APPEALS

TECHNICAL GUIDANCE PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY:	All Industries
ISSUE:	Exclusion of Income: Non-Corporate Entities and Contributions to Capital, I.R.C. § 118
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UIL NO:	118.01-02
FACTUAL/LEGAL ISSUE:	Legal

APPROVED:

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Director, Technical Services **DATE**
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EFFECTIVE DATE: March 2, 2011

APPEALS SETTLEMENT GUIDELINE
ALL INDUSTRIES

Exclusion of Income:
Non-Corporate Entities and Contributions to Capital
UIL: 118.01-02

STATEMENT OF ISSUE:

Whether partnerships and other entities, not classified as corporations for Federal tax purposes, (non-corporate entities) may exclude from gross income amounts received from a non-owner under I.R.C. § 118(a) or any common law contribution to capital doctrine?

Compliance position regarding these issues is as stated in the LMSB Coordinated Issue Paper LMSB4-1008-051, Exclusion of Income: Non-Corporate Entities and Contributions to Capital, effective date November 18, 2008. [1] Taxpayer position is based on comments provided by stakeholders to the draft of the subject CIP and taxpayer protests regarding this issue.

COMPLIANCE POSITION:

Neither I.R.C. § 118(a) nor any common law contribution to capital doctrine permits the exclusion from gross income of amounts paid to non-corporate entities by a non-owner.

INDUSTRY/TAXPAYER POSITION:

If the transfer of funds or property constitutes a contribution to capital under the criteria established in case law, it does not matter whether the form of the entity receiving the funds or property is a partnership or other non-corporate entity.

DISCUSSION:

BACKGROUND

The specific terms in I.R.C. § 118(a) provide only for the exclusion of non-shareholder contributions to capital to corporations. Third party contributions to capital for non-corporate entities are not addressed by I.R.C. § 118. Compliance has taken the position that when I.R.C. § 118(a) was enacted codifying the existing case law, Congress effectively "pre-empted the issue of excluding contributions to the capital of partnerships from gross income."[2] However, taxpayers operating in non-corporate form have taken the position that an exclusion from income is available in the case of

[1] The CIP can be reviewed by visiting the LMSB Website at: http://www.irs.gov/businesses/article/0,,id=200263,00.html
[2] LMSB CIP LMSB4-1008-051 effective date November 18, 2008, 2008 WL 4960262.

contributions to capital, under a “common law contribution to capital doctrine.” Taxpayers operating as state law partnerships, and limited liability companies classified as partnerships for Federal tax purposes, have made this argument, for example, with respect to Universal Service Fund payments, and in regards to federal, state and local subsidies, grants, and other types of inducement payments.

LEGAL ANALYSIS

I.R.C. § 118(a) provides that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. This code section deals with situations where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. Since contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services.

Treas. Reg. § 1.118-1 provides for an exclusion from gross income for contributions of money or property to the capital of a corporation. The exclusion applies to 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. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production.

In Edwards v. Cuba Railroad Co., 268 U.S. 628 (1925), the first major case addressing the proper treatment of non-shareholder contribution to capital cases, the Supreme Court held that government subsidies provided to induce the construction of facilities were not taxable income. Cuba Railroad, along with the 1939 Code and predecessor statutes, created an opportunity for a corporation to receive basis in an asset acquired via a non-shareholder contribution to capital. A corporate taxpayer receiving property from a nonshareholder as a contribution to capital, not only received the property free from income tax, but also received the contributors’ basis in the subject property. As a result, corporations had the opportunity to claim a double benefit (exclude contributed amount and claim depreciation expense on the contributed asset). To remove the potential for a double benefit, Congress codified existing case law in 1954 by enacting I.R.C. § 118(a) (specifically providing for an exclusion from income for certain capital contributions to corporations) and reversed case law and related statutory provisions regarding basis by enacting I.R.C. § 362(c) (requiring a reduction to basis in contributed assets).

