

Part I

Section 469.--Passive Activity Losses And Credits Limited

26 CFR 1.469-1: General rules.

(Also: § 45D; 1.45D-1; 1.469-4; 1.469-5T; 1.469-9).

Rev. Rul. 2010-16

ISSUE

Where the acquisition of the qualified equity investment in a qualified community development entity (CDE) is not in connection with the conduct of a trade or business (or in anticipation of a trade or business), is the new markets tax credit allowable under § 45D a passive activity credit under § 469?

FACTS

Situation 1. On February 1, 2010, X, an individual, acquires a qualified equity investment (as defined in § 45D(b)) in a CDE (as defined in § 45D(c)). Because X holds the qualified equity investment on February 1, 2010, the initial credit allowance date (as defined in § 45D(a)(3)), a new markets tax credit under § 45D is allowable to X. X's

acquisition of the qualified equity investment in the CDE is not in connection with the conduct of a trade or business by X (or in anticipation of a trade or business).

Situation 2. On February 1, 2010, ABC, an entity treated as a partnership for federal tax purposes, acquires a qualified equity investment (as defined in § 45D(b)) in a CDE. Because ABC holds the qualified equity investment on February 1, 2010, the initial credit allowance date (as defined in § 45D(a)(3)), a new markets tax credit under § 45D is allowable to ABC. ABC allocates the new markets tax credit to its partners A, B, and C, in accordance with § 704(b). ABC's acquisition of the qualified equity investment in the CDE is not in connection with the conduct of a trade or business by ABC (or in anticipation of a trade or business).

LAW AND ANALYSIS

Section 45D(a)(1) provides that for purposes of § 38, in the case of a taxpayer who holds a qualified equity investment on a credit allowance date (as defined in § 45D(a)(3)) of the investment that occurs during the taxable year, the new markets tax credit determined under § 45D for the taxable year is an amount equal to the applicable percentage (as defined in § 45D(a)(2)) of the amount paid to the CDE for the investment at its original issue. Section 7701(a)(14) defines the term "taxpayer" to mean any person subject to any internal revenue tax. Section 7701(a)(1) provides that the term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company, or corporation.

Section 45D(b)(1) provides that an equity investment in a CDE is a "qualified equity investment" if, among other requirements, the CDE uses substantially all of the cash from the investment to make qualified low-income community investments.

Section 45D(d) defines the term “qualified low-income community investment” as (A) any capital or equity investment in, or loan to, any qualified active low-income community business, (B) the purchase from another CDE of any loan made by such entity which is a qualified low-income community investment, (C) financial counseling and other services specified in regulations prescribed by the Secretary to businesses located in, or residents of, low-income communities, and (D) any equity investment in, or loan to, any CDE.

Section 469(a) provides that for any taxable year of any individual, estate, trust, closely-held C corporation, or personal service corporation, neither the passive activity loss, nor the passive activity credit for the taxable year will be allowed.

Section 469(d)(2)(A) defines “passive activity credit” as the amount (if any) by which (A) the sum of the credits from all passive activities allowable for the taxable year under (i) subpart D of part IV of subchapter A, or (ii) subpart B (other than § 27(a)) of part IV, exceeds (b) the regular tax liability of the taxpayer for the taxable year allocable to all passive activities.

Section 469(c) defines a “passive activity” as (1) any activity which involves the conduct of any trade or business, and in which the taxpayer does not materially participate, and (2) any rental activity, except as provided by § 469(c)(7).

Section 469(c)(6) provides that, to the extent provided in the regulations, “trade or business” includes (A) any activity in connection with a trade or business, or (B) any activity with respect to which expenses are allowable as a deduction under § 212.

Section 1.469-1(e)(2) of the Income Tax Regulations provides that trade or business activities are activities that constitute trade or business activities within the meaning of § 1.469-4(b)(1).

Section 1.469-4(b)(1) defines “trade or business activities” as activities, other than rental activities or activities that are treated under § 1.469-1T(e)(3)(vi)(B) as incidental to an activity of holding property for investment, that (i) involve the conduct of a trade or business (within the meaning of § 162), (ii) are conducted in anticipation of the commencement of a trade or business, or (iii) involve research or experimental expenditures that are deductible under § 174.

