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IRS Issues Proposed Regulations for Targeted Populations

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On September 24, the Internal Revenue Service (IRS) proposed regulations that provide rules for determining how qualified active low-income community business (QALICB) requirements are satisfied for investments made to low-income targeted populations and GO Zone targeted populations under the new markets tax credit (NMTC) program. Except as described below, the proposed regulations are consistent with Notice 2006-60. The proposed regulations will apply to tax years ending on or after the date final regulations are issued. Until final regulations are issued, taxpayers may continue to rely on Notice 2006-60.

Notice 2006-60

The American Jobs Creation Act of 2004 amended Section 45D(e) of the Internal Revenue Code (IRC) to provide that pursuant to regulations targeted populations may be treated as low-income communities (LIC). Targeted populations that will be treated as an LIC are defined as individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or who are individuals who otherwise lack adequate access to loans or equity investments.

IRS Notice 2006-60 defines "low-income persons" for metropolitan areas as individuals having an income, adjusted for family size, of not more than 80 percent of the area median family income; and for non-metropolitan areas as individuals having an income that is the greater of 80 percent of the area median family income or 80 percent of the statewide nonmetropolitan area median family income.

Low–Income Targeted Populations

IRS Notice 2006-60 provides that a business will be treated as a QALICB for low-income targeted populations if for each tax year: at least 50 percent of total gross income is derived from sales, rentals, services or other transactions with low-income persons; at least 40 percent of employees are low-income persons; or at least 50 percent of the owners are low-income persons. The test with respect to employees is applied at the time the employee is hired, without regard to any increase in the employee's income after the time of hire. The test is applied to owners of the business at the time the loan or investment is made in the business without regard to any increase in income after such date. The QALICB may also be the owner of rental real estate if at least 50 percent of the lessees are low-income persons or the property is leased to businesses that satisfy the foregoing QALICB requirements for serving or employing low-income persons. The business must be located and conduct its activities primarily in census tracts at or below 120 percent of either statewide median family income for non-metropolitan area tracts, or the greater of statewide or metropolitan area median family income for tracts located within a metropolitan area. The 120 percent restriction does not apply to a business that is located within a census tract with a population of less than 2,000 if such tract is not located in a metropolitan area or if it is located in a metropolitan area, more than 75 percent of the tract is zoned for commercial or industrial use. The CDFI Fund guidance (discussed on page 7) provides that data from its Information and Mapping System (CIMS) may be relied on to determine whether a census tract has a median family income at or below the 120 percent restriction.

GO Zone Targeted Populations

IRS Notice 2006-60 provides rules for making qualified low-income community investments solely with respect to CDEs with a GO Zone allocation under the increase in the NMTC limitation. The NMTC limitation

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otherwise determined under IRC Section 45D(f)(1) was increased by an amount equal to $300 million for 2005 and 2006 and $400 million for 2007, to be allocated among CDEs to make qualified low-income community investments within the GO Zone.

An individual qualifies as a member of a GO Zone targeted population if the individual was displaced from his or her principal residence as a result of Hurricane Katrina and/or the individual lost his or her principal source of employment as a result of Hurricane Katrina. The individual's principal residence or principal source of employment must have been located in a census tract that contains one or more areas designated by FEMA as flooded, having sustained extensive damage, or having sustained catastrophic damage as a result of Hurricane Katrina (FEMA designated tract). The QALICB tests above apply, provided that the business is located in one or more of the FEMA designated tracts. The location of the business is determined based on the gross income, tangible property and services tests applicable to QALICBs. The QALICB may also be the owner of rental real estate if at least 50 percent of the lessees are low-income persons or the property is leased to businesses that satisfy the foregoing QALICB requirements for serving or employing low-income persons. The business must be located and conduct its activities primarily in census tracts at or below 200 percent of either statewide median family income for non-metropolitan area tracts, or the greater of statewide or metropolitan area median family income for tracts located within a metropolitan area. The 200 percent restriction does not apply to a business located within a census tract with a population of less than 2,000 if such tract is not located in a metropolitan area, or if located in a metropolitan area, more than 75 percent of the tract is zoned for commercial or industrial use. CDFI Fund guidance (discussed on page 7) provides that CIMS data may be relied on to determine whether a census tract has a median family income at or below the 200 percent restriction.

