
Internal Revenue Service

New Markets Tax Credit

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Department of the Treasury
Internal Revenue Service
LMSB-04-0510-016 (May 2010)



Internal
Revenue
Service

Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.



Department of the Treasury
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Ten Core Ethical Principles *

Honesty
Integrity/Principled
Promise-Keeping
Loyalty
Fairness
Caring and Concern for Others
Respect for Others
Civic Duty
Pursuit of Excellence
Personal Responsibility/Accountability

The Five Principles of Public Service Ethics *

Public Interest
Objective Judgment
Accountability
Democratic Leadership
Respectability

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Chapter 1

Introduction to the New Markets Tax Credit

Introduction

This chapter provides a brief overview of the New Markets Tax Credit (NMTC) under IRC §45D.

Congressional Intent

The New Markets Tax Credit (NMTC) Program, enacted by Congress as part of the Community Renewal Tax Relief Act of 2000, is incorporated as section 45D of the Internal Revenue Code. This Code section permits individual and corporate taxpayers to receive a credit against federal income taxes for making Qualified Equity Investments (QEIs) in qualified community development entities (CDEs).

These investments are expected to result in the creation of jobs and material improvement in the lives of residents of low-income communities. Examples of expected projects include financing small businesses, improving community facilities such as daycare centers, and increasing home ownership opportunities.

A “low-income community” is defined as any population census tract where the poverty rate for such tract is at least 20% or in the case of a tract not located within a metropolitan area, median family income for such tract does not exceed 80 of statewide median family income, or in the case of a tract located within a metropolitan area, the median family income for such tract does not exceed 80% of the greater of statewide median family income or the metropolitan area median family income.

As part of the American Jobs Creation Act of 2004, IRC §45D(e)(2) was amended to provide that targeted *populations* may be treated as low-income communities. A “targeted population” means individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments.

“Targeted population” also includes the Hurricane Katrina Gulf Opportunity (GO) Zone, where individuals’ principal residences or principal sources of income were located in areas that were flooded, sustained heavy damage, or sustained catastrophic damage as a result of Hurricane Katrina.

See Notice 2006-60, [2006], 2006-2 C.B. 82, for additional guidance on targeted populations.

Taxpayers' Qualified Equity Investment (QEI)

Qualified Equity Investment (QEI) Defined

The actual cash investment made by the investor to the CDE, which is referred to as the equity investment, is the first step in defining a QEI. This cash investment eventually qualifies for the NMTC provided that the CDE makes qualified low-income community investments (QLICIs).

A QEI is, in general, any equity investment in a CDE if:

1. Such investment is acquired by the investor at its original issue (directly or through an underwriter) solely in exchange for cash,
2. Substantially all (at least 85%) of the cash is used by the CDE to make qualified low-income community investments (QLICI), and
3. The investment is designated by the CDE as a QEI on its books and records using any reasonable method.

The term equity investment means any stock in an entity which is a corporation, and any capital interest in an entity which is a partnership.

Amount Paid at Original Issue

Under IRC §45D(b)(1)(A) and Treas. Reg. §1.45D-1(b)(4), the amount paid by the investor to the CDE for a QEI at its original issue consists of all amounts paid by the taxpayer to, or on behalf of, the CDE and includes any underwriter fees to purchase the investment at its original issue.

Time of Investment

In general, an equity investment in a CDE is not eligible to be designated as a QEI if it is made before the CDE enters into an allocation agreement with the Community Development Financial Institutions Fund (CDFI). The allocation agreement specifies the terms of the NMTC allocation under IRC §45D(f)(2). However, for exceptions to the rule, see Treas. Reg. §1.45D-1(c)(3)(ii).

Reporting Requirements

A CDE must provide notice to any investor who acquires a QEI in the CDE at its original issue that the equity investment is a QEI entitling the investor to claim the NMTC. The notice is made using Form 8874-A, Notice of Qualified Equity Investment for New Markets Credit, or for periods before March 2007, a written notification prepared by the CDE. The notice must be provided by the CDE to the taxpayer *no later than 60 days* after the date the investor makes the equity investment in the CDE. The notice must contain the amount paid to the CDE for the QEI at its original issue and the CDE's taxpayer identification number. (Treas. Reg. §1.45D-1(g)(2)(A).)

Allocation Limitation

The amount of QEIs designated by a CDE may not exceed the amount allocated to the CDE by the CDFI Fund. The term QEI *does not include*:

1. Any equity investment issued by a CDE more than 5 years after the CDE enters into an allocation agreement with the CDFI Fund, and
2. Any equity investment by a CDE in another CDE, if the CDE making the investment has received an allocation under IRC §45D(f)(2). This prevents a CDE with an allocation from investing in another CDE with an allocation, and

thereby doubling up credits on a single investment.

Allowance of Credit

The NMTC is included under IRC §38(a)(13) as part of the General Business Credit. The credit equals 39% of the investment and is claimed during a seven-year credit period. Investors may not redeem or otherwise cash out their investments in the CDEs prior to the conclusion of the seven-year credit period.

Credit Allowance Date

A taxpayer holding a qualified equity investment (QEI) on a credit allowance date occurring during the taxable year may claim the NMTC for such taxable year in an amount equal to the applicable percentage of the amount paid to a qualified community development entity (CDE) for such investment at its original issue. Under IRC §45D(a)(3), the term credit allowance date means, with respect to any QEI:

1. The date on which the investment is initially made; and
2. Each of the six anniversary dates of such date thereafter.

In other words, the credit period is the seven-year period beginning on the date a QEI is initially made, even though the credit is allowable on the first day of each credit year.

Applicable Percentage

The credit provided to the investor equals 39% of the QEI and is claimed over the seven-year credit period. Under IRC §45D(a)(2), the applicable percentage is 5 percent for the first three credit allowance dates and 6 percent for the last four credit allowance dates.

Example 1:

A CDE receives a \$2 million NMTC allocation. Investors make \$2 million of equity investments in the CDE. Assuming all other requirements are met, the investors would be entitled to claim NMTC equal to 39% of \$2 million or \$780,000 as follows:

Year One:	5% of \$2 million = \$100,000
Year Two:	5% of \$2 million = \$100,000
Year Three:	5% of \$2 million = \$100,000
Year Four:	6% of \$2 million = \$120,000
Year Five:	6% of \$2 million = \$120,000
Year Six:	6% of \$2 million = \$120,000
<u>Year Seven:</u>	<u>6% of \$2 million = \$120,000</u>
Total:	\$780,000

Although the CDE has the authority to designate up to \$ 2 million in QEI, its investors can only claim the NMTC on the actual cash invested in the CDE.

Example 2:

Assuming the same facts in Example 1, except the CDE raises \$1 million for investments in qualified active low-income businesses. Assuming all other requirements are met, the investors would be entitled to claim \$150,000 in NMTC for the first three years and \$240,000 in NMTC for the last four years computed as follows:

$$\begin{array}{r} (5\% \text{ of } \$1 \text{ million}) \times 3 \text{ years} = \$150,000 \\ \underline{(6\% \text{ of } \$1 \text{ million}) \times 4 \text{ years} = \$240,000} \\ \text{Total:} \qquad \qquad \qquad \$390,000 \end{array}$$

In essence, an investor in the NMTC program gets 39 cents in tax credits during the seven-year credit period for every dollar invested and designated as a QEI.

Manner of Claiming the New Markets Tax Credit

A taxpayer may claim the NMTC for each applicable year by completing Form 8874, New Markets Credit, and filing the form with the taxpayer's federal income tax return.

Subsequent Purchasers

Under Treas. Reg. §1.45D-1(c)(7), a QEI includes any equity investment that would be a QEI in the hands of the taxpayer (but for the requirement that the investment be acquired by the taxpayer at its original issue) if the investment was a QEI in the hands of a prior holder.

Credit Recapture

If, at any time during the 7 years beginning on the date of the original issue of a QEI in a CDE, there is a recapture event with respect to the investment, then the tax imposed for the taxable year in which the recapture event occurs is increased by the credit recapture amount. A recapture event requires recapture of credits allowed to the taxpayer who purchased the equity investment from the CDE at its original issue and to all subsequent holders of that investment.

Under IRC §45D(g)(3), there is a recapture event with respect to any equity investment in a CDE if one of the following three events occurs:

1. The CDE ceases to be a CDE,
2. The taxpayer's investment ceases to meet the substantially-all requirement, which involves investments in qualified low-income community investments (QLICIs), or
3. The investment is redeemed or otherwise cashed out by the CDE.

Relationship to Other Federal Tax Benefits

Interaction with Other Federal Tax Benefits

The availability of other federal tax benefits does not limit the availability of the NMTC. Under Treas. Reg. §1.45D-1(g)(3), examples include:

1. The Rehabilitation Credit under IRC §47.

2. All deductions under IRC §§167 and 168, including first year depreciation under IRC §168(k), and the expense deduction for certain depreciable property under IRC §179.
3. All tax benefits relating to certain designated areas such as empowerment zones and enterprise communities under IRC §1391 through IRC §1397D, the District of Columbia Enterprise Zone under IRC §1400 through IRC §1400B, renewal communities under IRC §1400E through IRC §1400J, and the New York Liberty Zone under IRC §1400L.
4. A CDE is not prohibited from purchasing tax-exempt bonds because tax-exempt financing provides a subsidy to borrowers and not bondholders. See T.D. 9171, 69 FR 77627, for discussion of Tax Exempt Bonds under IRC §103.

Exception for Low-Income Housing Credit

If a CDE makes a capital or equity investment or a loan with respect to a qualified low-income building under IRC §42, the investment or loan is not a QLICI to the extent the building's eligible basis under IRC §42(d) is financed by the proceeds of the investment or loan. See Treas. Reg. §1.45D-1(g)(3)(C)(ii).

Anti Abuse Rules

If a principal purpose of a transaction, or a series of transactions, is to achieve a result that is inconsistent with the purpose of IRC §45D and the regulations thereunder, the Commissioner may treat the transaction or series of transactions as causing a recapture event. IRC §45D(i)(1) and Treas. Reg. §1.45D-1(g)(1).

Qualified Community Development Entity (CDE)

Qualified Community Development Entity (CDE) Defined

Under IRC §45D(c)(1), a CDE is any domestic corporation or partnership:

1. Whose primary mission is serving or providing investment capital for low-income communities or low-income persons,
2. That maintains accountability to residents of low-income communities through their representation on any governing board or advisory board of the CDE, and
3. Has been certified as a CDE by the CDFI Fund. See www.cdfifund.gov for more information.

Under IRC §45D(c)(2), any specialized small business investment company as defined in IRC §1044(c)(3) and CDFI as defined in §103 of the Community Development Banking and Financial Institutions Act of 1994 are treated as having met these requirements.

A CDE certification lasts for the life of the organization unless it is revoked or terminated by the CDFI Fund. To maintain its CDE certification, a CDE must certify annually during this period that the CDE has continued to meet the CDE certification requirements.

Both for-profit and non-profit CDEs may apply to the CDFI Fund for an allocation of NMTC, but only a for-profit CDE is permitted to provide the NMTC to its investors. Thus, if a non-profit CDE receives an allocation of NMTC, it must “sub-allocate” its NMTC allocation to one or more for-profit CDEs.

Qualified Low-Income Community Investments (QLICI)

The investor’s cash investment received by a CDE is treated as invested in a QLICI only to the extent that the cash is so invested no later than 12 months after the date the cash is paid by the investor (directly or through an underwriter) to the CDE. The cash investment can be one of the four following types of QLICIs under IRC §45D(d)(1):

1. Any capital or equity investment in, or loan to, any qualified active low-income community business.
2. A loan purchased by a CDE from another CDE which is a QLICI.
3. Financial counseling and other services to any qualified active low-income community business, or to any residents of a low-income community.
4. Any equity investment in, or loan to, other CDEs. See Treas. Reg. §1.45D-1(d)(1)(iv).

Community Development Financial Institutions Fund’s Responsibilities

The CDFI Fund is responsible for establishing the credit application process, eligibility guidelines, and a scoring model for ranking applicants requesting allocations of NMTC. The CDFI Fund grants credit authority to the CDE; i.e., the ability to issue a specific amount of NMTC in exchange for equity investments.

Throughout the life of the NMTC Program (2001-2009), the CDFI Fund has been authorized to allocate to CDEs the authority to issue credit to their investors up to the aggregate amount of \$21.5 billion in equity. Under the Gulf Opportunity Zone Act of 2005, the CDFI Fund allocated an additional \$1 billion from 2005 to 2007 for QLICIs in the Hurricane Katrina GO Zone.

Internal Revenue Service’s Responsibility

The Internal Revenue Service (IRS) is responsible for the tax administration aspects of IRC §45D, including responsibility for ensuring taxpayer compliance. The IRS has developed a comprehensive compliance program that focuses on both filing and reporting compliance by CDEs that received credit allocations, as well as taxpayers making investments and claiming the credit.

The IRS has developed this audit technique guide as part of its compliance program. The remaining chapters of this guide will focus on key terminology used in the NMTC arena, tax law, entity structures, examination issues at the CDE and investor levels, disclosure concerns, and report writing.

