

IRS Memo States TCAP Grants are Taxable at Time TCAP Agreement is Signed

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On February 11, 2011 the Internal Revenue Service (IRS) released Office of Chief Counsel Memo 201106008 stating that Tax Credit Assistance Program (TCAP) grants are taxable and that the income accrues at the time the grant agreements are signed. Should developers be concerned? Does a check need to be cut to Uncle Sam for 35 percent of the amount of the TCAP funds that a project receives? The answer for most developers is that no check needs to be cut and no taxes are due. But the memo is interesting and bears some analysis.

Background

Congress passed the American Recovery and Reinvestment Act (ARRA) in 2009 to help stimulate the economy. One of the provisions of ARRA created the TCAP program and provided \$2.25 billion in funds to help projects using federal low-income housing tax credits (LIHTCs). The funds were granted to the state credit agencies that then loaned or granted the funds to owners of LIHTC projects. While the LIHTC rules normally provide that a project's LIHTC eligible basis is reduced by the amount of a federal grant, the TCAP statute specifically states that TCAP funds do not reduce eligible basis. However, other than this reference to eligible basis, the TCAP statute was silent as to the tax treatment of TCAP funds.

Memo 201106008 asked two questions: Are TCAP grants included in the gross income of the recipient? And if the grant is taxable, would the grant be included into income in the year the grant is awarded or the year the grant is received?

Following discussions with IRS personnel involved in the

creation of the memo, the IRS Chief Counsel Office was requested to issue the memo to assist in drafting an upcoming revised audit guide for the LIHTC program.

Taxable Income – No Surprise

Industry practitioners have always considered TCAP grants to be includible in taxable income. The ARRA statute was silent as to whether TCAP grants would be includible in taxable income. While the IRS stated in Notice 2010-18 that funds available under Section 1602 of ARRA, commonly referred to as exchange funds, are not includible in gross income, this was based on specific legislative history in ARRA providing for such a result. With respect to TCAP there also was nothing in the legislative history of ARRA to indicate that TCAP grants would not be included in gross income. Lacking any guidance showing congressional intention for non-taxability, Memo 201106008 applied the general rule that gross income includes all income from whatever source, unless excluded by law, according to Section 61 of the Internal Revenue Code (IRC) of 1986, as amended. While there is an exception to taxability for governmental general welfare grants to low- and moderate-income individuals to assist them in their needs, the memo concluded that this exception does not apply because the TCAP funds are granted to businesses entities such as corporations and partnerships.

The reason most developers should not be concerned about the taxability of TCAP grants is that most TCAP funds were structured as loans. Most tax practitioners had always considered such funds to be taxable, so developers commonly requested that the credit agencies make bona fide loans to their projects. In addition, some tax credit agencies were in-

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terested in the repayment of the TCAP loans and therefore wanted to have the funds structured as loans rather than as grants. Because loans must be repaid, they are not included in taxable income when received, and as a result most project owners have received TCAP funds as loans and therefore such funds are not includible in gross income and no taxes are owed. Note that tax practitioners would normally review the loan to make sure that it would be considered bona fide debt, including that there is a reasonable expectation that the loan will be repaid. Loans for which there is no expectation of repayment would be considered a grant for tax purposes.

The Grant Accrues When?!

Most people's interest in Memo 201106008 may have just ended based on the analysis that they received a loan and don't owe any tax. However, the memo's analysis concerning when a TCAP grant is includible in income is curious and deserves some attention because it could imply when income from other types of grants should be included in income. For example, while exempt from tax, when Section 1602 exchange funds accrue can impact when an owner's capital accounts and basis are increased. (For a more detailed discussion, see "Low Income Housing Tax Credit Provisions of the Recovery Act of 2009: Tools to Close Financing Gaps in a Weak Tax Credit Equity Market," by Michael J. Novogradac, Glenn A. Graff and Nicolo R. Pinoli in the American Bar Association Journal of Affordable Housing, Volume 18, Number 4.) The issue is if one does receive a TCAP grant rather than a TCAP loan, is that grant includible in income when the grant agreement is signed or when the grant funds are received?

The first step in the analysis is to distinguish between taxpayers that use the cash method of accounting for tax purposes and those on the accrual method of accounting for tax purposes. Cash method taxpayers generally do not have income until cash is received. However, cash method taxpayers cannot manipulate when income is included in gross income merely by not claiming cash that is available to them. Memo 201106008 states that income from a TCAP grant is includible in income at the time the taxpayer may draw on the funds in the account set up by the credit agency, or the taxpayer could have drawn upon the funds if notice had been given. Again, no surprises in this analysis.