In the LMSB CIP (LMSB4-1008-051, 2008 WL 4960262), Compliance takes the position that the plain language of I.R.C. § 118(a) limits the scope of the provision to corporations. In support of this position, Compliance points out that all applicable case law concerning capital contributions preceding the enactment of I.R.C. §§118 and 362(c) pertained only to corporations, and not partnerships or other non-corporate entities. Additionally, Compliance in its CIP cites the legislative history regarding I.R.C. § 118 as support that Congressional intent was to place in the code court decisions made on the subject, as follows:

> Beyond the clear and plain meaning of I.R.C. §118 which does not extend exclusion treatment of income to non-corporate entities for capital contributions, the legislative history regarding these provisions unambiguously indicates that Congress limited the scope of the statutory provisions to businesses operating in corporate form, because that is precisely what the pre-existing case law addressed. Specifically, in S. Rep. No. 83-1622, at 4648 (1954), Congress elaborated:
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> > [I]n the case of a corporation, gross income is not to include any contribution to the capital of the taxpayer. This in effect places in the code the court decisions on this subject. It deals with cases where a contribution is made to a corporation by a governmental unit . . . or other . . . having no proprietary interest in the corporation.
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> Similarly in H.R. Rep. No. 83-1337, at 4042 (1954), Congress also noted that:
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> > [I]n the case of a corporation, gross income is not to include any contribution to the capital of the taxpayer. This in effect places in the code the court decisions on this subject.

Furthermore, Compliance asserts that in enacting I.R.C. §§ 118 and 362(c) in 1954, Congress effectively pre-empted the issue of excluding contributions to capital of partnerships from gross income. Compliance cites <u>Commissioner v. Kowalski</u>, 434 U.S. 77 (1977) and <u>In Re Chrome Plate v. District Director</u>, 614 F.2d 990 (5th Cir. 1980), <u>aff'g</u> 442 F.Supp. 1023 (W.D. Tex. 1977), <u>cert. denied</u>, 449 U.S. 842 (1980) in support of this position.

The Supreme Court in <u>Kowalski</u> addressed the issue of whether cash payments designated as meal allowances for state police troopers are included in gross income under I.R.C. § 61, and, if includible, whether the subject allowances are excludible under I.R.C. § 119. The Court held that absent a specific exemption, the meal allowance payments are includible in gross income, and that no reliance could be placed on a convenience of employer doctrine to allow exclusion from gross income. In reaching this conclusion, the Court analyzed the legislative history of I.R.C. § 119 and determined that Congress intended to modify prior law; therefore, I.R.C. § 119 must be construed as a replacement for prior law. <u>Kowalski</u>, 434 U.S. at 78. Additionally, it was argued that it is unfair that members of the military may exclude similar allowances while state police troopers may not. The Court indicated that while this may be true, “arguments of equity have little force in construing the boundaries of exclusions and deductions from income many of which, to be administrable, must be arbitrary.” Id. at 96.

Similarly, in Chrome Plate, the Court of Appeals held that a judicially developed rule, the Kimbell-Diamond doctrine, is extinct under the 1954 code regarding corporate taxpayers. Chrome Plate, 614 F.2d at 1000. The Court of Appeals reasoned that Congress was well aware of the Kimbell-Diamond doctrine and the intent requirement, yet Congress provided only one exception to the carryover basis rule, the exception found in I.R.C. § 334(b)(2). Id. at 999. Regarding the logic of applying I.R.C. § 334(b)(2) to corporations and not to individuals, the Court of Appeals addressed this as follows:

> Although it may seem anomalous, that does not give this court the right to twist the meaning of a statute which clearly requires satisfaction of certain prerequisites before a cost basis may be obtained. Congress either ignored or chose to exclude the individual taxpayers, but we may not assume from either alternative that this court thus has the right to equalize the situation. Congress has specifically provided for corporate taxpayers, and we are bound by that legislation.

Id. at 1000.

Taxpayers do not agree with this conclusion. Taxpayers assert that silence by the Supreme Court regarding the treatment of other entity forms in those cases addressing the non-shareholder contribution to capital issue does not “pre-empt” the application of this same common law reasoning to non-corporate entities. Several points were offered in support of this position:

(1) I.R.C. §§ 118 and 362(c) were enacted to address a narrow issue. These code sections were enacted in response to concern that the contribution to capital exclusion coupled with the carryover basis provided corporations with a double benefit (exclusion of income without corresponding basis reduction resulted in permanent deferral of income). Taxpayers assert that because a similar problem (double benefit) does not arise when a contribution is made to the capital of a non-corporate taxpayer (no statutory provision allowing carryover basis), no inference can be drawn from the enactment of these codes sections regarding the application of common law doctrine regarding non-shareholder contributions to capital.

I.R.C. §§ 118 and 362(c) specifically address corporations. Whether Congress ignored other forms of entity or deliberately chose to exclude other forms of entity from this provision is not known.

