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IRS Issues Final Targeted Populations Regulations

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The Internal Revenue Service published final Treasury Regulations effective December 5, 2011 providing rules for satisfaction of the "qualified active low-income community business" requirements for businesses serving targeted populations.

Background

The American Jobs Creation Act of 2004 amended the New Markets Tax Credit (NMTC) program under Section 45D(e) of the Internal Revenue Code (IRC) to expand the definition of low-income communities (LICs) beyond the geographic definition, to include targeted populations. Targeted populations treated as LICs means individuals, or an identifiable group of individuals including an Indian tribe, who are low-income persons (defined below) or lack adequate access to loans or equity investments.

Examples of targeted population transactions that have benefitted to date from the expanded definition of LICs include

- healthcare facilities in Alaska that serve very low-income persons in rural villages but that are required to be located in a hub that does not constitute a geographic LIC in order to access the necessary resources;
- businesses located in highly economically distressed areas that are part of a census tract that does not qualify as a geographic LIC; and
- not-for-profits serving low-income persons, providing necessary services in areas, e.g. metropolitan areas, that do not qualify as geographic LICs.

About the Final Regulations

The final regulations supersede the guidance set forth in IRS Notice 2006-60 and the proposed regulations issued September 24, 2008. The final regulations generally are consistent with the guidance issued in the notice and proposed regulations. This article summarizes the rules and highlights the issues raised by the final regulations.

The final regulations apply to tax years ending on or after December 5, 2011. Taxpayers can apply the final regulations to prior tax years with respect to targeted populations designated as LICs after October 22, 2004.

Definition of QALICB Serving Targeted Populations

A business will be treated as a QALICB for low-income targeted populations if for each tax year one of the following three tests is satisfied:

i. at least 50 percent of total gross income is derived from sales, rentals, services or other transactions with low-income persons (gross income test);
ii. at least 40 percent of employees are low-income persons (employee test); or
iii. at least 50 percent of the owners are low-income persons (ownership test).

The business must also satisfy the QALICB requirements with respect to engaging in the "active conduct" of a "qualified business," and the limitations on the ownership of "nonqualified financial property" and "collectibles."

Definition of Low-Income Persons

- Low-Income: An individual is low-income if the individual's family income, adjusted for family size, is not more than (a) for metropolitan areas, 80 percent of area

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median family income and (b) for non-metropolitan areas, the greater of 80 percent of area median family income or 80 percent of the statewide non-metropolitan area median family income.

- Area median family income: The final regulations provide that area median family income is determined in a manner consistent with determinations of median family income under Section 8 of the Housing Act of 1937, as amended. Taxpayers must rely on the annual estimates of median family income released by the Department of Housing and Urban Development (HUD) and may rely on those figures until the later of 45 days after HUD releases a new list of income limits, or until HUD's effective date for the new list.
- Determining family income: The final regulations provide that family income is determined using any one of the following three methods for measuring family income:
  - Household income as measured by the U.S. Census Bureau;
  - Adjusted gross income under Section 62 of the IRC as reported on IRS Form 1040; provided that adjusted gross income must include the adjusted gross income of any member of the individual's family (defined to include brothers, sisters, spouse, ancestors and lineal descendants) if the family member resides with the individual regardless of whether the family member files a separate return; or
  - Household income determined under Section 8 of the Housing Act of 1937, as amended (Section 8/low-income housing tax credit definition). See HUD Handbook 4350.3 REV-1 for the definition of household income.
- Participation in other federal programs serving low-income persons does not result in automatic qualification: Consistent with the proposed regulations, the final regulations did not accept the comment that businesses that qualify and participate in other federal programs targeted specifically to low-income individuals should automatically satisfy the targeted populations' requirements. Such qualification does not substitute for compliance with the statutory requirements of Section 45D(e). Other federal programs may not use the same definition of low-income and the requirements are subject to change.

Gross Income Test

- *"Derived from"*: The final regulations incorporate the conclusions of recent private letter rulings that "derived from" includes payments (a) made directly by low-income persons and (b) money and the fair market value of property or services provided to the business primarily for the benefit of low-income persons, but only if the persons providing the money, property or services do not receive a direct benefit from the business. A contribution that benefits the general public is not a direct benefit. The preamble states that federal, state, or local grants, charitable donations, in-kind contributions, collected

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fees, insurance reimbursements, and other income are included if the funds are provided for the benefit of low-income persons on an individual basis or as a class of individuals. The preamble states that the business must document that such amounts are legally required to be paid on behalf of individuals who meet the definition of low-income persons in order to include these amounts as "derived from" transactions with low-income persons. The business will have to evaluate whether the criteria are at least as stringent for determining low-income status. This approach raises concerns due to potential changes in the requirements of the funding sources.

