‘Contributions to Capital’ From Nonowners

By Calvin H. Johnson

Calvin H. Johnson is a professor of law at the University of Texas. The author wishes to thank Martin McMahon, Michael Schler, Kimberly Blanchard, Harvey Braverman, and Larry Zelenak for help, without binding them to the conclusions.

Under current law, a corporation excludes nonshareholder ‘‘contributions to capital’’ from tax. The proposal would end the exclusion because the transfers from nonshareholders are economic income because they improve the net worth of the corporation and its owners. A transfer from a nonowner is not capital to the corporation in any meaningful sense of the word: The corporation does not have any basis recovered by the transfer, and the amount received does not have to be retained by the corporation as a cushion for creditors. The exclusion and related deduction grant a federal subsidy to transactions that do not merit one. Contributions by shareholders in return for stock or pro rata to stock holdings can properly be excluded because they represent a mere pooling by owners of assets previously held apart from the corporate form, in which case the owners recapture the value given up by value or enhanced value of their stock. Transfers by nonowners, by contrast, are an expenditure, even considering value recaptured by shareholdings. The proposal would apply to partnerships, and to shareholder contributions that are not justified by increase in stock.

The proposal is made as a part of the Shelf Project, a collaboration among tax professionals to develop and perfect proposals to serve Congress when it is ready to raise revenue. Shelf Project proposals should become part of a new Treasury study, like the one that preceded the Tax Reform Act of 1986. Congress faces a revenue crisis because government revenue is at 13.4 percent of GDP, and long-term projections for government spending are at 22.4 percent of GDP, which implies an increase in necessary revenue of 168 percent of current yields. Provisions that are politically impossible in ordinary times become political necessities in a revenue crisis. Shelf Project proposals defend the tax base and improve the rationality and efficiency of the tax system. They are designed to raise revenue without raising rates because the best tax systems have the broadest possible base to allow for the lowest feasible tax rates. A longer description of the Shelf Project is found at ‘‘The Shelf Project: Revenue-Raising Projects That Defend the Tax Base,’’ *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

Section 118 gives a corporation an exemption for a ‘‘contribution to capital’’ received from a nonshareholder or a shareholder not acting as such. A typical transaction within the exemption is a transfer by a local government or business group to a corporation to induce the corporation to locate its factory in the locality. The exemption dates back to early court decisions suggesting that transfers from governments and other nonshareholders were not ‘‘income,’’ for reasons that now seem unpersuasive.

Contributions from nonowners are income under the now-prevailing economic definition of income because they improve the net worth of the corporation and its owners. The money or assets are received from outsiders without restriction or reservations as to its use. A broad tax base that encompasses all economic income from whatever source derived is superior to a narrower tax base, no matter whether government revenue needs are high or low, because the broader base necessarily keeps tax rates lower by spreading the needed revenue over a broader base.

Ending the exclusion would simplify the law by eliminating complicated and incoherent distinctions the courts are required to make. Current law requires a distinction between payments for specific services and payments for more intangible radiations, between contributions in aid of construction and contributions to support other corporate investments, between payments for corporate investments and payments to make good corporate losses or for corporate expenses, and between payments by potential customers and potential suppliers or employees. Practitioners have complained that the factors used to identify contributions to capital ‘‘do not adequately explain the adverse rulings nor do they provide a basis for distinction.''[1] Whatever ''contribution to capital'' means, nothing encompassed by the term justifies the exclusion when the transfer is from a nonshareholder and improves the net worth of the corporation.

The proposal would tax transfers from a nonowner to a taxpayer entity, even if the transfer qualifies as a contribution to capital under current law. The proposal would continue the exemption for transfers by shareholders in return for stock of the corporation and for pro rata contributions from shareholders when extra stock would be a meaningless gesture. But the proposal would preclude manipulations by taxing contributions from shareholders not acting as such, and it would measure the amount in that nonshareholder capacity as the amount by which the contribution exceeds the amount recaptured by the increase in the value of stock holdings by reason of the transfer.

