

# Section 45D.—New Markets Tax Credit

26 CFR 1.45D-1: New markets tax credit.

T.D. 9171

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

### New Markets Tax Credit

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

**SUMMARY:** These regulations finalize the rules relating to the new markets tax credit under section 45D and replace the temporary regulations which expire on December 23, 2004. A taxpayer making a qualified equity investment in a qualified community development entity that has received a new markets tax credit allocation may claim a 5-percent tax credit with respect to the qualified equity investment on each of the first 3 credit allowance dates and a 6-percent tax credit with respect to the qualified equity investment on each of the remaining 4 credit allowance dates.

**DATES:** *Effective Date:* These regulations are effective December 22, 2004.

*Date of Applicability:* For date of applicability, see §1.45D-1(h).

**FOR FURTHER INFORMATION CONTACT:** Paul F. Handleman or Lauren R. Taylor, (202) 622-3040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

#### Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1765. Responses to this collection of information are mandatory so that a taxpayer may claim a new markets tax credit on each credit allowance date during the 7-year credit period and report compliance with the requirements of section 45D to the Secretary.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent varies from 15 minutes to 5 hours, depending on individual circumstances, with an estimated average of 2.5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

#### Background

This document amends 26 CFR part 1 to provide rules relating to the new markets tax credit under section 45D of the Internal Revenue Code (Code). On December 26, 2001, the IRS published in the **Federal Register** temporary and proposed

regulations (the 2001 temporary regulations) (T.D. 8971, 2002-1 C.B. 308 [66 FR 66307]), (REG-119436-01, 2002-1 C.B. 377 [66 FR 66376]). On March 11, 2004, the IRS published in the **Federal Register** temporary and proposed regulations revising and clarifying the 2001 temporary regulations (the 2004 temporary regulations) (T.D. 9116, 2004-14 I.R.B. 674 [69 FR 11507]), (REG-115471-03, 2004-14 I.R.B. 706 [69 FR 11561]). On March 14, 2002, and June 2, 2004, the IRS and Treasury Department held public hearings on the 2001 temporary regulations and the 2004 temporary regulations, respectively. Written and electronic comments responding to the temporary regulations and notices of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision, and the corresponding temporary regulations are removed. The revisions are discussed below.

Section 45D was added to the Code by section 121(a) of the Community Renewal Tax Relief Act of 2000 (Pub. L. 106-554). The Secretary has delegated certain administrative, application, allocation, monitoring, and other programmatic functions relating to the new markets tax credit program to the Under Secretary (Domestic Finance), who in turn has delegated those functions to the Community Development Financial Institutions Fund.

Sections 221 and 223 of the American Jobs Creation Act of 2004 (Pub. L. 108-357) amended the definition of a low-income community under section 45D(e). This document does not provide guidance on these amendments. The IRS and Treasury Department are studying the amendments for guidance in the near future.

#### Explanation of Provisions

##### *General Overview*

Taxpayers may claim a new markets tax credit on a credit allowance date in an amount equal to the applicable percentage of the taxpayer's qualified equity investment in a qualified community development entity (CDE). The credit allowance date for any qualified equity investment is

the date on which the investment is initially made and each of the 6 anniversary dates thereafter. The applicable percentage is 5 percent for the first 3 credit allowance dates and 6 percent for the remaining credit allowance dates.

A CDE is any domestic corporation or partnership if: (1) the primary mission of the entity is serving or providing investment capital for low-income communities or low-income persons; (2) the entity maintains accountability to residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity; and (3) the entity is certified by the Secretary for purposes of section 45D as being a CDE.

The new markets tax credit may be claimed only for a qualified equity investment in a CDE. A qualified equity investment is any equity investment in a CDE for which the CDE has received an allocation from the Secretary if, among other things, the CDE uses substantially all of the cash from the investment to make qualified low-income community investments. Under a safe harbor, the substantially-all requirement is treated as met if at least 85 percent of the aggregate gross assets of the CDE are invested in qualified low-income community investments.

Qualified low-income community investments consist of: (1) any capital or equity investment in, or loan to, any qualified active low-income community business; (2) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; (3) financial counseling and other services to businesses located in, and residents of, low-income communities; and (4) certain equity investments in, or loans to, a CDE.

In general, a qualified active low-income community business is a corporation or a partnership if for the taxable year: (1) at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business within any low-income community; (2) a substantial portion of the use of the tangible property of the entity is within any low-income community; (3) a substantial portion of the services performed for the entity by its employees is performed in any low-income community; (4) less than 5 percent of the average of the aggregate unadjusted bases

of the property of the entity is attributable to certain collectibles; and (5) less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to certain nonqualified financial property.

A recapture event requiring an investor to recapture credits previously taken occurs for an equity investment in a CDE if the CDE: (1) ceases to be a CDE; (2) ceases to use substantially all of the proceeds of the equity investment for qualified low-income community investments; or (3) redeems the investor's equity investment. In addition, the investor's basis in any qualified equity investment is reduced by the amount of the new markets tax credit.

#### *Substantially All*

As indicated above, a CDE must use substantially all of the cash from a qualified equity investment to make qualified low-income community investments. Section 1.45D-1T(c)(5)(i) provides that the substantially-all requirement is treated as satisfied for an annual period if either the direct-tracing calculation under §1.45D-1T(c)(5)(ii), or the safe harbor calculation under §1.45D-1T(c)(5)(iii), is performed every six months and the average of the two calculations for the annual period is at least 85 percent. The final regulations clarify that a CDE may choose the same two testing dates for all qualified equity investments regardless of the date each qualified equity investment was initially made. To conform the annual testing requirement with the 12-month time limit for making qualified low-income community investments, the final regulations provide that for the first annual period, the substantially-all calculation may be performed on a single testing date. The final regulations also amend the beginning of the 12-month period for making qualified low-income community investments to provide that the 12-month period begins on the same date as the beginning of the first annual period of the 7-year credit period.

Section 1.45D-1T(d)(3) provides that reserves (not in excess of 5 percent of the taxpayer's cash investment under §1.45D-1T(b)(4)) maintained by the CDE for loan losses or for additional investments in existing qualified low-income

community investments are treated as invested in a qualified low-income community investment. In response to comments, the final regulations provide that reserves include fees paid to third parties to protect against loss of all or a portion of the principal of, or interest on, on a loan that is a qualified low-income community investment.

#### *Qualified Active Low-Income Community Business*

As indicated above, qualified low-income community investments include any capital or equity investment in, or loan to, any qualified active low-income community business. Under §1.45D-1T(d)(4)(i)(B), an entity is a qualified active low-income community business only if, among other requirements, at least 40 percent of the use of the tangible property of such entity (whether owned or leased) is within any low-income community. In response to comments, the final regulations provide an example of how the tangible property test applies to property that is used both outside and inside a low-income community. The example demonstrates that use is measured based on the entity's business hours of operation and does not include non-business hours.

Under section 45D(d)(2)(C), a qualified active low-income community business includes any trade or business that would qualify as a qualified active low-income community business if such trade or business were separately incorporated. Commentators requested clarification of how this rule applies.

The final regulations provide that a CDE may treat any trade or business (or portion thereof) as a qualified active low-income community business if the trade or business (or portion thereof) would meet the requirements to be a qualified active low-income community business if the trade or business (or portion thereof) were separately incorporated and a complete and separate set of books and records is maintained for that trade or business (or portion thereof). The final regulations further provide, however, that under this rule a CDE's capital or equity investment or loan is not a qualified low-income community investment to the extent the proceeds of the investment or loan are not used for the trade or business

(or portion thereof) that is treated as a qualified active low-income community business.

