Novogradac
Journal of Tax Credits
News, Analysis and Commentary On Affordable Housing, Community Development and Renewable Energy Tax Credits

June 2011, Volume II, Issue VI

Published by Novogradac & Company LLP

Targeted Populations Guidance to Date Leaves Some Unanswered Questions

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The American Jobs Creation Act of 2004 amended the new markets tax credit (NMTC) program under Section 45D(e) of the Internal Revenue Code (IRC) to provide that targeted populations may be treated as low-income communities (LIC). Final regulations providing targeted populations rules are on the Internal Revenue Service's 2010-2011 priority guidance list and may be issued by June 30, 2011. In anticipation of the final regulations, this article considers what is known and what is yet to be resolved in regards to serving low-income targeted populations.

Background on the Guidance to Date

Since 2004, a number of issues have been resolved with the help of guidance provided in Notice 2006-60 as well as proposed regulations issued in 2008.

In Notice 2006-60, the Internal Revenue Service (IRS) said that in order to obtain NMTC financing for low-income targeted populations, the recipient of the financing must be a "qualified active low-income community business" (QALICB) that establishes that it substantially serves low-income persons, employs low-income persons or is owned by low-income persons (as further described below). Transactions financing targeted populations have closed relying on each of these criteria.

Proposed regulations issued September 24, 2008 provide rules, generally consistent with Notice 2006-60, for determining how the QALICB requirements are satisfied for investments made to low-income targeted populations.

Despite the guidance provided in the proposed regulations and Notice 2006-60, a number of open issues remain in regard to providing the benefits of NMTC financing to low-income targeted populations outside of qualified low-income census tracts. The proposed regulations will apply to tax years ending on or after the date final regulations are issued. Prior to issuance of the final regulations, taxpayers should continue to rely on Notice 2006-60. With respect to issues not addressed by the notice and in the absence of other guidance, it should be reasonable to rely on the proposed regulations.

Common Concerns and Open Questions

Definition of Low-Income Persons

IRS Notice 2006-60 defines "low-income persons" as individuals having an income, adjusted for family size, of not more than:

a. 80 percent of the area median family income for metropolitan areas; and
b. the greater of 80 percent of the area median family income or the statewide nonmetropolitan area median family income for non-metropolitan areas.

The preamble to the proposed regulations states that taxpayers must rely on the annual estimates of median family income released by the Department of Housing and Urban Development (HUD) and may rely on those figures until the later of 45 days after HUD releases a new list of income limits, or until HUD's effective date for the new list. HUD computes and lists the income limits, according to family size, for every metropolitan statistical area, primary metropolitan statistical area and nonmetropolitan county. HUD estimates of median family income are based on census data

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updated by annual census bureau surveys.

There is no published guidance regarding the appropriate method to use to determine a person's income for purposes of qualifying that person as "low-income." The proposed regulations requested comments regarding the appropriate method and proposed using the measure of income used by the census bureau to ensure a consistent comparison between the individual's family income and the applicable area median family income. Other approaches referenced in the proposed regulations include income as reported on IRS Form 1040, or the definition set forth in 24 CFR Part 5, which applies to certain HUD and federal programs. Until the final regulations are issued, any of these methods should be reasonable, depending on the facts of the transaction. The HUD standards that apply to the low-income housing tax credit program are frequently used. (See HUD Handbook 4350.3 REV-1, which provides guidance regarding definitions of income and family size.) Accountants with income verification experience are usually engaged to review the data to confirm compliance at closing and to review or provide procedures to maintain compliance.

Definition of QALICB Serving 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 rental real estate QALICB will qualify if at least 50 percent of the QALICB's gross income is from rentals to individuals who are low-income persons or to QALICBs that satisfy either the gross income or employee requirement.

Notice 2006-60 provides an upper limit on the income levels of the census tract in which the QALICB operates. The QALICB must be located and conduct its activities primarily in census tracts where the median family income is at or below 120 percent of the 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. CDFI Fund Mapping System (CIMS) data (available at the CDFI Fund web site) may be relied on to determine whether a census tract has a median family income at or below the 120 percent restriction.

The QALICB must satisfy the QALICB requirements with respect to engaging in the "active conduct" of a "qualified business," and the limitations on the ownership of "nonqualified financial property" and "collectibles." Treasury regulations provide that the active conduct requirement is satisfied if at the time the QLICI

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ISSN 2152-646X

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is made, the CDE reasonably expects the business will generate revenues (or in the case of a nonprofit, engage in activity that furthers its purposes as a nonprofit) within three years after the date the QLICI is made. The proposed regulations provide that this safe harbor applies only to determine whether the active conduct requirement is satisfied and does not apply in determining compliance with the targeted populations' requirements such that the gross income, employee or ownership test must be satisfied in the QALICB's tax year that the QLICI is made.