(2) I.R.C. § 118 does not expressly limit application of the common law doctrine to corporations. The legislative history states that I.R.C. § 118 places in the code, court

decisions regarding contributions to capital by non-shareholders. Taxpayers hold that absent an express statement that the statute intended to remove any rights from the non-corporate taxpayer, the common-law contribution to capital doctrine remains in effect. Taxpayers assert that inducements qualify for exclusion from gross income under the common law criteria developed in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973) (CB&Q), (establishing characteristics that need to be present for a payment or contribution to qualify as a non-shareholder contribution to capital), and other cases which considered the subject of contributions to capital in the non-shareholder context (see Detroit Edison Co. v. C.I.R., 319 U.S. 98 (1943), Brown Shoe Co. Inc. v. C.I.R., 339 U.S. 583 (1950)).

Taxpayers make a valid point that the criteria used to characterize a transfer of property or money as a contribution to capital would be the same regardless of the entity form. However, based on the Kowalski and Chrome Plate decisions (where the Court refused to allow a common-law argument once a specific statute was enacted), it is unlikely that the exclusion from income provided by I.R.C. § 118 would be extended beyond corporations, as provided in the plain reading of the statute, to non-corporate entities.

(3) Expanded definition of gross income did not eviscerate Cuba Railroad, 268 U.S. 628 (1925). Taxpayers assert that Cuba Railroad is a landmark case in which the Court held that contributions to capital are not income. Taxpayers point out that this case has not been overruled and is still cited by the Service as well as others.

Cuba Railroad is the genesis of the capital contribution doctrine. The Supreme Court ruled that payments received from the Cuban government which were proportional to the mileage completed in the construction of a railroad represented a reimbursement of capital expenditures. When Cuba Railroad was decided, the judicial definition of income was limited to "… gain derived from capital, from labor, or from both combined…" Eisner v. Macomber, 252 U.S. 189, 207 (1920). The Supreme Court, relying on this definition, determined that the subsidy payments were not to be used for the payment of dividends, interest or anything else properly chargeable to or payable out of earnings or income; were not for services and were not profits from the operation of the railroad; therefore, did not constitute income within the meaning of the Sixteenth Amendment. Cuba Railroad, 268 U.S. at 633. Subsequent court decisions and statutory changes expanded the definition of gross income rendering the constitutional basis for the Cuba Railroad decision invalid. See C.I.R. v. Glenshaw Glass, 348 U.S. 426 (1955) (holding that a damage award was income). Cuba Railroad continues to be cited for this contribution to capital issue and the functional use test. Cuba Railroad, 268 U.S. at 631-633. The functional use test requires examination of the subsidy's function to determine if the subsidy represents a reimbursement of capital expenditures. United States v. Coastal Utilities, 483 F. Supp. 2d 1232 (S.D. Ga 2007) aff'd 514 F.3d 1184 (11th Cir. 2008), at 1239. However, the Court has moved away from the functional use test. In Detroit Edison Co. v. C.I.R., 319 U.S. 98 (1943) and Brown Shoe Co. v. C.I.R., 339 U.S. 583 (1950), the Court developed a contributor motivation test which focused on the intent of the contributor rather than the function of the payments to determine whether the payments represented contributions to capital.

(4) General inducements are not income. Taxpayers assert that some inducement items are not considered gross income regardless of the form of the entity receiving the inducement. Examples provided were purchase price adjustments where one party to a transaction provides consideration to induce another party to acquire or retain property. The courts have held that the inducement should be excluded from income and a reduction to basis in the affected property required. In James Brown v. C.I.R., 10 B.T.A. 1036 (1928) the court held that payment by a third party to Brown to induce purchase of stock was a reduction in the basis of stock, not gross income. In Freedom Newspapers, Inc. v. Commissioner, T.C. Memo 1977-429 (1977) the court held that payment by a broker to Freedom to induce the purchase of newspapers from a third party was a reduction in the price when all agreements were considered together as one transaction, and was not gross income.