Proposed Regulations - Modifications

The proposed regulations provide useful clarification on several issues.

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Reasonable Expectation Safe Harbor Applies

The existing Treasury Regulations relating to QALICBs apply, except as stated otherwise. For example, the reasonable expectation safe harbor applies to determinations of QALICB status. If the CDE reasonably expects, at the time the community development entity (CDE) makes the investment in, or loan to, the business that the business will satisfy the QALICB requirements throughout the period of the investment or loan, the business will be treated as a QALICB for the duration of the CDE's investment. However, based on the preamble to the regulations, the QALICB must meet one of the three targeted populations tests (gross income, employees or ownership) at the time the QLICI is made.

Median Family Income Limitations

Taxpayers must rely on the annual estimates of median family income released by the U.S. Department of Housing and Urban Development (HUD) and may rely on those figures until 45 days after HUD releases a new list of income limits, or until HUD's effective date for the new list, whichever is later. The income limits are computed and listed, according to family size, by HUD for every metropolitan statistical area, primary metropolitan statistical area, non-metropolitan county of the U.S. and Puerto Rico, and for the possessions of Guam and the Virgin Islands.

120 Percent/200 Percent Restrictions

In response to comments received, the regulations provide that the 75 percent calculation should be made using the area of the population census tract. Property for which commercial or industrial use is a permissible zoning use will be treated as zoned for commercial or industrial use.

FEMA Designated Tracts

The preamble to the proposed regulations states that FEMA designated tracts are available on the CDFI Fund web site. See the document titled, "Census Tracts Containing Parcels of Land Flooded or Severely Damaged by Hurricane Katrina."

Active conduct of a trade or business

Treasury regulations provide that a business is treated as engaged in the active conduct of a trade or business if at the time the CDE make the QLICI, the CDE reasonably expects the business will generate revenues (or in the case of a not-for-profit, engage in activity that further its purposes as a nonprofit corporation) within three years after the date the QLICI is made. The proposed regulations clarify that this safe harbor applies only for purposes of determining whether a business is engaged in the active conduct of a trade or business and does not apply for purposes of determining whether the gross-income requirement is satisfied. Based on the preamble, one of the three tests (gross income, employee or ownership) must be met at the time the QLICI is made.

Comments Requested

The IRS and Treasury Department invite comments generally and specifically encourage comments on the following:

1. The standard to be used to determine an individual's income. The IRS and Treasury propose using the measure of income used by the U.S. Census Bureau to ensure a consistent comparison between the individual's family income and the applicable area median family income. Other approaches include income as reported on IRS Form 1040, or the definition set forth in 24 CFR Part 5 that applies to certain HUD and Federal programs.
2. Whether it should be reasonable to use the HUD standards which apply to the low-income housing tax credit program pending issuance of the final regulations.
3. Whether the gross income requirements should include the fair market value of goods and services provided to low-income persons at reduced fees.
4. Whether additional restrictions should be added to the employee requirements, such as a requirement that the employee is a member of a targeted group as defined by the work opportunity tax credit or that the business must pay a wage that would increase the income of the

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low-income individual being hired.

Deadlines

Written comments are due by December 23, 2008 and outlines of topics to be discussed at a public hearing scheduled for January 22, 2009 must be received by Friday, December 26, 2008. Final regulations are to be issued before June 30, 2009.

The CDFI Fund issued guidance September 30, 2008 (NMTC Q&A Document) to CDEs that serve targeted populations and certain geographic areas. The guidance provides that a CDE does not have to obtain pre-approval of investments with respect to targeted populations. All certified CDEs may serve targeted populations within their approved service area and in compliance with the terms of their allocation agreement. The CDE accountability requirement is also not impacted by serving targeted populations.

Transactions have closed using the targeted populations criteria for LIC and the proposed regulations provide further assurances as to the applicable rules that will facilitate broader use of this tool to expand the availability of the NMTC.

The information presented in this article is intended solely for informational purposes and should not be construed as legal advice by the author or Future Unlimited Law PC. For more information contact Ruth Sparrow, of Future Unlimited Law PC at rsparrow@futureunlimitedlaw.com; (360) 458-1720; futureunlimitedlaw.com.