The Complete Picture

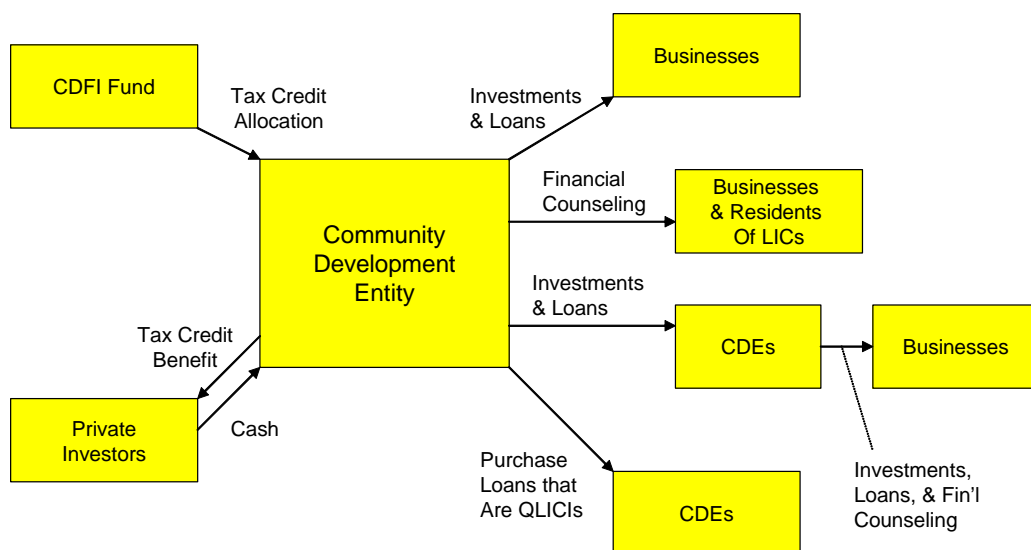
To conclude this chapter, the following diagram demonstrates the relationship between the organizations involved with the New Markets Tax Credit (NMTC) program.

In the upper left hand corner is the CDFI Fund, which has authority to allocate a portion of the NMTC limitation to the CDE, which means that the CDFI Fund allocates equity eligible for the NMTC.

Private investors (lower left hand corner) make cash investments in the CDE and claim the NMTC on their federal income tax returns. Although not demonstrated here, the investor may leverage the investment by investing funds borrowed from another source, thereby increasing the amount of the investment and credit.

The CDE must then invest substantially all of the cash in low-income communities within 12 months of receiving the funds.

On the right-hand side of the chart are the types of investments the CDE can make.



Summary

1. The NMTC was enacted on December 21, 2000, as part of the Community Renewal Tax Relief Act of 2000. As part of the American Jobs creation Act of 2004, IRC §45D(e)(2) was amended to provide for investment in targeted populations, in addition to investments in low-income areas where there is at least a 20% poverty level or where the median family income does not exceed 80% of the median family income. The Hurricane Katrina GO Zone has also been identified as an area where low-income persons lack adequate access to loans or equity investments.

2. IRC §45D creates a tax credit for equity investments in CDEs. QEIs are made as stock or capital interest purchases in a for-profit corporation or partnership, respectively. QEIs must remain with the CDE for the entire 7-year credit period.
3. The NMTC is 39% of the QEI during a 7-year credit period. The investor may claim 5% in each of the first 3 years and 6% in each of the final 4 years.
4. The NMTC is recaptured if the substantially-all requirement is not met and is not corrected within the one-time 6 month cure period, the CDE ceases to be a CDE, or the CDE redeems or otherwise cashes out the investment.
5. A CDE's primary mission is to provide investment capital for low-income communities. A CDE can be a corporation or partnership.
6. The CDFI Fund is responsible for determining which CDEs will be granted authority to issue NMTC. The CDFI Fund has created an application process, eligibility guidelines, and a scoring model for ranking applicants. The CDFI Fund also certifies entities as CDEs and monitors CDEs for compliance.
7. Throughout the life of the NMTC Program, the CDFI Fund is authorized to allocate to CDEs the authority to issue to investors up to the aggregate amount of \$21.5 billion in equity for which the NMTC can be claimed. In addition, under the Gulf Opportunity Zone Act of 2005, the CDFI Fund allocated an additional \$1 billion from 2005 to 2007 for QLICs in the Hurricane Katrina Gulf Opportunity Zone. The American Recovery and Reinvestment Tax Act of 2009 provides the CDFI Fund with an additional \$3 billion of NMTC authority to be divided equally between 2008 and 2009.
8. The IRS is responsible for establishing procedures and processes to ensure taxpayers are in compliance with IRC §45D.

Chapter 2 Issues at the CDE Level

Introduction

This chapter outlines the basic issues and audit techniques for reviewing a qualified Community Development Entity's (CDE's) New Markets Tax Credit (NMTC) activities.

References

- IRC §45D
- Treas. Reg. §1.45D-1
- Notice 2006-60, 2006-2, C.B. 82
- Chief Counsel Advice (CCA) POSTS-101102-09

Pre-Contact Analysis of Tax Returns

As part of the pre-contact analysis, the tax return should be reviewed, including line items, credits, balance sheet, elections and schedules, and any documents related to the NMTC that the taxpayer included with the tax return. Common NMTC items, and their significance, are discussed here. See IRM 4.10.2.3, In-depth Pre-contact Analysis, for more information.

Balance Sheet

The balance sheet analysis is a useful technique for reviewing a taxpayer's financial position.

1. Cash at the beginning of the year will include equity investments received in exchange for the NMTC. These investments will be designated as qualified equity investments (QEI) in the taxpayer's books and records.
2. Cash at the end of the year should decrease and assets such as mortgages, real estate loans and other investments should increase, indicating that the CDE has used the equity investments to make qualified low-income community investments (QLICIs). A schedule of investments may be attached to the tax return.
3. The paid-in capital accounts for CDEs that are partnerships for federal tax purposes should also indicate the amount of each equity investment.

During the audit, these account balances should be verified, adjusting entries reviewed and transactions tested. See IRM 4.10.3.8.4, which provides techniques for examining specific balance sheet accounts.

Income Statement

The income statement will reflect activities associated with qualified investments, such as amortization of start-up costs and interest income earned from qualifying investments.

**Form 851,
Affiliations
Schedule
(Corporations)**

If a CDE is a corporation that is a member of an affiliated group that files a consolidated return, it will include Form 851. This form identifies the subsidiary corporations and provides information such as business activities and stock holdings. The form will indicate:

1. The number of shares in the CDE.
2. The number of shares the parent corporation or related subsidiary has in the subsidiary CDE, suggesting that Form 8874, New Markets Credit, will be filed by the parent corporation or related subsidiary to claim the credit.
3. The number of shares may equal the investment amount. For example, \$1 per share x 5 million shares equals an investment of \$5,000,000.

**Form 8874,
New Markets
Credit**

The Form 8874 may identify transactions between related parties. For example, a parent corporation invests \$4,000,000 in a CDE on December 31, 2005. Form 8874 will identify the CDE by name and EIN, as well as the amount of credit that will be included on Form 3800.

**Schedule K,
Partners'
Distributive
Share
(Partnerships)**

If the CDE is a partnership, the tax return will include Schedule K. For the first year, the investor's investment and capital account may be equal. The partners file Form 8874 to directly claim the NMTC.

Preliminary Analysis

Purpose

The purpose of the preliminary analysis is to determine what information is needed for evaluating the CDE's compliance with the requirements of IRC §45D.

It will be necessary to review the CDE's books and records, as well as documentation associated with the NMTC application and allocation process. It will also be necessary to interview the CDE and analyze the CDE's internal controls.

**Review
Documents
Associated
with the NMTC
Allocation**

The following documents will need to be reviewed.

1. CDE Certification Application and Approval
2. Notice of Allocation Availability
3. Notice of Allocation and the Allocation Agreement

CDE Certification Application and Approval

To qualify as a CDE, an entity must be a domestic corporation or partnership that has a primary mission of serving, or providing investment capital for low-income communities or low-income persons. The CDE must maintain accountability to residents of low-income communities through their representation on a governing or advisory board to the entity, and must be certified as a CDE by the Community Development Financial Institutions (CDFI) Fund. Any organization seeking CDE designation must apply to the CDFI Fund. The CDE application documents are insightful in understanding how the CDE is organized, its mission, how it intends to

operate, and the type of investments the organization intends to make.

- Confirmation that the CDE is certified and has current CDE status can be obtained at www.cdfifund.gov.

Failure to maintain certification or revocation of the certification is an NMTC recapture event under IRC §45D(g)(3)(A). Under Treas. Reg. §1.45D-1(e)(4), bankruptcy of a CDE is not a recapture event. NMTC recapture is discussed in Chapter 4.

Notice of Allocation Availability (NOAA)

The Notice of Allocation Availability is published by the CDFI Fund for each allocation round. The document describes program priorities, discloses criteria for selecting allocates, and provides information related to the allocation process. Key dates are also identified.

Notice of Allocation and Allocation Agreement

Each CDE applying for the NMTC will be notified of the CDFI Fund's decision through a Notice of Allocation or a declination letter. There is no right to appeal the decision.

The Notice of Allocation will contain the general terms and conditions underlying the CDFI Fund's allocation of the NMTC. The CDE executes the Notice of Allocation and returns it to the CDFI Fund.

A CDE selected to receive an NMTC allocation must enter into an allocation agreement with the CDFI Fund. The agreement sets forth certain terms and conditions of the allocation, such as the amount of the NMTC allocation and approved uses, locations of the low-income communities to be served, the time period by which the CDE must receive QEIs and reporting requirements. The CDE must also provide an opinion from its legal counsel, the content of which is specified in the allocation agreement.

Review Commitments & Agreements Between CDE and Investors

When a QEI is made, the investor and CDE will enter into an agreement defining the terms of the investment, including the amount of the investment, when the investment is made, and the circumstances under which an investment may be withdrawn (penalties or fees). The commitment will also outline the CDE's responsibilities. Remedies should either party fail to perform according to the agreement may also be identified.

If the CDE is a partnership, the partnership agreement should also be reviewed. The agreement may outline exit strategies available to the investor.

Review Commitments & Agreements Between CDE and QALICBs

When a QLICI is made, the CDE and business will enter into an agreement regarding the use of the funds (except for situations involving multiple CDEs and counseling and other services specified in the regulation). Agreements, commitments and loan documents should be reviewed. The purpose of this review will be discussed later in this chapter.

Interview the Taxpayer (IRM 4.10.3.2)

As directed in IRM 4.10.3.2, a representative of the CDE should be interviewed to provide information about the CDE that will not be apparent when reviewing the books and records. The interview should be held with the person most knowledgeable about the CDE's activities.

Evaluate Internal Controls (IRM 4.10.3.4)

As directed in IRM 4.10.3.4, evaluate the existence and effectiveness of the CDE's internal controls to determine the accuracy and reliability of the books and records. For CDEs, it will be particularly important to determine how:

1. QEIs are identified in the books and records, segregated, and applied to qualified low-income community investments (QLICs),
2. the substantially-all percentage is calculated, and
3. the taxpayer ensures that the substantially-all requirement is met.

Qualified Equity Investment (QEI)

QEI Defined

An investor with a QEI is entitled to claim the NMTC, if a credit allowance date occurs during the investor's taxable year. For each equity investment in the CDE, examiners should determine whether the investment is a QEI for purposes of IRC §45D.

Step One: Analyze Equity Investments

To be considered a QEI, the investment must meet the following criteria:

1. The equity investment is acquired by the investor at its original issue (directly or through an underwriter) solely in exchange for cash to the CDE or on behalf of the CDE. The equity investment can be for any stock in a CDE that is a corporation for federal tax purposes (other than nonqualified preferred stock under IRC §351(g)(2)) and any capital interest in a CDE that is a partnership for federal tax purposes.
2. The equity investment must be designated as a QEI under IRC §45D by the CDE in its books and records using any reasonable method.

Generally, an equity investment is not eligible to be designated as a QEI if it is made before the CDE enters into an allocation agreement with the CDFI Fund. However, there are exceptions as listed in Treas. Reg. §1.45D-1(c)(3)(ii) for investments made after April 20, 2001, and allocation applications submitted by August 29, 2002, or for investments made after the date of the Notice of Allocation Availability is published in the Federal Register.

3. Substantially all of the cash is used by the CDE to make QLICs. This test will be discussed later in this chapter.
Equity investments issued more than 5 years after the CDE enters into an allocation agreement are not QEIs. A CDE that has received an allocation cannot make a QEI in another CDE. A CDE cannot issue more QEIs than the NMTC awarded under the allocation agreement.