The case law described as the “general inducement principle” cited by taxpayers is distinguishable from the typical capital contribution fact pattern and does not support a common law argument that inducements received by non-corporate entities are excludible from income. In the cases cited, the courts determined the inducement payments were part of the sale/purchase transaction. Treas. Reg. § 1.118-1 describes the typical contribution to capital situation – a corporation needs additional funds to conduct its business operations and obtains these funds from its shareholders. Cases cited above by taxpayers in support of a general inducement principle involve a sale of an asset between private parties. Since the intent of the inducement is to facilitate the sale/purchase, the inducement payment results in a direct benefit to the payer. This is distinguishable from a non-shareholder contribution to capital where an inducement or grant payment is made to increase the capital of the recipient and the contributor expects to derive an indirect benefit.

SETTLEMENT GUIDELINES:

Based upon evaluation of the relevant judicial precedents, the hazard to the government’s position is whether a court would apply the definition developed through case law of a “non-shareholder contribution to capital” for corporations to non-corporate entities. The plain language of I.R.C. § 118(a) limits the application of the exclusion for non-shareholder contributions to capital from income to corporations. Cases leading up to the enactment of I.R.C. § 118(a) regarding the non-shareholder contribution to capital issue did not address the form of the entity and, therefore, provide no guidance regarding non-corporate entities or support for applying this exclusion to non-corporate entities. The decisions in Chrome Plate and Kowalski indicate that the Court would not support a common-law argument when a statute has been enacted specifically limiting the exclusion to corporate entities. Hence, Appeals concludes that the chances are remote that a court would apply the definition developed through case law of a “non-shareholder contribution to capital” for corporations to non-corporate entities allowing an exclusion from income.

I.R.C. § 61(a) provides a general definition that except as otherwise provided, gross income means all income from whatever source derived. The Supreme Court has ruled payments which constitute accessions to wealth, clearly realized, and over which the taxpayers have complete dominion fall squarely within the definition of income and the intent of Congress was for this code section to have a pervasive and broad scope. C.I.R. vs. Glenshaw Glass, 348 U.S. 426 (1955) (holding that penalty payments were not gifts and did not fall within any other exemptions from gross income). More specifically, the court has held that payments by the government to reimburse a taxpayer for expenditures to construct or purchase property or to make repairs were income to the recipient. Baboquivari Cattle Co. v. Commissioner, 135 F.2d 114 (9th Cir. 1943) (where the taxpayer's unfettered use of the funds received was an important factor in determining that the funds were includable in income). Where the taxpayer has complete dominion and control over the funds or property received, hazards strongly favor the determination that "contributions" received by non-corporate entities which represent an accession to wealth will be considered gross income.

While I.R.C. § 61(a) provides a broad definition of "gross income" and the Supreme Court has repeatedly emphasized the "sweeping scope" of this section; the Supreme Court has also emphasized the corollary, namely, the "default rule of statutory interpretation that exclusions from income must be narrowly construed". Commissioner v. Schleier, 515 U.S. 323, 328 (1995). Therefore, as I.R.C. § 118(a) is an exclusionary provision; it must be narrowly construed in determining whether government inducement payments qualify as contributions to capital. The Supreme Court has narrowly construed the exclusion of income for nonshareholder contributions to capital. Both situations where the Supreme Court approved non-shareholder payments as contributions to capital were prior to Glenshaw Glass. See Cuba Railroad (1925) (holding government subsidies were received for capital expenditures) and (Brown Shoe Co. (1950) (holding community and civic group donations were made to induce a business to locate in a particular area).

Non-corporate entities can not rely on I.R.C. § 118 to exclude funds or properties received from non-owners from gross income. Case law preceding the enactment of I.R.C. § 118 did not address the form of the entity. There is no clear provision allowing non-corporate entities to exclude non-shareholder contributions to capital from income. As discussed earlier, it is unlikely that the exclusion from income provided by I.R.C. § 118 would be extended beyond corporations, as provided in the plain reading of the statute, to non-corporate entities.

In addition, the type of entity is clearly a choice made by the taxpayer with the associated benefits and burdens. The Second Circuit Court of Appeals held that when "knowledgeable parties cast their transaction voluntarily into a certain formal structure … they should be and are, bound by the tax consequences of the particular type of transaction which they created." Federal Bulk Carriers, Inc. v. Commissioner, 558 F2d 128, 130 (2nd Cir. 1977). The Supreme Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not. Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974). By choosing to operate as a non-corporate entity, the taxpayer has, in effect, elected that the exclusionary provision of I.R.C. § 118(a) does not apply.

Based upon evaluation of the relevant and judicial precedents as described above, the government's hazards are de minimis. Taxpayer's full concession of the issue is the appropriate resolution.