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What Are the Tax Implications of Receiving Tax Incremental Financing Grants?

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Municipalities often grant Tax Incremental Financing (TIF) funds to real estate developers as an inducement to locate in the municipality in order to spur economic development. Some TIF programs provide an up-front payment to the developer, while others provide a stream of payments (often known as "pay-as-you-go" TIFs).

But what is the tax impact of receiving TIF funding? The Internal Revenue Code specifically provides that certain "contributions to the capital of a corporation" can be received on a tax-free basis if the payments satisfy certain requirements. The Code recognizes that sometimes a corporation will receive a contribution from a non-shareholder that should not result in taxable income to the corporation. Thus, an S corporation or a C corporation can usually receive TIF funds without paying tax on the receipt of the funds.

Developers and investors often form limited liability companies (LLCs) to operate their real estate development projects. Unless a multi-member LLC elects to be treated as a corporation for tax purposes, it will be taxed as a partnership. What is the tax impact of receiving TIF funding if the recipient is a tax partnership? Some taxpayers take the position that the special tax-free capital contribution rule described above should apply to the partnership. However, the Internal Revenue Service takes the position that the special rule does not apply to contributions to tax partnerships, because the Code specifically refers to contributions to the capital of a "corporation."

In order to avoid a confrontation with the IRS, developers and investors should consider forming two entities for the development project. The primary development entity is formed as a tax partnership LLC. A second entity is formed as an S corporation for tax purposes (the entity could be either a corporation or an LLC for legal purposes). The S corporation enters into the TIF arrangement and subsequently contributes the TIF funds to the development LLC in exchange for a membership interest in the LLC. The special tax rule for corporate contributions should apply because the recipient of the TIF funds is a corporation for tax purposes.