Qualified Low-Income Community Investment (QLICI)

QLICI Defined

The CDE must invest the QEIs in QLICIs. The investments can be:

- a. A capital or equity investment in, or loan to, any qualified active low-income community business.
- b. The purchase from another CDE of any loan that was a QLICI either at the time the loan was made or at the time the CDE purchases it. It is not necessary for the CDE from which the loan is purchased to have received an NMTC allocation. See Treas. Reg. §1.45D-1(d)(1)(ii)(B) if the original loan was made before the CDE was certified. See Treas. Reg. §1.45D-1(d)(ii)(1)(C) regarding multiple purchases of a loan, and Treas. Reg. §1.45D-1(d)(1)(ii)(D) for examples.
- c. Providing financial counseling or other services to qualified active low-income community businesses located in, or residents of, a low-income community.
- d. An equity investment in, or loan to, another CDE, but only to the extent that the second, third or fourth CDE uses the investment or loan to make a QLICI. See Treas. Reg. §1.45D-1(d)(1)(iv) for complete discussion and examples of investments by CDEs in other CDEs.

Step 2: Review CDE's Investments In QLICIs

Once the amount of equity available for investment in QLICIs is identified, the next step is to determine whether the CDE timely invested the funds in QLICIs. This requires an investment-by-investment evaluation of the CDE's investment activities.

Low-Income Community Defined

Under IRC §45D(e)(1), a low-income community is identified by population census tract.

- a. The poverty rate for the tract is at least 20%, or
- b. The tract is not located within a metropolitan area and the median family income does not exceed 80% of the statewide median family income, or
- c. The tract is located within a metropolitan area and the median family income for such tract does not exceed 80% of the greater of statewide median family income or the metropolitan area median family income.
- d. In the case of census tracts located in a possession of the United States, possession-wide median family income is used for (b) and (c) above.

A census tract with a population of less than 2,000 is treated as a low-income community if it is within an empowerment zone under IRC §1391 and is contiguous to one or more low-income communities.

For census tracts within high migration rural counties, the median family income cannot exceed 85% of the statewide median family income. A high migration county is any county which, during the 20-year period ending with the year the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10% of the population of the county at the beginning of the 20-year period.

In the event that an area is not tracted for population census tracts, equivalent county divisions can be used. The county divisions must be those used by the Bureau of Census to determine poverty areas.

Prior to October 23, 2004, IRC §45D(e)(2) provided that the Secretary may designate any areas within any census tract as a low-income community if:

- a. The boundary of the areas is continuous,
- b. The area would be a low-income community if it were a census tract, and
- c. An inadequate access to investment capital exists in the area.

This provision was repealed and areas within census tracts cannot be designated as low-income communities after October 22, 2004.

Confirmation that the CDE's investments were in low-income communities can be obtained at www.cdfifund.gov.

Targeted Populations

After October 22, 2004, IRC §45D(e)(2) instructs the Secretary to provide regulations under which targeted *populations* may be treated as low-income communities. No regulations have been issued to date, but the IRS has issued Notice 2006-60, 2006-2 C.B. 82, which can be relied upon until Treas. Reg. 1.45D-1 is revised.

A "targeted population" means individuals or an identifiable group of individuals, including an Indian tribe, who are *low-income* persons or otherwise *lack adequate access to loans or equity investments*. The term "low-income" means having an income, adjusted for family size, of not more than:

1. For metropolitan areas, 80 percent of the area median family income.
2. For non-metropolitan areas, the greater of 80 percent of the area median family income or 80 percent of the statewide nonmetropolitan area median family income.

A "targeted population" includes individuals in the Hurricane Katrina Gulf Opportunity (GO) Zone 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. In order to meet this definition, the individual's principal residence or principal source of employment must have been located in a population census tract within the GO Zone 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.

Time of Investment in a Low-Income Community

Under Treas. Reg. §1.45D-1(c)(5)(iv), the CDE's investments in low-income communities must be made within 12 months of receiving the taxpayer's cash investment beginning on the date the cash is paid by the taxpayer (directly or through an underwriter).

Special Rules for Loans

Periodic amounts received during a calendar year as repayment of principal on a loan that is a QLICI are treated as continuously invested in a QLICI if reinvested by the end of the following year. See Treas. Reg. §1.45D-1(d)(2)(iii).

Special Rule for Reserves

Reserves (not more than 5% of the taxpayer's cash investment) maintained by the CDE for loan losses or for additional investments in existing low-income community investments are treated as invested in a qualified low-income community investment. Reserves include fees paid to third parties to protect against loss of all or a portion of the principal of, or interest on, a loan. See Treas. Reg. §1.45D-1(d)(3).

Requirements for Subsequent Reinvestments

Since the original investment in a QLICI may be returned to the CDE at some point during the 7-year credit period, it is also important to evaluate whether these funds were reinvested in QLICIs within a 12-month period. See Treas. Reg. §1.45D-1(d)(2)(i).

1. If the amount received by the CDE is equal to or greater than the cost basis of the original QLICI (or applicable portion thereof), and the CDE reinvests an amount at least equal to the original investment in another QLICI within 12 months, then an amount equal to the original amount will be treated as continuously invested in a QLICI.
2. If the amount received by the CDE is equal to or greater than the cost basis of the original QLICI (or applicable portion thereof), and the CDE reinvests an amount less than the original investment in another QLICI within 12 months, then only the amount reinvested will be treated as continuously invested in a QLICI.
3. If the amount received by the CDE is less than the cost basis of the original QLICI (or applicable portion thereof), and the CDE reinvests an amount of funds, then the amount treated as continuously invested in a QLICI is equal to the excess (if any) of the original cost basis over the amounts received by the CDE that are not reinvested.

Example (Treas. Reg. 1.45D-1(d)(2)(iv)):

On April 1, 2003, A, B, and C each pay \$100,000 to acquire a capital interest in X, a partnership. X is a CDE that has received an NMTC allocation. X treats the 3 partnership interests as one QEI under Treas. Reg. §1.45D-1(c)(6).

- In August 2003, X uses the \$300,000 to make a QLICI in Business 1
- In August 2005, the QLICI in Business 1 is redeemed for \$250,000.
- In February 2006, X reinvests \$230,000 of the \$250,000 in a second QLICI, Business 2, and uses the remaining \$20,000 for operating expenses.

Under Treas. Reg. §1.45D-1(d)(2)(i), \$280,000 is treated as continuously invested in QLICIs (\$300,000 minus \$20,000). In other words, \$50,000 remains invested

in Business 1 and \$230,000 is invested in Business 2.

- In December 2008, X sells the February 2006 investment in Business 2 and receives \$400,000.
- In March 2009, X reinvests \$320,000 of the \$400,000 in a third QLICI, Business 3.

Under Treas. Reg. §1.45D-1(d)(2)(i) and (ii), \$280,000 of the proceeds of the QLICI treated as continuously invested in a QLICI. (\$50,000 from Business 1 and \$230,000 from Business 2.) The remaining \$40,000 (\$320,000 - \$280,000) is treated as invested in a new QLICI in March 2009.

4. Amounts received by the CDE during the seventh year of the 7-year credit period do not need to be reinvested by the CDE in order to be treated as continuously invested in a QLICI.

**Loans Must Be
Bona Fide Debt**

Under IRC §45D(d)(2), a QLICI includes any loan to a qualified active low-income business (QALICB). Therefore, the loan documents should be reviewed to determine whether the loan is bona fide debt. Supporting documents also include, but are not limited to, appraisal reports, historical and forecasted statements of operations and cash flows, and guarantee agreements and balance sheets for guarantors.

Notice 94-47, 1994-1 C.B. 357, provides that the characterization of an instrument for federal income tax purposes depends on the terms of the instrument and all the surrounding facts and circumstances. Among the factors that may be considered when making such a determination are:

1. whether there is an unconditional promise on the part of the QALICB to pay a fixed sum on demand or at a fixed maturity date that is in the reasonable foreseeable future,
2. whether the CDE has the right to enforce the payment of principal and interest,
3. whether the CDE's rights are subordinate to rights of general creditors,
4. whether the instruments give the CDE the right to participate in the management of the QALICB,
5. whether the QALICB is thinly capitalized,
6. whether the stockholders or partners of the CDE are related to the QALICB's owners,
7. the label placed upon the instrument by the parties, and
8. whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

The weight given to any factor depends upon all the facts and circumstances. No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. There is no fixed or precise standard. As noted in Goldstein v. Commissioner, T.C. Memo 1980-273, 40 TCM 752 (1980), among the common factors considered when making this determination are whether:

1. a note or other evidence of indebtedness exists,
2. interest is charged,
3. there is a fixed schedule for repayments,
4. any security or collateral is requested,
5. there is any written loan agreement,
6. a demand for repayment has been made,
7. the parties' records, if any, reflect the transaction as a loan
8. any repayments have been made, and
9. the borrower was solvent at the time of the loan.

The key inquiry is not whether certain indicators of a bona fide loan exist or do not exist, but whether the parties actually intended and regarded the transaction to be a loan. There is a direct consequence for the NMTC investor if loans made by the CDE to the QALICI are not bona fide debt. Under IRC §45D(i)(2) and Treas. Reg. §1.45D-1(g)(1), if a principal purpose of a transaction or a series of transactions is to achieve a result that is inconsistent with the purposes of IRC §45D, the Commissioner may treat the transaction or series of transactions as causing a recapture event.

Intent to Forgive or Otherwise Not Collect Debt

An essential element of bona fide debt is whether there exists a good-faith intent on the part of the recipient of the funds to make repayment and a good-faith intent on the part of the person advancing the funds to enforce repayment. (See Fisher v. Commissioner, 54 TC 905 (1970).)

In Story v. Commissioner, 38 TC 936 (1962), the Court held that the mere fact that the original payee indicated he might or might not attempt to collect on the notes, or that he might forgive all or portions of them in the future, makes the notes no less binding obligations until the events occurred which would relieve the obligation. However, the Commissioner, in C.B. 1965-1, 4, limited his acquiescence in this case to the factual nature of that particular case. Furthermore, the Commissioner stated that such acquiescence would not be considered the basis for issuing rulings in advance of the consummation of the transaction. See Rev. Proc. 65-4, C.B. 1965-1, 720.

The Court relied upon Story v. Commissioner, supra, in Haygood v. Commissioner, 42 TC 936 (1964) in concluding that notes created enforceable indebtedness even though petitioner had no intention of collecting the debts but did intend to forgive each payment as it became due. In an Action on Decision, the Commissioner stated that it will “continue to challenge transfers of property where the vendor had no intention of enforcing the notes given in exchange for the interest transferred but instead intended to forgive them as they became due. The [Commissioner] believes the intent to forgive the notes is the determinative factor....where the facts indicate that the vendor as part of a prearranged scheme or plan intended to forgive the notes he received for the transfer of his land, so valuable consideration will be deemed received...” Action on Decision, 1976 A.O.D. LEXIS 364

In some instances, as an exit strategy, the CDE may intend to eventually forgive or otherwise not collect on the debt after the end of the 7-year credit period. If such an intention is reflected in a pre-arranged feature; i.e., a statement in the loan documents that the lender will forgive the loan, the loan is not bona fide debt for federal income tax purposes.

Transfer of Funds is Considered a Capital or Equity Investment

If a loan is not bona fide debt, it may be appropriate to treat what appears to be a loan as an equity investment (either in whole or in part). However, the CDE must demonstrate that (1) it held a partnership interest (capital investment) in a partnership or stock (equity investment) in a corporation that is a QALICB, and (2) all requirements for such investment were timely met. As noted in Internal Revenue Manual (IRM) 4.10.7.3.9, Documentary Evidence, “... writings made contemporaneously with the happenings of an event generally reflect the actual facts and show what was on the minds of the parties... While documentary evidence has great value, it should not be relied upon to the exclusion of other facts.”

Discharge of Bona Fide Indebtedness/Income to QALICB

If the loan does represent bona fide debt, then the loan amount is considered for purposes of the substantially-all requirement under IRC §45D(b)(1)(B). Should the loan be forgiven, the CDE would have an ordinary loss (deduction) in the amount of the discharged debt under IRC §165.

If the debt is forgiven, the QALICB may be subject to IRC §§ 61(a)(12), 108, and 1017:

- The discharged indebtedness may be included gross income. IRC §61(a) defines gross income to mean all income from whatever source derived except as otherwise provided by law. IRC §61(a)(12) specifically includes income from the discharge of indebtedness in gross income. See also Treas. Reg. 1.61-12(a).
- IRC §108 provides that gross income does not include any amount which would be includible in gross income by reason of the discharge of a taxpayer's indebtedness if (1) the discharge occurs in a title 11 bankruptcy case, (2) the discharge occurs when the taxpayer is insolvent, (3) the indebtedness discharged is qualified farm indebtedness, or (4) in the case of a taxpayer other than a C corporation, the indebtedness is qualified real property business indebtedness.

- IRC §1017 provides that if an amount is excluded from gross income under IRC §108, and any portion of such amount is to be applied to reduce basis, then such portion shall be applied in reduction of the basis of the property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.

Loan is Not Bona Fide Debt or Equity

If it is determined that the loan does not represent bona fide debt or equity, then the loan is treated as a grant. The grant does not qualify as a QLICI under IRC §45D(d)(1) and the loan amount will not be considered for purposes of the substantially-all requirement under IRC §45D(b)(1)(B), which will be discussed later.