Section §1.45D-1T(d)(4)(iv) provides that an entity will be treated as engaged in the active conduct of a trade or business if, at the time the CDE makes a capital or equity investment in, or loan to, the entity, the CDE reasonably expects that the entity will generate revenues (or, in the case of a nonprofit corporation, receive donations) within 3 years after the date the investment or loan is made. The final regulations amend this rule with respect to a nonprofit corporation by providing that the nonprofit corporation must be engaged in an activity that furthers its purpose as a nonprofit corporation within the 3-year period.

Under §1.45D-1T(d)(4)(i)(E), an entity is a qualified active low-income community business only if, among other requirements, less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property (as defined in section 1397C(e)). Section 1397C(e)(1) contains an exception to the definition of nonqualified financial property for reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less. The final regulations provide that, for these purposes, the proceeds of a capital or equity investment or loan by a CDE that will be expended on construction of real property within 12 months after the date the investment or loan is made qualify as a reasonable amount of working capital.

Section 45D(d)(3)(A) provides that the rental to others of real property located in any low-income community is treated as a qualified business only if, among other requirements, there are substantial improvements located on such property. Commentators requested clarification of the term *substantial improvements*. The final regulations provide that the term *substantial improvements* means improvements the cost basis of which equals or exceeds 50 percent of the cost basis of the land on which the improvements are located and the costs of which are incurred after the date the CDE makes the investment or loan. In addition, the final regulations provide that a CDE's investment in or loan to a business engaged in the rental of real property is not a qualified low-income community investment to the

extent any lessee of the real property is not a qualified business.

### *Recapture*

As indicated above, there is a recapture event with respect to an equity investment in a CDE if such investment is redeemed by the CDE. Commentators requested clarification of when distributions by a CDE to its investors will be treated as redemptions. The final regulations provide guidance on when a distribution by a CDE that is a corporation for Federal tax purposes will be treated as a redemption.

Some commentators suggested that, in the case of a CDE that is treated as a partnership for Federal tax purposes, a redemption should be limited to purchases by the CDE of a partner's capital interest. Alternatively, commentators requested guidance on how to distinguish between a return of capital and a distribution of profits if a return of capital is treated as a redemption. In response to comments, the final regulations provide a safe harbor under which cash distributions by a partnership will not be treated as a redemption. Under the safe harbor, 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 CDE's operating income (as defined in the final regulations) for the taxable year. In addition, a non-*pro rata de minimis* cash distribution by a CDE to a partner or partners during the taxable year will not be treated as a redemption. A non-*pro rata de minimis* cash distribution may not exceed the lesser of 5 percent of the CDE's operating income for that taxable year or 10 percent of the partner's capital interest in the CDE.

Commentators suggested that cure periods be provided to enable CDEs to correct any noncompliance with the requirements under section 45D. One commentator suggested that a cure period be provided to allow an investment that no longer qualifies as a qualified low-income community investment to be replaced with a qualifying investment by the end of the calendar year following the year the original investment lost its status as a qualified low-income community investment. Other commentators suggested that, if a qualified equity investment fails the substantially-all require-

ment, the failure should not be a recapture event if the CDE corrects the failure within 6 months after the date the CDE discovers (or reasonably should have discovered) the failure. The final regulations provide that, if a qualified equity investment 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. Only one correction is permitted for each qualified equity investment during the 7-year credit period.

### *Other Issues*

Section 45D(i)(1) authorizes the Secretary to prescribe regulations as may be appropriate to carry out section 45D including regulations that limit the new markets tax credit for investments that are directly or indirectly subsidized by other Federal tax benefits (including the low-income housing credit under section 42 and the exclusion from gross income under section 103). The final regulations do not prohibit a CDE from purchasing tax-exempt bonds because tax-exempt financing provides a subsidy to borrowers and not bondholders. However, the final regulations provide that if a CDE makes a capital or equity investment or loan with respect to a qualified low-income building under section 42, the investment or loan is not a qualified low-income community investment to the extent the building's eligible basis under section 42(d) is financed by the proceeds of the investment or loan.

### **Effective Dates**

The final regulations are effective December 22, 2004, and may be applied by taxpayers before December 22, 2004. However, both the definition of the term *substantial improvements* and the requirement that each lessee be a qualified business apply to qualified low-income community investments made on or after February 22, 2005.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been de-

terminated that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that any burden on taxpayers is minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notices of proposed rulemaking preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

### Drafting Information

The principal author of these regulations is Paul F. Handleman, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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### Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.45D-1 also issued under 26 U.S.C. 45D(i); \* \* \*

Par. 2. Section 1.45D-1 is added to read as follows:

#### §1.45D-1 New markets tax credit.

(a) *Table of contents.* This paragraph lists the headings that appear in §1.45D-1.

- (a) Table of contents.
- (b) Allowance of credit.
  - (1) In general.
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  - (4) Amount paid at original issue.
- (c) Qualified equity investment.
  - (1) In general.
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(3) Equity investments made prior to allocation.

- (i) In general.
- (ii) Exceptions.
  - (A) Allocation applications submitted by August 29, 2002.
  - (B) Other allocation applications.
- (iii) Failure to receive allocation.
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- (4) Limitations.
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    - (iii) Safe harbor calculation.
    - (iv) Time limit for making investments.
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  - (6) Aggregation of equity investments.
  - (7) Subsequent purchasers.
    - (d) Qualified low-income community investments.
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        - (i) Investment in a qualified active low-income community business.
        - (ii) Purchase of certain loans from CDEs.
          - (A) In general.
          - (B) Certain loans made before CDE certification.
          - (C) Intermediary CDEs.
          - (D) Examples.
        - (iii) Financial counseling and other services.
          - (iv) Investments in other CDEs.
            - (A) In general.
            - (B) Examples.
      - (2) Payments of, or for, capital, equity or principal.
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    - (3) Special rule for reserves.
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          - (1) In general.
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        - (C) Services performed.
        - (D) Collectibles.
        - (E) Nonqualified financial property.
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          - (2) Construction of real property.

- (ii) Proprietorships.
- (iii) Portions of business.
  - (A) In general.
  - (B) Examples.
- (iv) Active conduct of a trade or business.
  - (A) Special rule.
  - (B) Example.
  - (5) Qualified business.
    - (i) In general.
    - (ii) Rental of real property.
    - (iii) Exclusions.
      - (A) Trades or businesses involving intangibles.
      - (B) Certain other trades or businesses.
      - (C) Farming.
    - (6) Qualifications.
      - (i) In general.
      - (ii) Control.
        - (A) In general.
        - (B) Definition of control.
        - (C) Disregard of control.
    - (7) Financial counseling and other services.
      - (8) Special rule for certain loans.
        - (i) In general.
        - (ii) Example.
      - (e) Recapture.
        - (1) In general.
        - (2) Recapture event.
        - (3) Redemption.
          - (i) Equity investment in a C corporation.
          - (ii) Equity investment in an S corporation.
          - (iii) Capital interest in a partnership.
      - (4) Bankruptcy.
      - (5) Waiver of requirement or extension of time.
        - (i) In general.
        - (ii) Manner for requesting a waiver or extension.
        - (iii) Terms and conditions.
    - (6) Cure period.
    - (7) Example.
    - (f) Basis reduction.
      - (1) In general.
      - (2) Adjustment in basis of interest in partnership or S corporation.
      - (g) Other rules.
        - (1) Anti-abuse.
        - (2) Reporting requirements.
          - (i) Notification by CDE to taxpayer.
            - (A) Allowance of new markets tax credit.
            - (B) Recapture event.
            - (ii) CDE reporting requirements to Secretary.

(iii) Manner of claiming new markets tax credit.

(iv) Reporting recapture tax.

(3) Other Federal tax benefits.

(i) In general.

(ii) Low-income housing credit.