Repeal of the exemption of contributions to capital would apply to both corporations and partnerships. Lapse of an option to buy corporate stock or partnership interest would give the entity short-term capital gain equal to the amount received for the warrant.

A. Current Law[2]

Section 118 provides that gross income of a corporation does not include any contribution to the capital of the taxpayer from a nonshareholder. According to the regulations, an excluded contribution to capital from a nonshareholder includes, for example, ''the value of land or other property contributed to a corporation by a [local] government unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community or . . . expand its operating facilities.''[3] However, the section 118 exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered[4]:

> Because the contributor expects to derive indirect benefits, the contribution can not be called a gift [which would be a tax exemption under section 102]; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services.[5]

Tax-exempt contributions must have ''no quantifiable correlation with the amounts or extent of the functions performed or services rendered'' by the corporate recipient.[6] The exclusion also does not apply to subsidies paid for the purpose of inducing the corporation to limit production.[7] Exempted contributions to capital, however, must also be the result of bargaining.[8] The bargaining implies that the transferor must be getting back something that is the subject of the bargaining, albeit not something so closely related that the payment is a payment for services. Thus, a requirement that the corporation maintain jobs in the area for a set number of years did not prevent the exclusion under section 118, because the benefit went to the potential employees and not to the local government that made the transfer.[9]

In 1986 Congress cut back the scope of the prior exemption by providing that contributions in aid of construction and payments ''as a customer or potential customer'' would not be treated as tax-exempt contributions.[10] The 1986 amendment reversed the Supreme Court case that had originated the exclusion now codified in section 118. In 1925 the Supreme Court, in *Edwards v. Cuba Railroad*,[11] had held that a contribution to a railroad corporation in 1911-1916 from the government of Cuba to aid and induce the taxpayer to construct and then operate a railroad across Cuba was not income in the constitutional sense. The contributions ''were to be used directly to complete the undertaking.''[12] The 1986 amendment made aids to construction taxable. In 1996, however, Congress partially reversed itself again by allowing exemption for a contribution in aid of construction, but only narrowly, for the benefit of a public utility that provides for water or sewage disposal.[13]

An exempt contribution to capital must become a permanent part of the transferee's working capital.[14] Thus, grants from a government available for the payment of dividends, interest, and operating expense do not qualify as contributions to capital.[15] The exclusion, accordingly, does not cover payments by the Department

[1]James Maule, ''Gross Income: Overview and Conceptual Aspects,'' *Tax Management Portfolio Series* 501-3, at A120 (2009).

[2]Helpful commentary includes Tom Evans, The Taxation of Nonshareholder Contributions to Capital: An Economic Analysis, 45 *Vand. L. Rev.* 1457 (1992) (arguing for taxation of contributions from nonowners in general but for repeal of aid to construction taxation on transaction specific contributions); Kimberly Blanchard, ''The Taxability of Capital Subsidies and Other Targeted Incentives,'' *Tax Notes*, Nov. 8, 1999, p. 781, *Doc 1999-35675, 1999 TNT 215-65* (arguing that there is doubt as to whether partnerships can use the contribution to capital exemption).

[3]Reg. section 1.118-1 (1956).

[4]*Id.*

[5]Senate Finance Committee Report on Internal Revenue Code of 1954, S. Rep. No. 1622 (1954) (explaining the adoption of section 118).

[6]*Board of Trade of the City of Chicago v. Commissioner*, 106 T.C. 369, 381 (1996), *Doc 96-16040, 96 TNT 106-3*.

[7]Reg. section 1.118-1 (1956).

[8]*United States v. Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. 401, 414-515 (1973).

[9]*Frank Holton & Co. v. Commissioner*, 10 B.T.A. 1317 (1928).

[10]Tax Reform Act of 1986, P.L. 99-514, section 824, adding subsection (b) to section 118.

[11]268 U.S. 628 (1925).

[12]*Id.* at 632.

