

Proposed Regulations Issued, Clarification Welcomed

By Brad Elphick, CPA, Novogradac & Company LLP

On August 11, the Internal Revenue Service (IRS) released proposed amendments to the new markets tax credit (NMTC) regulations as a result of a project undertaken to revise and clarify certain rules relating to the recapture of the new markets tax credit (NMTC). The proposed regulations are the first amendments to the NMTC regulations since the targeted population addition in May 2005. The proposed regulations specifically address the redemption safe harbor for partnership community development entities (CDEs), termination of a partnership CDE under Internal Revenue Code (IRC) Section 708(b)(1)(B) and the application of the reasonable expectations rule when an investment in or loan to another CDE is made. In addition to the proposed changes, the IRS is also asking for specific comments on the treatment of dollar amounts received by a CDE. We will address each of the proposed changes and the questions they have resolved and possibly created.

Redemption Safe Harbor for Partnership CDEs

When the final regulations were issued in December 2004 and corrected in January 2005, a safe harbor was created for CDEs that are partnerships for federal tax purposes. The safe harbor allows a CDE to make a pro rata cash distribution to its partners if the distribution does not exceed the CDE's operating income for the taxable year. The regulations then go on to define operating income. Partnership CDEs have always struggled with making distributions because the regulations required that the distribution be made in the same year to which the operating income is attributed. The NMTC Working Group, a membership organization of CDEs and other professionals that has been addressing these issues since its inception, submitted a letter on this issue to the IRS dated April 24, 2006. In the letter

the group wrote, "By requiring that the distribution be made in the same year, CDEs are required to estimate operating income before the end of the taxable year. This is because in the normal course of business, a CDE will not have its books and records for a given month closed and adjusted until after the end of the month." The IRS acknowledged this burden on CDEs and proposed that the regulations provide:

"...in the case of an equity investment that is a capital interest in a CDE that is a partnership for Federal tax purposes, a pro rata cash distribution by the CDE to its partners based on each partner's capital interest in the CDE during the taxable year will not be treated as a redemption for purposes of §1.45D-1(e)(2)(iii) if the distribution does not exceed the sum of the CDE's operating income for the taxable year and the CDE's undistributed operating income (if any) for the prior taxable year."

With the new proposed regulations, partnership CDEs will be allowed to calculate the amount of distributable operating income using the current year and any undistributed operating income (if any) from the prior taxable years. It is important to note that it is only for one year prior and not cumulative of all years prior. So if a CDE has any undistributed operating income from the previous three years, it will not be allowed to distribute it under the proposed regulations.

While the proposed change gives partnership CDEs more flexibility in making distributions, it does raise other questions that will need further clarification from the IRS. For example, how is the determination of undistributed operating income made? If the prior taxable year has \$100 of undistributed operating income and the current taxable year has \$100 of distributable operating income and the

(continued on page 2)

Proposed Regulations Issued

(continued from page 1)

CDE distributes \$120, has the CDE distributed \$100 from the prior year and \$20 from the current year? Or has the CDE distributed \$20 from the prior year and \$100 from the current year, losing the ability to distribute \$80 of distributable operating income from the prior year? Also, there are examples of CDEs that were not making distributions because of the lack of guidance that now wonder if there will be any catch-up period that will allow them to make the distributions based upon these proposed regulations.

In addition to addressing the distribution issue, the proposed regulations also make modifications to the definition of operating income to include "tax-exempt income under IRC Section 103 and any other depreciation and amortization deductions under the Code to the list of Code sections that determine the amount of operating income." The proposed regulations further clarify that the allocable share of income, gain, loss and deduction (including most notably depreciation and amortization expense) attributable to an equity investment should be added back in the calculation of operating income. This amendment confirms what most in the NMTC industry

believed to be clear but for which explicit clarification had been asked.

One item clearly absent from the proposed regulations is the treatment of capital gains in the calculation of operating income. In an NMTC Working Group letter to the IRS dated April 24, 2006, it is recommended that capital gains be included in the calculation of operating income because otherwise it is unclear if profits, which are not required to be reinvested by the CDE, can be distributed without risking recapture. This exclusion is potentially preventing short-term venture capital investments in qualified businesses until further clarification is provided.

Termination of a Partnership CDE Under Section 708(b)(1)(B)

The IRS provided clarification that recapture is not triggered when the sale of a qualified equity investment (QEI) causes the termination of a CDE partnership under IRC Section 708(b)(1)(B). IRC Section 708(b)(1)(B) considers a partnership terminated if within a 12-month period there is a sale or exchange of 50 percent or more

(continued on page 3)

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Proposed Regulations Issued

(continued from page 2)

of the total interest in partnership capital and profits. The IRS determined it was not a recapture event because “the sale of a QEI is not a recapture event under IRC Section 45D(g)(3) and because the remaining partner or partners are not being cashed out.”

Reasonable Expectations

The NMTC regulations provide that “an entity is generally treated as a QALICB for the duration of the CDE’s investment in the entity if the CDE reasonably expects, at the time the CDE makes the capital or equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a QALICB under §1.45D-1(d)(4)(i) throughout the entire period of the investment or loan.” However, the final regulations did not address how this applied to investments in or loans to another CDE. The proposed regulations clarify that the CDE may rely on the reasonable expectations test when it makes an investment in or loan to another CDE, including cases where the portions of a business rule is used, the rental to others of real property and the exclusion from the definition of a qualified business under Treasury Regulation 1.45D-1(d)(5)(iii).

Comments and Public Hearing

The regulations are proposed and will not become effective until Treasury issues a decision in the *Federal Register* adopting the proposed regulations as final. The benefit to taxpayers by issuing them as pro-

posed regulations is that it allows the public to provide its input on changes and further clarification needed before they are finalized.

In addition to inviting taxpayers to submit comments on issues related to the proposed regulations, the IRS specifically asked for comments on how to define, under Sec. 1.45D-1(d)(2)(i), the dollar amounts received by a CDE “in payment of, or for, capital, equity, or principal” that are set aside either for financial counseling and other services, for an equity investment, or as principal received on a loan.

Public comments are welcomed before the proposed regulations are finalized. Comments must be received by November 10, 2008. A public hearing has been scheduled for December 12, 2008. Taxpayers planning to speak at the public hearing must submit an outline by November 3, 2008.

Conclusion

Overall, the clarification and guidance included in the proposed regulations is good news welcomed by the NMTC industry. However, as many questions as the proposed regulations have answered, new ones have been created. The NMTC Working Group will be submitting its follow-up comments in the coming months. If you are interested in participating, please visit www.nmtcworkinggroup.com. ❖

(continued on page 4)

Proposed Regulations Issued

(continued from page 3)

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