

# Beware of TCAP, Exchange Pitfalls

BY JONETTE HAHN AND TERRY KIMM

The Tax Credit Assistance Program (TCAP) and credit exchange, authorized by the American Recovery and Reinvestment Act (ARRA), saved many tax credit transactions and infused life support to the low-income housing tax credit industry at its time of most dire need.

Today, most TCAP and exchange funds have been awarded because of the tight timeframes mandated by ARRA. Enough projects have received commitments and closed to make some general observations of potential pitfalls.

## Tax Credit Assistance Program

TCAP is funded through the HOME program and apportioned by



T. Kimm / J. Hahn

the Department of Housing and Urban Development (HUD) to state housing finance agencies (HFAs). Known as the “HOME Overhang,” a project receiving TCAP funds must comply with certain HOME restrictions, including:

- Fair Housing;

- Nondiscrimination;
- Davis-Bacon; and
- HUD environmental standards.

Most developers are accustomed to conforming with Fair Housing and nondiscrimination policies, as they have typically been required by the HFAs. But Davis-Bacon wage rates, monitoring and reporting, and the HUD environmental approval process were not usually required for tax credit transactions that did not involve HUD programs. Davis-Bacon wage rates could increase construction costs significantly and must be included in the development budget, and the environmental approval process must be included in the development schedule.

TCAP may be awarded as a grant, and basis will not be reduced. However, the grant will be taxable to the recipient. Thus, TCAP is usually awarded to a project in the form of a soft loan.

The allocating agency has discretion whether to charge interest on the loan. Because TCAP will probably be a loan to the project, there could be accrued, unpaid interest in addition to the principal

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due at maturity. Developers and investors will be concerned with the “back-end” balance of accrued, deferred interest and principal and its impact on the partners’ exit strategy. TCAP funds must be repaid if used for ineligible costs, if the project is not completed, or fails to meet the requirements of Sec. 42.

TCAP funds may only be used to pay for eligible basis, land, on-site demolition, and environmental remediation costs. TCAP explicitly prohibits funding swimming pools, permanent loan costs, reserves, and allocating agencies’ administrative costs. The use limitation on TCAP funds may cause some challenges in tax-exempt bond deals because both sources are generally limited to the same uses.

### Tax credit exchange

Also known as Sec. 1602, the credit exchange has few pitfalls and has saved some projects that would otherwise not have been possible because they could not obtain a tax credit investor.

Exchange funds are generally received as a grant. Many states are structuring these funds as forgivable loans, which are treated as grants for tax purposes. Exchange funds do not have to be repaid as long as the project complies with its 15-year use agreement. The legislative history of ARRA and informal guidance from the IRS indicate that exchange funds are not subject to federal income tax, but they may be subject to state income tax. Partners at the time of receipt of exchange funds are likely to receive basis in their capital accounts for the tax-exempt income.

Exchange funds may not exceed 85 percent of a project’s eligible basis, including any 130 percent basis boost, and they may be used to pay for any costs for which equity could have been used.

There is no reduction in depreciable basis or LIHTC eligible basis related to exchange funds. Therefore, projects with these funds will be entitled to full depreciation deductions. Ownership entities should be carefully structured, before any exchange funds are received, to ensure that deductions can be allocated to

intended recipients.

### Benefits outweigh pitfalls

The benefits of TCAP and the credit exchange far outweigh these potential pitfalls. The pitfalls are manageable as long as they are addressed in the financial structuring before closing the ownership entities and the financing.

TCAP and the credit exchange were creative solutions that helped affordable rental housing survive the serious economic problems of the recession and

provided successful examples of ways to improve subsequent affordable housing programs. ■

*Jonette Hahn, a principal in the Baltimore office of Reznick Group, is a member of the firm’s National Affordable Housing Group. She can be reached at Jonette.Hahn@reznickgroup.com. Terry Kimm, CPA, a tax principal in Reznick Group’s Bethesda office, is co-head of the firm’s Real Estate Consulting Group. He can be reached at Terry.Kimm@reznickgroup.com.*

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