[13]Small Business Job Protection Act of 1996, section 1613, adding subsection (c) to section 118. The utility, however, must exclude the contribution from its rate base, meaning that it cannot charge customers fees attributable to investments financed by the local government or other transferors.

[14]*Chicago, Burlington & Quincy R.R.*, 412 U.S. 401 at 414-515.

[15]*Helvering v. Claiborne-Annapolis Ferry Co.*, 93 F.2d 875 (4th Cir. 1938); *Springfield Street Ry.*, 577 F.2d 700 (Ct. Cl. 1974).

of Transportation Maritime Security Fleet Program because those grants may be used for any corporate purpose.[16] Nor does the exclusion apply to payments by the Department of Energy bioenergy program, because the grants can be used to pay current expenses and are not limited to the acquisition of capital assets.[17] The exclusion does not apply to payments made under the Continued Dumping and Subsidy Offset Act of 2000 because the payments were made to offset losses the taxpayer had suffered from the illegal dumping of its products, rather than to finance new investments.[18] "There is no preexisting checklist of objective factors that can be used as a template for deciding if the payors have an investment" motive,[19] so the courts must look through evidence without a template for which pieces of evidence are relevant to exclusion and which are irrelevant or of little weight.

If a contribution from a nonshareholder is treated as an excluded contribution, then, under section 362(c), the corporation has a zero basis in the contributed property.[20] If an excluded contribution from a nonshareholder is in money, money always has its own basis, but the corporation then must reduce basis in other property the corporation owns by the amount of the money received.[21]

B. Reasons for Change

1. Reasons for income.

a. Improvement to net worth. A transfer to a corporation from a nonshareholder is not appropriately excluded from the corporation's income even when the transfer is considered to be a contribution to capital. A transfer from a nonshareholder is income to the business entity under the standard economic definition of income because it represents an increase of the net worth of the corporation and its owners. The standard definition of economic income is the Haig-Simons definition of income, which provides that income is the sum of amounts consumed plus amounts invested, and plus or minus the change in value of the investments.[22] A contribution from a nonshareholder is an increase in the net worth of the corporation when received.

b. Always a quid pro quo. Current law recognizes that a transfer to the corporation is income if the corporation must perform functions or services tied to the transfer. Section 118 allows exclusion only if there is no direct correlation between services and payment. But even for the excluded contributions, the transferor is getting something from the corporation that motivated the contribution. The outside transferor will always bargain to ensure it is getting its money's worth in the contribution. The recipient corporation must do something to earn both a payment for services and the strings-attached contribution to capital from an outsider. Thus, a requirement that the corporation maintain jobs in the locality for a set period is both the point of the contribution and the required quid pro quo, even if the requirement does not preclude the exclusion. The line between direct and diffuse connection is difficult to draw in theory or practice, and in the end it should make no difference. From the corporation's point of view, the payment is an increase in its net worth no matter what the payer is getting out of the payment. The payer is another taxpayer with no relation to the corporation that has received the contribution.

2. Contributions from owners are different. If it is the shareholders making the contribution to capital in return for stock or pro rata to stock, the contribution is appropriately treated as tax exempt. The corporation is an artificial entity that aggregates the assets of the owners. Contributions from the owners to the entity are just aggregation of the assets, even though the corporation, an artificial entity, is a different taxpayer in the eyes of the tax law. Because a contribution from an owner is just an aggregation, no owner or real person has had an improvement by reason of the contribution, nor has anyone suffered a loss. The shareholders maintain a continuity of interest in their assets in altered form and hold their old assets indirectly. Just as natural marriage is not treated as a gain to either the husband or wife, so accumulation of assets still indirectly owned by the contributors is not considered gain to any contributor or to the artificial entity that receives the contribution. Thus, a corporation never reports gain from the sale of its stock.[23] With contributions from shareholders pro rata to their holdings, issuance of more stock would be a meaningless gesture because new stock would not change the percentage ownership of any shareholder, and the contribution is again a mere aggregation.

