

## Attention Developers: Beware of TCAP Tax Pitfalls and Be Aware of Credit Exchange Tax Benefits

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Low-income housing tax credit (LIHTC) allocating agencies (credit agencies) are currently busy evaluating applications by affordable housing developers for two LIHTC specific funding programs. These programs, contained in the American Recovery and Reinvestment Act of 2009 (Recovery Act), are the Tax Credit Assistance Program (TCAP) managed by the U.S. Department of Housing and Urban Development (HUD), and the Section 1602 Exchange Program (exchange program) managed by the U.S. Department of the Treasury. While both programs will bring significant resources to help restart the construction of affordable housing projects, this article discusses some of the tax pitfalls of TCAP funds and the tax benefits of exchange program funds of which developers should be aware. This article also explains how the viability of some TCAP funded developments may depend on whether credit agencies also award those developments exchange funds.

### Description of the TCAP and Exchange Programs

TCAP funds may be loaned or granted to LIHTC projects. If the funds are granted to the project, then the owner will generally have taxable income from the receipt of the funds. Because most owners will be subject to income tax, it is likely that such owners would prefer to have the funds loaned to the project. Loans of TCAP funds, if respected as loans for tax purposes, do not generate taxable income to the borrower. To be respected as loans for tax purposes, the borrower of TCAP funds must be able to demonstrate

that there is a reasonable expectation that the loan can be repaid in full at maturity. A failure to demonstrate an ability repay a TCAP loan may cause the loan to be treated as a grant, thus resulting in taxable income in the year of receipt of the funds. Developers should note that whether the funds are taxable or not, TCAP statutory language provides that TCAP funds do not reduce the LIHTC eligible basis of a project.

The tax nature of exchange funds is different. First, Treasury has stated that credit agencies that receive subawards of exchange funds cannot loan such funds to projects but must instead grant the funds. (Note that the form of the grant may be a loan, but Treasury guidance clearly implies that the "loans" must have repayment provisions that are sufficiently contingent, along with other loan provisions that cause the loan to be treated as a grant for income tax purposes.) Second, based on the legislative history of the Recovery Act it is believed that exchange grants are not taxable income to their recipients. Finally, it is believed that such grants do not reduce either eligible basis or depreciable basis. The Internal Revenue Service (IRS) has been asked to confirm the non-taxable nature of the grants and their ability to be included in basis. While the IRS is still reviewing the issue, informal discussions with the IRS personnel indicate that forthcoming guidance will confirm that receipt of the grants will not cause taxable income and that eligible and depreciable basis are not reduced by exchange grant proceeds. It is hoped that such guidance will be issued near the end of August 2009.

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## The Trouble with Excessive TCAP Funds

Many projects may receive large TCAP loans from credit agencies without realizing that those TCAP funds may create intractable challenges under tax law. Those challenges are the same challenges that are created by any large soft loans. The challenges are threefold:

1. potential reallocation of credits away from the investor,
2. increased investor exit taxes, and
3. re-characterization of the TCAP loan as a taxable grant.

As outlined below, these challenges can be ameliorated in most cases by replacing a portion of the TCAP loan with an exchange grant.

For many LIHTC projects, TCAP loans will be used to close financing gaps caused by a reduction in equity pricing or LIHTC investor interest. In some cases, there may be very little LIHTC equity left and TCAP funds may re-

place substantially all of the LIHTC equity. If a project retains a relatively small amount of LIHTC and receives a very large TCAP award, then the result may be that the LIHTC investor has an unusually small amount of equity when compared to the total project costs. Losses from depreciation and other expenses will likely deplete the investor's equity during the project's 10-year credit period. Once an investor's capital goes to zero, the ability to continue to allocate losses to the investor depends on whether the partnership has "minimum gain." A complete discussion of minimum gain is beyond the scope of this article, but any partnership that has general partner loans or equity, or deferred development fees owed to parties related to a partner, likely will not have minimum gain for a period of years. Once an investor's capital goes to zero and the partnership does not have minimum gain, losses and LIHTCs are reallocated to another partner until the partnership has minimum gain. If capital account problems are forecasted to prevent the LIHTC investor from being allocated LIHTCs during any portion of the 10-year credit period, then the investor will likely not make its investment.

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This is where the tax benefits of exchange program funds can help. This situation can be avoided if a portion of the TCAP loan was replaced with exchange funds. Under partnership tax law, the receipt of an exchange grant should increase the capital account of the partner to which it is allocated, as well as boost such partner's basis in its partnership interest. As such, the investor partner has a larger capital account, and therefore can be allocated more losses before going to zero. Thus the conversion of a portion of a contemplated TCAP loan to an exchange grant may cure a potential reallocation of credits triggered by insufficient investor capital. The increase in capital account and basis from the exchange grant may also lead to additional tax losses for the investor, which may increase the price the investor pays.

In addition to alleviating capital account issues and providing possible beneficial impacts on investor return and pricing, conversion of a portion of a large TCAP loan to an exchange grant would reduce the overall debt of the project. Many TCAP loans will be structured to require no payments on the loan until the loan matures, say at the end of a project's 30-year extended use period. However, some LIHTC projects may struggle to demonstrate the ability to repay the loan at maturity, potentially triggering taxable grant treatment for the TCAP loan. The conversion of some of the TCAP loan to an exchange grant will make it easier for a project to demonstrate the ability to repay the debt at maturity.

Finally, at the date the investor exits the LIHTC partnership, many projects struggle with what is called exit taxes. In general, this occurs when the investor's capital account swings negative, resulting in a gain when the investor exits the LIHTC partnership. The use of a large TCAP loan in place of LIHTC equity may result in increased exit taxes. Projects with significant exit taxes may be faced with a paucity of investor interest. However, replacing a portion of a TCAP loan with an exchange pro-

gram grant would increase the investor's starting capital account, thereby reducing or eliminating the exit taxes.

Because of the federal requirements that accompany TCAP funds for projects that already satisfy such requirements, credit agencies may be tempted fill all of the financing gaps of such project with TCAP loans. However, such large TCAP loans may result in capital account, exit tax and debt repayment problems. If developers and credit agencies can quickly identify projects that will face such situations, then the credit agency may be able to modify the financing to replace a portion of the TCAP loan with exchange funds. If this analysis is completed after a credit agency has allocated its TCAP and exchange funds, it may be too late to change the allocation for a project that encounters the problems triggered by large TCAP loans. Typical situations in which capital account and exit tax problems are more prevalent include:

1. LIHTC equity is low,
2. debt financing, including deferred developer fees, is provided by any partner other than the investor partner, or a party related to any non-investor partner,
3. any partner other than the investor has made a significant capital contribution, or
4. any partner other than the investor, or a party related to a non-investor partner, has guaranteed partnership financing.

However, as the financing and projected tax implications for each project are different, developers should work with their tax professional early in the process to assess potential problems and identify solutions. ❖

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