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NMTC Uncertainty in Indian Country

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The push by the Community Development Financial Institutions (CDFI) Fund to boost the use of the New Markets Tax Credit (NMTC) program in rural areas has led to increased interest in projects in areas including Native American reservations, Indian communities and trust lands, often referred to as "Indian Country." Many tribal trust lands are located in highly distressed rural census tracts in need of economic development that is consistent with the goals of the NMTC program.

That said, parties should be mindful of two significant issues when structuring NMTC transactions in Indian Country, namely: uncertainty regarding the use of tribal corporations in NMTC transactions, and risks that a tribe's non-qualified business activities (e.g., owning and operating a casino) might taint an NMTC transaction. While additional guidance from the Internal Revenue Service (IRS) regarding these two issues would be welcome, with proper structuring, neither should be an impediment to successfully closing and funding NMTC transactions.

Tribal Corporations

Internal Revenue Code (IRC) Section 45D and Treasury Regulation §1.45D-1(d)(4)(i) provide that "[t]he 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 trade or business. Neither Section 45D nor the regulation defines the terms "corporation" or "nonprofit corporation" for NMTC purposes. Consequently, it is unclear whether a tribal corporation formed under Section 17 of the Indian Reorgani-

zation Act of 1934 or the laws of a federally recognized Native American tribe can serve as a qualified active low-income community business (QALICB) in an NMTC transaction.

Generally, Native American tribes are considered sovereign political entities exempt from federal income tax. In Revenue Ruling 94-16, the Internal Revenue Service ruled that a tribal corporation owned by a Native American tribe shares the same tax status as its parent tribe. Thus, such a tribal corporation is disregarded as an entity separate from its parent tribe. Since the exempt status of a tribal corporation stems from the status of the parent tribe as a sovereign political entity, many practitioners have concluded that such tribal corporations are not "corporations" for NMTC purposes. Consequently, such tribal corporations have not been used as QALICBs in NMTC transactions involving Native American tribes.

Nevertheless, the inability to use a tribal corporation to serve as a QALICB does not preclude successful NMTC transactions in Indian Country. A tribe seeking NMTCs for a project simply needs to form a taxable state-law corporation to serve as the QALICB. While, as noted above, the IRS ruled that a tribal corporation shares the same tax status as its parent tribe, the IRS in that same ruling ruled that "a corporation organized by an Indian tribe under state law does not share the same tax status as the tribe for federal income tax purposes and is subject to federal income tax on any income earned, regardless of the location of the business activities that produced the income." Thus, such a tribal owned state corporation can serve as a QALICB.

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That such a state corporation would be subject to federal income tax on its income should not be a major concern. In a typical NMTC transaction on a reservation, the tribe would ground lease real property to the QALICB that in turn would lease back the property to the tribe after construction of the improvements is complete. During the seven-year NMTC compliance period, the depreciation and other tax deductions available to the QALICB should offset most of the rental income. Once the NMTC compliance period is complete, the tribe could liquidate the QALICB. While such a liquidation would generate taxable gain at the QALICB level if the fair market value of the QALICB's assets exceed their tax bases, such a result is unlikely due to the limited transferability of tribal trust lands.

Tenant Excluded Businesses

The IRS has promulgated regulations under IRC Section 45D that enumerate certain activities (such as the operation of a casino) that will not be "qualified businesses" for NMTC purposes (Treasury Regulation Section 1.45D-1(d)(5)(iii)(B)). Treasury Regulation Section 1.45D-1(d)(5)(ii) provides 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 under paragraph (d)(1)(i) of this section **to the extent a lessee of the real property** is described in paragraph (d)(5)(iii)(B) of this section (emphasis added)."

Thus, if a tenant of an NMTC project engages in an excluded activity, the NMTC project would be tainted. Because of the wording in the emphasized language above, a CDE's investment could be considered by certain practitioners to be disqualified merely because the lessee is engaged in one of the prohibited businesses listed in paragraph (d)(5)(iii)(B) at another location, regardless of the activity for which the NMTC loan or investment is made.

This interpretation of the regulation could disqualify many development projects on tribal trust lands for qualifying for NMTCs. An example would be a Native American tribe that leases office space from a QALICB for its government offices, but which operates a casino on a property not owned by the QALICB. The Native American tribe's activities in the leased space clearly would not be considered a non-prohibited business. However, various gaming laws and treaties preclude Native American tribes from operating casinos through separately recognized taxpayer entities. Consequently, if the above language is interpreted to apply to all activities conducted by a tenant regardless of whether those activities occur in the property leased from the QALICB, the mere operation of the casino by the tenant tribe at another location would disqualify the office space project from receiving an NMTC loan or investment.

While the language in the regulation can be interpreted as de-

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scribed, in light of the goals of the NMTC program, an acceptable interpretation would be to treat the operations of the lessee at the rented location as the relevant business and disregard its operations elsewhere. Such an interpretation finds support in other language from IRC Section 45D and the regulation. Particularly, Section 45D(d)(2)(c) provides that "[t]he term 'qualified active low income community business' includes any trades or businesses which would qualify as a qualified active low income community business if such trades or businesses were separately incorporated." Similarly, Treasury Regulation Section 1.45D(iii)(A) permits a CDE to treat a trade or business (or portion thereof) as a QALICB if the trade or business (or portion thereof) would otherwise qualify if it were separately incorporated and such trade or business maintains complete and separate books and records.

That Section 45D and the regulations contemplate that the concept of a "business" relates to a distinct business unit rather than the whole of a business entity indicates that a reasonable interpretation of Treasury Regulation Section 1.45D-1(d)(5)(ii) would be to look at the operations of the tenant at the QALICB's property. If such operations encompass a stand-alone trade or business then the operations of tenant's other business units at other locations should not disqualify the tenant.

Conclusion

While clarification and further IRS guidance regarding NMTC transactions in Indian Country certainly would be welcome, neither of the issues discussed above should be an impediment to successfully closing an NMTC transaction on tribal trust lands. As economic development is sorely needed on many tribal reservations, hopefully NMTC financing can be used to move needed projects forward. ♦

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