Contributions from nonowners are different. If we treat the corporation as a mere artificial entity representing the owners, the owners as a whole have had their net worth improved by contribution. A contribution from an outsider is never just an aggregation of wealth previously held by owners outside the aggregation.

---

[16]FSA 200231015 (June 21, 2002), *Doc 2002-17965*, *2002 TNT 150-33*.

[17]"Characterization of Bioenergy Program Payments," LMSB-04-0308-019 (2008), *Doc 2008-7802*, *2008 TNT 69-58*.

[18]TAM 200434019 (Apr. 19, 2004), *Doc 2004-16849*, *2004 TNT 163-16*.

[19]*Board of Trade of the City of Chicago*, 106 T.C. 369 at 382.

[20]Section 362(c)(1). Section 362(c) was enacted in 1954 to reverse the result in *Brown Shoe v. Commissioner*, 339 U.S. 583 (1950), in which the Supreme Court held that Brown Shoe could both exclude from income and deduct as depreciation amounts received from various local governments and community groups as an inducement to locate a factory in the community. The combination of exclusion and deduction meant that the taxpayer had extra deductions that could shelter unrelated income from tax. *United States v. Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. 401 (1973), avoided the double benefit of both exclusion and deduction, for transfers before the effective date of section 362(c) by finding that railroad overpasses and underpasses constructed for the railroad by governments were not contributions to the capital of the railroad because, among other things, the overpasses and underpasses were constructed for public safety rather than to improve the net worth of the railroad. The taxpayer kept its tax exemption but had no basis in the overpasses and underpasses, as if the local governments had never transferred title or economic benefit to the railroad.

[21]Section 362(c)(2).

[22]Henry C. Simons, *Personal Income Taxation*, 50 (1938).

[23]Section 1032.

3. Distinctions that do not matter. Various arguments and distinctions have been offered to justify the exemption, which do not in fact justify the exemption.

a. Unearned does not matter. Even if the contribution to capital were not earned, that should make no difference. It was once thought that income was amounts earned from capital or labor or both derived. The Court in *Edwards v. Cuba Railroad,* which started the exemption for contributions to capital, seems to have considered the subsidy from the government of Cuba not an earned amount. But under the Haig-Simons definition of income, a taxpayer should pay tax on all improvements to its net worth, whether earned or not. Unearned windfalls, indeed, are excellent things to tax and should be taxed. If a windfall falls like manna from heaven, productive earning activity will not be suppressed by taxing it.[24]

b. No earmarking in a pool. Under current law, a transfer to support the corporation's investments can qualify for exemption, but a transfer to be used for operating expenses, dividends, or to cover past losses precludes the exemption. All of the corporation's assets, however, are part of single pool covering investments, losses, and expenses. If a government pays $100x to a corporation to cover expenses, that means the corporation has $100x to spare to make investments or dividends it would not otherwise be able to make, and if a government pays $100x *for* investment, that frees up $100x that the corporation can use for dividends or expenses. Within a common pool, one cannot maintain an earmarked use of the assets any more than one can say that this drop within a pool of fresh water will be used for drinking, but this other drop will be used for irrigation. Who knows or who cares which drop is which? A contribution to capital improves the common pool and net worth of the corporation as a whole, no matter what the earmark.

c. Suppliers, employees, and customers are alike. Current law prohibits the exemption for contributions from customers or potential customers, but tolerates the exemption for contributions on or behalf of potential suppliers. Suppliers and customers are just different directions from the taxpayer along a continuous supply line. Why is one exemption prohibited but the other tolerated? Contributions on behalf of employees and potential employees are apparently tolerated as contributions to capital, but are employees that different from suppliers and customers?

d. Initial value no longer matters. It is difficult to think of any meaning of the word ''capital'' that now justifies an exemption to the corporation. Early in the income tax, capital was thought of as the *value* of property at the time it was received by the taxpayer, even if the cost or investment in the property was much lower. For nontax purposes, a corporation states the value of contributed property as the asset recorded on its balance sheet, and that prevents the corporation from reporting gains accrued before the contribution as if the gains were earned by the corporation.[25] Thus in *Edwards v. Cuba Railroad*, which started the exemption for contribution to capital, subsidies from the Republic of Cuba for building a railroad were plausibly considered to be the initial value or starting point for the corporation's business activities.

