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EXCLUSION OF INCOME: NON-CORPORATE ENTITIES AND CONTRIBUTIONS TO CAPITAL

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ISSUE:

Whether partnerships and other entities that are not classified as corporations for Federal tax purposes (non-corporate entities) can use section 118(a) of the Internal Revenue Code or any common law contribution to capital doctrine to exclude amounts received from a non-owner from gross income.

CONCLUSION:

Neither section 118 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.

FACTS:

Taxpayers operating in both corporate and non-corporate form have taken the position that an exclusion from income is available under the tax law in the case of contributions to capital, under section 118 and/or under an alleged "common law contribution to capital doctrine." Non-corporate entities, including 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, with respect to federal, state and local subsidies, grants, payments etc., as well as with respect to other miscellaneous section 118 issues.

LAW & ANALYSIS:

In the genesis of capital contribution cases, the Supreme Court held that government subsidies provided to induce the construction of facilities were not taxable income within the meaning of the Sixteenth Amendment in **Edwards v. Cuba Railroad Co.**, 268 U.S. 628 (1925). The Court's opinion in **Cuba Railroad** rested principally on the definition of income adopted five years previously, that is, "income" at the time was considered to be only the gain derived from capital, labor, or both, under **Eisner v. Macomber**, 252 U.S. 189, 207 (1920).

As noted by the Tax Court in **State Farm Road Corporation v. Commissioner**, 65 T.C. 217, 227 (1975), subsequent Supreme Court decisions substantially eviscerated, if not eliminated, the applicability of **Cuba Railroad** to capital contribution cases by the broad sweep accorded section 61 in **Commissioner v. Glenshaw Glass Co.**, 348 U.S. 426 (1955); **General American Investors Co. v. Commissioner**, 348 U.S. 434 (1955); and **Commissioner v. LoBue**, 351 U.S. 243 (1956). Later Supreme Court cases also rendered the reasoning of **Cuba Railroad** obsolete in establishing new standards for evaluating the merits of taxpayers' capital contributions exclusion arguments. **See Texas & Pacific Railway Co. v. United States**, 286 U.S. 285 (1932); and **United States v. Chicago, Burlington, & Quincy Railroad Co.**, 412 U.S. 401 (1973). Nevertheless, the early **Cuba Railroad** case and its progeny, along with the 1939 Code and predecessor statutes, created the anomaly of a corporation receiving basis in the asset(s) acquired with the capital contribution. The result was a potential double benefit to the corporation, exclusion of income upon contribution and depreciation deductions for assets acquired through nontaxable accessions to its wealth.

To address this anomaly, Congress in 1954 codified existing case law on the income side in the form of section 118, specifically providing for an exclusion from income for certain capital contributions to corporations, but reversing the case law and related statutory provisions concerning depreciation deductions by enacting section 362(c), providing for a zero basis for property acquired with nonshareholder capital contributions, and in the case of money contributions, the basis of the property is reduced by the amount of such contributions. In enacting these statutory provisions, Congress effectively pre-empted the issue of excluding contributions to the capital of partnerships from gross income.[1]

Beyond the clear and plain meaning of section 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 preexisting case law addressed. Specifically, in S. Rep. No. 1622, 83rd Congress, 2d Sess. 18 (1954), Congress elaborated:

. . . in 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 . . . (emphasis added).
Similarly in H.R. Rep. No. 1337, 83d Congress, 2d Sess. 17, A-38 (1954), Congress also noted that:
. . . in 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 (emphasis added.)

Indeed, all applicable case law concerning capital contributions preceding the enactment of sections 118 and section 362(c) pertained only to corporations, and not partnerships or other non-corporate entities.

Accordingly, since there is no statutory provision under which payments or other transfers from a third party/non-owner to non-corporate entities can be excluded, such amounts are includable in gross income under section 61[2]. **See Glenshaw Glass, General American Investors**, and **LoBue**; **see also MAS One Ltd. Partnership v. United States**, 271 F. Supp 2d 1061 (S.D. Ohio), **aff'd**, 390 F.3d 427 (6th Cir. 2004).

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1. Compare **Commissioner v. Kowalski**, 434 U.S. 77 (1977) (addressing the replacement by section 119 of prior law excluding amounts under the convenience-of-the-employer doctrine), and **In Re Chrome Plate v. District Director**, 614 F.2d 990 (5th Cir. 1980), **aff'g** 442 F. Supp. 1023 (W.D. Tex. 1977), **cert. denied**, 449 U.S. 842 (1980) (addressing the extinction of the Kimball-Diamond doctrine by section 334(b)(2) and noting its inapplicability to individuals).
2. Note that the determination of whether or not non-corporate entities would receive basis in assets contributed or assets purchased with amounts contributed is not determinative of whether such contribution must be included in gross income under section 61.