

CLIENT ALERT

IRS Expands Audit Campaigns to Include Economic Development Incentives

November 8, 2017

On November 3, 2017, the [IRS announced](#) 11 additional issue-focused compliance campaigns. The IRS had previously announced 13 compliance campaigns in January of 2017. The campaigns are part of the IRS Large Business and International Division's move towards issue-based examinations.

One of the new campaigns focuses on taxpayers' treatment of government economic incentives, including refundable credits, credits against other business taxes (*e.g.*, payroll tax), nonrefundable credits, transfers of property, including land, and grants, including cash payments.

The economic development incentives campaign is directed at taxpayers who claim the benefits of Section 118 of the Internal Revenue Code, which excludes nonshareholder capital contributions from gross income. The Supreme Court has held that location inducements in the form of land contributions and cash grants are nonshareholder capital contributions under Section 118. Moreover, Treas. Reg. § 1.118-1 provides that nonshareholder capital contributions include contributions for the purpose of inducing a corporation to locate its business in a particular community or to enable a corporation to expand existing operations.

It is unclear if the IRS seeks to challenge the Supreme Court cases under Section 118. However, it has been clear for some time that the IRS hopes to limit a taxpayer's ability to take advantage of the cases and Treas. Reg. § 1.118-1. In its announcement, the IRS states that the economic development incentives campaign is warranted because taxpayers "may improperly treat government incentives as non-shareholder capital contributions, exclude them from gross income and claim a tax deduction without offsetting it by the tax credit received." It is unknown how expansive or aggressive the IRS's economic development incentives campaign will be. However, the inclusion of land contributions and cash grants suggests an aggressive campaign.

The IRS's position is at odds with recent statements made by the Ways and Means Committee Majority Tax Staff. On November 2, 2017, House Republicans announced their tax reform bill, the Tax Cuts and Jobs Act (H.R. 1), which would eliminate the exclusion for nonshareholder capital contributions. In its [Section-by-Section Summary](#) of the bill, the Ways and Means Committee Majority Tax Staff states that eliminating the exclusion removes a federal tax subsidy for state and local governments to offer incentives and concessions to businesses that locate operations within their jurisdictions. Accordingly, the Committee recognizes that, under current law, Section 118 can apply to state and local economic development incentives.

This campaign is relevant for both taxpayers who have received economic development incentives and taxpayers who are or will be seeking such incentives. Taxpayers who have received incentives should be prepared for an issue-focused examination with an aggressive IRS. Taxpayers negotiating economic development incentives should be aware that certain incentives are harder for the IRS to challenge and that there are steps they can take to make it more likely the incentives qualify as nonshareholder capital contribution. Also, taxpayers negotiating such incentives will need to be aware of possible legislative changes to Section 118.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

David B. Blair

Partner – Washington, D.C.

Phone: +1 202.624.2765

Email: dblair@crowell.com

Dwight N. Mersereau

Partner – Washington, D.C.

Phone: +1 202.624.2856

Email: dmersereau@crowell.com