



Client Alert

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IRS GUIDELINES NARROW EXCLUSION OF STATE AND LOCAL INCENTIVES FOR DEVELOPERS

Section 118 provides an exclusion from the income of a corporation for capital contributions made by parties other than shareholders. For many years, developers utilized Section 118, particularly for urban renewal projects. State and local governments provided incentives that were treated as capital contributions to the development entity, which excluded them from income.

About five years ago, the Internal Revenue Service began a study of Section 118. It has since issued a number of public statements about that statute.

From what can be seen, the result of the Internal Revenue Service study was an institutional decision to narrow the exclusion as much as possible. There has been a series of announcements, most of which have focused on what is not available for exclusion.

The Internal Revenue Service recently issued two Audit Technique Guidelines that further the trend of narrowing the utility of Section 118. One states definitively that Section 118 is available only for a corporation, not for an LLC or a partnership. The other states that the Internal Revenue Service will not accept a gambit that has recently been in vogue, where a corporation utilizes Section 118 to deduct its state and local taxes, even though it receives abatements or reductions of those taxes.

If you are receiving state or local incentives in exchange for development, make sure you know the tax rules while you are planning the capital structure of the development entity.

IRS Circular 230 Notice

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