The reasonable expectations safe harbor for determining QALICB status applies to targeted populations QALICBs. Treasury regulations provide that an entity is 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 QLICI, that the entity will satisfy the QALICB requirements throughout the entire period of the investment or loan, unless the CDE controls or obtains control of the QALICB during the seven-year credit period. In order to have a reasonable expectation of ongoing compliance, the targeted populations tests are generally required to be met at levels in excess of 60 percent, and procedures are established to support ongoing compliance with the requirements.

Gross Income

The gross income criterion is used, for example, with respect to healthcare and social service facilities. In the preamble to the proposed regulations, Treasury rejected a comment that businesses that qualify and participate in other federal programs targeted specifically to low-income individuals should be deemed to satisfy the targeted populations' requirements. Such qualification does not substitute for compliance with the statutory requirements of Section 45D(e). However, documentation of an individual client's eligibility for other federal programs with similar income thresholds and criteria is useful evidence of qualification at closing and for purposes of the reasonable expectations safe harbor. Analysis of the differences in the applicable criteria of the other federal program would be required throughout the NMTC compliance period. Other factors that may contribute to the reasonable expectation of ongoing compliance with the gross income test are the client base and the geographical communities served by the QALICB.

The calculation of the QALICB's gross income derived from low-income persons is not specifically addressed in Notice 2006-60 or the proposed regulations. The proposed regulations requested comments as to whether to use the fair market value of goods and services to determine income received if discounts are provided to low-income persons. There is no published guidance yet on this issue. The IRS has concluded that gross income "derived from" transactions with low-income persons, includes payments made on behalf of low-income persons, either individually or as a

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class, including federal, state or local grants, charitable donations, in-kind contributions and insurance. (See Private Letter Ruling 200910024). The funds paid from sources other than the customers/clients must be allocable to transactions with low-income persons such that at least 50 percent of the entities' gross income (including payments made directly by the individuals) is attributable to such transactions.

Based on the preamble to the proposed regulations, the gross income criteria cannot be satisfied by providing services to an intermediary business which engages in transactions with low-income persons, unless the QALICB engages in the rental of real estate to a business which is a QALICB that satisfies the gross income test.

Employees

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. If the QLICI is financing an existing business, the challenge will be to verify the income of employees hired several years before the QLICI is closed. In the absence of specific guidance, the methods described above should be reasonable to determine the income of such employees.

Owners

The ownership 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 of such owners after such date. Notice 2006-60 and the proposed regulations do not address individuals that become owners after the QLICI is made. Consequently, admission of new owners and transfers of interests would be precluded during the NMTC compliance period by providing for automatic redemption by the QALICB or re-allocation of interests among the initial low-income owners. These restrictions are not consistent with the intent of the targeted populations provisions. It may be reasonable to view this provision as an unintended technical error and take the position that new owners should be allowed during the NMTC compliance period. Based on existing guidance, the ownership criteria is not available to nonstock nonprofit corporations.

Start-Up Businesses

Based on the proposed regulations, the applicable low-income targeted populations test (gross income, employees, or ownership) must be satisfied for the tax year of the QALICB in which the QLICI is made. If a QALICB is constructing a facility for its operations or to rent to another party, the QALICB (or its tenants) may not have employees or provide services that generate gross income until construction is completed. As stated above, it is not sufficient that the QALICB is reasonably expected to satisfy the gross income or employee requirements within three years of closing the QLICI. The requirement to satisfy one of the tests in the tax year that the QLICI is made supports using a QLICI to refinance construction financing for a facility that is completed prior to closing or is likely to be completed within the first tax year. This requirement adversely impacts the ability to finance QALICBs structured as special purpose entities that will rely on the gross income test in particular, for example, community facilities.

Conclusion

Our experience is that NMTC financing of low-income targeted populations is becoming more acceptable to investors, subject to additional due diligence and ongoing compliance requirements, and the transactions have been targeted to highly distressed individuals, businesses and/or geographical areas, in rural and urban communities. The release of additional guidance in the form of final regulations is expected to encourage even more confidence from investors and will likely strengthen this trend.

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.

This article first appeared in the June 2011 issue of the Novogradac Journal of Tax Credits.

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