Consistently, early in the income tax, all taxpayers were given a basis in property held at the time of adoption of the income tax equal to its value at the date of enactment so that gain accrued before enactment would not be taxed even in a sale after enactment.[26] Before 1918, the only statutory provision covering basis provided that basis was the value as of March 13, 1913 (the start of the income tax), and value at the start was considered then to be the normal rule of basis.[27] Thus, before 1921 a gift had a basis equal to value at the time of donation.[28] Before 1924, corporations were given a fair market value basis for property contributed by shareholders even if the shareholders paid no tax on the appreciation built into the contributed property.[29] Before 1954, partnerships acquired a step up in basis for appreciated property contributed to the partnership without the partners paying tax on the gain.[30]

The concept of exempt capital as the starting point value of a contribution has been replaced in evolutionary steps by investment cost as the only exclusion necessary in an income.[31] Capital has been replaced by basis, and ''basis'' in general means the investment cost of the property less allowable depreciation. Basis is now conceptualized as the tax or monetary history of an asset, recording costs incurred but not yet deducted. The only capital in a gift is now the donor's investment, and the only capital in a tax-free transfer is the successor's investment. The corporate taxpayer has no cost for the contribution by the outsider, and so it has no capital to recover. That should end the argument for exemption.

A local government or community group that makes a contribution does have a cost for the contribution to the

[24]Calvin H. Johnson, ''The Illegitimate 'Earned' Requirement in Tax and Nontax Accounting,'' 50 *Tax L. Rev.* 373 (1995), focuses primarily on the timing of taxation of prepaid receipts, but argues that ''earning'' is an illegitimate requirement in both tax and nontax accounting.

[25]Accounting Principles Board, APB Statement No. 4, ''Basic Concepts,'' para. 4 (1964) (measurement of owner's investment is based on the fair market value of contributed assets).

[26]Section 1095.

[27]John Potts, ''Did Your Law Professor Tell You Basis Means Cost?'' 22 *Valparaiso L. Rev*. 233, 241 (1988).

[28]Treasury Reg. 33 (Rev.), art. 4, paras. 41, 44, 20 Treas. Reg. Int. Rev. (1918) reversed by the enactment of what is now section 1015 by the Revenue Act of 1921, section 202(a)(2), providing in general for a carryover of the donor's basis.

[29]*Himelhoch Bros. & Co. v. Commissioner*, 26 B.T.A. 541 (1932) (applying initial value basis for contributions before 1924 and carryover basis thereafter); *Rosenbloom Finance Co. v. Commissioner*, 24 B.T.A. 763, 772 (1931) *rev'd on appeal* (by recharacterizing the transaction as a gift), 66 F.2d 556 (3d Cir. 1933).

[30]*Chisholm v. Commissioner*, 79 F.2d 14 (2d Cir. 1935).

[31]*See, e.g.*, section 1012 (basis is cost, unless otherwise provided). Calvin H. Johnson, ''The Legitimacy of Basis From a Corporation's Own Stock,'' 9 *American J. of Tax Policy* 155, 165-177 (1991), discusses the rise and phasing out of initial value basis.

corporation or partnership, but it would be inappropriate to give the corporation a carryover basis from the contributor. The transfer is not a gift, and the transferor is not a related party or within a single economic unit. Customers cannot give their costs to the corporations to use to avoid tax, and governments making a contribution to capital are just customers with a more diffuse relationship to the corporation. For the corporation, the contribution is new money and should be taxed as such.