(4) Bankruptcy of CDE.

(h) Effective dates.

(1) In general.

(2) Exception for certain provisions.

(b) *Allowance of credit*—(1) *In general*. For purposes of the general business credit under section 38, a taxpayer holding a qualified equity investment on a credit allowance date which occurs during the taxable year may claim the new markets tax credit determined under section 45D and this section 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. *Qualified equity investment* is defined in paragraph (c) of this section. *Credit allowance date* is defined in paragraph (b)(2) of this section. *Applicable percentage* is defined in paragraph (b)(3) of this section. A *CDE* is a qualified community development entity as defined in section 45D(c). The amount paid at original issue is determined under paragraph (b)(4) of this section.

(2) *Credit allowance date*. The term *credit allowance date* means, with respect to any qualified equity investment—

(i) The date on which the investment is initially made; and

(ii) Each of the 6 anniversary dates of such date thereafter.

(3) *Applicable percentage*. The *applicable percentage* is 5 percent for the first 3 credit allowance dates and 6 percent for the other 4 credit allowance dates.

(4) *Amount paid at original issue*. The amount paid to the CDE for a qualified equity investment at its original issue consists of all amounts paid by the taxpayer to, or on behalf of, the CDE (including any underwriter's fees) to purchase the investment at its original issue.

(c) *Qualified equity investment*—(1) *In general*. The term *qualified equity investment* means any equity investment (as defined in paragraph (c)(2) of this section) in a CDE if—

(i) The investment is acquired by the taxpayer at its original issue (directly or through an underwriter) solely in exchange for cash;

(ii) Substantially all (as defined in paragraph (c)(5) of this section) of such cash is used by the CDE to make qualified low-income community investments (as defined in paragraph (d)(1) of this section); and

(iii) The investment is designated for purposes of section 45D and this section by the CDE on its books and records using any reasonable method.

(2) *Equity investment*. The term *equity investment* means any stock (other than nonqualified preferred stock as defined in section 351(g)(2)) in an entity that is a corporation for Federal tax purposes and any capital interest in an entity that is a partnership for Federal tax purposes. See §§301.7701-1 through 301.7701-3 of this chapter for rules governing when a business entity, such as a business trust or limited liability company, is classified as a corporation or a partnership for Federal tax purposes.

(3) *Equity investments made prior to allocation*—(i) *In general*. Except as provided in paragraph (c)(3)(ii) of this section, an equity investment in an entity is not eligible to be designated as a qualified equity investment if it is made before the entity enters into an allocation agreement with the Secretary. An *allocation agreement* is an agreement between the Secretary and a CDE relating to a new markets tax credit allocation under section 45D(f)(2).

(ii) *Exceptions*. Notwithstanding paragraph (c)(3)(i) of this section, an equity investment in an entity is eligible to be designated as a qualified equity investment under paragraph (c)(1)(iii) of this section if—

(A) *Allocation applications submitted by August 29, 2002*.

(1) The equity investment is made on or after April 20, 2001;

(2) The designation of the equity investment as a qualified equity investment is made for a credit allocation received pursuant to an allocation application submitted to the Secretary no later than August 29, 2002; and

(3) The equity investment otherwise satisfies the requirements of section 45D and this section; or

(B) *Other allocation applications*.

(1) The equity investment is made on or after the date the Secretary publishes a Notice of Allocation Availability (NOAA) in the **Federal Register**;

(2) The designation of the equity investment as a qualified equity investment is

made for a credit allocation received pursuant to an allocation application submitted to the Secretary under that NOAA; and

(3) The equity investment otherwise satisfies the requirements of section 45D and this section.

(iii) *Failure to receive allocation*. For purposes of paragraph (c)(3)(ii)(A) of this section, if the entity in which the equity investment is made does not receive an allocation pursuant to an allocation application submitted no later than August 29, 2002, the equity investment will not be eligible to be designated as a qualified equity investment. For purposes of paragraph (c)(3)(ii)(B) of this section, if the entity in which the equity investment is made does not receive an allocation under the NOAA described in paragraph (c)(3)(ii)(B)(1) of this section, the equity investment will not be eligible to be designated as a qualified equity investment.

(iv) *Initial investment date*. If an equity investment is designated as a qualified equity investment in accordance with paragraph (c)(3)(ii) of this section, the investment is treated as initially made on the effective date of the allocation agreement between the CDE and the Secretary.

(4) *Limitations*—(i) *In general*. The term *qualified equity investment* does not include—

(A) Any equity investment issued by a CDE more than 5 years after the date the CDE enters into an allocation agreement (as defined in paragraph (c)(3)(i) of this section) with the Secretary; and

(B) Any equity investment by a CDE in another CDE, if the CDE making the investment has received an allocation under section 45D(f)(2).

(ii) *Allocation limitation*. The maximum amount of equity investments issued by a CDE that may be designated under paragraph (c)(1)(iii) of this section by the CDE may not exceed the portion of the limitation amount allocated to the CDE by the Secretary under section 45D(f)(2).

(5) *Substantially all*—(i) *In general*. Except as provided in paragraph (c)(5)(v) of this section, the term *substantially all* means at least 85 percent. The substantially-all requirement must be satisfied for each annual period in the 7-year credit period using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section, or the safe harbor calculation under paragraph (c)(5)(iii) of this section. For

the first annual period, the substantially-all requirement is treated as satisfied if either the direct-tracing calculation under paragraph (c)(5)(ii) of this section, or the safe-harbor calculation under paragraph (c)(5)(iii) of this section, is performed on a single testing date and the result of the calculation is at least 85 percent. For each annual period other than the first annual period, the substantially-all requirement is treated as satisfied if either the direct-tracing calculation under paragraph (c)(5)(ii) of this section, or the safe harbor calculation under paragraph (c)(5)(iii) of this section, is performed every six months and the average of the two calculations for the annual period is at least 85 percent. For example, the CDE may choose the same two testing dates for all qualified equity investments regardless of the date each qualified equity investment was initially made under paragraph (b)(2)(i) of this section, provided the testing dates are six months apart. The use of the direct-tracing calculation under paragraph (c)(5)(ii) of this section (or the safe harbor calculation under paragraph (c)(5)(iii) of this section) for an annual period does not preclude the use of the safe harbor calculation under paragraph (c)(5)(iii) of this section (or the direct-tracing calculation under paragraph (c)(5)(ii) of this section) for another annual period, provided that a CDE that switches to a direct-tracing calculation must substantiate that the taxpayer's investment is directly traceable to qualified low-income community investments from the time of the CDE's initial investment in a qualified low-income community investment. For purposes of this paragraph (c)(5)(i), the *7-year credit period* means the period of 7 years beginning on the date the qualified equity investment is initially made. See paragraph (c)(6) of this section for circumstances in which a CDE may treat more than one equity investment as a single qualified equity investment.

(ii) *Direct-tracing calculation.* The substantially-all requirement is satisfied if at least 85 percent of the taxpayer's investment is directly traceable to qualified low-income community investments as defined in paragraph (d)(1) of this section. The direct-tracing calculation is a fraction the numerator of which is the CDE's aggregate cost basis determined under section 1012 in all of the qualified low-income community investments that

are directly traceable to the taxpayer's cash investment, and the denominator of which is the amount of the taxpayer's cash investment under paragraph (b)(4) of this section. For purposes of this paragraph (c)(5)(ii), cost basis includes the cost basis of any qualified low-income community investment that becomes worthless. See paragraph (d)(2) of this section for the treatment of amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment.

