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CREDITS & INCENTIVES TALK WITH DELOITTE

Tax Reform Impacts on Section 118

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State and local jurisdictions have a long history of using economic incentives to attract business to their communities. These economic incentives usually come in the form of statutory tax credits or discretionary incentives. Statutory credits generally do not require pre-approval and are usually generated when a taxpayer meets specified criteria outlined in the state's statute.

Discretionary incentives typically require some sort of pre-approval, have to be negotiated before the specified action takes place, and may have a "but for" clause requirement. The "but for" clause is one that essentially means if it were not for the incentives offered by the selected jurisdiction, the project may not move forward at the proposed scope and scale. Discretionary incentives can take on several different forms and may include benefits including, but not limited to: property tax abatements, cash grants, sales tax abatements, infrastructure assistance, permit waivers or free land.

Prior to enactment of The Tax Cuts and Jobs Act of 2017 ("TCJA"), an often overlooked and underutilized benefit of some of these discretionary incentives, such as a cash grant or free land, was the federal tax treatment a corporation could receive for those items under Internal Revenue Code ("IRC") Section 118. With the enactment of the TCJA, there are still some limited opportunities for corporations to take advantage of Section 118 as it used to exist, prior to the amendments made by the TCJA.

Section 118 was enacted following a series of court cases dealing with the question of whether corporations could exempt capital contributions from income when they were made by non-shareholders. In 1950, in *Brown Shoe Co., Inc. v. Commissioner,*[1] the U.S. Supreme Court held that contributions of cash and buildings made to a shoe manufacturer from community groups to entice the manufacturer to establish operations in a particular location could be excluded from income. The Court's reasoning was that the contributions held a community benefit.

In 1973, the U.S. Supreme Court made it clear that not all subsidies qualify as non-shareholder contributions to capital in *U.S. v. Chicago, Burlington, & Quincy Railroad Co.*[2] In that case, the Court rejected a railroad's contention that highway under-crossings, bridges, and other improvements constructed at public expense were non-shareholder contributions to capital and could be depreciated. Although decided in 1973, the case dealt with subsidies provided to the railroad prior to the enactment of the 1954 Code.

In ruling that the assets had a zero basis and could not be depreciated, the Court established a list of five characteristics a payment or transfer of assets must have to be considered a non-shareholder contribution to capital:

- The payment must become a permanent part of the corporation's working capital.
- The payment cannot be compensation for any services performed for the corporation.
- The payment must be bargained for.
- Any assets transferred to the corporation must benefit the company in an amount commensurate with the valuation of the assets.
- The asset must ordinarily be employed in the production of additional income.

The Court's five-factor test was formulated under common law, when it was still possible for a recipient of a subsidy to exclude the subsidy from its gross income yet claim depreciation deductions on the property acquired with the subsidy.

Allowing a taxpayer to include the amount of non-shareholder capital contributions in its depreciable tax basis could produce a double benefit for the taxpayer. Congress addressed the issue with the enactment of IRC Sections 118 and 362 in the 1954 Code to ensure that contributions of capital by non-shareholders could not be included as depreciable assets. Even following the enactment of these sections, courts still use the five-factor test to determine if a payment qualifies as a non-shareholder contribution to capital and can be excluded from gross income under Section 118.

Under the 1954 Code, the general rule of IRC Section 118 was that the gross income of a corporation does not include any contribution to its capital.[3] The statute went on to say that a contribution to capital did not include any contribution in aid of construction or any other contribution from a customer or potential customer,[4] meaning that these amounts were taxable and included in gross income.[5] This meant that other non-shareholder capital contributions could be excluded from a corporation's gross income.

These non-shareholder contributions to capital could include land or other property contributed to the corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate or expand its operations in a particular community. In other words, a discretionary incentive of a cash grant or free land to the company could receive Section 118 treatment and not be included in gross income. The effect of this is that the corporation would not pay tax on the value of the land or cash grant in the year when the incentives were received. The rule only applied to corporations, so the company needed to be a corporation in order for Section 118 treatment to apply.