Transfer of Funds Not Considered a Gift

The QALICB may wish to treat the discharged loan amount or contribution of equity as a gift since IRC §102(a) provides that gross income does not include the value of property acquired by gift, bequest, devise, or inheritance. However, neither the Code nor the legislative history accompanying IRC §102 defines “gift.” In Commissioner v. Duberstein, 363 U.S. 278 (1960), 1960-2 C.B. 428, the Supreme Court ruled that a gift proceeds from a “detached and disinterested generosity ...out of affection, respect, admiration, charity or like impulses.” In this respect, the most critical consideration is the transferor’s intent. If a payment proceeds primarily from “the constraining force of any moral or legal duty” or from “the incentive of anticipated benefit” of an economic nature, it is not a gift. However, the mere absence of a legal or moral obligation to make the payment is not sufficient to render it a gift.

The Court further stated that the determination of whether a specific transfer is a gift for income tax purposes is one that must be reached on consideration of all factors. In this case, since the loan was made with the expressed purpose of making a QLICI under IRC §45D that would qualify to the NMTC, the transfer of funds would not be considered a gift.

Transfer of Funds Not Considered a Charitable Contribution

The CDE may wish to treat the discharged loan amount or contribution of equity as a deductible charitable contribution. IRC §170 generally allows as a deduction, subject to certain limitations and restrictions, any charitable contribution (as defined in IRC §170(c)), payment of which is made within the taxable year. To be deductible as a charitable contribution under IRC §170, a transfer must be a gift to, or for the use of, an organization described in IRC §170(c). A gift for purposes of IRC §170 is a voluntary transfer of money or property *without receipt or expectation of receipt of adequate consideration*. See United States v. American Bar Endowment, 477 U.S. 105, 117-18 (1986) and Treas. Reg. §1.70A-1(h).

As there are many requirements that must be met in order for a deduction to be allowable under IRC §170, whether and to what extent a deduction is allowable under IRC §170 will depend on the specific facts of a particular case. Addition

technical guidance should be requested if it is discovered that a CDE has forgiven a loan and claimed a charitable contribution deduction for the amount of the discharged indebtedness.

Qualified Active Low-Income Community Businesses (QALICB)

Qualified Active Low-Income Community Business Defined Under IRC §45D(d)(1)(A), a CDE may invest in a QALICB as defined in IRC §45(d)(2). See also Treas. Reg. §1.45D-1(d)(4)(i) and Notice 2006-60.

Step 3: Evaluate CDE's Investments in Qualified Active Low-Income Community Businesses Now that the amount of equity available for investment in qualified investments has been identified and traced to investments in low-income communities, the next step is to determine whether the investments were made to QALICBs. Again, this will require an investment-by-investment evaluation. There are four issues to consider:

1. Whether the investment was made to an *entity* that qualifies,
2. Whether the *business activity* qualifies,
3. Whether the entity is engaged in the *active conduct* of a qualified business, and
4. Whether the entity's *income, activities, and assets* qualify.

Issue 1: Qualifying Business Entities The business entity can be a corporation (including a nonprofit corporation) or a partnership. A sole proprietorship can also qualify if the business would otherwise meet the requirements if it were incorporated. See Treas. Reg. §1.45D-1(d)(4)(ii).

A CDE can treat any trade or business (or portion thereof) as a qualified active low-income business if the entity would otherwise meet all the requirements if it were separately incorporated and a separate set of books and records are maintained for that trade or business (or portion thereof). The CDE's equity investment (or loan) is a QLICI to the extent that the proceeds are used by the trade or business (or portion thereof) that is treated as a qualified active low-income community business.

Generally, an entity is treated as a qualified active low-income community business for the duration of the CDE's investment in the entity if the CDE reasonably expects, *at the time of the investment or loan*, that the entity will satisfy all the requirements to be a qualified active low-income community business throughout the entire period of the investment or loan. In other words, the ultimate failure of a qualified active low-income community business will not require recapture of the NMTC if the CDE uses the reasonable expectation test. See Treas. Reg. §1.45(D)-1(d)(6)(i).

If the CDE controls or obtains control of the entity at any time during the 7-year credit period, then the entity will be treated as a qualified active low-income community business only if the requirements of Treas. Reg. §1.45D-1(d)(4)(i) are met throughout the entire period the CDE controls the entity.

- Control is defined as direct or indirect ownership (based on value) or control (based on voting or management rights) of more than 50 percent of the entity.
- Management rights are defined as the power to influence the management policies

or investment decisions of the entity. See Treas. Reg §1.45D-1(d)(6)(ii).

There is an exception under Treas. Reg. §1.45D-1(d)(6)(ii)(C) for the first 12 months after acquiring control if the CDE acquires control due to financial difficulties that were unforeseen at the time of the investment and the acquisition of control occurs before the seventh year of the 7-year period; i.e., the CDE can step in to assist the entity. However, by the end of the 12-month period, the entity must again meet the requirements for QALICBs, or the CDE must sell or redeems the entire amount of the investment and reinvest the proceeds in a QLICI by the end of the 12-month period.

**Issue 2:
Qualifying
Business
Activities**

Generally, all business activities are acceptable, with the following qualifications and exceptions.

Rental of Real Property

The rental to others of real property located in a low-income community is acceptable if and only if:

1. The property is not residential rental property under IRC §168(e)(2)(A), and
2. There are substantial improvements on the property.

Further, the CDE's investment or loan is not a QLICI to the extent that a lessee of the real property is an excluded business as described in 2 below.

Excluded Businesses

Specific business activities are excluded under Treas. Reg. §1.45D-1(d)(5)(ii) and are listed here:

1. Trades or businesses consisting predominantly of the development or holding of intangibles for sale or license.
2. Trades or businesses consisting of the operation of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, race track or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off the premises.
3. Farming (within the meaning of IRC §2032A(e)(5)(A) or (B)) if, as of the close of the taxable year of the taxpayer conducting such trade or business, the sum of the aggregate unadjusted basis (or, if greater, the fair market value) of the assets owned by the taxpayer that are used in such trade or business, and the aggregate value of the assets leased by the taxpayer that are used in such trade or business, exceeds \$500,000. Two or more trades or businesses will be treated as a single trade or business under rules similar to the rules of IRC §52(a) and (b).

**Issue 3:
Active Conduct
of a Qualified
Business**

The entity must be engaged in the active conduct of a qualified business, as defined in Treas. Reg. §1.45D-1(d)(4)(i). The entity will be treated as engaged in the active conduct of a trade or business if, at the time the CDE makes the investment or loan, the CDE reasonably expects the entity to generate revenues within 3 years after the

investment or loan is made. In the case of a nonprofit corporation, the CDE expects the entity to engage in an activity that furthers its purposes as a nonprofit entity. (See Treas. Reg. §1.45D-1(d)(4)(iv).)

**Issue 4:
Business
Located in
Low-Income
Community**

An entity must meet the following requirements to be a qualified active low-income community business. Different standards, as discussed later, are applied if the business is serving a targeted population.

- A. Gross-income requirement – at least 50% of the total gross income of the entity is derived from the active conduct of a qualified business within a low-income community. Alternatively, this requirement is considered met if the requirement under B or C below is met when 40% is replaced with 50%. The requirement may be met based on consideration of all the facts and circumstances.
- B. Use of tangible property requirement – at least 40% of the use of the tangible property of such entity (whether owned or leased) is within any low-income community. The percentage is determined based on the average value of the tangible property owned or leased by the entity that is used in a low-income community divided by the average value of all the property owned or leased by the entity and used during the year. Property owned by the entity is valued at its cost basis under IRC §1012 and property leased by the entity is valued at a reasonable amount established by the entity. See Treas. Reg. §1.45D-1(d)(4)(B)(2) for an example.
- C. Services performed requirement – at least 40% of the services performed for such entity by its employees are performed in a low-income community. The percentage is determined based on the amount paid to employees; i.e., the amount for services performed in low-income communities divided by the total amount paid. Note: employees need not live in the low-income community.

If the business has no employees, this requirement and the gross-income requirement are considered met if the use of tangible property requirement in B above is met using 85% instead of 40%.
- D. Collectibles – Less than 5% of the average of the aggregate unadjusted basis of the entity's property is attributable to collectibles (defined under IRC § 408(m)(2)) other than collectibles that are held primarily for resale to customers in the ordinary course of business.
- E. Nonqualifying financial property – Less than 5% of the average of the aggregate unadjusted bases of the entity's property is attributable to nonqualified financial property. The term nonqualified financial property means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities and other similar property.

The definition does not include reasonable amounts of working capital held as cash, cash equivalents, or debt instruments with a term of 18 months or less. Further, proceeds of a capital or equity investment or loan by a CDE that will be expended for construction of real property within 12 months after the date the

investment or loan is made are treated as a reasonable amount of working capital.

Note: this requirement essentially eliminates banks, credit unions, and other financial institutions from the definition of a QALICB because debt instruments with a term longer than 18 months are nonqualified financial property.

**Entity Serving
Low-Income
Targeted
Population**

An entity serving a low-income targeted population is considered to be engaged in the active conduct of a qualified business as defined in §1.45D-1(d)(5) if any one of the following standards is met:

1. At least 50 percent of the entity's total gross income for any taxable year is derived from sales, rentals, services, or other transactions with individuals who are low-income persons.
2. At least 40 percent of the entity's employees are individuals who are low-income persons. The determination of whether an employee is a low-income person must be made at the time the employee is hired. If the employee is a low-income person at the time of hire, that employee is considered a low-income person throughout the time of employment without regard to any increase in the employee's income after the time of hire.
3. At least 50 percent of the entity is owned by individuals who are low-income persons. The determination of whether an owner is a low-income person must be made at the time the QALICB is made. If an owner is a low-income person at the time the QALICB is made, that owner is considered a low-income person for purposes of §45D(e)(2) throughout the time the ownership interest is held by that owner.

See Notice 2006-60.

In addition, the rental to others of real property that otherwise satisfies the requirements to be a qualified business will be treated as located in a low-income community if at least 50 percent of the entity's total gross income is derived from rentals to individuals who are low-income persons for purposes of IRC §45D(e)(2) and/or to a QALICB that meets the requirements for low-income targeted populations.

Notwithstanding meeting one of the above standards, an entity will not be treated as a QALICB if the entity is located in a population census tract for which the median family income exceeds 120 percent of:

1. in the case of a tract not located within a metropolitan area, the statewide median family income, or
2. in the case of a tract located within a metropolitan area, the greater of statewide median family income or metropolitan area median family income.

An entity will also be considered to be located in a population census tract for which the median family income exceeds 120 percent of the applicable median family

income if all three of the following conditions are met:

1. At least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business within one or more non-qualifying population census tracts (non-qualifying gross income amount);
2. At least 40 percent of the use of the tangible property of the entity (whether owned or leased) is within one or more non-qualifying population census tracts (non-qualifying tangible property usage); and
3. At least 40 percent of the services performed for the entity by its employees are performed in one or more non-qualifying population census tracts (non-qualifying services performance).

There are two possible modifications:

1. The entity is considered to have the non-qualifying gross income amount if the entity has non-qualifying tangible property usage or non-qualifying services performance of at least 50 percent instead of 40 percent.
2. If the entity has no employees, the entity is considered to have the non-qualifying gross income amount as well as non-qualifying services performance if at least 85 percent of the use of the tangible property of the entity (whether owned or leased) is within one or more non-qualifying population census tracts.

The 120-percent-income restriction shall not apply to an entity located within a population census tract with a population of less than 2,000 if such tract is not located in a metropolitan area. Nor will it apply to an entity located within a population census tract with a population of less than 2,000 if such tract is located in a metropolitan area and more than 75 percent of the tract is zoned for commercial or industrial use.

**Inadequate
Access to
Loans or Equity
Investments**

The Hurricane Katrina GO Zone targeted population rules only apply to New Markets Credit allocations under IRC §1400N(m)(2). An entity serving the Hurricane Katrina GO Zone targeted population is considered engaged in the active conduct of a qualified business if:

1. at least 50 percent of the entity's total gross income for any taxable year is derived from sales, rentals, services, or other transactions with the Hurricane Katrina GO Zone targeted population, low-income persons, or some combination thereof;
2. at least 40 percent of the entity's employees consist of the Hurricane Katrina GO Zone targeted population, low-income persons, or some combination thereof; or
3. at least 50 percent of the entity is owned by the Hurricane Katrina GO Zone targeted population, low-income persons, or some combination thereof.

See Section 3.04 of Notice 2006-60.

In addition, the rental to others of real property for the Hurricane Katrina GO Zone

targeted population that otherwise satisfies the requirements to be a qualified business will be treated as located in a low-income community if at least 50 percent of the entity's total gross income is derived from rentals to the Hurricane Katrina GO Zone targeted population, low-income persons, or some combination thereof and/or to a QALICB that meets the requirements for the Hurricane Katrina GO Zone targeted population.