(iii) *Safe harbor calculation.* The substantially-all requirement is satisfied if at least 85 percent of the aggregate gross assets of the CDE are invested in qualified low-income community investments as defined in paragraph (d)(1) of this section. The safe harbor calculation is a fraction the numerator of which is the CDE's aggregate cost basis determined under section 1012 in all of its qualified low-income community investments, and the denominator of which is the CDE's aggregate cost basis determined under section 1012 in all of its assets. For purposes of this paragraph (c)(5)(iii), cost basis includes the cost basis of any qualified low-income community investment that becomes worthless. See paragraph (d)(2) of this section for the treatment of amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment.

(iv) *Time limit for making investments.* The taxpayer's cash investment received by a CDE is treated as invested in a qualified low-income community investment as defined in paragraph (d)(1) of this section only to the extent that the cash is so invested within the 12-month period beginning on the date the cash is paid by the taxpayer (directly or through an underwriter) to the CDE.

(v) *Reduced substantially-all percentage.* For purposes of the substantially-all requirement (including the direct-tracing calculation under paragraph (c)(5)(ii) of this section and the safe harbor calculation under paragraph (c)(5)(iii) of this section), 85 percent is reduced to 75 percent for the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section).

(vi) *Examples.* The following examples illustrate an application of this paragraph (c)(5):

*Example 1.* X is a partnership and a CDE that has received a \$1 million new markets tax credit allocation from the Secretary. On September 1, 2004, X uses a line of credit from a bank to fund a \$1 million loan to Y. The loan is a qualified low-income community investment under paragraph (d)(1) of this section. On September 5, 2004, A pays \$1 million to acquire a capital interest in X. X uses the proceeds of A's equity investment to pay off the \$1 million line of credit that was used to fund the loan to Y. X's aggregate gross assets consist of the \$1 million loan to Y and \$100,000 in other assets. A's equity investment in X does not satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section using the direct-tracing calculation under paragraph (c)(5)(ii) of this section because the cash from A's equity investment is not used to make X's loan to Y. However, A's equity investment in X satisfies the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section because at least 85 percent of X's aggregate gross assets are invested in qualified low-income community investments.

*Example 2.* X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On August 1, 2004, A pays \$100,000 for a capital interest in X. On August 5, 2004, X uses the proceeds of A's equity investment to make an equity investment in Y. X controls Y within the meaning of paragraph (d)(6)(ii)(B) of this section. For the annual period ending July 31, 2005, Y is a qualified active low-income community business (as defined in paragraph (d)(4) of this section). Thus, for that period, A's equity investment satisfies the substantially-all requirement under paragraph (c)(5)(i) of this section using the direct-tracing calculation under paragraph (c)(5)(ii) of this section. For the annual period ending July 31, 2006, Y no longer is a qualified active low-income community business. Thus, for that period, A's equity investment does not satisfy the substantially-all requirement using the direct-tracing calculation. However, during the entire annual period ending July 31, 2006, X's remaining assets are invested in qualified low-income community investments with an aggregate cost basis of \$900,000. Consequently, for the annual period ending July 31, 2006, at least 85 percent of X's aggregate gross assets are invested in qualified low-income community investments. Thus, for the annual period ending July 31, 2006, A's equity investment satisfies the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section.

*Example 3.* X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On August 1, 2004, A and B each pay \$100,000 for a capital interest in X. X does not treat A's and B's equity investments as one qualified equity investment under paragraph (c)(6) of this section. On September 1, 2004, X uses the proceeds of A's equity investment to make an equity investment in Y and X uses the proceeds of B's equity investment to make an equity investment in Z. X has no assets other than its investments in Y and Z. X controls Y and Z within the meaning of paragraph (d)(6)(ii)(B) of this section. For the annual period ending July 31, 2005, Y and Z are qualified active low-income com-

munity businesses (as defined in paragraph (d)(4) of this section). Thus, for the annual period ending July 31, 2005, A's and B's equity investments satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section or the safe harbor calculation under paragraph (c)(5)(iii) of this section. For the annual period ending July 31, 2006, Y, but not Z, is a qualified active low-income community business. Thus, for the annual period ending July 31, 2006—

(1) X does not satisfy the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section;

(2) A's equity investment satisfies the substantially-all requirement using the direct-tracing calculation because A's equity investment is directly traceable to Y; and

(3) B's equity investment does not satisfy the substantially-all requirement because B's equity investment is traceable to Z.

*Example 4.* X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On November 1, 2004, A pays \$100,000 for a capital interest in X. On December 1, 2004, B pays \$100,000 for a capital interest in X. On December 31, 2004, X uses \$85,000 from A's equity investment and \$85,000 from B's equity investment to make a \$170,000 equity investment in Y, a qualified active low-income community business (as defined in paragraph (d)(4) of this section). X has no assets other than its investment in Y. X determines whether A's and B's equity investments satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section on December 31, 2004. The calculation for A's and B's equity investments is 85 percent using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section or the safe harbor calculation under paragraph (c)(5)(iii) of this section. Therefore, for the annual periods ending October 31, 2005, and November 30, 2005, A's and B's equity investments, respectively, satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section. For the subsequent annual period, X performs its calculations on December 31, 2005, and June 30, 2006. The average of the two calculations on December 31, 2005, and June 30, 2006, is 85 percent using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section or the safe harbor calculation under paragraph (c)(5)(iii) of this section. Therefore, for the annual periods ending October 31, 2006, and November 30, 2006, A's and B's equity investments, respectively, satisfy the substantially-all requirement under paragraph (c)(5)(i) of this section.

(6) *Aggregation of equity investments.* A CDE may treat any qualified equity investments issued on the same day as one qualified equity investment. If a CDE aggregates equity investments under this paragraph (c)(6), the rules in this section shall be construed in a manner consistent with that treatment.

(7) *Subsequent purchasers.* A qualified equity investment includes any equity investment that would (but for paragraph (c)(1)(i) of this section) be a quali-

fied equity investment in the hands of the taxpayer if the investment was a qualified equity investment in the hands of a prior holder.

(d) *Qualified low-income community investments—(1) In general.* The term *qualified low-income community investment* means any of the following:

(i) *Investment in a qualified active low-income community business.* Any capital or equity investment in, or loan to, any qualified active low-income community business (as defined in paragraph (d)(4) of this section).

(ii) *Purchase of certain loans from CDEs—(A) In general.* The purchase by a CDE (the ultimate CDE) from another CDE (whether or not that CDE has received an allocation from the Secretary under section 45D(f)(2)) of any loan made by such entity that is a qualified low-income community investment. A loan purchased by the ultimate CDE from another CDE is a qualified low-income community investment if it qualifies as a qualified low-income community investment either—

(1) At the time the loan was made; or

(2) At the time the ultimate CDE purchases the loan.

(B) *Certain loans made before CDE certification.* For purposes of paragraph (d)(1)(ii)(A) of this section, a loan by an entity is treated as made by a CDE, notwithstanding that the entity was not a CDE at the time it made the loan, if the entity is a CDE at the time it sells the loan.

(C) *Intermediary CDEs.* For purposes of paragraph (d)(1)(ii)(A) of this section, the purchase of a loan by the ultimate CDE from a CDE that did not make the loan (the second CDE) is treated as a purchase of the loan by the ultimate CDE from the CDE that made the loan (the originating CDE) if—

(1) The second CDE purchased the loan from the originating CDE (or from another CDE); and

(2) Each entity that sold the loan was a CDE at the time it sold the loan.

(D) *Examples.* The following examples illustrate an application of this paragraph (d)(1)(ii):

*Example 1.* X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. Y, a corporation, made a \$500,000 loan to Z in 1999. In January of 2004, Y is certified as a CDE. On September 1, 2004, X purchases the loan from Y. At the time X purchases the loan,

Z is a qualified active low-income community business under paragraph (d)(4)(i) of this section. Accordingly, the loan purchased by X from Y is a qualified low-income community investment under paragraphs (d)(1)(ii)(A) and (B) of this section.

