THIS ARTICLE WAS WRITTEN BY CHRISTOPHER HANEWALD WHILE HE WAS WORKING AT THE CBIZ ACCOUNTING FIRM.

That Publicly Financed Private Project May Be Taxable

BY CHRISTOPHER HANEWALD

Tax reform under what is commonly known as Tax Cuts and Jobs Act (TCJA) brought drastic and immediate changes to the tax code. The TCJA gave real estate developers a lot to consider, from provisions concerning the deductibility of business interest to a deduction for qualified business income of a pass-through entity and significant alterations to capital expensing. Considering the sheer amount of changes, the speed at which the legislation passed and the associated confusion of practitioners and business owners alike, perhaps it should not be surprising that certain aspects of the TCJA have gone relatively undetected in the six short months since the TCJA's effective date. But in the world of tax, overlooked or unnoticed change can cost businesses serious money. Real estate developers need to be aware of an often overlooked provision related to public financing of private projects. Changes brought by the TCJA could present a serious obstacle in public-private partnerships.

A History of Public Financing for Private Projects

Over the past two decades, state and local government grants – most often structured through a variety of tax incentives – have provided significant economic growth opportunities, providing an estimated $50 billion in benefits annually. Most often, these incentives come in the form of tax incremental financing (TIF) districts, land grants, cash grants and tax exemptions.

With the sheer amount of money at stake, it is a surprise to see so little attention paid to the change the TCJA made to Code Section 118. Under prior law, Section 118 enabled a corporation to receive a government grant without recognizing income on the amount received;

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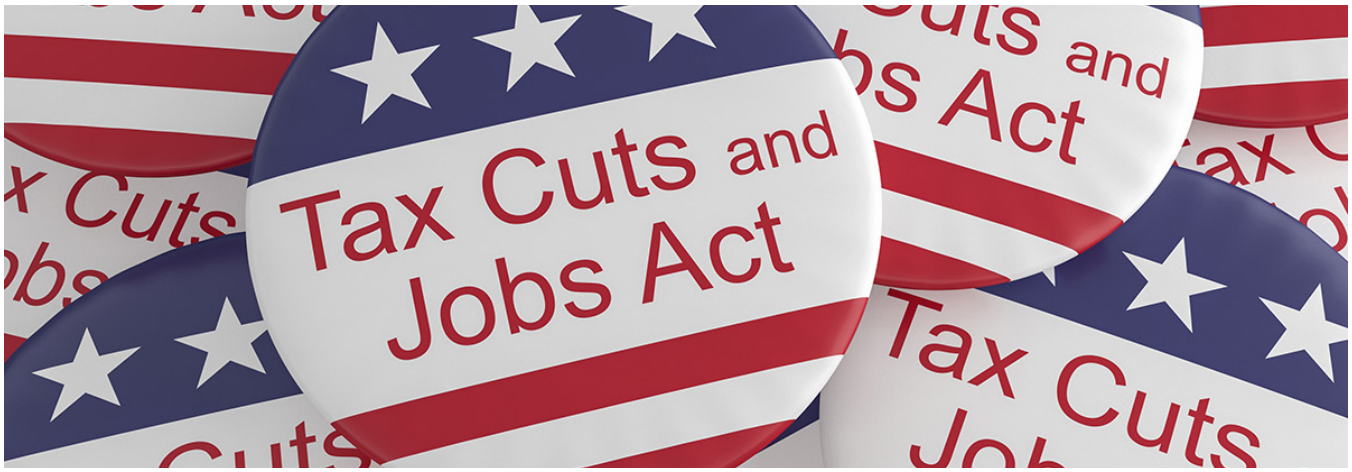

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rather, the grant was treated as a nonequity contribution to capital by a nonshareholder. The regulations under the Code provision specifically excluded from gross income the amount of "the value of land or other property contributed to a corporation 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 for the purpose of enabling the corporation to expand its operating facilities."

Thus, developers of large mixed-use, commercial and residential projects could receive significant state and local government grants – usually to the tune of tens of millions of dollars – and avoid recognizing those vast sums as income.

How Code Section 118 Benefits Have Changed Under Tax Reform

Among its many other changes, the TCJA targets the robust public subsidies provided to private development projects. It eliminates the Section 118 benefits previously available to corporations by changing the types of capital contributions that can be excluded from a taxpayer's gross income. It modifies Section 118 to read that corporations can exclude capital contributions from gross income, but capital contributions do not include "any contribution by any governmental entity or civic group."

What that means is that under the TCJA, government grants received by developers that were previously tax-free will now have to be recognized as income in the year of receipt. Reporting governmental grants as gross income will result in multi-million dollar tax liabilities for developers and investors.

It may take real estate developers some time to feel the full effect of the change to Section 118. Congress provided a transitional rule that allows "contributions made after Dec. 22, 2017 by a governmental entity under a master development plan that has been approved before Dec. 22, 2017 by a governmental entity" to use the previous language in Section 118, meaning government-funded projects approved prior to the TCJA will continue to be tax-free to corporations.

Although the transition rule buys the real estate community some time to prepare for the potentially disastrous income recognition consequences wrought by the change to Section 118, real estate developers should be assessing the rule change now. There are many potential entity structuring solutions that may help mitigate or altogether resolve the Section 118 issue, but any potential solution's utility will be worthless if not adequately addressed during the project's planning process. A tax professional familiar with the nuances of the changes to Section 118 and the many moving pieces involved in the TCJA can help your organization adjust its approach to financing new projects and maximize other tax benefits that may be available.

For more information about this tax topic, contact Chris Hanewald or your local CBIZ MHM tax professional.

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