)(i) requires that the property be property with respect to which depreciation is allowable to the lessor.

The lessor and the lessee may both be considered as the original users of the property. The lessee would be considered the original user if he is the first person to use the property for its intended function. Treasury Regulation § 1.48-4(b).

*Lease Requirements*

The Treasury Regulations generally allow the lessor to elect to treat the lessee as owner of the property if the lease is a long-term lease. A credit may be allowed if the lease is a "short-term lease" as defined in Treasury Regulation § 1.48-4(a)(2), however, the amount of the credit allowed is reduced. Additionally, the credit is not allowed in the case of a short-term lease that is a "net lease." Treasury Regulation § 1.48-4(a)(2)(iv).

In general, if a lessor elects to treat the lessee as the purchaser of the property, the lease is considered a short-term lease if the lease term is less than 80% of the class life of such property (currently 39 years for non-residential rental and 27.5 years for residential rental). Accordingly, if the lease term is at least 31.2 years for non-residential rental property or 22 years for residential rental property, the short-term lease election rules do not apply.

In the case of short-term lease property, the lessee is treated as having acquired only a portion of the leased property. The amount the lessee is treated as having acquired is an amount equal to a fraction (the numerator of the fraction is the term of the lease and the denominator is the class life of the property leased) of the amount for which the lessee would have been treated as having acquired if the property were not short-term lease property. Treasury Regulation § 1.48-4(c)(3).

This is illustrated in the following example:

*Taxpayer X agrees to lease its entire property to Taxpayer A for 10 years. Taxpayer X spends $120,000 as QREs to substantially rehabilitate* *his property and makes the pass-through election under Treasury Regulation § 1.48-4 so that Taxpayer A can take Taxpayer X's QREs into account for claiming the rehabilitation credit*. *Pursuant to Treasury Regulation § 1.48-12(f)(1) the fair market value of the property after rehabilitation is limited to the portion of X's basis in the property that is attributable to the QREs, or $120,000.*

*Taxpayer A determines a rehabilitation credit in the amount of $6,154. (20% x ($120,000 x 10/39))*

A lease is not a short-term lease if the lease is a "net lease." A "net lease" is one where the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income. Treasury Regulation § 1.48-4(a)(2)(iv).

*Basis and Income Implications*

Internal Revenue Code § 50(c) requires a taxpayer to reduce the basis of the property by the amount of the rehabilitation credit determined. However, section 50(c) does not apply when a lessor elects to treat the lessee as the owner of the property pursuant to Treasury Regulation § 1.48-4. Thus, the lessor is not required to reduce its basis in the property by the amount of the rehabilitation credit determined. In lieu of a basis adjustment, a lessee must include in gross income an amount equal to the rehabilitation credit determined. 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 property is placed in service and continuing on each one-year anniversary date thereafter until the end of the applicable recovery period.

Treasury Regulations §§ 1.47-7 and 1.50-1 provide examples that illustrate the application of these rules. Treasury Regulation §1.50-1(a) provides an explanation of the history of the relevant Internal Revenue Code provisions.

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