*Example 2.* The facts are the same as in *Example 1* except that on February 1, 2004, Y sells the loan to W and on September 1, 2004, W sells the loan to X. W is a CDE. Under paragraph (d)(1)(ii)(C) of this section, X's purchase of the loan from W is treated as the purchase of the loan from Y. Accordingly, the loan purchased by X from W is a qualified low-income community investment under paragraphs (d)(1)(ii)(A) and (C) of this section.

*Example 3.* The facts are the same as in *Example 2* except that W is not a CDE. Because W was not a CDE at the time it sold the loan to X, the purchase of the loan by X from W is not a qualified low-income community investment under paragraphs (d)(1)(ii)(A) and (C) of this section.

(iii) *Financial counseling and other services.* Financial counseling and other services (as defined in paragraph (d)(7) of this section) provided to any qualified active low-income community business, or to any residents of a low-income community (as defined in section 45D(e)).

(iv) *Investments in other CDEs—(A) In general.* Any equity investment in, or loan to, any CDE (the second CDE) by a CDE (the primary CDE), but only to the extent that the second CDE uses the proceeds of the investment or loan—

(1) In a manner—

(i) That is described in paragraph (d)(1)(i) or (iii) of this section; and

(ii) That would constitute a qualified low-income community investment if it were made directly by the primary CDE;

(2) To make an equity investment in, or loan to, a third CDE that uses such proceeds in a manner described in paragraph (d)(1)(iv)(A)(1) of this section; or

(3) To make an equity investment in, or loan to, a third CDE that uses such proceeds to make an equity investment in, or loan to, a fourth CDE that uses such proceeds in a manner described in paragraph (d)(1)(iv)(A)(1) of this section.

(B) *Examples.* The following examples illustrate an application of paragraph (d)(1)(iv)(A) of this section:

*Example 1.* X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On September 1, 2004, X uses \$975,000 to make an equity investment in Y. Y is a corporation and a CDE. On October 1, 2004, Y uses \$950,000 from X's equity investment to make a loan to Z. Z is a qualified active low-income community business under paragraph (d)(4)(i) of this section. Of X's equity investment in Y, \$950,000 is a qualified low-income community investment under paragraph (d)(1)(iv)(A)(1) of this section.

*Example 2.* W is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On September 1, 2004, W uses \$975,000 to make an equity investment in X. On October 1, 2004, X uses \$950,000 from W's equity investment to make an equity investment in Y. X and Y are corporations and CDEs. On October 5, 2004, Y uses \$925,000 from X's equity investment to make a loan to Z. Z is a qualified active low-income community business under paragraph (d)(4)(i) of this section. Of W's equity investment in X, \$925,000 is a qualified low-income community investment under paragraph (d)(1)(iv)(A)(2) of this section because X uses proceeds of W's equity investment to make an equity investment in Y, which uses \$925,000 of the proceeds in a manner described in paragraph (d)(1)(iv)(A)(1) of this section.

*Example 3.* U is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On September 1, 2004, U uses \$975,000 to make an equity investment in V. On October 1, 2004, V uses \$950,000 from U's equity investment to make an equity investment in W. On October 5, 2004, W uses \$925,000 from V's equity investment to make an equity investment in X. On November 1, 2004, X uses \$900,000 from W's equity investment to make an equity investment in Y. V, W, X, and Y are corporations and CDEs. On November 5, 2004, Y uses \$875,000 from X's equity investment to make a loan to Z. Z is a qualified active low-income community business under paragraph (d)(4)(i) of this section. U's equity investment in V is not a qualified low-income community investment because X does not use proceeds of W's equity investment in a manner described in paragraph (d)(1)(iv)(A)(1) of this section.

(2) *Payments of, or for, capital, equity or principal—(i) In general.* Except as otherwise provided in this paragraph (d)(2), amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment must be reinvested by the CDE in a qualified low-income community investment no later than 12 months from the date of receipt to be treated as continuously invested in a qualified low-income community investment. If the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount at least equal to such original cost basis will be treated as continuously invested in a qualified low-income community investment. In addition, if the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph

(d)(2)(i), an amount less than such original cost basis, then only the amount so reinvested will be treated as continuously invested in a qualified low-income community investment. If the amounts received by the CDE are less than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests an amount in accordance with this paragraph (d)(2)(i), then the amount treated as continuously invested in a qualified low-income community investment will equal the excess (if any) of such original cost basis over the amounts received by the CDE that are not so reinvested. Amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment during the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section) do not have to be reinvested by the CDE in a qualified low-income community investment in order to be treated as continuously invested in a qualified low-income community investment.

(ii) *Subsequent reinvestments.* In applying paragraph (d)(2)(i) of this section to subsequent reinvestments, the original cost basis is reduced by the amount (if any) by which the original cost basis exceeds the amount determined to be continuously invested in a qualified low-income community investment.

(iii) *Special rule for loans.* Periodic amounts received during a calendar year as repayment of principal on a loan that is a qualified low-income community investment are treated as continuously invested in a qualified low-income community investment if the amounts are reinvested in another qualified low-income community investment by the end of the following calendar year.

(iv) *Example.* The application of paragraphs (d)(2)(i) and (ii) of this section is illustrated by the following example:

*Example.* 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 a new markets tax credit allocation from the Secretary. X treats the 3 partnership interests as one qualified equity investment under paragraph (c)(6) of this section. In August 2003, X uses the \$300,000 to make a qualified low-income community investment under paragraph (d)(1) of this section. In August 2005, the qualified low-income community investment is redeemed for \$250,000. In February 2006, X reinvests \$230,000 of the \$250,000 in a second qualified low-income community investment and uses the remaining \$20,000

for operating expenses. Under paragraph (d)(2)(i) of this section, \$280,000 of the proceeds of the qualified equity investment is treated as continuously invested in a qualified low-income community investment. In December 2008, X sells the second qualified low-income community investment and receives \$400,000. In March 2009, X reinvests \$320,000 of the \$400,000 in a third qualified low-income community investment. Under paragraphs (d)(2)(i) and (ii) of this section, \$280,000 of the proceeds of the qualified equity investment is treated as continuously invested in a qualified low-income community investment (\$40,000 is treated as invested in another qualified low-income community investment in March 2009).

(3) *Special rule for reserves.* Reserves (not in excess of 5 percent of the taxpayer's cash investment under paragraph (b)(4) of this section) maintained by the CDE for loan losses or for additional investments in existing qualified low-income community investments are treated as invested in a qualified low-income community investment under paragraph (d)(1) of this section. 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 that is a qualified low-income community investment.

(4) *Qualified active low-income community business—(i) In general.* The term *qualified active low-income community business* means, with respect to any taxable year, a corporation (including a nonprofit corporation) or a partnership engaged in the active conduct of a qualified business (as defined in paragraph (d)(5) of this section), if the requirements in paragraphs (d)(4)(i)(A), (B), (C), (D), and (E) of this section are met. Solely for purposes of this section, a nonprofit corporation will be deemed to be engaged in the active conduct of a trade or business if it is engaged in an activity that furthers its purpose as a nonprofit corporation.

(A) *Gross-income requirement.* At least 50 percent of the total gross income of such entity is derived from the active conduct of a qualified business (as defined in paragraph (d)(5) of this section) within any low-income community (as defined in section 45D(e)). An entity is deemed to satisfy this paragraph (d)(4)(i)(A) if the entity meets the requirements of either paragraph (d)(4)(i)(B) or (C) of this section, if "50 percent" is applied instead of 40 percent. In addition, an entity may satisfy this paragraph (d)(4)(i)(A) based on all the facts and circumstances. See paragraph (d)(4)(iv) of this section for certain

circumstances in which an entity will be treated as engaged in the active conduct of a trade or business.

