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Investor Secures Guidance from the IRS Regarding Application of the NMTC Cure Period

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Almost since the inception of the new markets tax credit (NMTC) program, industry participants have debated whether the cure period described in Treasury Regulation Section 1.45D-1(e)(6) is available to correct a qualified community development entity's (QCDE) failure to invest "substantially all" (defined as meaning at least 85 percent) of the proceeds of a qualified equity investment (QEI) in qualified low-income community investments (QLICIs) within the 12-month period specified in Treasury Regulations Section 1.45D-1(c)(5)(iv) and thereby avoid a potential recapture or disallowance of NMTCs. Fortunately, guidance provided by the Internal Revenue Service in a new private letter ruling may shed some light on this debate.

Background

Cure period regulations provide that, "[i]f a qualified equity investment fails the substantially all requirement under paragraph (c)(5)(i) of this section, the failure is not a recapture event under paragraph (e)(2)(ii) of this section if the CDE [community development entity] corrects the failure within 6 months after the date the CDE becomes aware (or reasonably should have become aware) of the failure."

Recapture Risk

In accordance with Section 45D(g) and the Treasury Regulations thereunder, certain events occurring during the seven-year period beginning on the date of the original issue of a QEI require a taxpayer to recapture all of the NMTCs taken previously with respect to such QEI, plus interest. A recapture event occurs if:

- the CDE ceases to be a QCDE,
- the proceeds of the QEI cease to be used in a manner that satisfies the substantially all requirement, or
- the QEI is redeemed by the QCDE.

Initial 12-Month Investment Period and Investment Challenges

In accordance with Treasury Regulation Section 1.45D-1(c)(5)(iv), a taxpayer's cash investment received by a QCDE generally is treated as invested in a QLICI for purposes of the substantially all requirement to the extent that the cash is so invested within the 12-month period beginning on the date the cash is paid by the taxpayer to the QCDE. While 12-months in most circumstances seems like a sufficient time period, even in a good market, there are many challenges to the successful closing of a NMTC transaction. Not the least among these challenges is helping potential lenders, investors and borrowers understand the complexities and requirements of the program. However, the normal challenges have been compounded by the current economic crisis and tight credit markets. The negotiation of an NMTC transaction is often an extremely complex and time consuming process. Traditional loan financing in the current market is difficult enough, but add to that the CDFI Fund's requirement that QCDEs offer flexible and non-traditional investment products, combine that with the reasons underlying the difficulties faced by a typical QALICB in obtaining investment capital, and many NMTC transactions have become a much more arduous and extended process to underwrite, document and close.

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Legal Argument for Application of the Cure Period

An argument can be made that application of the cure period to the initial investment period is consistent with a plain reading of the statute and regulations, since in accordance with Section 45D(a) and Treasury Regulations Section 1.45D-1(b) a taxpayer is entitled to claim a portion the NMTC in the year the QEI is made. This argument can be made even though the substantially all requirement has not yet been satisfied because a QCDE is generally allowed 12 months to satisfy the substantially all requirement; thus, the substantially all requirement is essentially deemed to be satisfied in the first year even if no investments in QLICIs have actually been made. However, if the QCDE fails to satisfy the substantially all requirement within the 12-month period beginning on the date the QEI was made, the requirement ceases to be satisfied and the taxpayer is subject to recapture provisions and/or disallowance unless the cure period applies and its conditions are met.

Policy Argument for Application of the Cure Period

An argument can also certainly be made that application of the cure period to the initial investment period is in keeping with the NMTC program's policy objectives of encouraging QCDEs to offer flexible and non-traditional investment products, including below-market interest rates. A case can be made that this incentivizes investors to provide an influx of investment capital into low-income communities, and bolsters businesses and not-for-profit organizations that are located within low-income communities or that serve low-income persons. The NMTC program by its very design is intended to spur investments in communities that historically have had poor access to investment capital by allowing taxpayers a credit against federal income taxes for making qualifying investments. Disallowing the application of the cure period would mean recapture or disallowance of the NMTC credit, loss of the allocation and no corresponding investment would be made within the low-income community.

