

Final New Markets Tax Credit Regulations

The Department of Treasury (“Treasury”) released final regulations for the new markets tax credit (“NMTC”) program and technical corrections to those regulations on December 22, 2004 and January 28, 2005, respectively (together, the “final regulations”). These final regulations relate to the NMTC authorized under section 45D of the Internal Revenue Code of 1986, as amended (the “Code”) and replace the temporary regulations released in December 2001 and amended in March 2004. The final regulations do not contain a substantial number of changes from the temporary regulations, as amended, but several of the new provisions are quite significant. This memorandum provides a summary of some of the new provisions included in the final regulations, as well as an analysis of certain of these changes.

Brief Summary of the NMTC

The NMTC program was enacted in 2000 and capital generated through the program is now being invested throughout the country. The goal of the NMTC is to develop new sources of capital for investment in businesses in low-income communities. The NMTC is structured to meet this goal by providing taxpayers who make a qualified equity investment (“QEI”) in a community development entity (“CDE”) with a federal tax credit equal to 39% of the value of their investment. The NMTC is taken over a seven-year period and is subject to recapture under certain conditions. To avoid such recapture, the CDE must, at a minimum, ensure that substantially all of the QEIs it receives from investors are used to make qualified low-income community investments (“QLICIs”), including, without limitation, investments in or loans to qualified active low-income community businesses (“QALICBs”) (this is referred to below as the “Substantially All Test”).

Summary of New Provisions in the Final Regulations

In general, the new provisions contained in the final regulations provide clarity and address, in a helpful way, issues that were proving problematic for the development of the NMTC marketplace. Such provisions can be generally grouped in four broad areas:

- Those that address compliance matters related to the Substantially All Test;
- Those that address key investor concerns, particularly with respect to the issue of tax credit recapture;
- Those that address certain of the tests used to assess if an entity is a QALICB; and
- Those that address the coordination of the NMTC with other federal tax benefits.

There is, however, one additional provision in the final regulations that is likely to be problematic for the industry. The specific provisions relating to all of the foregoing are described below.

The Substantially All Test

As noted above, in order to avoid recapture of the NMTC, CDEs must meet the Substantially All Test. The final regulations contain four new provisions that provide guidance to CDEs with respect to meeting this test.

1. The final regulations provide that a CDE may select the same two testing dates for determining whether the Substantially All Test is met with regard to each of its QEIs, regardless of the date each such QEI was made, so long as the dates are six months apart.
2. The final regulations provide that for the first annual testing period, the calculation for determining whether the Substantially All Test is met may be performed on a single testing date.
3. The final regulations also provide that the beginning of the 12-month period for making QLICIs begins on the same date as the beginning of the first annual period of the tax credit period.
4. Finally, the final regulations provide that fees paid to third parties to protect against the loss of all or a portion of the principal or interest on a loan that is a QLICI can be treated as reserves for the purposes of the Substantially All Test.

Though these clarifications do not change the basic requirements set forth in the temporary regulations, they do provide clarity and will facilitate administrative efficiency.

Addressing Investor Concerns

Other changes included in the final regulations seem primarily designed to address key investor concerns, particularly with respect to the issue of tax credit recapture. Specifically, two new rules respond to these concerns.

1. The final regulations provide a safe harbor rule for an issue that was particularly difficult to answer under the temporary regulations: when may a CDE distribute cash to its investors without triggering a recapture event? The new rule provides that a CDE that is a partnership may make pro rata cash distributions to its partners, without causing a recapture event, if the distributions are based on each partner's capital interest in the CDE and do not exceed the CDE's operating income for that taxable year. The CDE's operating income is generally defined as its taxable income with certain add-backs.
2. Additionally, the final regulations provide a cure period in the event that a QEI fails to meet the Substantially All Test. Specifically, the failure to meet this test will not be deemed a recapture event if the CDE corrects the deficiency within six months.

These provisions should be helpful in meeting one of the fundamental investor concerns about the NMTC program.