(B) *Use of tangible property*—(1) *In general.* At least 40 percent of the use of the tangible property of such entity (whether owned or leased) is within any low-income community. This percentage is determined based on a fraction the numerator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year in a low-income community and the denominator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year. Property owned by the entity is valued at its cost basis as determined under section 1012. Property leased by the entity is valued at a reasonable amount established by the entity.

(2) *Example.* The application of paragraph (d)(4)(i)(B)(1) of this section is illustrated by the following example:

*Example.* X is a corporation engaged in the business of moving and hauling scrap metal. X operates its business from a building and an adjoining parking lot that X owns. The building and the parking lot are located in a low-income community (as defined in section 45D(e)). X's cost basis under section 1012 for the building and parking lot is \$200,000. During the taxable year, X operates its business 10 hours a day, 6 days a week. X owns and uses 40 trucks in its business, which, on average, are used 6 hours a day outside a low-income community and 4 hours a day inside a low-income community (including time in the parking lot). The cost basis under section 1012 of each truck is \$25,000. During non-business hours, the trucks are parked in the lot. Only X's 10-hour business days are used in calculating the use of tangible property percentage under paragraph (d)(4)(i)(B)(1) of this section. Thus, the numerator of the tangible property calculation is \$600,000 (4/10 of \$1,000,000 (the \$25,000 cost basis of each truck times 40 trucks) plus \$200,000 (the cost basis of the building and parking lot)) and the denominator is \$1,200,000 (the total cost basis of the trucks, building, and parking lot), resulting in 50 percent of the use of X's tangible property being within a low-income community. Consequently, X satisfies the 40 percent use of tangible property test under paragraph (d)(4)(i)(B)(1) of this section.

(C) *Services performed.* At least 40 percent of the services performed for such entity by its employees are performed in a low-income community. This percentage is determined based on a fraction the numerator of which is the total amount paid by the entity for employee services performed in a low-income community during the taxable year and the denominator of

which is the total amount paid by the entity for employee services during the taxable year. If the entity has no employees, the entity is deemed to satisfy this paragraph (d)(4)(i)(C), and paragraph (d)(4)(i)(A) of this section, if the entity meets the requirement of paragraph (d)(4)(i)(B) of this section if "85 percent" is applied instead of 40 percent.

(D) *Collectibles.* Less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles (as defined in section 408(m)(2)) other than collectibles that are held primarily for sale to customers in the ordinary course of business.

(E) *Nonqualified financial property*—(1) *In general.* Less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to *nonqualified financial property*. For purposes of the preceding sentence, the term *nonqualified financial property* means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property except that such term does not include—

(i) Reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (because the definition of *nonqualified financial property* includes debt instruments with a term in excess of 18 months, banks, credit unions, and other financial institutions are generally excluded from the definition of a *qualified active low-income community business*); or

(ii) Debt instruments described in section 1221(a)(4).

(2) *Construction of real property.* For purposes of paragraph (d)(4)(i)(E)(1)(i) of this section, the 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.

(ii) *Proprietorships.* Any business carried on by an individual as a proprietor is a qualified active low-income community business if the business would meet the requirements of paragraph (d)(4)(i) of this section if the business were incorporated.

(iii) *Portions of business*—(A) *In general.* A CDE may treat any trade or business (or portion thereof) as a qualified

active low-income community business if the trade or business (or portion thereof) would meet the requirements of paragraph (d)(4)(i) of this section if the trade or business (or portion thereof) were separately incorporated and a complete and separate set of books and records is maintained for that trade or business (or portion thereof). However, the CDE's capital or equity investment or loan is not a qualified low-income community investment under paragraph (d)(1)(i) of this section to the extent the proceeds of the investment or loan are not used for the trade or business (or portion thereof) that is treated as a qualified active low-income community business under this paragraph (d)(4)(iii)(A).

(B) *Examples.* The following examples illustrate an application of paragraph (d)(4)(iii) of this section:

*Example 1.* X is a partnership and a CDE that receives a new markets tax credit allocation from the Secretary. A pays \$1 million for a capital interest in X. Z is a corporation that operates a supermarket that is not in a low-income community (as defined in section 45D(e)). X uses the proceeds of A's equity investment to make a loan to Z that Z will use to construct a new supermarket in a low-income community. Z will maintain a complete and separate set of books and records for the new supermarket. The proceeds of X's loan to Z will be used exclusively for the new supermarket. Assume that Z's new supermarket in the low-income community would meet the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section if it were separately incorporated. Pursuant to paragraph (d)(4)(iii)(A) of this section, X treats Z's new supermarket as the qualified active low-income community business. Accordingly, X's loan to Z is a qualified low-income community investment under paragraph (d)(1)(i) of this section.

*Example 2.* X is a partnership and a CDE that receives a new markets tax credit allocation from the Secretary. A pays \$1 million for a capital interest in X. Z is a corporation that operates a liquor store in a low-income community (as defined in section 45D(e)). A liquor store is not a qualified business under paragraph (d)(5)(iii)(B) of this section. X uses the proceeds of A's equity investment to make a loan to Z that Z will use to construct a restaurant next to the liquor store. Z will maintain a complete and separate set of books and records for the new restaurant. The proceeds of X's loan to Z will be used exclusively for the new restaurant. Assume that Z's restaurant would meet the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section if it were separately incorporated. Pursuant to paragraph (d)(4)(iii) of this section, X treats Z's restaurant as the qualified active low-income community business. Accordingly, X's loan to Z is a qualified low-income community investment under paragraph (d)(1)(i) of this section.

*Example 3.* X is a partnership and a CDE that receives a new markets tax credit allocation from the

Secretary. A pays \$1 million for a capital interest in X. Z is a corporation that operates an insurance company in a low-income community (as defined in section 45D(e)). Five percent or more of the average of the aggregate unadjusted bases of Z's property is attributable to nonqualified financial property under paragraph (d)(4)(i)(E) of this section. Z's insurance operations include different operating units including a claims processing unit. X uses the proceeds of A's equity investment to make a loan to Z for use in Z's claims processing operations. Z will maintain a complete and separate set of books and records for the claims processing unit. The proceeds of X's loan to Z will be used exclusively for the claims processing unit. Assume that Z's claims processing unit would meet the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section if it were separately incorporated. Pursuant to paragraph (d)(4)(iii) of this section, X treats Z's claims processing unit as the qualified active low-income community business. Accordingly, X's loan to Z is a qualified low-income community investment under paragraph (d)(1)(i) of this section.

(iv) *Active conduct of a trade or business*—(A) *Special rule.* For purposes of paragraph (d)(4)(i) of this section, an entity will be treated as engaged in the active conduct of a trade or business if, at the time the CDE makes a capital or equity investment in, or loan to, the entity, the CDE reasonably expects that the entity will generate revenues (or, in the case of a nonprofit corporation, engage in an activity that furthers its purpose as a nonprofit corporation) within 3 years after the date the investment or loan is made.

(B) *Example.* The application of paragraph (d)(4)(iv)(A) of this section is illustrated by the following example:

*Example.* X is a partnership and a CDE that receives a new markets tax credit allocation from the Secretary on July 1, 2004. X makes a ten-year loan to Y. Y is a newly formed entity that will own and operate a shopping center to be constructed in a low-income community. Y has no revenues but X reasonably expects that Y will generate revenues beginning in December 2005. Under paragraph (d)(4)(iv)(A) of this section, Y is treated as engaged in the active conduct of a trade or business for purposes of paragraph (d)(4)(i) of this section.

