Clarify Section 118 of the Internal Revenue Code to Encourage Private Sector Investment in Underserved Areas

- To encourage economic development in underserved areas, state and local governments provide financial incentives in the form of capital contributions through means such as tax increment financing ("TIF"). Often these incentives are necessary to make a project economically viable.

    - In a typical TIF, a state or local government provides funds for private investment based on future property and/or sales tax revenues resulting from such investment.

    For example, a municipality may provide funds to a developer for the rehabilitation of a substandard commercial building based on the future (and enhanced) property and/or sales tax revenues generated by the rehabilitated building, which are expected to more than offset the incentives originally provided by the municipality.

- Unfortunately, the usefulness and effectiveness of these important economic development tools has been threatened by the IRS's narrow interpretation of Section 118 principles by not applying income tax exemptions to partnerships who receive capital contributions such as TIFs.

    - Based on common law and practices, all business entities, including partnerships, should not be subject to federal income taxes upon the receipt of a capital contribution such as a TIF.

    - Under Section 118, corporations are not subject to immediate federal income tax upon the receipt of a capital contribution such as a TIF.

    - There is no policy rationale for the disparate treatment of corporations and partnerships with respect to the receipt of capital contributions such as TIFs.

- The IRS's position is problematic because many of the investors in underserved areas are typically organized as real estate partnerships.

- An immediate federal income tax on state and local tax incentives will limit the amount of investment that partnerships can make in underserved areas and put more pressure on state and local governments to make up the difference.

- The decision to not apply Section 118 principles to partnerships by the IRS also represents an inappropriate transfer of state and local government funds to the federal government, reducing the benefits of a TIF.

    For example, if a state or local government provides a TIF of $100 and the partners are subject to a 35% tax rate, $35 of the TIF is paid to the federal government as income tax, leaving only $65 to be invested.

    - Such a transfer of state and local government funds to the federal government is particularly troubling considering that the federal government has reduced its financial support of state and local economic development initiatives. As a result, many state and local governments that have been particularly impacted by the recent economic downturn and are looking to property and/or sales tax revenue generated by commercial development to make up for losses in residential property tax revenue.

- Legislation should clarify Section 118 to provide that partnerships, like corporations, are not subject to immediate federal income tax upon the receipt of a state or local economic development incentive in the form of capital contribution such as a TIF. Such clarifying legislation would encourage private sector investment in underserved areas and make sure that state and local governments are receiving the maximum benefits from their investments.