ISSUE PAPER

Preserving Investment in Neighborhoods

- The IRS directive on Section 118(a) conflicts with Congressional intent and common law.
- State and Local economic development and infrastructure funds are being inappropriately transferred to the federal government.
- ICSC supports the Preserving Investment in Neighborhoods Act to extend the tax exemption for state grants.

Position: ICSC strongly supports H.R. 1416 to clarify Section 118(a) of the IRC to extend the exemption of state or local economic development incentives from federal income tax and encourage private sector investment in underserved areas.

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Background: State and local governments invest in economic development and infrastructure projects to leverage private capital. The public investment can be in the form of real property, easements, or direct capital to assist with the costs of demolition, environmental remediation, or infrastructure.

Dating back to 1925, courts have treated this type of investment as a tax-free "contribution to capital." However, in 1954 the codification of this rule under Section 118 only listed corporations within its scope since partnerships were not widely utilized at the time. In 2007, the IRS reversed its interpretation to strictly follow the letter of the law and to no longer recognize the federal income tax exemption for capital contributions from state and local governments to partnerships. This decision discriminates against non-corporate entities and significantly limits the amount of state and local funds available to underserved markets, effectively discouraging real estate partnerships from investing in areas with the greatest need. Legislation that explicitly extends the application of Section 118 to all entity types is required to support much needed private sector investment in critical economic development projects.

In these cases, the federal government is inappropriately taxing state and local tax revenues that are deployed for economic development and infrastructure projects. It does not make sense, and it stops development projects mid-stream, as the immediate tax liability creates economic feasibility problems or requires the state or local government to make up the capital deficiency.

Current Activity: On March 7, 2017, Representatives Pat Tiberi (R-OH). Jason Smith (R-MO) and Danny Davis (D-IL), introduced H.R. 1416, the Preserving Investment in Neighborhoods Act, to extend the tax exemption of state and local government capital contributions to all entity types.

Rationale: An immediate federal income tax on state and local tax incentives limits the amount of investment that partnerships can make in underserved areas. State and local governments will be forced to offset the difference in order to attract economic development projects and the related revenues. The IRS position on Section 118 represents an inappropriate transfer of state and local government revenue to the federal government.

Summary: The IRS currently does not extend federal income tax exemptions to partnerships on capital contributions from state and local governments under Section 118(a). This decision, at a minimum, significantly limits the impact of state and local tax incentives for underserved markets and effectively discourages real estate partnerships from investing in areas with the greatest need. Therefore, H.R. 1416 explicitly extends the application of Section 118 principles to partnerships. This change is necessary to support much needed private sector investment in critical economic development projects.