



IRS Releases Taxpayer-Friendly Guidance on New Markets Tax Credits

On June 8, 2010 the Internal Revenue Service (the Service) released taxpayer-friendly guidance on New Markets Tax Credits (NMTCs). First, Revenue Ruling 2010-16 concluded that the passive activity credit limitation rules do not limit certain individual investors from taking NMTCs. This ruling confirms the interpretation of Squire Sanders on this issue and removes uncertainty that has kept some individual investors from the NMTC investor pool by providing a taxpayer-friendly clarification of these passive activity rules. Second, Revenue Ruling 2010-17 confirms that cash from a recourse loan can generate NMTCs.

Passive Activity Rules

In Revenue Ruling 2010-16 the Service ruled that the ability of investors to claim NMTCs in two hypothetical scenarios is not limited by the passive activity credit rules in Section 469 of the Internal Revenue Code (the Code). In the first scenario, an individual investor acquired a qualified equity investment (QEI) in a qualified community development entity (CDE) and the investor's acquisition of the QEI was not in connection with the conduct of the individual's trade or business. In the second scenario, a partnership, all the partners of which were individuals, acquired a QEI in a CDE and the partnership's acquisition of the QEI was not in connection with the conduct of the partnership's trade or business.

Code Section 469 limits the ability of individuals and certain closely held corporations to claim credits or losses from a passive activity. A "passive activity" is defined as

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(1) any activity that involves the conduct of any trade or business, and in which the taxpayer does not materially participate, and (2) certain rental activities. Revenue Ruling 2010-16 confirmed that NMTCs are subject to the provisions of Code Section 469 and, therefore, that a claim for NMTCs may be disallowed under Code Section 469 if the NMTC arises in connection with the conduct of a passive activity. The Service went on to state that, in determining whether the investor's acquisition of a QEI is a passive activity, only the character of the activity of the investor's acquisition of the QEI is relevant in determining whether the passive activity rules will limit NMTCs, and that the activities of the CDE and the qualified active low-income community business are not relevant in making such a determination. Further, the Service stated that the acquisition of a QEI is not a rental activity.

In Revenue Ruling 2010-16 the Service assumed that the investor's acquisition of QEIs were not in connection with the conduct of the investors' respective trade or business and therefore did not constitute a passive activity. Most individual investors will be able to avoid the passive activity credit restrictions, but it is possible that some individuals might be treated as acquiring a QEI in connection with a trade or business, and therefore not eligible to claim NMTCs. Revenue Ruling 2010-16 is welcome guidance because it provides more certainty as to how the Service will apply the passive activity credit rules to NMTCs, and it makes clear that if an individual's acquisition of a QEI is not in connection with the individual's trade or business, the NMTC may be claimed by the individual.

The rationale of Revenue Ruling 2010-16 suggests that Code Section 469 would not limit **losses** claimed by an individual investor resulting from a QEI that was not acquired in connection with the individual's trade or business.

Recourse Loans

In Revenue Ruling 2010-17 the Service ruled that cash received from a recourse loan that is used to acquire a QEI can generate NMTCs. This ruling addressed a hypothetical scenario in which a limited liability company (LLC) classified as a partnership for federal tax purposes made a QEI that included proceeds from a recourse loan to the LLC. The Service concluded that, for purposes of determining the amount of the NMTCs allowable to the LLC under Code Section 45D, the amount of the QEI includes cash from the recourse loan to the LLC.

In reaching its conclusion in this ruling, the Service applied the rationale of Ruling 2003-20, 2003-1 C.B. 659, which ruled that Code Section 45D does not prohibit a taxpayer from using cash derived from a borrowing to

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acquire a QEI. In Revenue Ruling 2003-20, the Service ruled that a QEI acquired by a limited liability company classified as a partnership for federal income tax purposes includes cash from a loan that was non-recourse to the limited liability company where such cash was used to acquire the QEI, and in Revenue Ruling 2010-17, the Service extended this conclusion to recourse loans.

For more information on this topic, please contact your principal Squire Sanders lawyer or one of the individuals listed in this *Alert*.

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