To be a QALICB, the entity must be located in a population census tract within the Hurricane Katrina GO Zone 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 (qualifying population census tract). An entity will be considered to be located in a qualifying population census tract if:

1. at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business within one or more qualifying population census tracts (gross income requirement);
2. at least 40 percent of the use of the tangible property of the entity (whether owned or leased) is within one or more qualifying population census tracts (use of tangible property requirement); and
3. at least 40 percent of the services performed for the entity by its employees are performed in one or more qualifying population census tracts (services performed requirement). If the entity has no employees, the entity is deemed to satisfy the services performed requirement as well as the gross income requirement if at least 85 percent of the use of the tangible property of the entity (whether owned or leased) is within one or more qualifying population census tracts.

The entity is deemed to satisfy the gross income requirement if the entity meets either the use of tangible property requirement or the services performed requirement of at least 50 percent instead of 40 percent.

Notwithstanding meeting the requirements above, an entity will not be treated as a QALICB if the entity is located in a population census tract for which the median family income exceeds 200 percent of:

1. in the case of a tract not located within a metropolitan area, the statewide median family income, or
2. in the case of a tract located within a metropolitan area, the greater of statewide median family income or metropolitan area median family income (200-percent-income restriction).

The 200-percent-income restriction shall not apply to an entity located within a population census tract with a population of less than 2,000 if such tract is not located in a metropolitan area. Neither will the 200-percent income restriction apply to an entity located within a population census tract with a population of less than 2,000 if such tract is located in a metropolitan area and more than 75 percent of the tract is zoned for commercial or industrial use.

For purposes of the 200-percent-income restriction, an entity will be considered to be located in a population census tract for which the median family income exceeds 200 percent of the applicable median family income (non-qualifying population census tract) if:

1. at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business within one or more nonqualifying population census tracts (non-qualifying gross income amount);
2. at least 40 percent of the use of the tangible property of the entity (whether owned or leased) is within one or more nonqualifying population census tracts (non-qualifying tangible property usage); and
3. at least 40 percent of the services performed for the entity by its employees are performed in one or more non-qualifying population census tracts (non-qualifying services performance). If the entity has no employees, the entity is considered to have the non-qualifying gross income amount as well as non-qualifying services performance if at least 85 percent of the use of the tangible property of the entity (whether owned or leased) is within one or more non-qualifying population census tracts.

For 1, 2, and 3 above, the entity is considered to have the non-qualifying gross income amount if the entity has nonqualifying tangible property usage or non-qualifying services performance of at least 50 percent instead of 40 percent.

Rental of Real Property for the GO Zone Targeted Population.

In addition, the rental to others of real property for the GO Zone Targeted Population that otherwise satisfies the requirements to be a qualified business will be treated as located in a low-income community if at least 50 percent of the entity's total gross income is derived from rentals to the GO Zone Targeted Population, low-income persons, or some combination thereof and/or to a QALICB that meets the requirements for the GO Zone Targeted Population.

Substantially-All Requirement under Treas. Reg. §1.45D-1(c)(5)

Substantially-All Requirement

Substantially all the investors' equity investment in a CDE must be invested by the CDE in QLICs. Treas. Reg. §1.45D-1(c)(5)(i), defines substantially all to mean at least 85 percent and provides two alternative methods for meeting the substantially-all requirement. The next step of the review will be to determine whether the CDE has complied with this requirement.

Step 4: Determine Whether the CDE Satisfied the Substantially-All Requirement

The substantially-all requirement must be satisfied for each annual period in the 7-year credit period. For the first annual period, the requirement is considered met if the calculation is performed on a single testing date and the result is at least 85%. For all subsequent annual periods, the substantially-all requirement is considered met if the calculation is performed every six months and the average of the two computations for the annual period is at least 85%. In the seventh year of the 7-year credit period, 85% is reduced to 75%.

The CDE may choose the same testing date for all QEIs without regard to the actual date of investment, providing the testing dates are six months apart.

The two methods for determining compliance with the substantially-all requirement are:

- Direct-Tracing Calculation
- Safe Harbor Calculation

The CDE can use either method for any annual period.

Direct Tracing Calculation

The substantially-all requirement is satisfied if at least 85% of the investor's investment in the CDE is directly traceable to QLICIs. The fraction is the CDE's aggregate cost basis in QLICIs directly traceable to the investor's cash investment divided by the investor's qualified equity investment. For purposes of this computation, cost basis includes the cost basis in any QLICI that becomes worthless.

Safe Harbor Calculation

The safe harbor is satisfied if the CDE's aggregate cost basis in all of its QLICIs divided by the CDE's aggregate cost basis of all its assets is at least 85 percent. For purposes of this computation, cost basis includes the cost basis in any QLICI that becomes worthless.

Failure to Satisfy the Substantially-All Requirement

Under Treas. Reg. §1.45D-1(e)(6), if a QEI fails the substantially-all requirement, the failure is not a recapture event if the CDE corrects the failure within 6 months after the date the CDE becomes aware (or reasonably should have become aware) of the failure (the cure period). "Reasonably should have become aware" is limited because the CDE should have been aware of the failure on at least one of the two 6-month testing dates for each annual period other than the first annual period. For the first annual period, the 6-month cure period begins when the CDE becomes aware (or reasonably should have become aware) of the failure to invest the investor's cash in order to satisfy the substantially-all requirement. See Treas. Reg. §1.45D-1(c)(5)(iv). Only one correction is permitted per qualified equity investment during the 7-year credit period. See Treas. Reg. §1.45D-1(e)(6).

Failure to satisfy the substantially-all requirement is a recapture event under IRC §45D(g)(3)(B). NMTC recapture is discussed in Chapter 3.

Redemption of an Equity Investment by the CDE

The Investment is Redeemed or Cashed Out by the CDE

There is a recapture event with respect to an equity investment in a CDE if the investment is redeemed or otherwise cashed out by the CDE. See Treas. Reg. §1.45D-1(e)(2)(iii).

Step 5: Analyze Distributions to Equity Holders

The final step of the audit is an analysis of the distributions made by the CDE to its equity investors. Redemptions and distributions can be identified through a review of the balance sheet equity accounts. Key accounts that should be reviewed include:

1. Investments – Obtain a schedule of investments on hand at the beginning of the year and the end of the year and analyze credit entries to identify dispositions of investments.

2. Loans to Shareholders – Determine whether the amounts advanced to the shareholder or partner are bona fide loans or distributions of a different character. (See IRM 4.10.3.8.4.5)
3. Capital Stock – Verify all debit entries to determine the nature of the transaction. (See IRM 4.10.3.8.4.19)
4. Treasury Stock – Review any changes in the account, particularly increases, which indicate redemptions of stock.

CDE is a Corporation (C or S)

If the CDE is a C or S corporation for Federal tax purposes, an equity investment is *redeemed* when IRC §302(a) applies to amounts *received by the equity holder from the CDE*. Under IRC §302(a), if a corporation redeems its stock within the meaning of IRC §317(b) and if IRC §302(b)(1), (b)(2), (b)(3), or (b)(4) applies, the redemption will be treated as a distribution in part or full payment in exchange for the stock. Paragraph (b)(1) through (b)(4) of IRC §302 are outlined below.

1. The redemption is not essentially equivalent to a dividend,
2. The distribution is substantially disproportionate,
3. The redemption is in complete redemption, with respect to the shareholder, of all stock of the corporation owned by the shareholder, or
4. The distribution is in redemption of stock held by a shareholder who is not a corporation and the distribution is in partial liquidation of the distributing corporation.

For a C corporation, an equity investment is treated as *cached out* if IRC §301(c)(2) or (3) applies to amounts received by the equity holder. Under these sections, the distribution amount that is not a dividend is applied against the adjusted basis of the stock. In general, that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, is treated as a gain on the sale or exchange of property. The equity investment is not considered cached out if only IRC §301(c)(1) applies; i.e., the distribution is treated as a dividend as defined in IRC §316.

For an S corporation, an equity investment is treated as *cached out* when a distribution to a shareholder described in IRC §1368(a) exceeds the accumulated adjustments account determined under Treas. Reg. §1.1368-2 and any accumulated earnings and profits of the S corporation.

CDE is a Partnership

Under Treas. Reg. §1.45D-1(e)((3)(iii)), if the CDE 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 if the distribution does not exceed the “operating income” for the year. Operating income is calculated as the sum of:

1. The CDE’s taxable income as determined under IRC §703, except that:
 - The items described in IRC §703(a)(1) shall be aggregated with the nonseparately stated tax items of the partnership, and
 - Any gain resulting for the sale of a capital asset under IRC §1221(a) or IRC §1231 property shall be excluded.
2. Loss deductions under IRC §165, but only to the extent the losses were realized from QLICIs under Treas. Reg. §1.45D-(d)(1),
3. Deductions under IRC §§167 and 168, including the additional first year depreciation under IRC §168(k),
4. Start-up expenditures amortized under IRC §195, and
5. Organizational expenses amortized under IRC §709.

A non-pro rata *de minimis* cash distribution by the CDE to one or more partners during the taxable year will not be treated as a redemption. A non-pro rata *de minimis* distribution is the lesser of 5 percent of the CDE’s operating income for that taxable year (as defined above) or 10 percent of the partner’s capital interest in the CDE.

Conclusion

Once a determination of whether the CDE’s investments are QLICIs, a final report will be prepared reflecting the results. See chapter 6 for instructions.

If an adjustment to the NMTC has been identified, an audit of the investor’s tax return will be required. The adjustment will be made as a flow-through adjustment if the CDE is a partnership. If the CDE is a corporation, procedures outlined in IRM 4.10.5.4 for Related Returns should be followed to make adjustments to the investor’s tax return. See chapter 3 for details.

Summary

1. CDEs can make investments (equity or loans) directly to QALICBs, purchase any loan that is a QLICI from another CDE, provide loans to or investments in other CDEs, or provide financial counseling and other services to businesses or residents of low-income communities.

2. For purposes of determining the amount of allowable NMTC at the CDE level, there are three basic issues to address:
 - Whether the investors' cash investments were properly handled by the CDE. Substantially all (85%) of an investor's cash must be invested in QLICIs by the CDE within 12 months. In year 7 the percentage drops to 75%.
 - Whether the cash investments were timely invested in low-income communities (including targeted populations) throughout the 7-year credit period. If the investment is returned to the CDE, it must be reinvested within 12 months. If the CDE is receiving periodic loan repayments, the payments must be reinvested in another QLICI by the end of the following calendar year. No reinvestment is required in year 7.
 - Whether the entities in which the CDE invested in were QALICBs. QALICBs must meet the requirements for gross income generated from conducting business in a low-income community, the use of tangible property in a low-income community, and performing services within a low-income community. Targeted populations are also treated as low-income communities, but have different QALICB requirements as outlined in Notice 2006-60. Not all business activities are qualified businesses; e.g., residential rental property, the development or holding of intangibles, golf courses, race tracks, gambling facilities, certain farming businesses, liquor stores, and suntan or hot tub facilities.
3. Three events will trigger the recapture of the NMTC under IRC §45D(g):
 - The CDE ceases to qualify as a CDE,
 - The substantially-all requirement is not satisfied, or
 - The equity investment is redeemed or otherwise cashed out by the CDE.
4. Adjustments to the NMTC at the investor level are discussed in chapter 3.

Chapter 3 Issues at the Investor Level

Introduction

This chapter outlines the issues and audit techniques for determining whether the investor has correctly computed the allowable New Markets Tax Credit (NMTC), made the required adjustments to the basis of the investment, and if a recapture event has occurred, correctly computed the NMTC recapture amount. Report writing will be addressed in chapter 6.

Background

The NMTC is claimed using Form 8874, New Markets Credit. The credit results from an investment made directly with a qualified community development entity (CDE) or from an investment made through a pass-through entity. If the taxpayer can claim more than one credit under IRC §38, the credit will be included on Form 3800, General Business Credit.

An investor's return may be audited as a related return under IRM 4.10.5.3, because an adjustment was identified at the CDE level. In addition, the NMTC may be independently classified as an audit issue of the investor's tax return.

References

- IRC §45D
- Treas. Reg. §1.45D-1

Current Year NMTC Adjustments

Adjustment to the Current Year NMTC

Adjustment to the current year NMTC will be needed if the taxpayer has incorrectly computed the credit amount.

- The amount of the investment is incorrect – the amount paid to the CDE for the investment at the *original* issue that is designated as a qualified equity investment is the basis for computing the credit.
- The Credit Allowance date is incorrect – the date the investment with the CDE was originally made, and each of the six anniversary dates thereafter.
- The Applicable Percentage is incorrect – 5 percent for the first 3 credit allowance dates, and 6 percent for the remaining 4 credit allowance dates.

Adjustment Limited to Open Tax Years

Adjustment can be made to the current year credit on any tax return open by statute. However, an adjustment to the current year credit is not a recapture event (discussed later in this chapter), and the recapture provisions cannot be used to correct errors on tax returns otherwise closed by statute.

Audit Techniques

As a starting point, the original documentation for the original investment should be reviewed to determine whether the credit was correctly computed.

