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When Are Tax Increment Revenues Federally Taxable?

Tax increment financing ("TIF") has had a long and effective history in Colorado. In many cities and towns throughout Colorado, TIF has successfully been used to help remediate environmental issues and spur development in blighted areas where market realities would have prohibited such progress. A great example of a successful TIF development project is Belmar, an open-air shopping center in Lakewood, Colorado, that previously contained a dilapidated shopping center with high vacancy rates. More to the point, the site contained a large chemical plume that was costly to remediate. But for the public-private partnership and the use of TIF, the successful Belmar redevelopment project would have never been feasible. Accordingly, TIF is an important governmental tool to encourage the type of development that supports a thriving community.

In Colorado, many large development projects that are supported by TIF are constructed with the help of a governmental district such as a metropolitan district, or other special improvement district, which has certain tax considerations and treatment that is different than a private developer. The law is clear and undisturbed that most governmental districts can receive TIF revenues for eligible public improvements without, in most cases, a negative tax treatment.

However, not all development projects are of sufficient size and scope to justify the cost and complexity of forming a district, or don't lend themselves to the use of a district or tax-exempt municipal financing for other reasons. Instead, many developments are financed, constructed, owned and managed by private entities.

Prior to the Tax Cuts and Jobs Act of 2017 ("TCJA"), if a private entity was a corporation and received incremental tax funds as part of the project's financing, such revenues were not considered federal taxable income pursuant to the contribution to capital exclusion found in Section 118 of the Internal Revenue Code ("IRC"). Additionally, a private developer could (and still can) receive TIF as reimbursement for the construction of public infrastructure without immediate taxation of the TIF proceeds irrespective of whether or not the entity is a corporation. The issue that many private developers will have to resolve is that not all TIF revenues received by a private developer can be directly linked to or measured as reimbursement for the limited scope of public infrastructure recognized by the IRC and applicable case law. Many improvements and amenities that are generally considered "public" in the development world are not treated as such by the federal tax code. For those development expenditures by a private developer that are not recognized as public infrastructure costs but have appropriately received TIF revenues for reimbursable costs, will the developer now be taxed on such TIF revenues as ordinary income for the tax year in which the developer receives the TIF revenues? The answer remains unclear.

Historical Safe Harbor for Private Developers

The prior version of IRC Sec. 118 allowed the contribution of capital, such as the receipt of tax

increment revenues, to be excluded in most circumstances from the definition of gross income for a corporation (this treatment did not apply to partnerships). Accordingly, before the TCJA, a private developer corporation could receive free land or monetary support from a governmental entity in order to incentivize the developer's real estate project. In the case of a contribution of land, the developer would, in most circumstances, receive a basis of zero in the property and, therefore, would pay taxes on the contributed property at the time of sale. In the case of the receipt of tax increment revenues, the revenues would, in most circumstances, reduce the basis in the property and improvements thereto. Accordingly, taxes were ultimately recovered, to some extent, by the sale; the impact of the incentive contribution, however, wasn't diminished at the outset of the development project by the immediate taxation of the tax increment revenues.

TCJA Changes to IRC Sec. 118

The TCJA gutted the ability of a corporation to exclude tax increment revenues from ordinary income in the tax year received by the private corporate developer entity by adding the following exclusion to the definition of "contribution to capital to the taxpayer" in Section 118 of the IRC: any contribution by any governmental entity or civic group (other than a contribution made by a shareholder). For example, a privately owned parking structure could, in certain circumstances, be funded with TIF revenues but would have to be received by a corporate developer entity as a contribution to capital pursuant to Sec. 118 of the IRC in order to avoid immediate taxation as ordinary income. With the TCJA changes to Sec. 118, it is likely that the foregoing scenario would result in a contribution that is immediately taxable as ordinary income.

The good news is that the revisions to Sec. 118 may not be applicable to many TIF revenues! While the Internal Revenue Service ("IRS") has not yet issued Treasury Regulations on this issue, the revised Sec. 118 provides the following exception:

"The amendments made by this section shall not apply to any contribution, made after the date of enactment of this Act by a governmental entity, which is made pursuant to a **master development plan that has been approved prior to such date** by a governmental entity." (emphasis added).

Accordingly, it is possible that urban renewal plans approved and in effect in Colorado as of Dec.22, 2017, could be considered approved master development plans that are not subject to the revisions to Sec. 118. As such, private developers should work with their legal counsel to determine, in the absence of clear guidance from the IRS, whether the anticipated receipt of TIF revenues pursuant to an adopted urban renewal plan may be eligible for beneficial tax treatment under the former version of Sec. 118.

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