Tax Consequences of Contributions to Corporations to induce Favorable Location

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TAX CONSEQUENCES OF CONTRIBUTIONS TO CORPORATIONS TO INDUCE FAVORABLE LOCATION

One of the expedients to which civic groups of a local community may resort to induce industry to settle in its particular area is the granting of cash, land, and/or buildings to the incoming business. As more and more Southern communities bid for the favor of spreading industrialism, given hope by both military and economic arguments for dispersion of industry in the atomic era, it becomes increasingly important to consider the tax consequences of such a grant to the corporation the community desires to flourish in its midst. A correspondingly growing body of federal tax law indicates certain factors to be given consideration when making such grants.

The courts have found it difficult to determine the tax classification into which such subsidies should fall. The usual contention of the Commissioner is that they are ordinary income, and as such fully taxable. In turn the taxpayer argues them to be either 1) gifts, in which case there is no income tax liability and in addition the assets may be depreciated at the tax basis of the transferor,[1] or 2) "contributions to capital," in which case there may be a similar depreciation[2] and the transferor's basis may be included in taxpayer's "equity invested capital" when computing excess profits taxes.[3]

The uniform view has been that aids and grants, whether extended by the federal government,[4] local community groups,[5] or private individuals,[6] are not gifts where they are granted only in return for location in the area, lower rates, or extension of services. The nature of the case is determinative of whether they are to be considered ordinary income or contributions to capital.

In *Edwards v. Cuba Railroad,*[7] the Cuban government subsidized the taxpayer railroad in return for taxpayer's building trackage and agreeing to extend reduced rates to government personnel. The subsidies were credited by the railroad to surplus and used directly for capital expenditures. The court found them to be neither gifts nor income, but rather contributions to capital, since they were "proportionate to mileage completed, and this indicates a purpose to reimburse plaintiff for capital expenditures."[8]

In the *Detroit Edison* case[9] taxpayer sought to justify a deduction for depreciation computed on a basis including the payments in controversy, claiming them to be either gifts or contributions to capital. Taxpayer was engaged in generating and selling electric energy in Detroit and vicinity. Upon receipt of applications for the extension of its already existing lines to places it considered too far from those lines to warrant the expenditures involved, it required the applicant to pay a sum representing the cost per mile of constructing the lines, with a stipulation for refunds over a given period of time. The court held that while all expenditures having a reasonable relationship to the asset are part of its cost, so must all receipts having a similar relationship be deducted from that cost, and that the contributions by prospective users of the facilities were of the latter nature. Thus those contributions were excluded from the cost basis of the asset. The court also found the contributions to be neither gifts nor contributions to capital because "it overtaxes the imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the company."[10] According to one writer, *Detroit Edison* suggests that a payment will not be considered a contribution to capital if exacted from a prospective customer as a prerequisite to doing business with him.[11] The court did not have before it the question of whether the contributions were in the nature of ordinary income, a circumstance which seems likely.

A leading case in which subsidies were treated as income is *Baboquivari Cattle Co. v. Comm.*[12] There the taxpayer qualified for payments under the federal Soil Conservation Act by making capital improvements to land he had leased from the government. The payments, which amounted to less than taxpayer's expenditures, were computed with reference to acreage of the land involved and number of cattle grazed thereon. The court, finding that taxpayer was free to use the money for any purpose he desired, whether to defray operating expenses or pay dividends, concluded the payments were within the broad definition of income under §22(a) of the Code. The inference to be drawn from the case is that the court considered the capital outlays as only conditions precedent to qualification for subsidies designed to supplement taxpayer's ordinary income.