- Review the documentation for the transfer of funds (check, wire transfer, etc.). IRC §45D does not prohibit a taxpayer (including any taxpayer who is a person

as defined under IRC §7701(a)(1)) from using cash derived from a borrowing, including nonrecourse borrowing, to make a qualified equity investment in a qualified CDE if (1) the loan is from an unrelated third party, (2) the loan is not secured by any assets of the CDE, and (3) the loan is not convertible into an equity interest in the investor (partnership or corporation). See Rev. Rul. 2003-20, 2003-1 C.B. 465, for complete discussion.

- Review the notice provided by the CDE on Form 8874-A, Notice of Qualified Equity Investment for New Markets Credit or, for periods before March 2007, the written notification prepared by the CDE. Under Treas. Reg. §1.45D-1(g)(2)(i)(A), the CDE must provide the investor notice that the equity investment is a qualified equity investment entitling the investor to claim the NMTC. The notice must be provided within 60 day of the investment, and identify both the amount of the investment and the CDE's taxpayer identification number (TIN).

Annual Adjustment to Basis

Introduction Under IRC §45D(h), the basis of any qualified equity investment shall be reduced by the amount of any NMTC associated with the investment.

For investments made as ownership interests in partnerships and S corporations, this reduction may affect the amount of loss the taxpayer may claim in any one given year. This reduction will also impact the computation of the gain or loss at the time the taxpayer disposes of the investment. See Treas. Reg. §1.45D-1(f).

- Partnerships**
- Under IRC §752, a partner's share of liabilities is included in the adjusted basis of the partner's interest in the partnership.
 - Under IRC §704(d), a partner's share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess loss is repaid to the partnership.
- S Corporations**
- Under IRC §1366(d)(1), a shareholder's share of the S corporation's loss that can be used to determine the shareholder's tax liability cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.
 - Under IRC §1366(d)(2), any loss or deduction, which is disallowed because it exceeds the shareholder's basis, shall be treated as incurred by the corporation in the succeeding taxable year with respect to that taxpayer. As explained in PLR 9304004, such losses are treated as "suspended loss" until such time as the shareholder has basis against which the loss can be applied.

Disposition of Investor's Holding

Dispositions of Interest	Under IRC §45D(a)(1), an investor is entitled to claim the NMTC if the investor holds a qualified equity investment on the credit allowance date for such investment during the investor's taxable year. Disposition of a holding in a qualified equity investment is not a recapture event under IRC §45D(g). However, the timing of the disposition will determine the tax impact for the investor.
Disposition Before the Credit Allowance Date	If the investor disposes of its qualified equity investment <i>before</i> the credit allowance date for the taxable year, the investor will not be entitled to the NMTC for that taxable year and no adjustment under IRC §45D(h) would be required for the year of sale. Gain or loss upon disposition of the qualified equity investment is computed using the adjusted basis of the investment reflecting the annual adjustments required under IRC §45D(h) for all prior years.
Disposition After the Credit Allowance Date	If the investor disposes of its qualified equity investment <i>after</i> the credit allowance date for the taxable year, the investor will be entitled to the NMTC for the taxable year and the adjusted basis of the qualified equity investment would be reduced as required under IRC §45D(h). Gain or loss upon disposition of the qualified equity investment is computed using the adjusted basis of the investment reflecting the annual adjustments required under IRC §45D(h) for all years, including the current year adjustment.
Treatment of Carry Forwards of Unused NMTC	The investor is entitled to claim carryforwards of unused NMTC from prior tax years to reduce federal income tax liabilities in years subsequent to the disposition. The investor cannot transfer the unused NMTC to the new owner of the qualified equity investment.
Treatment of Subsequent Holders	Under IRC §45D(b)(4), the subsequent holder of the qualified equity investment is entitled to claim the NMTC for the remainder of the seven-year credit period; i.e., the new holder steps into the former owner's position. The credit allowance date continues to be the date of the original investment (not the date the subsequent holder purchased the investment).

NMTC Recapture Events

NMTC Recapture Events Defined	<p>As discussed in Chapter 1, Under IRC §45D(g)(3), there are three events that can result in the recapture of NMTC at the investor level.</p> <ul style="list-style-type: none">• The CDE ceases to qualify as a community development entity,• The substantially-all requirement is not satisfied, or• The investment is redeemed or otherwise cashed out by the CDE and the CDE distributes the funds to the equity holder. Both conditions must be met.
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The above recapture events are discussed in detail in Chapter 2. Further, while it is anticipated that redemptions will be identified at the CDE level, a review of the investor's accounts and records may also result in the identification of investment redemptions. Review schedules and documents related to investments on hand at both the beginning of the year and the end of the year. Analyze credit entries to identify dispositions of investments. See Chapter 2 for complete discussion.

If there is a recapture event at any time during the 7-year credit period, all holders of the qualified equity investment (both prior and current holders) are subject to recapture in the year of the recapture event. Further, the annual basis adjustment under IRC §45D(h) is *not* reversed when an NMTC recapture amount is determined.

Notification of Recapture Event

If, at any time during the 7-year credit period, there is a recapture event with respect to a qualified equity investment (QEI), the CDE must provide notice to each investor, including all prior investors, that a recapture event has occurred. This notice must be provided by the CDE using Form 8874-B, Notice of Recapture Event for New Markets Credit, or, for periods before March 2007, a written notification prepared by the CDE, no later than 60 days after the date the CDE becomes aware of the recapture event. Treas. Reg. § 1.45D-1(g)(2)(i)(B).

Recapture Amount

The credit recapture amount is the sum of:

1. The aggregate decrease in the credits allowed to the taxpayer under IRC §38 for all prior taxable years which would have resulted if no credit had been determined with respect to such investment, plus
2. Interest at the underpayment rate established under IRC §6621 on the amount determined in 1. above for each prior taxable year for the period beginning on the due date for filing the tax return for the prior taxable year involved.

Tax Benefit Rule

The tax for the taxable year of the recapture event shall be increased only with respect to credits allowed which were used to reduce tax liability. In the case of credits not used to reduce tax liability, the carryforwards and carrybacks under IRC §39 shall be appropriately adjusted.

Computing the Recapture Amount

NMTC Recapture Amount Defined

The recapture amount is defined in IRC §45D(g)(2) as the decrease in NMTC allowed to the taxpayer, as if no credit had been allowable for the investment, plus interest (at the underpayment rate) beginning on the due date (without extensions) for the filing of the tax return on which the NMTC was originally claimed. Three issues must be considered:

- Application of the tax benefit rule,
- The General Business Credit ordering rules under IRC §38(d) if the taxpayer is claiming more than one credit under the General Business Credit, and
- The General Business Credit limitation under IRC §38(c). This limitation is noted here, but will not be discussed in depth.

The best method for consideration of these limitations is to work through the computation as presented on Form 8874 (claiming only NMTC) or Form 3800 if the taxpayer is claiming more than one credit under the General Business Credit.

**Step 1:
Determine the
Amount of
NMTC Subject
to Recapture**

IRC §45D(g)(4)(A) provides for the application of the tax benefit rule, which is explained in Regulation §1.1016-3(e)(1).

[T]here are situations in which it is necessary to determine...the extent to which the amount allowed...resulted in a reduction for any taxable year of the taxpayer's taxes....This amount, (amount allowed which resulted in a reduction of the taxpayer's taxes) is hereinafter referred to as the "*tax benefit amount allowed.*" For purposes of determining whether the tax-benefit amount allowed exceeded the amount allowable, a determination must be made of that portion of the *excess of the amount allowed over the amount allowable* which, if disallowed, would not have resulted in an increase in any such tax previously determined. If the entire excess of the amount allowed over the amount allowable could be disallowed without any such increase in tax, the tax benefit amount shall not be considered to have exceeded the amount allowable.

Therefore, the first step in determining the recapture amount is identifying the actual amount of NMTC used to reduce the investor's tax liability which, when disallowed, will result in additional tax. At the same time, the carryforwards of unused NMTC will be identified.

Example 1: Applying the Tax Benefit Rule

An investor makes a valid \$1,000,000 qualified equity investment on July 2, 2004. The investor is a calendar year taxpayer and used NMTC equal to \$30,000, \$50,000, \$25,000 and \$52,000 to reduce federal income tax liabilities for tax years 2004, 2005, 2006, and 2007, respectively. An NMTC recapture event occurred in 2008.

The following table shows how the investor applied the credit against its tax liabilities. The allowable credit is determined as a percentage of the investment. The available credit is computed as the sum of the current year allowable credit and the carryforward of credit from the previous year. The credit claimed is the amount used to reduce the taxpayer's tax liability. The carryforward is the difference between the amount of credit available and the amount of credit claimed.

(a) Credit Period Year	(b) Allowable NMTC	(c) Available NMTC	(d) Tax Liability	(e) NMTC Claimed	(f) Carry Forward
2004	\$50,000	\$50,000	\$30,000	\$30,000	\$20,000
2005	\$50,000	\$70,000	\$50,000	\$50,000	\$20,000
2006	\$50,000	\$70,000	\$25,000	\$25,000	\$45,000
2007	<u>\$60,000</u>	\$105,000	\$52,000	<u>\$52,000</u>	\$53,000
Total	\$210,000			\$157,000	

The amount of NMTC subject to recapture under IRC §45D(g)(2)(A) is \$157,000. In addition, the carryforward of \$53,000 at the end of 2007 is reduced to zero.

Example 2: Applying the Ordering Rules under IRC §38(d)

The NMTC is included under IRC §38 as a general business credit. Therefore, the ordering rules under IRC §38(d) must also be applied. This is important because taxpayers who invest in low-income communities through the NMTC are likely to invest in low-income communities through the Rehabilitation Credit (IRC §47) and the Low-Income Housing Credit (IRC §42). Both of these credits must be exhausted before the NMTC is applied against the investor's tax liability (see IRC §§46(a) and 38(b)).

The facts are the same as in Example 1, except that the taxpayer has \$15,000 of low-income housing credits under IRC §42 for tax years 2004 and 2005.

The following table shows how the investor applied the credit against its tax liabilities. In this case, the LIHC must be applied to the liability before the NMTC is considered. This is accomplished in columns (b)-(e), with column (e) indicating the tax liability against which the NMTC is to be applied.

(a) Credit Period Year	(b) Allowable LIHC	(c) Tax Liability	(d) LIHC Claimed	(e) Reduced Tax Liability	(f) NMTC Allowable	(g) NMTC Available	(h) NMTC Claimed	(i) NMTC C/F
2004	\$15,000	\$30,000	\$15,000	\$15,000	\$50,000	\$50,000	\$15,000	\$35,000
2005	\$15,000	\$50,000	\$15,000	\$35,000	\$50,000	\$85,000	\$35,000	\$50,000
2006		\$25,000		\$25,000	\$50,000	\$100,000	\$25,000	\$75,000
2007		\$52,000		\$52,000	<u>\$60,000</u>	\$135,000	<u>\$52,000</u>	\$83,000
Total					\$210,000		\$127,000	

The amount of NMTC subject to recapture IRC §45D(g)(2)(A) is \$127,000. In addition, the carryforward of \$83,000 at the end of 2007 is reduced to zero.

**Step 2:
Determine
the Amount
of Interest**

IRC §45D(g)(2)(B) states that the recapture amount will include the interest on the amount of NMTC used to reduce the tax liability for each prior taxable year. Interest will be calculated using the underpayment rate established under IRC §6621, beginning on the due date for filing the return for the prior taxable year involved and ending (though not stated in the statute) on the due date for filing the return for the taxable year in which the recapture amount occurs.

Example 3: Computing Interest under IRC §6621

Continuing with the fact pattern in Example 2, the following chart shows the interest computed based on the NMTC used to reduce the tax liability.

(a) Credit Period Year	(b) NMTC Claimed	(c) Interest Computation Dates	(d) Interest under IRC §45D(g)(2)(B)
2004	\$15,000	April 15, 2005 to April 15, 2009	\$4,469
2005	\$35,000	April 15, 2006 to April 15, 2009	\$6,544
2006	\$25,000	April 15, 2007 to April 15, 2009	\$2,690
2007	<u>\$52,000</u>	April 15, 2008 to April 15, 2009	<u>\$2,398</u>
Total	\$127,000		\$16,101

The amount of interest under IRC §45D(g)(2)(B) to be included in the recapture amount is \$16,101.

**Step 3:
Compute the
NMTC
Recapture
Amount**

The final step is adding the aggregate decrease in NMTC identified in Step 1 and the total interest calculated in Step 2. The resulting recapture amount is an indivisible amount, and is neither tax credit nor interest. As a result:

- Under IRC § 45D(g)(2)(B), no deduction is allowable for the interest portion of the recapture amount, and
- The recapture amount cannot be reduced by any remaining General Business Credit generated from another source. Under IRC §38(a), the General Business Credit can only be applied against federal income tax liabilities.

Example 4: Computing the Recapture Amount

Following the fact pattern in Examples 2 and 3, the recapture amount is

$$\$127,000 + \$16,101 = \$143,101$$

Generally, the credit recapture amount reported on a tax return will be included on the line for “other taxes” or “total taxes” if the taxpayer correctly reports the credit recapture.

Chapter 6 will provide instructions for preparing the audit report reflecting an adjustment to the NMTC.

