

IRS Proposes Changes In New Markets Tax Credit Program To Encourage Investments In Non-Real Estate Businesses

◆ *IR-2011-61, Advance NPRM REG-114206-11, NPRM REG-101826-11*

The IRS has proposed several changes to the new markets tax credit (NMTC) program to encourage more investment in non-real estate businesses located in low-income communities. The proposed regs would apply to tax years ending on or after the date of publication of final regs.

■ **CCH Take Away.** “The recent IRS NMTC notices regarding NMTC investing in non-real estate operating businesses are thought-provoking exercises that I expect to yield significant long

term results, but will have limited short-term impact,” Michael Novogradac, CPA, Novogradac & Company LLP, San Francisco, told CCH. “I commend Treasury and the IRS for taking these initial steps. I also expect that as the new round of application funding is being made available, more CDEs may apply with the goal of lending to non-real estate businesses.”

Background

Code Sec. 45D, enacted in 2000, allows an NMTC for a qualified equity

investment (for cash) in a qualified community development entity (CDE). The CDE must invest substantially all of its funds in qualified low-income community investments. These include investments in, or loans to, qualified active low-income community businesses, providing financial counseling and other services, purchase of a loan from a CDE, or investing in or making a loan to a CDE. A qualified business is any trade or business, including the rental of real property located in a low-income community.

Proposed changes

The IRS proposed various changes to the NMTC program. The advance notice would:

- Simplify the substantiation requirements for second-tier CDEs; and
- Change the reasonable expectation test.

The proposed regs would allow reinvestment of income from a non-real-estate business into community development financial institutions.

Rationale

A primary CDE that invests in a second CDE must ensure that the proceeds are ultimately invested in a qualifying business or activity. This layer of substantiation has constrained the ability of a primary CDE to invest in a second CDE, particularly where the latter intends to make smaller loans to non-real estate businesses. The IRS would simplify the rules for certain smaller loans where the second CDE and the business are unrelated to the primary CDE, and where the business met basic qualification rules.

A CDE that receives returns on investments before the seven-year credit period expires must reinvest those proceeds. This discourages working capital and equipment loans which ordinary are for five years or less. Easing the reinvestment rules would address this.

References: *FED ¶¶46,373, 46,374, 49,481; TRC BUSEXP: 54,900.*

Basis Overstatement

Continued from page 268

Matthew Lerner of Steptoe & Johnson LLP, told CCH.

Background

The taxpayer engaged in a Son of BOSS (“Bond and Option Sales Strategy”) tax shelter transaction to generate an inflated basis for a ranch owned by the partnership. In an earlier case (*Salman II*, 2009-2 *ustc ¶50,528*), the IRS challenged the partnership’s 1999 income. In this case (*Salman III*), it challenged income for 2001 and 2002. In each case, the IRS asserted that the partnership had overstated the ranch’s basis and therefore understated the income reported on each year’s return. Also, in each case, the IRS issued Notices of Final Partnership Adjustments (FPAAs) more than three years, but less than six years, after the returns were filed.

■ **Comment.** Code Sec. 6501(a) normally requires the IRS to issue an FPA within three years after a return is filed. However, under Code Sec. 6501(e)(1)(A), the period is extended to six years “if the taxpayer omits from gross income” more than 25 percent of the amount of gross income stated in the return.

Salman Ranch cases

In *Salman II*, the Federal Circuit, reversing

the Court of Federal Claims, held that the alleged overstatement of basis was not an omission from gross income and that the IRS could not apply the six-year statute of limitations. In *Salman III*, the Tax Court sided with the Federal Circuit, applying the three-year statute to the FPAAs for 2001 and 2002.

Regs

The IRS issued temporary regs in October 2009 that defined an omission from gross income as including an overstatement of basis, outside of a trade or business. In March 2011, the Court of Appeals for the Federal Circuit affirmed the basis overstatement regs in *Grapevine*, effectively overruling its decision in *Salman Ranch II*.

Tenth Circuit’s analysis

The Tenth Circuit concluded that the regs should be given judicial deference. The statute was ambiguous, allowing the IRS to fashion its own interpretation of the statute. Citing *Mayo Foundation, SCt*, 2011-1 *ustc ¶50,143* and *Grapevine*, the court then concluded that the IRS’s interpretation was reasonable. Since the regs were final, it did not matter that the regs were prompted by litigation, were applied retroactively or were issued without notice and comment.

References: 2011-1 *ustc ¶50,405; TRC IRS: 30,052.*