Assessing QALICB Status

The final regulations also clarified several issues related to the rules concerning QALICBs that have created challenges for the industry.

1. The final regulations provide a new example that demonstrates how a business that uses its property both in and out of a low-income community is evaluated for the purposes of meeting the tangible property test. The example specifies that any such business is to be evaluated solely on the use of its property during business hours; non-business hours do not count.

2. The final regulations also provide guidance on how to determine if a portion of a business can separately qualify as a QALICB, even if the entire business does not qualify. Specifically, a portion of a business may qualify as a QALICB if that portion of the business (i) would meet the QALICB requirements if separately incorporated and (ii) it has a completely separate set of books and records. However, any portion of an investment or loan made by a CDE to such a business will not be a QLICI to the extent that it is not used for the portion that is treated as a QALICB.
3. Additionally, the final regulations clarify that a nonprofit corporation will be treated as engaged in the active conduct of a trade or business if it is engaged in an activity that furthers its charitable purpose.
4. Lastly, the final regulations provide helpful guidance as to how a business can satisfy the nonqualified financial property test. It is now clear that the proceeds of a loan or investment made by a CDE to a business will be treated as reasonable amount of working capital, and thus not nonqualified financial property, if such proceeds will be expended within twelve months for the purposes of constructing real property.

These new provisions provide much needed clarity and will likely facilitate more efficiency in underwriting and closing transactions involving QALICBs.

Coordinating with Other Federal Tax Benefits

The question of how the NMTC can be coordinated with other federal tax benefits, particularly the Federal low-income housing tax credit authorized under section 42 of the Code (the “LIHTC”), has been a persistent issue for practitioners in the industry. The final regulations address this issue in two ways.

1. In general, the final regulations adopt the approach that the availability of other Federal tax benefits does not limit the availability of the NMTC. For instance, it is now clear that a CDE may purchase tax-exempt bonds without impacting its ability to engage in NMTC transactions.
2. The final regulations do provide, however, that if a CDE makes a loan or investment to a building financed with the LIHTC, the loan or investment will not be treated as a QLICI to the extent that the building’s eligible basis, as calculated pursuant to section 42(d), is financed by the proceeds of the loan or investment. In other words, the final regulations confirm that the NMTC can only be used in connection with a mixed-use building that is also financed with the LIHTC under very limited and carefully structured circumstances.

New Provision

There is a new provision in the final regulations, relating to the eligibility of loans to or investments in projects that involve the rental of commercial real estate, that has already generated scrutiny by participants in the NMTC industry. With respect to such transactions, the final regulations include a new rule that provides that a loan or investment to a QALICB that leases real property to others is only a QLICI to the extent that its tenants are not certain types of specifically excluded businesses. The types of tenants that are problematic for NMTC purposes are referred to in the industry as “sin businesses” and include any business engaged in the operation of (i) a private or commercial golf course, (ii) country club, (iii) massage parlor, (iv) hot tub facility, (v) suntan facility, (vi) racetrack or other facility used for gambling or (vii) any store the principal business of which is the sale of alcoholic beverages for consumption off premises. Prior to the final regulations, it was only necessary to look at the eligibility of

the QALICB for NMTC compliance purposes; the status of its tenants was not at issue. In the future, this new rule may limit the value of the NMTC in otherwise eligible projects. Further, it will certainly add cost and complexity to the underwriting and due diligence associated with commercial real estate transactions and may also have other unanticipated consequences. Notably, this provision in the final regulations does not take effect until June 22, 2005 so industry participants will have a few months to adjust their transactions in light of this new rule.

Conclusion

The final NMTC regulations are an important step forward in the maturation of the NMTC program. They appear to address important issues in ways that should be of benefit to participants in this developing industry. We will provide future commentary and analysis in the event of the release of any additional guidance related to these final regulations. In the meantime, please feel free to contact us with any questions.

The purpose of this article is to provide a general summary of significant legal developments. It is not intended as and should not be construed as legal advice on any specific facts or circumstances. If you would like more information about this subject, or if we can be of assistance, please contact us.