e. Not a cushion for creditors. ''Capital'' in nontax law usually means the excess value of assets over debts that a corporation must keep as a cushion for the protection of creditors. A corporation may not make a distribution that impairs capital but must keep enough accounting assets so that the assets are greater than all debts and also greater than the corporation's required capital. Traditionally, capital was par value of a share — often $100 — multiplied by shares outstanding. Currently, however, corporations issue zero par or penny par stock, and the capital that must not be distributed is just the capital as stated by the board of directors with some nominal state-mandated minimum capital. When a contribution comes from an outsider, however, the corporation has no increase in the cushion that it must maintain for creditors. All contributions from nonowners are no par and entail no necessary addition to the cushion for creditors.[32]

4. Inappropriate subsidy.[33]

a. Exemption-deduction combination. Tax exemption for the contribution to capital from nonowners usually means not just a shield for the corporation, but a tax sword; that is, the transaction as a whole is a tax shelter used against unrelated income. A payment by a local government to induce a manufacturer to locate its plant in the locality is a typical contribution to capital under current law. The contributor's usual expectation is that the corporation will give back the net present value of the contribution in the form of increased property or sales taxes over time, or in the form of increased wages to local employees. Thus a $100x contribution is expected to be offset by future taxes and wages worth at least $100x in present value terms, or the contributor is not getting its money's worth. The pattern, however, yields an exemption for the inflow and a tax deduction for the related outflow, and the combination means that a transaction expected to break even in present value terms is reported for tax as if it were a $100x loss (again in present value terms). The loss from the exemption-deduction combination shelters unrelated income from tax. That means the transaction has a higher value after tax than it had before tax, and that the federal government has extended a negative tax or subsidy to the transaction.[34]

The federal government cannot and should not subsidize in any way payments to induce a corporation to locate a plant in one locality at the expense of another. The founding premise of the war for independence in this country was ''United we stand, divided we fall.'' The states, the Founders believed, should not undertake any activity injurious to the citizens of other states.[35] Thus the Articles of Confederation prohibited the states from imposing a ''duty, imposition or restriction'' on any out-of-state American that it did not impose on its own citizens.[36] The constitutional debates are filled with passionate appeals to the norm that it is unfair to favor one state or locality over another.[37] A location incentive hurts all the competitors that lose out. A benefit to one state at the expense of another is inconsistent with deep constitutional norms.

b. Overinvestment even before tax. Tax benefits measured from some appropriate baseline are a ''tax expenditure.'' Residual taxpayers are hurt as badly by a departure from normal tax directed to accomplish some subsidy as they are hurt by government payments. The only meaningful distinction is that government payments are better supervised by the budget process than are tax expenditures, so that tax expenditures tend to be sloppier in focus and less efficient as a government tool. As a matter of best tax policy, the government can not subsidize an activity with a tax expenditure that would be a violation of deep constitutional norms when accomplished with a better focused direct payment. The federal government should not be subsidizing one locality at the expense of another through either payment or tax advantages.

Payments to induce a corporation to locate locally get an overinvestment, even before tax, because of the game theory position of competing localities, which means that they don't have to take into account the losses to other competitors. Assume hypothetically that if a plant is located in community A, its location alone will radiate $102x value in spillover effects in the form of future excess wages beyond what local workers could otherwise make and added local taxes. Assume also the plant will radiate $100x in spillover added future wages and taxes if it located in town B, and $90x in spillover value if it located in C. If we view A, B, and C as part of the same common good, the business should go to A, because that most improves the radiant value of the plant. An economic system that paid the plant corporation just short of $2x to move to A instead of B would be economically efficient because location in A would improve the value of the spillover benefits by $2x compared with the next best alternative.

---

[32] *See, e.g.*, Bayless Manning and James J. Hanks Jr., *Legal Capital*, 33-37 (3d ed. 1990).

[33] Mark Taylor, ''A Proposal to Prohibit Relocation Subsidies,'' 72 *Tex. L. Rev.* 669, 678-685 (1994), argues that investment incentives misallocate capital, and that free market choices uninfluenced by government subsidies are better.

