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IRS Issues New Proposed Rule for New Markets Tax Credit Program

The Internal Revenue Service has issued a new proposed regulation revising and clarifying certain rules for the federal new markets tax credit program. The proposed changes relate to the recapture of new markets tax credits.

The IRS published the rule on 8/11/08 in the *Federal Register*, soliciting public comments on it by 11/10/08, and announcing a public hearing on it on 12/12/08 in Washington, DC.

Under the new markets tax credit (NMTC) program, Community Development Entities (CDEs) that receive allocations of NMTC authority provide the tax credits to investors in exchange for capital (Qualified Equity Investments, or QEIs) that the CDEs must use to make investments or loans in qualified businesses (Qualified Active Low-Income Community Businesses, or QALICBs) in low-income communities for at least seven years. A recapture event will occur during this seven-year period with respect to an equity investment in a CDE if: (1) the entity ceases to be a CDE; (2) the proceeds of the investment cease to be used to make Qualified Low-Income Community Investments (QLICIs); or (3) there is a redemption of the QEI by the CDE.

IRS rules provide that for an equity investment that is a capital interest in a CDE that is a partnership for federal tax purposes, a pro rata distribution by the CDE to its partners based on each partner's capital interest in the CDE during the taxable year won't be treated as a redemption, if the amount of the distribution doesn't exceed the CDE's operating income for a taxable year. Moreover, a non-pro rata de minimis cash

distribution by a CDE to a partner or partners during the taxable year won't be treated as a redemption if the size of the distribution doesn't exceed the lesser of: (1) 5% of the CDE's operating income for that taxable year; or (2) 10% of the partner's capital interest in the CDE.

The proposed regulation modifies the rule to exclude from treatment as a redemption a pro rata distribution during a taxable year that doesn't exceed the sum of: (1) the CDE's operating income for the taxable year; and (2) any undistributed operating income for the prior taxable year.

The rule also modifies the definition of what is included in operating income for purposes of the safe harbor for partnership CDEs to add, to the existing list of items that must be counted as part of operating income, interest on bonds exempt from federal taxation under Section 103 of the Internal Revenue Code, and other depreciation and amortization deductions under the Code not already on the list.

The proposed rule also clarifies that a CDE may rely on the federal partnership allocation rules to determine its allocable share of the deductions from another partnership, for inclusion by the CDE in calculating its operating income.

The proposed rule also provides that the termination of a CDE partnership caused by the sale of a QEI won't be treated as a new markets recapture event.

Finally, under the new markets program, an entity will generally be treated as a QALICB for the duration of the CDE's investment in the entity, if the CDE "reasonably expects," at the

time it makes a capital or equity investment in or a loan to the entity, that the entity will satisfy the requirements to be a QALICB during the entire period of the loan or investment.

The proposed rule clarifies that the reasonable expectation rule applies when a CDE makes an investment in or loan to another CDE. It also clarifies that a CDE for this purpose may treat an entity as a QALICB even if the CDE provides an investment or loan to the entity through one or more other CDEs.

San Francisco CPA Michael Novogradac, of Novogradac & Company LLP, told the *Tax Credit Advisor* he was “pleased” by the changes proposed by the new rule. “It will make it much easier to operate CDEs in partnership form and avoid recapture.”

He noted that some of the changes reflected in the proposed rule were recommended to the IRS, in submitted written comments, by the NMTC Working Group, an organization of NMTC program participants that has been coordinated by Novogradac’s firm. The Working Group has submitted numerous comments on various NMTC program issues to the IRS and to the Community Development Financial Institutions Fund, which runs the program. □