TAX CUTS AND JOBS ACT SECTION 118

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Overview

- Tax Cuts and Jobs Act (TCJA) changes affect the taxability of economic development incentives/grants for businesses and developers.
- Internal Revenue Code Section (“Section”) 118 previously allowed corporate taxpayers in most cases to exclude contributions that came from non-shareholders, such as governmental branches and agencies, from taxable income.
- Under the new law, property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or to enable the corporation to expand its operating facilities, and other incentive payments are generally **NOW** taxable to the corporation.

Tax Cuts and Jobs Acts Provisions

- A corporation receiving an upfront cash incentive can no longer exclude these contributions unless the government makes the contribution as a direct shareholder (i.e., takes back stock for its investment) in the corporation.
  - Having a governmental agency receive stock is not very common and is not very desirable from the viewpoint of pre-existing shareholders due to the dilutive nature of the issuance.

Tax Basis of Property

- Under old rules:
  - More specifically, under Section 362(c)(1), if property was acquired by a corporation as a contribution to capital and was not contributed by a shareholder as such, the adjusted tax basis of the property is zero. Therefore no tax depreciation was allowed.
  - This is essentially a deferral (through the basis reduction) for property "acquired by a corporation as a contribution to capital" or to property acquired with money "received by a corporation as a contribution to capital."
- New rules:
  - Tax basis in property equals the cost to construct or purchase the property for which the grant proceeds were used. Property is then eligible for tax depreciation once placed in service.

Deferral Versus Elimination

- As you could see from the required basis adjustments, when deferral is allowed, the mechanism was more of a deferral technique, as opposed to a pure tax exclusion that eliminated income altogether.
- It resulted in a reduced tax basis in property, in exchange for avoiding income recognition, thus ultimately deferring the tax liability on the grant to a later time when the asset would have been depreciated or when the asset whose tax basis as reduced as sold.
- This deferral provision better enabled taxpayers to manage its tax liability from receipt of the funds with related expenses once the funds were deployed.

Exceptions to New Rules

- While this change is concerning for many of our clients that work in economic development trades and businesses, relief exists in the following two situations:
  - When a taxpayer had a Tax Increment Financing plan or a master development plan in place prior to the passage of the law (Dec. 22, 2017). While the new law's modification is effective for contributions received after Dec. 22, 2017, it does not apply to post-modification contributions if the contribution occurs pursuant to a "master development plan" approved by a governmental entity prior to the effective date.
  - Second, a taxpayer located in a state that has opted out of the Section 118 modifications (i.e., Georgia) may escape state taxation even though the incentive funds received by a corporation would now be subject to federal tax.

Tax Planning Ideas

- Possible tax planning techniques around Section 118 to possibly avoid some of the immediate adverse income tax consequences:
  - Consider the use of partnerships as investment vehicles where the governmental entity is considered a partner as opposed to a shareholder since Section 118 applies to capital contributions into corporations. (Note: the partnership transaction would need to be structured in a manner that does not result in an immediate accession to wealth (or income) to the non-contributing partner(s) through careful tax planning).
  - Consider negotiating with the governmental authority to provide tax abatements or tax credits, as opposed to making capital contributions of cash or property, as those forms of assistance are no longer treated as a tax-free contribution to capital.
  - Negotiate for the provision of periodic payments, as needed, to avoid immediate upfront income recognition in order to defer the income recognition with the timing of related expenditure to possibly create offsetting income tax deductions as those government funds are employed in the relevant project.
  - Direct the municipal investment toward a publicly owned infrastructure project, rather than providing cash grants to private businesses to take ownership of those assets underlying the respective government grants.

Questions?

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