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Recent Developments Regarding Contributions to Capital

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A transfer of cash or other property to a corporation or partnership (or to a limited liability company (LLC) classified as a partnership) by one or more persons, in exchange for an ownership interest in the entity (stock or a partnership interest), is generally not includible in the income of the entity for income tax purposes. IRC Sections 721(a) (partnership), 1032(a) (corporation). Sometimes, however, a "non-owner," such as a governmental entity or civic group, will make a contribution to the capital of an entity, without receiving an equity interest in the entity or any other consideration, in order, for example, to facilitate the development of property by the entity in a manner expected to result in a public benefit. The appropriate tax treatment of such transactions, particularly in the case of partnerships, has been uncertain. This article notes two recent developments, one a statutory change, the other a judicial decision, relevant to corporations and partnerships receiving such contributions.

Legislation

Since 1954, and until the enactment of P.L. 115-97 (commonly referred to as the Tax Cuts and Jobs Act, or "TCJA") in December 2017, IRC Section 118(a) provided that, in general, a corporation's gross income did not include any contribution to the capital of the corporation. Under Section 118(b), however, this general exclusion rule did not apply to a "contribution in aid of construction" or (subject to a limited exception relating to public utilities) to any other contribution by a customer.

Section 118 was amended by the TCJA to provide that the exclusion from income will not apply, generally, in respect of any contribution by a governmental entity or civic group after the date of enactment, other than a contribution made by a shareholder in its capacity as a shareholder. (This new exclusion is in addition to the prior exclusion for contributions in aid of construction.) Thus, when a contribution is made to a corporation by a governmental entity or civic group that does not receive an equity interest in the recipient, the amount contributed must be included in the income of the corporation.

The discussion in the Conference Report for the TCJA relating to contributions to capital does not state a specific rationale for this change. It does state that "[t]he conferees intend that section 118, as modified, continue to apply only to corporations."

Partnership Contributions

Section 721 does not address the tax treatment of a capital contribution received by a partnership from a non-partner. The IRS ruled many years ago, in a private letter ruling (which may not be cited as precedent), that a capital contribution by a non-partner, to aid in the development of partnership property, was not includible in the income of the partnership (PLR 8038037 (June 24, 1980)); but subsequent guidance from the IRS has been to the contrary (see TAM 9032001 (Jan. 12, 1990)). This issue was squarely addressed a few weeks ago in *Uniquest Delaware LLC v. United States*, 121 AFTR 2d 2018-1240 (W.D.N.Y. Mar. 27, 2018), in the context of a limited liability company classified as a partnership for federal tax purposes.

Uniquest

In 2006, Uniquest Delaware LLC ("Uniquest") purchased an office building in Buffalo that had been closed due to environmental concerns. After receipt of advice that hoped-for tax credits under the New York State brownfield cleanup program would not be available, Uniquest sought and ultimately obtained from the New York State Empire State Corporation ("NYSESC") grants totaling $11 million to offset, in part, costs incurred to redevelop the property.

Uniquest represented to NYSESC that the redevelopment would result in hundreds of additional jobs. One of Uniquest's grant proposals also acknowledged that the amounts were to be paid not for services provided to the government agencies involved, but "solely for the purpose of obtaining an advantage for the general community."

The grants were paid to Uniquest in 2009. Uniquest did not include the grant funds in its income on its 2009 tax return. On audit, the IRS proposed to increase the income reported by Uniquest for 2009 by the $11 million amount of the grants.

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Uniquest appealed the proposed adjustment to the Appeals Branch of the IRS, which sustained the proposed adjustment, and Uniquest then brought an action in Federal district court for review of the adjustment. The government filed a motion for summary judgment, on the basis that the grant funds were income to Uniquest under IRC Section 61(a) and that there was no applicable exclusion by statute or "common law." Uniquest opposed the government's motion and made a cross-motion for summary judgement. One of the arguments made by Uniquest was that, because its members (disregarding an intermediate tier of LLCs) were themselves corporations (albeit S corporations), the members were entitled to exclude the contributions from income under Section 118.