However, based on the lack of existing guidance, it was not clear before the issuance of a recent PLR that the IRS would allow the use of the cure period to be applied in circumstances in which no QLICI was made within the initial 12-month period following the date the QEI was made to a QCDE. In some cases this has the potential to cause investors and QCDEs to shy away from particularly complex transactions that might take additional time that is needed to adequately complete the required underwriting and/or due diligence review. Further complications could include delays due to extended regulatory approval periods, or difficulties caused by unusual structure or documentation issues.

IRS Guidance

As the Journal of Tax Credits went to press, the IRS was scheduled to released a private letter ruling on January 29, 2010 confirming

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that the six-month cure period described in Treasury Regulations Section 1.45D-1(e)(6) is available to correct a QCDE's failure to invest substantially all of the proceeds of a QEI in QLICIs within the 12-month period specified in Treasury Regulations Section 1.45D-1(c)(5)(iv). A pre-release copy of the PLR states states specifically that it is directed only to the taxpayer requesting it and cannot be used or cited as precedent, it provides some indication of the IRS's position and some much needed guidance regarding whether and in what circumstances the cure period can be used to avoid a potential disallowance or recapture of the NMTC. The PLR summarizes the particular factual circumstances surrounding the sub-CDE's failure to meet the investment requirements required by Treasury Regulation 1.45D-1(c)(5)(iv) and then proceeds to go through much the same legal analysis as laid out above without mention of the policy arguments.

Open Question: When Should a QCDE Reasonably Become Aware of Its Impending Failure?

The IRS cautions that the cure period is not automatically tacked on to the end of the initial 12-month period. It further emphasizes that the cure period begins on the date the QCDE "becomes aware (or reasonably should have become aware)" of its impending failure to invest substantially all of the QEI in QLICIs, which is inherently a facts and circumstances determination. This leaves open for argument and further discussion the timeframe and circumstances under which a QCDE should reasonably become aware that it will fail the substantially all investment requirement within the 12-month period after the date the QEI is made. Despite the diligent efforts of a QCDE, there are many reasons a proposed transaction may seem to have insurmountable obstacles and may need to be abandoned after months of negotiations; however, it's also possible that after being restructured or receiving revised governmental approvals, the transaction may suddenly become revitalized and close in an expedited time frame. Additionally, some transactions close in merely a matter of weeks, especially at year-end, while others seem to drag on for years. Unless additional guidance is provided, each determination will need to be based on the specific facts surrounding the potential recapture event.

For example, in the facts discussed by the PLR, the investors represented that they had been working diligently to satisfy the substantially all requirement. In light of the current financial and real estate market conditions, it was especially difficult for some developers to obtain necessary third-party financing due to more rigid underwriting standards, even with the NMTC subsidy, and other developers were putting certain otherwise viable projects on hold until market conditions were more stable. At least 15 projects were considered, with the greatest amount of time being spent on four potential projects, including:

- the renovation and development of a 300,000-square-foot mixed-use building;

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- development of a building to house a supermarket, pharmacy and a local bank;
- renovation of a hotel; and
- construction of a new liquid storage facility.

On a certain date (reflected as "k" in the PLR), investors received notice that the two most viable deals could not be closed prior to the end of the initial 12-month period; however, the investors continued to work on these and other projects in anticipation of a potential closing within the cure period. Therefore, given the facts, the date of "k," (the date the investors received notice that the two most viable deals could not be closed prior to the end of the initial 12-month period) was the date the cure period began.

The PLR provides much needed guidance in these improving but still turbulent financial times. The positive guidance from the IRS will allow investors and QCDEs to continue to work toward closing and making investments during the cure period, even if for unexpected reasons they cannot close within the initial 12-month period.

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