- *Gross income includes the fair market value of goods and services:* The final regulations provide that a business with gross income from transactions with both non-low-income and low-income persons may treat the fair market value of goods and services or other transactions with low-income persons as gross income received even if the low-income persons do not pay fair market value. It seems reasonable that the amounts paid by the non-low-income persons can be used as a benchmark for the fair market value, depending on the facts of the particular transaction.
- *Rental real estate:* A business that rents real property for low-income targeted populations is 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 or to a QALICB that meets the gross income test or employee test. A single purpose rental real estate business satisfies the gross income test if the business is treated as being located in a LIC. The lessees, if they are not individuals, have to satisfy the QALICB requirements, including nonqualified financial property limitations.

Employee Test

- The test with respect to employees is applied at the time the employee is hired, without regard to any increase in the employee's income after the time of hire. The business must have

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employees who satisfy this requirement in the tax year that the qualified low-income community investment (QLICI) is closed. If the QLICI is financing an existing business, the challenge will be to verify the income of employees hired several years before the QLICI is closed.

Ownership Test

- The ownership test is applied to owners of the business at the time the loan or investment is made in the business, or if later, the date of acquisition by the owner of an interest in the business, without regard to any increase in income of such owners after such date. The request to provide an alternate ownership test based on board membership by low-income board members for not-for-profits was rejected as not adequately serving low-income targeted populations. The ownership criterion is not available to non-stock not-for-profit corporations.

Active Conduct of a Qualified Business/Start-Up Businesses

- A QALICB is required to engage in the "active conduct" of a "qualified business." The active conduct requirement is deemed satisfied if at the time the QLICI is made, the CDE reasonably expects the business will generate revenues (or in the case of a not-for-profit, engage in activity that furthers its purposes as a not-for-profit) within three years after the date the QLICI is made. The final regulations provide that this safe harbor applies only to determine whether the active conduct requirement is satisfied and does not apply in determining compliance with the targeted populations' requirements. The gross income, employee or ownership tests must be satisfied in the QALICB's tax year that the QLICI is made. Start-up businesses are more likely to rely on the ownership test as a result of this rule, or to assure hiring of qualifying employees during the start-up period, or construction period.
- With respect to businesses that are located in geographic LICs, the final regulations provide that the active conduct safe harbor does not apply for purposes of determining whether a business satisfies the gross income test. If the business has no gross income in any particular tax year, it must satisfy the gross income test based on satisfaction of the tangible property or employee services tests at a level of 50 percent instead of 40 percent.

120 Percent Income Restriction

- The final regulations retain the upper limit on the income levels of the census tract in which the QALICB operates. The QALICB must be located and conduct its activities primarily in census tracts where the median family income is at or below 120 percent of the statewide median family income for non-metropolitan area tracts, or the greater of statewide or metropolitan area median family income for tracts located within a metropolitan area.

Reasonable Expectations Safe Harbor

The reasonable expectations safe harbor for determining QALICB status applies to targeted populations QALICBs. Treasury Regulations provide that an entity is treated as a QALICB for the duration of the CDE's investment in the entity if the CDE reasonably expects, at the time the CDE makes the QLICI, that the entity will satisfy the QALICB requirements throughout the entire period of the investment or loan, unless the CDE controls or obtains control of the QALICB during the seven-year credit period. In order to have a reasonable expectation of ongoing compliance for purposes of the tax opinions issued at closing, the targeted populations tests are generally required to be met at levels in excess of 60 percent, and procedures are documented to support ongoing compliance with the requirements.

GO-Zone

The final regulations include rules regarding satisfaction of targeted population QALICB requirements for investments made in the GO-Zone under the increased NMTC allocations made by the CDFI Fund in 2005, 2006 and 2007.

Comments Requested

The final regulations include a request for comments to define additional targeted populations, including identifying individuals or groups who lack adequate access to loans or equity investments.

Conclusion

The issuance of final regulations provides additional certainty facilitating investments and loans to targeted populations.

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

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