Summary

1. Adjustment to the current year credit is required if an investor incorrectly computed the credit.
2. An investor must reduce the adjusted basis of the investment each year for the NMTC amount. This adjustment is important for determining the amount of allowable loss from flow-through entities and calculating the gain or loss upon disposition.
3. There are three events that will trigger a recapture event at the investor level:
 - The CDE ceases to qualify as a community development entity,
 - The substantially-all requirement is not satisfied, or
 - The investment is redeemed or otherwise cashed out by the CDE and the CDE distributes the funds to the equity holder.
4. The NMTC recapture must be made for the year of the recapture event. The entire credit claimed in the years prior to the recapture event is recaptured, which requires consideration of the tax benefit rule, and both the General Business Credit ordering rules and limitations.

Chapter 4

Issues at the Exempt Organization Level

Introduction

The New Markets Tax Credit (NMTC) Program includes nonprofit organizations as possible recipients of credit allocations and cash proceeds from qualified equity investments. Although Congress did not require these organizations to be exempt from tax pursuant to IRC §501(a), there are nonprofit organizations that are tax-exempt under IRC §501(c)(3), who have applied for, and received, a credit allocation from the Community Development Financial Institutions (CDFI) Fund or receive the cash proceeds from qualified equity investments. While not all nonprofit organizations are tax-exempt, all tax-exempt organizations are nonprofit. It should be noted that IRC §501(c)(4) organizations could also receive allocations.

Background

The IRS is responsible for the tax administration aspects of IRC §45D. This includes establishing procedures and processes to ensure taxpayers are in compliance with the Code.

The procedures in this chapter will assist Exempt Organization (EO) examiners in determining whether an exempt organization is in compliance with the provisions of IRC §45D and ensuring that the funds allocated to the exempt organization are used for exempt purposes as contemplated under IRC §501(a).

EO's Role in the NMTC Program

Exempt organizations must operate under the subsection for which they were recognized as tax-exempt. Whether it is organized for charitable or social welfare purposes, the NMTC program's focus is to encourage investment in low-income communities by working primarily with for-profit entities. While the involvement of exempt organizations in this program may seem to be contradictory, the NMTC program actually carries out an exempt purpose; namely, relieving the distress of the poor and lessening the burdens of government by promoting investment in low-income communities and businesses.

An exempt organization can apply for and receive a credit allocation from the CDFI Fund. Subsequently, an exempt organization may:

1. Set up a for-profit subsidiary (sub-allocatee) and sub-allocate the NMTC allocation to the sub-allocatee, which can raise money from investors;
2. The sub-allocatee can, in turn, set up portfolios that it can sell to raise money; and
3. The exempt organization can become the general partner in a partnership (or the managing member in a limited liability company) which can have agreements that determine how the credits will be used by partners in the partnership.

EO Issues with Regard to the NMTC

Because exempt organizations will work closely with for-profit organizations, the possibility for private benefit/inurement must be considered. These benefits can be derived from:

1. Favorable loans to for-profit subsidiaries or partners;
2. Loans to a for-profit entity owned by a member of the governing board of a CDE (an exempt organization) at less than fair market value;
3. Grants allocated specifically for a for-profit which is owned by an exempt organization governing board member; or
4. Excessive compensation granted to officers of the exempt organization. An officer or board member who receives an excess benefit from his position on the board of a CDE may be liable for taxes pursuant to IRC §4958.

There can also be issues with regard to the investments made to the sub-allocates, or through nonprofit CDEs. Examiners should be alert to investments that do not accomplish the purpose of the NMTC Program. Specifically, examiners should be alert to investments which enrich the investor more than the community.

Examination Procedures

Articles of Incorporation and By-Laws

Review the incorporation documents and by-laws of the organization in order to determine the structure of the board of directors and the relationships between officers.

1. Review the annual minutes of the organization to determine if investments have been made to qualified active low-income businesses and how investments are selected.
2. Determine if there are any family or business relationships between the governing boards of the exempt organization and allocatee organizations.
 - a. Determine the reasonableness of total compensation paid or accrued to principal officers. Take into consideration any compensation claimed under a heading other than "Officers' Salaries," such as contributions to pension plans, payments of personal expenses, year-end bonuses, use of company car, etc.
 - b. Look for organization structures that include multiple entities, in which compensation can be split between two or more related corporations, making the aggregate amount paid excessive.
 - c. Review the minutes to determine if loans were made to any board members or officers. If so, secure a copy of the loan documents for review. Loans to officers, while not prohibited, could result in an excess benefit transaction pursuant to IRC §4958.

- d. Analyze any business relationships or other dealings between the aforementioned individuals to determine if these individuals provided or received inappropriate benefits. This is particularly important if the organization has invested in qualified active low-income community businesses in which these individuals have a financial interest.

Examination of Investments Examine each investment to determine if the funds were used for exempt purposes; e.g., financial counseling to low income persons or businesses.

1. Review leases and other contracts, particularly transactions with officers or other related parties. Determine whether private individuals are receiving any form of inurement or whether the organization has executed any agreements not in furtherance of its exempt purpose.
2. Review copies of mortgages, contracts, agreements, etc. to determine if payments represent fair rental value and whether the agreements are at arm's length.

Exempt Organization Communication and Letters

Review correspondence files, which usually fall into four categories:

1. Letters soliciting funds that identify the nature of projects to be financed or supported;
2. Correspondence relating to use of funds which identify the type of organizations or activities being supported;
3. General correspondence which identify other activities carried on for, or on behalf of, the organization or related parties; and
4. Correspondence with the IRS.

Financial Records

Review financial information to identify important information about the organization's activities. Additionally, verify that the information reported on the return is correct. Examiners should complete the following audit techniques:

1. Reconcile the books to the return;
2. Compare prior and subsequent year income, expenses, assets, and liabilities;
3. Review chart of accounts;
4. Review year-end trial balance;
5. Review auditor's report;
6. Review audited financial statements and management reports;
7. Analyze income and expenses; and
8. Analyze the balance sheet.

Incomplete or Unorganized Records

When a taxpayer submits unorganized records, the burden is on the taxpayer to organize them and prepare summaries and reconciliations.

Referral Procedures

Requesting Assistance

When needed, revenue agents conducting examination of a qualified CDE can request EO assistance. A referral to EO Examination may be needed in the following situations:

1. The tax entity under examination has a salaried exempt organization officer on its governing board.
2. An exempt organization is a general partner of a partnership under audit.
3. There are written agreements between the taxpayer under audit and an exempt organization's officer, and the officer received compensation.
4. The exempt organization officer is compensated as an employee by the entity under audit.
5. In a partnership arrangement, the investors have a larger percentage of ownership in the partnership than the exempt organization.

If any of the above stated scenarios are present in a case, the examiner should refer the organization to the EO Examination function at the following address:

Internal Revenue Service
EO Classification MC 4980
1100 Commerce Street
Dallas, TX 75242

Summary

This chapter has discussed four topics:

1. EO Examination's role in the NMTC Program;
2. Issues specific to CDEs that are exempt organizations;
3. Examination procedures and audit techniques; and
4. Criteria for making referrals to EO Examination when the taxpayer is an exempt organization.

Chapter 5 Disclosure of Tax Information

Introduction

One of the most critical and sensitive responsibilities of every IRS employee is the proper handling of a taxpayer's confidential federal tax information. All tax returns and return information must be kept confidential. Except as noted in the Internal Revenue Code (IRC), IRS employees are prohibited from disclosing returns or return information to unauthorized persons. The term "disclosure" means making known to any person, in any manner whatsoever, a return or return information. Revealing tax information to persons who are not authorized to receive it is an unauthorized disclosure.

Persons who make unauthorized disclosures are subject to severe criminal penalties under IRC §7213 - a fine of as much as \$5,000 and/or up to 5 years in prison. In addition, they may be subject to disciplinary action by the Service. The government may also be subject to civil liability for unauthorized disclosure. All unauthorized disclosures should be reported promptly to the employee's manager.

This lesson is narrowly focused to awareness of disclosure topics associated with New Markets Tax Credit (NMTC) examinations and the disclosure of qualified community development entity (CDE) return and return information to related investors. Specifically, this lesson covers disclosure exceptions per IRC §6103(e) and IRC §6103(h) (4). Examiners needing additional information should refer to IRM 11.3, Disclosure of Official Information, or contact their local Disclosure Officer or staff.

Authorized Disclosures

Material Interest

Examiners may disclose tax returns and, unless otherwise instructed, return information to any person having a proper material interest in such information. IRC §6103(e) lists those individuals and/or entities that are entitled to such disclosure. The following apply to CDEs:

In general – The return of a person, upon written request, shall be open to inspection by or disclosure to -

in the case of the return of a partnership, any person who was a member of such partnership during any part of the period covered by the return; in the case of the return of a corporation or a subsidiary thereof--

- (a) any person designated by resolution of its board of directors or other similar governing body,
- (b) any officer or employee of such corporation upon written request signed by any principal officer and attested to by the secretary or other officer,

- (c) any bona fide shareholder of record owning 1% or more of the outstanding stock of such corporation,
- (d) if the corporation was an S corporation, any person who was a shareholder during any part of the period covered by such return during which an election under IRC §1362(a) was in effect, or
- (e) if the corporation has been dissolved, any person authorized by applicable State law to act for the corporation or any person who the Secretary finds to have a material interest which will be affected by information contained therein.

Example 1: Capital Interest

Upon formation of a CDE, an entity made a \$100,000 equity investment in the CDE. The CDE generated a total of \$1,000,000 cash in initial equity investments.

- a) If the CDE is a partnership and the investor entity is an individual, then return and return information can be disclosed to the individual upon written request if that person was a member of the CDE during any part of the period covered by the return.
- b) If the CDE was a subsidiary of a corporation and the investor entity is an individual, then the return and return information can be disclosed to the individual upon written request, since the investor was a bona fide shareholder of record owning 1% or more of the outstanding stock of such subsidiary.
- c) If the CDE was a corporation and the investor entity is a corporation, then the return and return information can be disclosed to the corporation upon written request, since the investor was a bona fide shareholder of record owning 1% or more of the outstanding stock of such subsidiary. However, the return information could not be disclosed to the shareholders of the investor, because there is not a direct ownership relationship to the CDE.

See IRM 11.3.2 for additional guidance on disclosures to persons with material interest.

Disclosures of Third Party Tax Information in Administrative Proceedings

IRC §6103(h)(4) permits the disclosure of returns and return information in federal and state judicial or administrative tax proceedings under specific conditions.

- IRC §6103(h) (4)(B)—permits the disclosure of items on a return where the treatment of an item reflected on such return is directly related to the resolution of an issue in the proceeding.
- IRC §6103(h) (4)(C) — permits the disclosure of items on a return where such return or return information directly relates to a transactional relationship

between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding.

“Return information” is very broad term that includes any information that the IRS has obtained from any source, or developed through any means in connection with determining a liability or potential liability under the Code. The statute does not define “administrative proceeding.” However, the term generally includes any proceedings regarding proposed or actual actions against a person(s) that are enforceable under agency laws or regulations.

The following is an example of disclosures of third party tax information in administrative proceedings which satisfy the conditions of IRC §6103(h)(4)(B) or (C).

Example 1: Disclosure in an Administrative Procedure

It was determined in an IRS examination that Corporation XYZ’s subsidiary, a CDE, failed to invest substantially all of its equity investment into a qualified active low-income community business. The CDE was aware of the problem and attempted to correct the error, but failed to do so within six months after the date of discovery.

IRC §6103(h)(4)(B) and IRC §6103(h)(4)(C) apply. In an examination of the investors returns (an administrative proceeding) the IRS can disclose the fact that the investor’s equity investment in the CDE does not qualify for the NMTC because the CDE had failed to invest substantially all of its equity investment into a qualified active low-income community business. The equity investment transaction between the CDE and the investors has an effect in the resolution of investor’s examination.

See IRM 11.3.32 for additional guidance on disclosures in judicial and administrative tax proceedings.

**CDFI Fund
Authorization**

IRC §6103 provides that returns and return information may also be disclosed to officers and employees of Treasury, attorneys of the Department of Justice (including United States Attorneys), and state tax officials pursuant to IRC §6103(h)(1), (h)(2) and (d), respectively, in connection with tax administration, provided the requirements for disclosure under such provisions are met. See IRM 11.3.22 for disclosure to Treasury and Department of Justice for tax administration purposes and IRM 11.3.32 for tax administration purposes.

Field examiners will not make any inquiries or disclosures to federal or state officials. Any requests for information to or from federal or state agencies are to be referred to the SBSE or LMSB program analysts assigned to the NMTC program. The program analyst is the liaison between the CDFI Fund and IRS personnel.

