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Your grant might be a wolf in sheep's clothing: IRS loophole can lead to tax consequences when partnerships receive New York State energy grants

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As a managing partner in a New York real estate partnership, you want to improve the energy efficiency of one of your properties. In fact, you may be required to under state and city regulations. As a savvy businessperson, you know exactly how to do it. The New York State Energy Research and Development Authority (NYSERDA) has pointed out the way to readily available grant money. You're about to apply for a $3 million grant. You intend to use it to install replacement windows with improved caulking that will make the property energy efficient.

Should you apply?

The answer may be a resounding no - not without a thorough consultation with a tax professional. A grant received directly by your partnership may turn out to be a wolf in sheep's clothing - one that will create a phantom income tax via a quirk in the tax code.

The problem is this: Due to a loophole in the Internal Revenue code, grants to partnerships - unlike grants to corporations - are taxable income. Worse, they are fully taxable in the year received, while the windows you've just replaced will have to be capitalized and depreciated over decades.

Think about the consequences: Having to tell your partners - especially the limited partners - that they have $3 million in taxable income and no distribution to pay the tax. The reaction is unlikely to be good.

Unfortunately, there is no after-the-fact remedy. Once the partnership receives the grant, the tax consequences are automatic. Only by advance planning can it be structured properly to avoid this potential tax time bomb.

New York State makes grants available to offset the cost of required energy improvements

The story of the tax consequences of New York State energy grants is one of good intentions, tax code quirks and professionals - including some tax advisors - who miss important details.

New York State and New York City have been aggressive in promoting energy efficiency. To offset the cost of new requirements for capital improvement to meet energy benchmarks, the state established services to help businesses locate and secure funds, usually in the form of grants.

The IRS allows corporations to exclude grants from income. But this does not apply to partnerships

For corporations, the process of securing energy grants is straightforward and the tax picture is beneficial. Section 118(a) of the Internal Revenue Code provides that a corporation's gross income does not include certain non-shareholder contributions - for example, grants.

The problem for developers and property owners is that the IRS specifically states that Section 118 applies only to corporations. For non-corporate entities such as partnerships (including LLCs treated as partnerships for tax purposes), grants are fully taxable as ordinary income in the year received. There are no exceptions.

A grant to a partnership can lead to a devastating tax bill

Consider the resulting tax picture. Your $3 million grant counts as income. The offsetting cost of capital improvements will be realized through capitalization and depreciation over a period of years or perhaps decades. Tax will be levied against the partners. It will be particularly devastating for limited partners who have no distributions or offsetting losses.

Bad tax advice increases the risk. Beware of professionals who set the grant against the costs in order to hide the income

The risk to the partnership is clear. There is an additional risk in the form of bad tax advice. Too many advisors - whether attorneys or tax professionals - are insufficiently familiar with this particular quirk of the tax code. And they are reluctant to tell their clients that there is phantom income on the books. Typically, they will set the grant against the cost of the improvements and remove both from the tax return. That is a time bomb. Once discovered, it could lead to severe penalties in addition to the bill for unpaid tax.

Through effective planning, a third-party entity can be created to receive and disburse the grant

The only effective remedy is careful planning. From a tax perspective, the optimal way to receive a grant is through a third-party entity - a corporation that can then disburse the funds to the partnership in the form of a loan. If you are contemplating applying for a grant, you need to discuss this option with professional advisors who can work with you to create the corporate structure.

If you have already received a grant through your partnership, then the tax liability is unavoidable without a private letter ruling which is no guarantee. The only responsible action a tax professional can take is to declare the grant as income. If the grant was received in a prior tax year, then a voluntary disclosure may serve to reduce or eliminate penalties.

But that is a less than optimal solution. If you are considering or actively applying for an energy grant, consult now with a professional who can create a tax-favorable structure for it. Energy grants are critical to many real estate partnership entities that have insufficient cash

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flow to make mandated energy efficient improvements. Foresight and effective planning will keep the tax wolf from your door.

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