Discussion

The court first determined that the grants were within the scope of the broad definition of income in Section 61(a). That provision states, in relevant part, that gross income "means all income from whatever source derived," including, but not limited to, categories of income specifically enumerated in Section 61(a). The court also agreed with the government that cases, including *Commissioner v. Glenshaw Glass Co.* (349 U.S. 426 (1955)), which interpreted a predecessor provision to Section 61(a) under the 1939 Code in the context of two corporations, each seeking to exclude from its income amounts received under punitive damage awards, had established that Congress intended to exert "the full measure of its taxing power," and that any accession to wealth was therefore includible in income under the Federal tax statute, absent evidence of specific Congressional intent to exclude the payment from income. The district court rejected Uniquest's argument that the grants should be excluded because they were not included in the categories of income specifically enumerated in Section 61(a), noting that *Glenshaw Glass* and subsequent cases had made clear that the listing of various categories of income in that provision was not intended to exclude other categories of payments from gross income.

Uniquest conceded that Section 721 did not apply to its transaction, because the grant funds were not provided in exchange for an equity interest. The grants were also not gifts excludible from income under IRC Section 102, because they were not made on the basis of a "detached and disinterested generosity," but, rather, on the basis of an intention to encourage development activities expected to benefit the community.

The court also rejected Uniquest's efforts to argue that the amount should be excluded under a "common law inducement doctrine" allegedly established by cases such as *Brown v. Commissioner*, 10 B.T.A. 1036 (1928), in which payments made to induce the recipient to enter into a transaction such as a stock purchase reduced the basis of the property purchased, but were not included in income. The decision asserts that the cases cited by Uniquest in support of such a doctrine were either wrongly decided (and effectively overturned by *Glenshaw Glass*) or held for the taxpayer on the basis of an "inducement to purchase" rationale, a rationale inapplicable in the circumstances before the court, because the grants were approved and disbursed a year or more after the property was purchased in 2006.

The court also rejected Uniquest's arguments for a general common law exclusion for contributions to the capital of a partnership. Although courts held non-shareholder contributions to the capital of corporations to be excludible from income, even prior to the codification of the exclusion in Section 118, on grounds that might conceptually apply equally well to contributions to partnerships, the *Uniquest* decision observes that all of the favorable cases in fact dealt with corporations, and notes that Section 118 by its terms pertains only to corporations.

Uniquest also argued that Section 118 should apply because its members (disregarding intermediate tier LLCs) were corporations, and that, because Uniquest itself is a "pass-through entity," the determination of whether or not the capital contributions were includible in the member corporations' incomes should take into account the tax classification of those members as corporations. The argument was apparently not raised in Uniquest's initial complaint, and the court rejected Uniquest's request for permission to amend its complaint in support of this argument.

The court further concluded that the argument lacked merit because, in this proceeding with respect to an entity under the "unified partnership audit provisions," the only determination the court should make is as to whether the grants were includible in the income of the entity before the court—that is, Uniquest. If the IRS were to assess additional tax against the S corporations or their shareholders after prevailing on the motion for summary judgment, they might raise at that time, in opposition to those assessments, an argument relating to Section 118's being applicable at the member level. (Your authors are less sanguine, and they would be concerned that the government might take the position, in such a later proceeding, for various technical reasons, that this argument could not be raised.)

Observations

The change made by the TCJA to Section 118 has obviously narrowed the scope of the exclusion from income for non-shareholder capital contributions to corporations. *Uniquest*, and the statement in the TCJA Conference Report underscoring that Section 118 is applicable solely to corporations, may cause the courts to be even more reluctant to seriously consider any argument for an exclusion from income of non-partner contributions to partnerships, even in cases in which a corporation would still be entitled to exclude amounts from income under the new provision.

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