Public-Private Partnerships – Tax Considerations

Even in a strong market, putting together a large real estate project is becoming more difficult and certainly more complicated than ever. With high land costs, continued increases in fee structures and escalating construction costs, a long term project is challenging - and that is without consideration to the substantial market risk that comes with such projects. Throw in issues related to large scale infrastructure requirements, environmental issues or below market rate components and a developer typically cannot make a deal pencil without some government help. As a result, public-private partnerships have become a permanent fixture for most projects of any scale. Those arrangements can take many forms, from bonds issued supported by additional taxes or special district taxes and fees to outright grants of funds from governmental authorities.

The transfer of benefits from the public side of the equation to the private side can also take many forms: use of special districts to allow the developer to act as a quasi-governmental entity to assess taxes to fund infrastructure, relief from zoning rules to allow more density, or direct transfers of public property and tax increment financing (TIF) to allow the developer to claim a portion of tax revenues from the developed property to help fund the development, to name a few. If the private side of the equation is receiving measurable benefit from the arrangement, the question of the income tax treatment must be addressed.

Some arrangements may take the form of debt (a borrowing with a required repayment), but if the benefit comes without substantial strings attached, it would, on its face, be income to the developer. That is, the Internal Revenue Code defines income by exception: anything received is income unless some provision of the statute says it is not. A loan (albeit cash received) would be an exception since it has to be repaid; a reward of increased density or use of public lands may be excepted because the public good offsets any value received, but a receipt of cash that will be used to create assets that will be owned by the private partner would generally be considered income without some explicit exception.

Some examples for consideration are receipt of some kind of TIF payment directly to the developer for their use in building assets that the developer will own or a transfer of property directly to the developer by a governmental entity (either public lands or private land acquired through eminent domain). These types of situations provide an obvious example where the developer has received a direct benefit which would be taxable under the normal tax rules which read, "gross income means all income from whatever source derived."

Unsurprisingly, there are a multitude of exceptions to this draconian concept with one particularly important one: a contribution to a corporation by a non-shareholder can be excluded from income. That means simply that a corporate structure (yes, S corporations qualify) should be used if the developer receives direct benefit, at least with respect to the entity receiving the benefit. To be sure, there are specific rules around qualifying for this corporate exception so do your homework, but most typical arrangements should qualify. The takeaway, however, is partnerships cannot qualify for this general exception from reporting income; no similar exception is available for non-partner contributions to a partnership. If you do use the corporate exception to opt out of reporting the benefit as income, the taxpayer is also not allowed basis in the asset, so no depreciation if a built asset (with non-shareholder funds) and no reduction for gain calculations upon sale (likely not a bad bargain since you push off the tax event until a later year).

If you are compelled to use a partnership structure, a possible out is to try to qualify the receipt of the benefit as a loan; proceeds from a loan, as noted above, are an exception from the general, "everything is income," requirement in the statute. This approach could be applicable where TIF bonds are created and will be repaid, but the "debt" under this approach must be treated as real debt with all that entails and any failure to repay could just defer the taxable income event to a later year. Public-private partnerships are a critical tool in any developer's toolbox, but don't forget the appropriate tax planning if you go down that path, particularly if you are new to that world. I would also note that the status of tax exempt bonds as such can be put at risk if not structured properly. But that's a topic for another day.

The information in this newsletter was gleaned from a number of sources. If you have a particular question, or would like a citation to the source, please contact Zane Dennis at **zane@richeymay.com** or 303-721-6131.