However the memo then analyzes the issue for accrual basis taxpayers. Accrual basis taxpayers take income and expenses into account when they accrue the income or expense rather than when they receive the cash income or pay the expense with cash. In determining when income accrues, the tax rules look to an "all events test." Under this test, income accrues when all events have occurred that fix the right to receive the income and the amount of income can be determined with reasonable accuracy. The memo states that the right to receive income occurs upon the earliest of

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when: the required performance takes place, payment is due, or payment is made.

But without any analysis, Memo 201106008 then jumps to the conclusion that “the income is fixed, and the amount is reasonably determinable, when the project owner and the state agency execute the TCAP written agreement, unless the written agreement provides that the TCAP grant is due at another time.”

What is odd about the memo’s analysis is that it ignores the fact that a TCAP grantee isn’t entitled to any TCAP funds until it needs to pay eligible costs. The memo itself states that “Federal funds cannot be drawn from the U.S. Treasury in advance of the need to pay an eligible cost.” HUD has provided a similar rule with respect to the grantees by providing in the TCAP Written Agreement Requirements that “[t]he [TCAP] written agreement must specify that the project owner cannot request disbursement of TCAP funds until the funds are needed for payment of eligible costs.” As a result, TCAP funds could not be disbursed prior to the time when a TCAP grant needs to pay a cost. Of course, a TCAP grantee generally has no need to pay a cost until services or materials have been provided to the grantee. In other words, before a TCAP grantee would be entitled to any funds, it must start incurring eligible costs for the project and it must need to pay the vendor or service provider. Put in terms of the all events test, until the TCAP grantee incurs eligible costs the required performance has not taken place, payment is not due, and payment has not been made.

In fact, beyond the mere incurring of costs, many TCAP agreements may have significant additional draw submission requirements and credit agency approval rights that must be satisfied before it can be determined to what amounts a TCAP grantee is entitled. This latter fact is acknowledged by the statement in Memo 201106008 that “the written agreement may provid[e] that the TCAP grant is due at another time.” For example, most agreements probably require that the project have sufficient funds in addition to the TCAP funds to construct the project. Thus TCAP funds would not be available until the TCAP grantee has had its construction and equity closing. Other requirements, such as showing that the project is not overfunded and has a need for the TCAP funds and that the other TCAP program requirements are being satisfied, may create additional requirements that must be satisfied before the grantee has the right to receive any funds.

A simplified example would be a situation in which a TCAP grantee is purchasing land in order to construct a new LIHTC project. At the time the TCAP grantee signs the written agreement it has not actually acquired the land or incurred any project costs. When the TCAP grantee signs the agreement it will not be entitled to receive any TCAP funds because the performance that

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needs to take place in order to receive the funds is the need to pay a capital cost ... and none of them have been incurred. Of course, once the construction/equity closing is reached, construction starts and invoices will start pouring in and the developer will be quick to turn in draw requests that will be disbursed promptly by the credit agency. Until this time, the grantee's right to the funds has not become fixed. As construction of the project progresses, the TCAP grantee's rights to additional funds would grow.

Where Are We Now?

The author has spoken to the IRS attorney that drafted the timing portion of Memo 201106008. The points above were discussed and the IRS attorney was going to discuss it with other IRS personnel. Because the memo represents only internal advice given to IRS senior program analyst Grace Robertson, the IRS attorney indicated that if the IRS decided to change its conclusion it is not clear whether any change would be made to the memo or perhaps, instead, there would be an informal communication with Ms. Robertson. On a follow-up call with Ms. Robertson just prior to publication, the grant accrual issue was discussed. Ms. Robertson was receptive to the idea that a TCAP grant should not accrue merely because a TCAP agreement is signed and that reimbursable expenditures and other requirements may have to

be satisfied before accrual would occur. Ms. Robertson also stated that it would be important that a TCAP loan be bona fide debt and specifically that a TCAP loan with a 150 year term and no expectation of repayment would be viewed as a grant.

Conclusion

For most TCAP projects, the TCAP funds were not structured as grants but instead were structured as loans that would be repaid. Therefore Memo 201106008 will be irrelevant for most projects. If there was a grant of TCAP funds, or perhaps a grant of Section 1602, Neighborhood Stabilization funds or other funds, then the grantee and its tax professional would need to review the memo and the specific TCAP written agreement at issue, as well as other tax authorities, to make an independent decision as when to accrue the grant. Given the questionable analysis in the memo, there is clearly room for such tax professionals to conclude that the entire grant need not be accrued at the time the written agreement is signed. ❖

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