Where such subsidies are designed primarily to supplement ordinary income, they are uniformly held taxable as income themselves, as for example, where each year a ferry company was subsidized $1000 per mile of its 23-mile run,[13] where a government subsidy was designed to provide a minimum of "guaranteed operating income,"[14] and where taxpayer, having agreed to deposit $250,000 in a special fund set aside for capital expenditures, was granted a contract with the Postmaster General giving him the right to carry the mails at rates substantially higher than usual.[15]

One of the latest and most important decisions in the field is *Brown Shoe Co. v. Comm.,*[16] a proceeding for redetermination of taxpayer's excess profits tax. The issue arose from the payment of cash and the transfer of buildings to the taxpayer by certain community groups as an inducement to the location or expansion of taxpayer's factory operations in the communities concerned. Taxpayer had received in 17 transactions some $885,559 in cash and $85,471 in buildings from various groups in 12 towns, a majority of the transfers being pursuant to written contracts between the parties. These contracts were of three types, requiring taxpayer to either 1) locate, equip, or enlarge a factory in the community and run it for ten years if practical, 2) enlarge an existing factory and run it for ten years with increased personnel, or 3) construct an addition to taxpayer's existing factory. The sums received by taxpayer pursuant to the contracts were placed in a general bank account from which general operating expenses, including costs of expansion, were paid. Taxpayer contended the contributions were contributions to capital within the meaning of that phrase in both the income and excess profits tax statutes. Therefore, said taxpayer, the basis for depreciation of the acquired buildings need not be reduced by the value of the contributions as was done in *Detroit Edison,* nor need those sums be excluded from "equity invested capital" in computing excess profits taxes. With this contention the Supreme Court agreed. Relying on another recent case,[17] the court asserted, contrary to the decision of the Tax Court, that contributions to capital need not originate with persons having a proprietary interest in the corporation. It found no difficulty in distinguishing *Detroit Edison,* noting that in the latter case consideration had run from the taxpayer to the individual contributor in the form of special services for which the contributor was paying, while in *Brown Shoe* the consideration ran to the benefit of the community at large. The court felt there should be no distinction in treatment afforded actually contributed buildings and cash donated to the company which may or may not have been traceable into buildings later purchased, although the Tax Court had seen such a distinction.[18]

In the light of the *Brown Shoe* decision, and the *McKay Products* case upon which it depends,[19] it would seem that, in spite of the inference in *Detroit Edison,* a donation may qualify as a contribution to capital although the contributor is a non-shareholder. It would appear, too, in spite of strong language in the *Baboquivari* decision, that it is not fatal that such contributions cannot be traced directly into capital expenditures of the corporation. Yet these factors are important when the nature of the transaction hints at a grant designed to supplement income or one coerced from the individual by the favorable position of the corporation.

It is evident that the courts have sought to give subsidy situations the most beneficial treatment to the taxpayer where the result of the contributions is to serve the community rather than certain individuals. Thus the favorable decision of the *Cuba Railroad* case will be followed in a *Brown Shoe* situation and the unfavorable results of the *Detroit Edison* case avoided where it is made apparent that the willing desire of the community and not the considered exploitation of the individual is the dominant factor inducing the contribution.

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FOOTNOTES

1. INT. REV. CODE § 113(a) (2).
2. INT. REV. CODE § 113(a) (8) (B).
3. INT. REV. CODE § 437(c).
4. Baboquivari Cattle Co. v. Comm., 135 F. 2d 114 (C. C. A. 9th, 1943).
5. Brown Shoe Co. v. Comm., 339 U. S. 583 (1950); Comm. v. McKay Products Corp., 178 F. 2d 639 (1949).
6. Detroit Edison Co. v. Comm., 319 U. S. 98 (1943).
7. 268 U. S. 628 (1925).
8. Id. at 632.
9. 319 U. S. 98 (1943).
10. Id. at 102.
11. See O'Meara, *Contributions to Capital by Non-Shareholders,* 3 TAX LAW REVIEW 568 (1948).
12. 135 F. 2d 114 (C. C. A. 9th, 1943).
13. Helvering v. Clairborne-Annapolis Ferry Co., 93 F. 2d 875 (C. C. A. 4th, 1938).
14. Texas & Pacific Ry. Co. v. U. S., 286 U. S. 285, 76 L. Ed. 1108 (1932).
15. Lykes Bros. Steamship Co., Inc. v. Comm., 42 B. T. A. 1395 (1940).
16. 339 U. S. 583 (1950).
17. Comm. v. McKay Products Corp., 178 F. 2d 639 (1949).
18. 10 T. C. 35 (1948).
19. See note 17, *supra.*