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How Reasonable are Reasonable Expectations Opinions?

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Law firms assisting clients in new markets tax credit (NMTC) transactions are routinely asked to render so-called "reasonable expectations opinions" to community development entities (CDEs) certified by the Community Development Financial Institutions (CDFI) Fund. This article discusses how a court or the Internal Revenue Service (IRS) would likely analyze whether a CDE has satisfied the reasonable expectations test. It also argues that taxpayers who rely on such opinions, especially when they do so in lieu of requiring other documentation of the CDE's expectations, are likely to come up short on audit or in court.

Under Section 45D of the Internal Revenue Code (IRC), CDEs are authorized to designate equity contributions from investors into those CDEs as qualified equity investments (QEIs) entitling the investors to NMTCs. The CDEs are then required to use such QEIs to make qualified low income community investments (QLICIs) in qualified active low income community businesses (QALICBs) during a seven-year compliance period. For the purposes of this article, we will assume these QLICIs are always loans.

IRC Section 45D(d)(2) sets forth the tests for the borrower to be a QALICB; generally, if any of these tests is not satisfied during the compliance period, the borrower will fail to be a QALICB. Section 1.45D-1(d)(6)(i) of the Treasury Regulations (Treas. Reg.) sets forth an exception to this general rule (the reasonable expectations test) and, subject to certain control prohibitions, generally provides that if the CDE reasonably expects that the borrower will remain a QALICB during the period the QLICI remains outstanding, the borrower will be treated as a QALICB even if the borrower later fails the QALICB status tests.

Implementing the Reasonable Expectations Test

On audit, how would the IRS determine whether the CDE could avail itself of the reasonable expectations test? Presumably the IRS would conduct a two-step inquiry. The first question is did the CDE expect the borrower to remain a QALICB during the term of the loan? The IRS presumably would answer this by asking the officers of the CDE whether they held such an expectation and reviewing other related internal memoranda. The second step would be to test whether the CDE's expectation was reasonable; to answer, the IRS presumably would conduct another two-part analysis. First, the IRS would determine the standard against which the CDE's conduct in forming its expectation should be measured (the RE standard). Second, the IRS would measure the CDE's conduct against the RE standard.

The first part of the analysis would be to decide how the RE standard would be determined. There is no clear guidance on this matter, but it seems highly likely that the IRS or a court would employ a combination objective/subjective approach similar to that used in the penalty protection provisions under IRC Section 6662. Under that section, penalties are not imposed on a taxpayer's underpayment if the taxpayer can show that there was reasonable cause for and the taxpayer acted in good faith with respect to the underpayment.

Treas. Reg. Section 1.6664-4 implements IRC Section 6662 and

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combines an objective and subjective approach in formulating the inquiry. It states that "the determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances [, and that g]enerally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." The regulations specifically take into account the "the experience, knowledge and education of the taxpayer."

Under this approach, even if the taxpayer actually believes his return positions do not result in an underpayment, the taxpayer must still demonstrate that that belief was reasonable. This is very similar to what is required under the reasonable expectations test; not only must the CDE expect the borrower will remain a QALICB, but that expectation must be reasonable.

The reasonableness standard against which that belief is tested for purposes of Section 6662 varies according to the facts and circumstances surrounding the taxpayer. In other words, what is reasonable for one taxpayer might well be unreasonable for another. This makes sense; tax professionals preparing their returns, for example, should be held to a higher standard of care than mimes.

Then it must be determined how the CDE's conduct would be measured against the RE standard. To answer this question, we first have to determine what the "CDE's conduct" really is. Are we talking about a factual issue or a question of law? Sometimes distinguishing questions of law from questions of fact is tricky, but not when you are talking about finding reasonableness: in this country, determinations of what conduct constitutes "reasonable conduct" are a questions of fact for a jury or other finder of facts.

Tax is no different. For example, in *Bilthouse v. U.S., 103 AFTR 2d 2009-429* (4th Cir. 2009), the issue was whether the taxpayer could use losses related to stock that had been suspended under IRC Section 469(g). The IRS took the position that the loss had been recognized earlier than the year in which the taxpayer reported it. Resolution of the case turned on the reasonableness of the taxpayer's expectation that the corporation's fortunes would improve. If the taxpayer held such a reasonable expectation, then the loss would have been recognized in a later year and the taxpayer would have been able to use the loss against his current liability. The court indicated that that it would be necessary for "a jury [to] infer from this show of support that [the corporation] had a viable case and a reasonable expectation of recovery (emphasis added)." Because satisfaction of the reasonable expectations test turns on the reasonableness of the CDE's conduct, determination of what the RE standard should be in any particular instance would very likely be a question of fact.

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What Role Do Tax Opinions Play in Finding Facts?

A legal opinion is an application of law to the facts. For example, ABA Formal Opinion 346 indicates that in the context of tax shelter opinions, an opinion "is advice concerning the federal tax law applicable to a tax shelter." Although a legal opinion will rely on known, represented or assumed facts, legal opinions do not opine to the existence of facts.

But what about Circular 230, which contains the rules governing practice before the Treasury Department? Given that Section 10.35(c)(1)(iii) of Circular 230 prevents a practitioner from relying on factual representations he knows or should have known are false, or relying on assumptions that are not supported by facts or expert opinion, doesn't he necessarily have to find facts to determine if he can render his tax opinion? The answer is that he does: he must evaluate, on his own behalf, the reasonableness of the assumptions he is making and the representations being made to him in order to apply the law to those facts and generate a legal conclusion. This very limited inquiry does not give the practitioner the ability to determine the existence of facts for a taxpayer, for the reasons discussed below.

The RE standard is a factual issue; the finder of fact would need to determine what steps a reasonable, prudent person in a situation similar to that of the CDE would take. Because this is a factual inquiry, a legal tax opinion can't be rendered with respect to the issue.

But what if the opinion merely says that "it is reasonable for a CDE to assume," as opposed to opining as to what the CDE expects? Not specifying who is to do the assuming ignores the very likely reality that what is reasonable for one party may not be reasonable for another. Not only may the education and sophistication levels of the parties differ, but the parties may have different knowledge about the transaction. And of course, all the forgoing are factual issues.

For example, assume CDE 1 is very sophisticated and CDE 2 is very unsophisticated, but they perform the same level of due diligence on the borrower. If the lawyer renders an opinion that it is "reasonable to assume" the borrower will be a QALICB, that may be accurate with respect to CDE 2 but not CDE 1, since further analysis by CDE 1, which has the expertise and experience to figure out the right answer, would reveal a problem.

Conclusion

A CDE is mostly likely to meet its burden of demonstrating a reasonable belief if it conducts and documents its own analysis of the likelihood that the borrower will remain a QALICB. The existence of a tax opinion that, provided the borrower does not breach its contractual obligations, the borrower should remain a QALICB, combined with some fact-appropriate inquiry into the likely abil-

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ity of the borrower to comply with those contractual obligations, would certainly go a long way toward meeting that standard. By contrast, the mere reliance on a "legal" opinion to demonstrate reasonableness of the taxpayer's belief is no guaranty that a court or the IRS will conclude the CDE acted reasonably.

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