Summary

1. IRS employees are prohibited from disclosing returns or return information to unauthorized persons or in an unauthorized manner. Persons who make unauthorized disclosures are subject to severe penalties under IRC §7213 - a fine of as much as \$5,000 and/or up to 5 years in prison.
2. “Return information” is very broad term that includes any information that the IRS has obtained from any source, or developed through any means in connection with determining liabilities or potential liabilities under the Code.
3. The statute does not define “administrative proceeding.” However, the term generally includes any proceedings regarding proposed or actual actions against a person(s) that are enforceable under agency laws or regulations.
4. Examiners may disclose tax returns and, in the absence of specific instructions, return information to any person having a proper material interest in such information. IRC §6103(e).
5. IRC §6103(h)(4)(B) authorizes disclosure of items on a return where the treatment of an item reflected on such return is directly related to the resolution of an issue in a judicial administrative tax proceeding.
6. IRC §6103(h)(4)(C) authorizes disclosure of items on a return information where such return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in a judicial administrative tax proceeding.
7. Contact the LMSB or SBSE program analysts if contact with the CDFI Fund, or other federal and state agencies is needed.

IRC §6103 Quick Reference Guide

6103(a) General rule of confidentiality

6103(b) Definitions of key terms

6103(c) Taxpayer authorizations to third parties

6103(d) Disclosures to State tax agencies

6103(e) Material interest specifications

- Individuals
- Corporations
- Trusts
- Bankruptcy
- Attorney in Fact
- Etc.

6103(f) Disclosures to committees of Congress

6103(g) Disclosures to the President and certain other persons (as described in this section)

6103(h) Disclosures to certain Federal officers and employees for purposes of *tax administration*.

6103(i) Disclosures to certain Federal officers and employees for administration of Federal criminal laws *NOT relating to tax administration*.

- (i)(1) & (i)(2) Criminal investigations
- (i)(3) Criminal or terrorist activities or emergency circumstances
- (i)(4) Judicial or administration proceedings
- (i)(5) Locating fugitives from justice
- (i)(6) Impairment provisions
- (i)(7) Terrorist activities
- (i)(8) Comptroller General issues

6103(j) Statistical use

6103(k) Disclosures for tax administration purposes — e.g., disclosure of:

- Accepted offers in compromise
- Amounts of outstanding liens
- State agencies regulating tax return preparers
- (k)(6) Investigative disclosures to third parties

6103(l) Disclosure for purposes other than tax administration — e.g., disclosures to/for:

- SSA — Social Security Administration
- DOL — Department of Labor
- Delinquent Federal loan accounts
- Personnel or Claimant Representative Matters
- Federal, state, local child support enforcement agencies
- Certain Welfare agencies
- Student loan verifications

6103(m) Disclosure of taxpayer identity information — e.g., for use of or in:

- Tax refund notification to media
- Certain Federal claims • NIOSH — National Institute for Occupational Safety and Health
- Pell Grants
- Default of student loans

6103(n) Disclosure to certain other persons (mostly to contractors)

6103(o) Disclosure with respect to wagering taxes and taxes on alcohol, tobacco, and firearms.

6103(p) Procedures and record keeping — e.g., safeguarding tax information

Chapter 6 Audit Reports

Introduction

Examination reports (unlike workpapers) are legally binding documents and, when executed, serve as the basis for assessment and collection action. Based on this importance, examiners should take all necessary steps to ensure report accuracy.

The key to this chapter is to remember that the New Market Tax Credit (NMTC) does not change the report writing requirements or procedures for agreed, unagreed, survey, or no-change reports or for any type of entity, i.e. individual, corporation, partnership, or trust. The audit report will document how the tax liability was computed and contain all the information necessary to ensure a clear understanding of the adjustments.

Background

Common scenarios that will be encountered in NMTC audits are that the qualified community development entity (CDE) will be a C corporation, S corporation, Limited Liability Company (LLC), or partnership with multiple investors (partnerships, corporations, trusts, individuals). The scope of the audit may be expanded to include additional issues warranting examination or limited to consideration of the NMTC only. The audit of a CDE may be expanded to include related investor returns and/or subsequent year tax returns.

Example: An examiner determined that a CDE failed to meet the substantially-all requirement and a NMTC recapture event has occurred. The audit will include the CDE's tax return for the year in which the equity investment was disqualified and all affected investor returns will be examined concurrently with the CDE to address the recapture issue in the year of disqualification. (See IRM 4.10.5.4, Related Returns.) In addition, any subsequent year returns on which the NMTC was claimed will be audited to disallow the credit in that year.

References

- IRM 4.10.5, Required Filing Checks
- IRM 4.10.8, Report Writing
- IRM 4.31.2, TEFRA Examinations-Field Office Procedures TEFRA

CDE (Corporation)

No-Change Audits

If the examination of the CDE's return does not result in a change to the CDE's tax liability, the allowable NMTC, or the identification of a credit recapture event, then a no-change report will be issued to the CDE upon the completion of the examination.

On Form 4549, Income Tax Examination Changes, the column for the no-change year should have zero on lines 2, 14 and 17. Refer to IRM 4.10.8.2.3 for detailed procedures.

Issuing No-Change Reports

Issue a Letter 3401, No-Change Report Transmittal Letter, and one copy of the no-change report to the taxpayer and the taxpayer's representative (if the representative is authorized to receive notices and communications). Letter 3401 advises the taxpayer that a no-change is proposed but is subject to review.

Letter 590 will be issued after the case is officially closed. Letter 590 (undated) should be prepared and signed by the examiner and included in the case file when closed from the group.

No-Change with Adjustments

CDE Report

The CDE will receive a no-change with adjustment report. In cases where the audit result in a disqualification of an equity investment, but no change to the tax liability of the CDE, it is important to notify the CDE and secure an agreement to the audit adjustment. A report with supporting schedules will be issued to the CDE at the conclusion of the examination. Although it is not necessary to secure the CDE's agreement since there is no additional tax liability, securing the agreement will document the CDE's concurrence with the examination results and facilitate completion of the subsequent examination of the investors' returns to recapture the NMTC.

Identifying Investors

The CDE is required to provide investors with notifications on Form 8874-A, Notice of Qualified Equity Investment for New Markets Credit, that their equity investments qualify for the NMTC. Examiners should solicit copies of these notices from the CDE. If the notices are insufficient for report purposes, a list of investors with EINs or SSNs, along with K-1 information submitted to investors for the years in which the NMTC was in effect, should be requested.

Investor Audit Reports

Each investor holding an affected qualified equity investment will be issued an examination report for agreement with the recapture. The examiner will control the returns requiring an adjustment and issue the required reports unless the Partnership Control System (PCS) for controlling returns is used.

CDE (Partnership)

The NMTC, like other tax attributes, will flow through the partnership entity to the partners. If required, the partners or shareholders should be controlled using PCS or TEFRA procedures.

Reports for No- Change Audits

TEFRA Procedures

If the audit is closed no-changed within 45 days from the date the Notice of the Beginning of the Administrative Procedure (NBAP) is issued, follow the procedures

in IRM 4.31.2.2.6.1, No Change Within 45 Days. If the audit is closed more than 45 days after the after the NBAP is issued, the taxpayer will be issued a summary report as described in IRM 4.31.2.2.6.3, Completing the Key Case Examination.

Non-TEFRA Audits

Follow procedures outlined in IRM 4.10.8.2.3, Issuance of No-Change Reports

Reports for Adjustments to NMTC

Three adjustments should be presented on Form 4605, Examination Changes – Partnerships, Fiduciaries, S Corporations, and Interest Charge Domestic International Corporations.

1. The current year adjustment to the NMTC is presented under line 5, Other adjustments.
2. The disallowance of future year credit should be disclosed and explained in the “Remarks” section.
3. The recaptured NMTC is also presented under line 5, Other Adjustments, as a separate line item from the current year adjustment. The entire recapture amount (credit + interest) should be combined as a single dollar amount.

Identifying Partners

Partners for the current year are identified on the Forms K-1 for the year under audit. Form 886-S, Partner's Share of Income, Deductions and Credits, are used to identify adjustments at the partner and shareholder level. Three adjustments should be identified:

1. disallowance of current year NMTC,
2. disallowance of credit in subsequent years, and
3. recaptured NMTC from prior years. However, since the tax benefit rule will be applied at the partner level, the credit and interest portions of the recapture amount should be separately stated.

Investors (Individuals and Corporations)

For examinations of investors claiming the credit (individuals or corporations), Form 4549, Income Tax Examination Changes, is used to document audit results and secure agreement. Form 886-A is used to provide explanations of audit adjustments.

Form 4549, Income Tax Examination Changes

The adjustment to the current year credit will be reflected on line 8, “Less Credits.” The recapture amount (recaptured NMTC + interest) is identified on line 10, “Plus Other Taxes.” A statement regarding the interest will be shown in the “Other Information” section of the report. The statement will include the years the NMTC was claimed, the interest computation dates and the interest for each period. The following example is for a recapture event in 2008

IRC §45D(g)(2)(B) states that the recapture amount is equal to the decrease in credit plus the interest on the amount of NMTC used to reduce the tax liability for each prior taxable year. Interest will be calculated using the underpayment rate established under IRC §6621, beginning on the due date for filing the return on which the credit was claimed and ending on the due date for the tax return on which the credit recapture is made.

We have also calculated your interest on the recapture amount from the due date of the return under audit to 30 days after the date of this report.

(a) Credit Period Year	(b) NMTC Claimed	(c) Interest Computation Dates	(d) Interest Under IRC §45D(g)(2)(B)	(e) Recapture Amount
2004	\$15,000	4/15/2005 to 4/15/2009	\$4,469	\$19,469
2005	\$35,000	4/15/2006 to 4/15/2009	\$6,544	\$41,544
2006	\$25,000	4/15/2007 to 4/15/2009	\$2,690	\$27,690
2007	<u>\$52,000</u>	4/15/2008 to 4/15/2009	<u>\$2,398</u>	<u>\$54,398</u>
Total	\$127,000		\$16,101	\$143,101

Form 886, Explanation of Items

The explanation will include facts, law, the taxpayer's position, argument, conclusion, and a calculation of the NMTC recapture.

Example: Explanation for Adjustment on Form 886

Facts

It has been determined that you have made a \$1,000,000 equity investment in XYZ Corp, a qualified community development entity, on July 2, 2004, which entitled you to the New Markets Tax Credit (NMTC). On your tax returns you used a NMTC equal to \$30,000, \$50,000, \$25,000, and \$52,000 to reduce federal income tax liabilities for calendar tax years 2004, 2005, 2006, and 2007, respectively. The following table shows how credits were applied against your tax liabilities.

(a) Credit Period	(b) Allowable NMTC	(c) Available NMTC	(d) Tax Liability	(e) NMTC Claimed (Recaptured)	(f) Carry Forward (Disallowed)
2004	\$50,000	\$50,000	\$30,000	\$30,000	\$20,000
2005	\$50,000	\$70,000	\$50,000	\$50,000	\$20,000
2006	\$50,000	\$70,000	\$25,000	\$25,000	\$45,000
2007	<u>\$60,000</u>	\$105,000	\$52,000	<u>\$52,000</u>	\$53,000
Total	\$210,000			\$157,000	

The allowable credit is determined as a percentage of your investment. The available credit is computed as the sum of the current year allowable credit and the carryforward of credit from the previous year. The credit claimed is the amount used to reduce the taxpayer's tax liability. The carry forward is the difference between the

amount of credit available and the amount of credit claimed.

Law

Under IRC §45D(g)(3), there are three events that can result in the recapture of NMTC at the investor level.

- The CDE ceases to qualify as a CDE,
- The substantially-all requirement is not satisfied, or
- The investment is redeemed or otherwise cashed out by the CDE and the CDE distributes the funds to the equity holder.

Under IRC §45D(g)(2)(A), the aggregate NMTC allowed to the taxpayer for all prior years will be recaptured.

Taxpayer's Position

The taxpayer's position, if known, should be included. The legal authority, if any, that the taxpayer is using to support their position should also be cited. If the taxpayer has provided a written position statement, it should be included in its entirety or summarized here and included in its entirety as an exhibit. If the taxpayer's position is not known, include statement: "Taxpayer's position unknown."

Argument

It has been determined that the XYZ corporation did not meet the requirements of IRC §45D(b)(1)(B) by failing to invest substantially all of the taxpayer's equity investment in qualified low-income community investments in 2008. Therefore, your equity investment in XYZ corporation has failed to qualify for the NMTC.

Conclusion

The amount of NMTC subject to recapture is \$157,000. In addition, the carry forward of \$53,000 at the end of 2007 is reduced to zero and you are not entitled to any NMTC associated with this investment in future years.

Summary

1. The NMTC does not change the report writing requirements or procedures.
2. A NMTC *disallowance* will require a Form 4549 report for the investor in the year of recapture and subsequent years on which the credit was claimed. The examiner will disallow the full amount of the credit taken and no credit will be shown on line 8 of the report, "Less Credits."
3. A NMTC *recapture* event will also require a Form 4549 report for the investor that includes a NMTC recaptured adjustment shown on line 10 of the report, "Plus Other Taxes."
4. The audit report should contain all the information necessary to ensure a clear understanding of the adjustments and document how the tax liability was computed.
5. A statement regarding the interest portion of the recapture amount, and how it was computed, will be shown in the "Other Information" section of the report.
6. The Form 886 will include facts, law, taxpayer's position, argument, conclusion and a calculation of the NMTC recapture.