Also prior to the TCJA, per IRC Section 362, property other than money received by a corporation as a contribution to capital from a non-shareholder had a zero basis.[6] If a contribution to capital was made via a cash grant by a non-shareholder, any property purchased with the grant funds within 12 months would also have a zero basis.[7]

For example, if a government unit gave a company a cash grant as an incentive to locate its new facility in the jurisdiction and the company used that cash to buy its new HVAC system within 12 months of receiving the grant funds, the HVAC system would have a zero basis and thus not be depreciated. If any grant funds were remaining after 12 months, the corporation would have to reduce the basis of other property it held to the extent of the remaining grant funds.[8] Using the HVAC example from earlier, if the government unit gave the company a cash grant in the amount of $1 million and the HVAC system cost the company $800,000, this means the company would have to reduce the basis of another asset by $200,000 to match the value of the cash grant of $1 million received.

This methodology makes sense when you look at it holistically. The company is not taxed on the $1 million it received as a cash grant, therefore the company should not get the depreciation deduction for the HVAC it purchased with the funds from the cash grant. Otherwise there would essentially be "double dipping" if the company got both the tax-free treatment and a depreciation deduction.

The TCJA had a major impact on IRC Section 118 as it relates to contributions by non-shareholders. The TCJA left unchanged Section 118's general rule that contributions to capital are not included in gross income. What did change is the addition of language to Section 118 that makes grant proceeds from governmental entities or civic groups to a corporation taxable upon receipt as gross income (other than contributions made by a shareholder as such).[9] However, it provided an exception for certain grants. Grants from governmental entities may be grandfathered to the extent that they are part of a master development plan that was approved by the governmental entity before enactment of the TCJA.[10]

Despite the seemingly negative impact of the changes to Section 118, there could be a short window of time for planning opportunities for some corporations. As stated above, one opportunity is that the amendments to Section 118 do not apply to any non-shareholder contributions if the contributions are made pursuant to a master development plan that has was approved by a governmental entity prior to the enactment of the TCJA. Therefore, if a jurisdiction has a master development plan in effect prior to the enactment of the TCJA, and it makes a non-shareholder contribution to capital, that contribution could still be excluded from gross income of the company.

Consequently, companies and developers should investigate if the jurisdictions they are planning on relocating to or expanding in have a master development plan. If there is a master development plan, then the company may be able to enhance the value of the incentives offered from the jurisdiction by excluding from gross income the value of the incentive. At the time of this article, the Internal Revenue Service had not defined what a master development plan consists of, only that it must be in place prior to the enactment of the TCJA.

The second planning opportunity comes in the form of a 14% permanent difference between the old corporate income tax rate of 35% and the newly enacted corporate income tax rate of 21%. Taxpayers should reexamine any incentive agreements entered into within the last three years, or longer if they are open under the statute of limitations, to see if they can take advantage of the tax treatment under the old IRC Section 118 for the incentives they received.

If they can, they should consider amending any tax returns, open under the statute of limitations, to exclude from income the contributions from non-shareholders of either cash or free land. In the event they received cash, they will get to exclude from income the value of the cash and will have to reduce the value of assets purchased by the incentives. In the event they received free land, they would exclude from income the value of the land and reduce the land to a zero basis.

While the taxpayer will forgo the depreciation deductions on assets going forward, those deductions are at a rate of only 21%. With the 35% tax rate, when the taxpayer excludes from income the non-shareholder contributions to capital and factors in the value of the depreciation expense it is forgoing, it could end up with a 14% permanent savings.

While the favorable tax treatment of contributions to capital from non-shareholders under the old Section 118 is no longer available to all corporations, those who can take advantage of it should consider doing so while there is still time under the statute of limitations. Corporate taxpayers who are interested should consult with a tax professional regarding the changes to Section 118 and their potential applicability.

[1] 339 U.S. 583.

[2] 412 U.S. 401.

[3] IRC Section 118(a).

[4] IRC Section 118(b).

[5] IRC Section 118(a).

[6] IRC Section 362(c)(1).

[7] IRC Section 362(c)(2).

[8] IRC Section 362(c)(2).

[9] Pub. L. 115-97, 131 Stat. 2054, §13312(a) (Dec. 22, 2017).

[10] *Id.* at §13312(b)(2).