(5) *Qualified business*—(i) *In general.* Except as otherwise provided in this paragraph (d)(5), the term *qualified business* means any trade or business. There is no requirement that employees of a qualified business be residents of a low-income community.

(ii) *Rental of real property.* The rental to others of real property located in any low-income community (as defined in section 45D(e)) is a *qualified business* if and only if the property is not res-

idential rental property (as defined in section 168(e)(2)(A)) and there are *substantial improvements* located on the real property. For purposes of the preceding sentence, the term *substantial improvements* means improvements the cost basis of which equals or exceeds 50 percent of the cost basis of the land on which the improvements are located and the costs of which are incurred after the date the CDE makes the investment or loan. However, a CDE's investment in or loan to a business engaged in the rental of real property is not a qualified low-income community investment under paragraph (d)(1)(i) of this section to the extent any lessee of the real property is not a qualified business under this paragraph (d)(5).

(iii) *Exclusions*—(A) *Trades or businesses involving intangibles.* The term *qualified business* does not include any trade or business consisting predominantly of the development or holding of intangibles for sale or license.

(B) *Certain other trades or businesses.* The term *qualified business* does not include any trade or business consisting of the operation of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

(C) *Farming.* The term *qualified business* does not include any trade or business the principal activity of which is farming (within the meaning of section 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 bases (or, if greater, the fair market value) of the assets owned by the taxpayer that are used in such a trade or business, and the aggregate value of the assets leased by the taxpayer that are used in such a trade or business, exceeds \$500,000. For purposes of this paragraph (d)(5)(iii)(C), two or more trades or businesses will be treated as a single trade or business under rules similar to the rules of section 52(a) and (b).

(6) *Qualifications*—(i) *In general.* Except as provided in paragraph (d)(6)(ii) of this section, 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 the CDE makes the capital or equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section throughout the entire period of the investment or loan.

(ii) *Control*—(A) *In general.* If a CDE controls or obtains control of an entity at any time during the 7-year credit period (as defined in paragraph (c)(5)(i) of this section), the entity will be treated as a qualified active low-income community business only if the entity satisfies the requirements of paragraph (d)(4)(i) of this section throughout the entire period the CDE controls the entity.

(B) *Definition of control.* Control means, with respect to an entity, direct or indirect ownership (based on value) or control (based on voting or management rights) of more than 50 percent of the entity. For purposes of the preceding sentence, the term *management rights* means the power to influence the management policies or investment decisions of the entity.

(C) *Disregard of control.* For purposes of paragraph (d)(6)(ii)(A) of this section, the acquisition of control of an entity by a CDE is disregarded during the 12-month period following such acquisition of control (the 12-month period) if—

(1) The CDE's capital or equity investment in, or loan to, the entity met the requirements of paragraph (d)(6)(i) of this section when initially made;

(2) The CDE's acquisition of control of the entity is due to financial difficulties of the entity that were unforeseen at the time the investment or loan described in paragraph (d)(6)(ii)(C)(1) of this section was made; and

(3) If the acquisition of control occurs before the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section), either—

(i) The entity satisfies the requirements of paragraph (d)(4) of this section by the end of the 12-month period; or

(ii) The CDE sells or causes to be redeemed the entire amount of the investment or loan described in paragraph (d)(6)(ii)(C)(1) of this section and, by the end of the 12-month period, reinvests the amount received in respect of the sale or redemption in a qualified low-income community investment under paragraph

(d)(1) of this section. For this purpose, the amount treated as continuously invested in a qualified low-income community investment is determined under paragraphs (d)(2)(i) and (ii) of this section.

(7) *Financial counseling and other services.* The term *financial counseling and other services* means advice provided by the CDE relating to the organization or operation of a trade or business.

(8) *Special rule for certain loans*—(i) *In general.* For purposes of paragraphs (d)(1)(i), (ii), and (iv) of this section, a loan is treated as made by a CDE to the extent the CDE purchases the loan from the originator (whether or not the originator is a CDE) within 30 days after the date the originator makes the loan if, at the time the loan is made, there is a legally enforceable written agreement between the originator and the CDE which—

(A) Requires the CDE to approve the making of the loan either directly or by imposing specific written loan underwriting criteria; and

(B) Requires the CDE to purchase the loan within 30 days after the date the loan is made.

(ii) *Example.* The application of paragraph (d)(8)(i) of this section is illustrated by the following example:

*Example.* (i) X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On October 1, 2004, Y enters into a legally enforceable written agreement with W. Y and W are corporations but only Y is a CDE. The agreement between Y and W provides that Y will purchase loans (or portions thereof) from W within 30 days after the date the loan is made by W, and that Y will approve the making of the loans.

(ii) On November 1, 2004, W makes a \$825,000 loan to Z pursuant to the agreement between Y and W. Z is a qualified active low-income community business under paragraph (d)(4) of this section. On November 15, 2004, Y purchases the loan from W for \$840,000. On December 31, 2004, X purchases the loan from Y for \$850,000.

(iii) Under paragraph (d)(8)(i) of this section, the loan to Z is treated as made by Y. Y's loan to Z is a qualified low-income community investment under paragraph (d)(1)(i) of this section. Accordingly, under paragraph (d)(1)(ii)(A) of this section, X's purchase of the loan from Y is a qualified low-income community investment in the amount of \$850,000.

(e) *Recapture*—(1) *In general.* If, at any time during the 7-year period beginning on the date of the original issue of a qualified equity investment in a CDE, there is a recapture event under paragraph (e)(2) of this section with respect to such investment, then the tax imposed by Chap-

ter 1 of the Internal Revenue Code for the taxable year in which the recapture event occurs is increased by the credit recapture amount under section 45D(g)(2). A recapture event under paragraph (e)(2) of this section 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.

(2) *Recapture event.* There is a recapture event with respect to an equity investment in a CDE if—

(i) The entity ceases to be a CDE;

(ii) The proceeds of the investment cease to be used in a manner that satisfies the substantially-all requirement of paragraph (c)(1)(ii) of this section; or

(iii) The investment is redeemed or otherwise cashed out by the CDE.

(3) *Redemption*—(i) *Equity investment in a C corporation.* For purposes of paragraph (e)(2)(iii) of this section, an equity investment in a CDE that is treated as a C corporation for Federal tax purposes is redeemed when section 302(a) applies to amounts received by the equity holder. An equity investment is treated as cashed out when section 301(c)(2) or section 301(c)(3) applies to amounts received by the equity holder. An equity investment is not treated as cashed out when only section 301(c)(1) applies to amounts received by the equity holder.

(ii) *Equity investment in an S corporation.* For purposes of paragraph (e)(2)(iii) of this section, an equity investment in a CDE that is an S corporation is redeemed when section 302(a) applies to amounts received by the equity holder. An equity investment in an S corporation is treated as cashed out when a distribution to a shareholder described in section 1368(a) exceeds the accumulated adjustments account determined under §1.1368-2 and any accumulated earnings and profits of the S corporation.

(iii) *Capital interest in a partnership.* In the case of an equity investment that is a capital interest in a CDE that 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 for purposes of paragraph (e)(2)(iii) of this section if the distribution does not exceed the CDE's *operating income* for the taxable year. In ad-

dition, a non-*pro rata de minimis* cash distribution by a CDE to a partner or partners during the taxable year will not be treated as a redemption. A non-*pro rata de minimis* cash distribution may not exceed the lesser of 5 percent of the CDE's *operating income* for that taxable year or 10 percent of the partner's capital interest in the CDE. For purposes of this paragraph (e)(3)(iii), with respect to any taxable year, *operating income* is the sum of:

(A) The CDE's taxable income as determined under section 703, except that—

(1) The items described in section 703(a)(1) shall be aggregated with the non-separately stated tax items of the partnership; and

(2) Any gain resulting from the sale of a capital asset under section 1221(a) or section 1231 property shall not be included in taxable income;

(B) Deductions under section 165, but only to the extent the losses were realized from qualified low-income community investments under paragraph (d)(1) of this section;

(C) Deductions under sections 167 and 168, including the additional first-year depreciation under section 168(k);

(D) Start-up expenditures amortized under section 195; and

(E) Organizational expenses amortized under section 709.