Section 1.469-9(b)(1) provides that a trade or business is any trade or business determined by treating the types of activities in § 1.469-4(b)(1) as if they involved the conduct of a trade or business, and any interest in rental real estate, including any interest in rental real estate that gives rise to deductions under § 212.

Section 469(h)(1) provides that a taxpayer will be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis that is regular, continuous, and substantial.

The new markets tax credit under § 45D is subject to the provisions of § 469 since it is a credit allowable under subpart D of part IV of subchapter A of the Code. A credit may be disallowed under § 469 for a taxable year if the credit attributable to the taxable year arises in connection with the conduct of a passive activity. Allowance of the new markets tax credit under § 45D is predicated on acquiring a qualified equity investment in the CDE. The CDE does not pass through the new markets tax credit to the person claiming the new markets tax credit. Rather, the amount of the new markets tax credit

is determined based on a percentage of the amount paid to the CDE for the qualified equity investment at its original issue. Accordingly, in determining whether the new markets tax credit under § 45D is disallowed under § 469, the determination depends on whether the acquisition of the qualified equity investment in the CDE arises in connection with the conduct of a passive activity. The determination of whether the new markets tax credit under § 45D is disallowed under § 469 does not depend on the taxpayer's interest or extent of participation in the CDE's trade or business.

To be a passive activity, the activity of acquiring a qualified equity investment in the CDE must be in connection with the conduct of a trade or business in which the person claiming the new markets tax credit does not materially participate, or be a rental activity. Because the activity of acquiring an equity investment in a CDE is not a rental activity, the only issue is whether the acquisition activity is in connection with the conduct of a trade or business activity (or in anticipation of a trade or business) in which the person claiming the new markets tax credit does not materially participate.

The term "trade or business" is not defined in either the Code or the regulations. The determination of what constitutes a trade or business depends on the facts and circumstances of each case. The Supreme Court, in Commissioner v. Groetzinger, 480 U.S. 23 (1987), has held that there are generally two requirements for an activity to constitute a trade or business: the activity must be conducted for income or profit, and the activity must be engaged in with some regularity and continuity.

If it is determined that the acquisition of a qualified equity investment in a CDE is in connection with the conduct of a trade or business activity (or in anticipation of a trade or business), a determination must next be made as to whether the person claiming the

new markets tax credit materially participates in the activity. If the person claiming the new markets tax credit materially participates in the activity, the new markets tax credit under § 45D will not be disallowed under § 469.

In Situation 1, X's activity of acquiring a qualified equity investment in the CDE is not in connection with the conduct of X's trade or business activity (or in anticipation of a trade or business). Consequently, X's new markets tax credit under § 45D will not be disallowed under § 469.

In Situation 2, ABC allocates to A, B, and C the amount of the new markets tax credit that ABC claims. This allocation must be made in accordance with § 704(b) (which provides rules regarding a partnership's allocation of income, gain, loss, deduction, or credit (or item thereof) among the partners). ABC's activity of acquiring a qualified equity investment in the CDE is not in connection with the conduct of ABC's trade or business activity (or in anticipation of a trade or business). Consequently, the new markets tax credit allowable to ABC, and claimed by A, B, and C, individually, will not be disallowed under § 469.

HOLDING

1. Where an individual's acquisition of a qualified equity investment in a CDE is not in connection with the conduct of the individual's trade or business (or in anticipation of the individual's trade or business), the new markets tax credit allowable to an individual under § 45D will not be a passive activity credit under § 469.

2. Where a partnership's acquisition of a qualified equity investment in a CDE is not in connection with the conduct of the partnership's trade or business (or in anticipation

of the partnership's trade or business), the new markets tax credit allowable to the partnership under § 45D will not be a passive activity credit under § 469.

DRAFTING INFORMATION

The principal author of this revenue ruling is Benjamin H. Weaver of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue ruling, contact Benjamin H. Weaver at (202) 622-3050. For information regarding issues under § 45D, contact Julie Hanlon Bolton of the Office of Associate Chief Counsel (Passthroughs & Special Industries) at (202) 622-3040. These are not toll-free calls.