

Practitioners' Corner

Practitioners' Corner: New Opportunities For New Markets Tax Credit Investments

The new markets tax credit (NMTC) is designed to encourage investments in businesses in low-income communities. The Obama Administration strongly backs the NMTC program. Government officials touted the program's successes at the recent Spring New Markets Tax Credit Conference: \$16 billion invested since the program began in 2009; 75 percent of the credits allocated to highly-distressed communities; and a multiplier effect of \$14 of additional economic activity for every dollar invested.

At the urging of program recipients, the Obama administration on June 3 proposed several changes to stimulate increased investment in non-real estate businesses (*see discussion of IR-2011-61, Advance NPRM REG-114206-11, and NPRM REG-101826-11 in the June 9, 2011 issue of this newsletter*). The administration believes the changes will spur permanent job creation and economic revitalization in low-income communities.

■ **Comment.** The recent notices "are thought provoking exercises that I expect to yield significant long term results ... because the IRS and Treasury have issued an expansive requesting for comments on this and other ways to increase the level of NMTC investment in non-real estate operation businesses," Michael Novogradac of Novogradac & Company, LLP, San Francisco, an advisor to NMTC investors, told CCH.

Allocations of credit

The timing of the proposed changes may have been fortuitous, because Treasury's Community Development Financial Institutions (CDFI) Fund just announced the opening of the application period for allocations of NMTC credits to community development entities (CDEs). The Fund has authority to allocate \$3.5 billion in credits to CDEs.

■ **Comment.** "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," Novogradac said. "The release of these notices at this time is quite helpful."

■ **Comment.** Small businesses are the drivers of economic growth, Treasury and other government officials said at the NMTC conference. The administration wants to modify the credit to promote operating businesses, which historically cannot use the credit as well as real estate

"The government asks whether these changes would facilitate greater investment in non-real estate businesses, Michael Novogradac of Novogradac & Company, LLP, San Francisco, an advisor to NMTC investors, told CCH. I believe they would."

The administration hopes to increase this authority to \$5 billion, the previous level at which the program operated, although persuading Congress to increase the allocation is clouded by the overall budget picture.

businesses. An IRS official indicated the government wants to encourage micro-lending – making small non-real estate loans of \$250,000 or less.

Background

Congress enacted Code Sec. 45D, the NMTC, in the *Community Renewal Tax Relief Act of 2000*, for investments in 2001 and subsequent years. The maximum credit is claimed over the period of a seven-year investment, based on a total of 39 percent of the CDE's investments. The CDFI Fund awards and allocates credits to CDEs each year, which then pass through the credits to their investors. For 2010, the Fund allocated credits to 99 CDEs, an average of approximately \$35 million per CDE, with total credits ranging from \$10-77 million per CDE.

Rationale

The preamble to the proposed regs indicates that only 35 percent of qualified investments are made in non-real estate trades or businesses, and that much of this 35 percent involves renting real estate to active trades or businesses.

Proposed regs

The proposed regs and notice of public hearing (NPRM REG-101826-11) aim to facilitate non-real estate investments by changing the reinvestment rules. Currently, the NMTC program requires that a CDE that receives returns on investments (including principal repayments from loans) reinvest those proceeds into other QLICs during the seven-year credit period.

As a practical matter, this makes it difficult for CDEs to provide working capital and equipment loans to non-real estate businesses, because these loans usually have a term of five years or less. The proposed regs would allow a CDE to invest returns of capital from a non-real estate investment into unrelated community development financial institutions that provide credit and financial services to underserved populations and that are certified as CDEs.

Continued on page 287

Questions Continue Regarding Reliance On Retroactive IRS Regs

In *Salman Ranch, Ltd.*, 2011-1 *ustc* ¶50,405 (discussed in *Federal Tax Weekly* No. 23), the Tenth Circuit Court of Appeals upheld the application of the six-year statute of limitations to an overstatement of basis, citing recent IRS regs issued after the IRS lost several court cases (see the June 9, 2011 issue of this newsletter). Matthew Lerner of Steptoe & Johnson LLP, Washington, D.C., provided the following additional comments to CCH on the decision.