(4) *Bankruptcy.* Bankruptcy of a CDE is not a recapture event.

(5) *Waiver of requirement or extension of time*—(i) *In general.* The Commissioner may waive a requirement or extend a deadline if such waiver or extension does not materially frustrate the purposes of section 45D and this section.

(ii) *Manner for requesting a waiver or extension.* A CDE that believes it has good cause for a waiver or an extension may request relief from the Commissioner in a ruling request. The request should set forth all the relevant facts and include a detailed explanation describing the event or events relating to the request for a waiver or an extension. For further information on the application procedure for a ruling, see Rev. Proc. 2005-1, 2005-1 I.R.B. 1, or its successor revenue procedure (see §601.601(d)(2) of this chapter).

(iii) *Terms and conditions.* The granting of a waiver or an extension to a CDE under this section may require adjustments of the CDE's requirements under

section 45D and this section as may be appropriate.

(6) *Cure period.* If a qualified equity investment fails the substantially-all requirement under paragraph (c)(5)(i) of this section, the failure is not a recapture event under paragraph (e)(2)(ii) of this section 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. Only one correction is permitted for each qualified equity investment during the 7-year credit period under this paragraph (e)(6).

(7) *Example.* The application of this paragraph (e) is illustrated by the following example:

*Example.* In 2003, A and B acquire separate qualified equity investments in X, a partnership. X is a CDE that has received a new markets tax credit allocation from the Secretary. X uses the proceeds of A's qualified equity investment to make a qualified low-income community investment in Y, and X uses the proceeds of B's qualified equity investment to make a qualified low-income community investment in Z. Y and Z are not CDEs. X controls both Y and Z within the meaning of paragraph (d)(6)(ii)(B) of this section. In 2003, Y and Z are qualified active low-income community businesses. In 2007, Y, but not Z, is a qualified active low-income community business and X does not satisfy the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section. A's equity investment satisfies the substantially-all requirement of paragraph (c)(1)(ii) of this section using the direct-tracing calculation of paragraph (c)(5)(ii) of this section because A's equity investment is traceable to Y. However, B's equity investment fails the substantially-all requirement using the direct-tracing calculation because B's equity investment is traceable to Z. Therefore, under paragraph (e)(2)(ii) of this section, there is a recapture event for B's equity investment (but not A's equity investment).

(f) *Basis reduction—(1) In general.* A taxpayer's basis in a qualified equity investment is reduced by the amount of any new markets tax credit determined under paragraph (b)(1) of this section with respect to the investment. A basis reduction occurs on each credit allowance date under paragraph (b)(2) of this section. This paragraph (f) does not apply for purposes of sections 1202, 1400B, and 1400F.

(2) *Adjustment in basis of interest in partnership or S corporation.* The adjusted basis of either a partner's interest in a partnership, or stock in an S corporation, must be appropriately adjusted to take into account adjustments made under paragraph (f)(1) of this section in the basis of a qualified equity investment held by the

partnership or S corporation (as the case may be).

(g) *Other rules—(1) Anti-abuse.* If a principal purpose of a transaction or a series of transactions is to achieve a result that is inconsistent with the purposes of section 45D and this section, the Commissioner may treat the transaction or series of transactions as causing a recapture event under paragraph (e)(2) of this section.

(2) *Reporting requirements—(i) Notification by CDE to taxpayer—(A) Allowance of new markets tax credit.* A CDE must provide notice to any taxpayer who acquires a qualified equity investment in the CDE at its original issue that the equity investment is a qualified equity investment entitling the taxpayer to claim the new markets tax credit. The notice must be provided by the CDE to the taxpayer no later than 60 days after the date the taxpayer makes the investment in the CDE. The notice must contain the amount paid to the CDE for the qualified equity investment at its original issue and the taxpayer identification number of the CDE.

(B) *Recapture event.* If, at any time during the 7-year period beginning on the date of the original issue of a qualified equity investment in a CDE, there is a recapture event under paragraph (e)(2) of this section with respect to such investment, the CDE must provide notice to each holder, including all prior holders, of the investment that a recapture event has occurred. The notice must be provided by the CDE no later than 60 days after the date the CDE becomes aware of the recapture event.

(ii) *CDE reporting requirements to Secretary.* Each CDE must comply with such reporting requirements to the Secretary as the Secretary may prescribe.

(iii) *Manner of claiming new markets tax credit.* A taxpayer may claim the new markets tax credit for each applicable taxable year by completing Form 8874, "New Markets Credit," and by filing Form 8874 with the taxpayer's Federal income tax return.

(iv) *Reporting recapture tax.* If there is a recapture event with respect to a taxpayer's equity investment in a CDE, the taxpayer must include the credit recapture amount under section 45D(g)(2) on the line for recapture taxes on the taxpayer's Federal income tax return for the taxable year in which the recapture event under paragraph (e)(2) of this section occurs (or

on the line for total tax, if there is no such line for recapture taxes) and write *NMCR* (new markets credit recapture) next to the entry space.

(3) *Other Federal tax benefits—(i) In general.* Except as provided in paragraph (g)(3)(ii) of this section, the availability of Federal tax benefits does not limit the availability of the new markets tax credit. Federal tax benefits that do not limit the availability of the new markets tax credit include, for example:

(A) The rehabilitation credit under section 47;

(B) All deductions under sections 167 and 168, including the additional first-year depreciation under section 168(k), and the expense deduction for certain depreciable property under section 179; and

(C) All tax benefits relating to certain designated areas such as empowerment zones and enterprise communities under sections 1391 through 1397D, the District of Columbia Enterprise Zone under sections 1400 through 1400B, renewal communities under sections 1400E through 1400J, and the New York Liberty Zone under section 1400L.

(ii) *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 section 42, the investment or loan is not a qualified low-income community investment under paragraph (d)(1) of this section to the extent the building's eligible basis under section 42(d) is financed by the proceeds of the investment or loan.

(4) *Bankruptcy of CDE.* The bankruptcy of a CDE does not preclude a taxpayer from continuing to claim the new markets tax credit on the remaining credit allowance dates under paragraph (b)(2) of this section.

(h) *Effective dates—(1) In general.* Except as provided in paragraph (h)(2) of this section, this section applies on or after December 22, 2004, and may be applied by taxpayers before December 22, 2004. The provisions that apply before December 22, 2004, are contained in §1.45D-1T (see 26 CFR part 1 revised as of April 1, 2003, and April 1, 2004).

(2) *Exception for certain provisions.* Paragraph (d)(5)(ii) of this section as it relates to the definition of the term *substantial improvements* and the requirement that each lessee must be a qualified

business applies to qualified low-income community investments made on or after February 22, 2005.

**§1.45D-1T [Removed]**

Par. 3 Section 1.45D-1T is removed.

**PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In §602.101, paragraph (b) is amended by removing the entry for “1.45D-1T” from the table.

Par. 6. In §602.101, paragraph (b) is amended by adding an entry to the table in numerical order to read as follows:

*§602.101 OMB Control numbers.*

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(b) \* \* \*

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CFR part or section where identified and described	Current OMB control No.
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1.45D-1 .....	1545-1765
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Mark E. Matthews,  
*Deputy Commissioner for Services and Enforcement.*

Approved December 21, 2004.

Eric Solomon,  
*Acting Deputy Assistant Secretary of the Treasury.*