"After the latest *Salman Ranch* decision, the state of the law remains muddled, although the trend appears to be in the IRS' favor. One must wonder whether the fact that these decisions are coming out of

cases involving tax shelters is influencing their outcome."

"In any event, the most recent cases in the Federal and Tenth Circuits (*Grapevine*, 2011-1 *ustc* ¶50,264 and *Salman Ranch*) are consistent with *Mayo Foundation*, 2011-1 *ustc* ¶50,143, in indicating that *Chevron* deference is appropriate to notice-and-comment IRS regulations. That conclusion is not, as a general proposition, surprising."

"The most troubling element of this case and *Grapevine* is the not the deference given to the regulations but to the courts' willingness to apply them to previously pending cases arising from facts that occurred before the new regulations were promulgated. The *Salman*

Ranch court dismissed an argument that this was inappropriate without much analysis. This conclusion causes me great concern. It hardly cultivates respect for the fairness of the tax law and its administration to allow the rules of the game to be changed after the game has begun, or here, after it was over. I have no problem with litigation being the trigger that causes the IRS to feel like a law needs to be changed or clarified prospectively, but in a case about the meaning of a law, to let one of the two litigants decide what the ambiguous law in question says and have the court give deference to that decision represents an abrogation of the court's independence and allows the regulator to become the judge and jury as well."

Practitioners' Corner

Continued from page 285

■ **Comment.** "Repayments would need to be reinvested with a certified CDFI within 30 days," Novogradac said. "There does not appear to be any NMTC related limits on the use of the money by the certified CDFIs. However, this reinvestment option is limited. Only a rising portion of investment repayments can be so reinvested, specifically 0 percent of the QEI in Year 1; 15 percent in Year 2; 30 percent in Year 3; 50 percent in Year 4, and 85 percent in Years 5 and 6."

Treasury and the IRS requested comments on whether this change would accomplish this purpose. They also asked whether to permit reinvestments in other entities and whether to apply the rules to existing investments.

■ **Comment.** "This proposal would help CDEs who want to provide amortizing five to seven year financial to non-real estate operating businesses," Novogradac said. "Such financing would be helpful, for example, to non-real estate operating businesses seeking longer lived equipment financing."

Advance rulemaking notice

The purpose of an advance notice (AN-PRM REG-114206-11) is to obtain com-

ments and provide an outline of suggested changes in the tax regs. The government indicated that the NMTC advance notice was suggesting changes that could facilitate greater investments in non-real estate businesses without disrupting the success real estate investments.

The primary suggestion is to streamline the substantiation requirements for second-tier CDEs that make small loans (potentially \$250,000 or less) to non-real estate businesses. A QLICI includes an investment in or loan to a second CDE by a primary CDE, provided the second CDE uses the funds for a qualified investment.

The net effect of these rules, the IRS indicated, is that the primary CDE must ensure that the second CDE ultimately invests the proceeds in a qualified manner. "This added layer of substantiation has placed constraints on the ability of a primary CDE to invest funds in a second CDE – particularly in instances where the second CDE intends to make smaller sized loans to non-real estate businesses, because transaction and compliance monitoring costs are higher relative to the size of smaller loans than they are for larger, real estate-secured transactions," the IRS said.

■ **Comment.** The government asks whether these changes would facilitate greater investment in non-real estate businesses, Novogradac said. "I believe that they would."

For this change, the government also asked:

- Should there be a cap and how would it work?
- What are the appropriate minimum substantiation requirements?
- What other limitations should apply (for example, should the second CDE be a nonprofit entity)?

The advance notice also asked whether (and how) the government should consider changing the reasonable expectations test in Reg. Sec. 1.45D-1(d)(6)(i). This provision treats a business as qualified "if the CDE reasonably expects," at the time of the investment, that the business will be qualified throughout the entire period of the investment (or loan).

Future action

This is a dynamic time for investors and companies involved in the NMTC program. "I expect the broader NMTC community to focus on the specific ideas in the notices and to also expand the discussion to other areas," Novogradac told CCH.

IRS officials indicated that the government will strive to issue the NMTC regs by the end of 2011, but she cautioned that action may not be completed until mid-year 2012. Novogradac cautioned that until the proposed regs are adopted, "[they] will not have much of an effect on investing in non-real estate operating businesses," but he expects significant long-term benefits from the changes.