[34] Section 362(c) attempts to take away the combination of exception and deduction for depreciation by giving the recipient taxpayer a zero basis for the contribution, but it does not reach this combination of exemption and deduction.

[35] Publius (James Madison), Federalist No. 44, at 301 (Jacob E. Cooke, ed. 1961).

[36] Art. of Confederation, Art. IV.

[37] Johnson, ''The Panda's Thumb: The Modest and Mercantilist Original Meaning of the Commerce Clause,'' 13 *Wm. & Mary Bill Rts. J.* 1, 46-51 (2004) (collecting appeals to fairness among the states in 1787 period).

The competing localities, however, have a game-position incentive to invest more than the rational $1.99x because they do not have to take into account the losses to competitors. Thus even town C has an incentive to invest just short of $90x in trying to induce the plant to locate in C, and if C were to win, it would damage the overall common good, even while being rational from its own position ignoring A and B. Community A will rationally pay just short of $102x to get a location that, when measured by the common good, improves the value of the radiating spillover benefits by only $2x. Community A might waste money on public relations or psychological warfare that benefits no other member of the economy but is still justified by A's potential to get the benefits of the plant at the expense of competitors B and C. The popularity of local government inducements to locate a plant may well be a product of the failure of a locality to take account of the losses it is inflicting on competing localities and ignoring the common good. Investments of $102x to get $2x extra benefits, judged from the whole, are wasteful investments that should be disincentivized, not subsidized by a federal negative tax or subsidy. Contributions to capital, in any event, are not merit goods deserving a subsidy, but transactions that already get an advantage in excess of the good that they produce.

c. No reduction in internal rate of return. While a contribution might increase future taxes and wages, it is also possible that the corporation captures all or most of the value of the contribution by reason of competition among the localities. Thus assume, at the other end of a scale, that the plant itself captures almost the full value of the $102x radiating values to the community as business profit and that there is no excess to the community beyond what it has paid for. Assume, thus, that the plant will make extra business profit on a $102x contribution and will not be forced to pay out a quid quo pro for the net present value of $102x in the form of extra wages or taxes.

Literally, the extra business profit will be taxed under an income tax when the corporation takes it in. Section 362(c) indeed prevents the corporation from using the $102x contribution as a cost of depreciable basis. Still, the ability to make earnings on a capital investment that has not been taxed means, as a matter of economics, that the internal rate of return (IRR) from the investment is not reduced by tax. The thesis that tax exemption for the initial capital is equivalent to an exemption of the subsequent return from tax, such that the IRR does not go down, is called the Cary Brown thesis after its first describer,[38] and it is one of the building blocks of modern tax economics.

For many, another proof of the Cary Brown thesis is unnecessary, and those readers should proceed to the final paragraph of this ''Reason for Change'' section. To show the Cary Brown thesis applies to section 118, for other readers, assume a $100 investment illustrated in Table 1, which is subject to a one-third tax and which returns 150 percent of investment in some unspecified number of periods. Column (A) represents the normal investment in income tax. The investment comes from earnings (of the corporation or some capital provider), and the cost is capitalized under section 263 so that the investable amount is reduced by tax. Column (B) represents an investment exempted by section 118 as a contribution to capital but generates gain that is fully taxed.

Table 1. 150 Percent Gain Is Tax-Exempt

	(A) Capitalized Investment From Internal Earnings	(B) Investment Exempt From Tax Under Section 118
1. Income at $100	$100	$100
2. Tax on row 1 at ⅓	($33.33)	0
3. Investable amount (row 1 - row 2)	$66.66	$100
4. Investment (row 3) grows 150 percent	**$100**	$150
5. Basis	*$66.66*	0
6. Taxable amount	*$33.33*	$150
7. Tax at ⅓ of row 6	*($11.11)*	($50)
8. End result (row 4 - row 7)	*$88.89*	**$100**

If we exempt the 150 percent gain in column (A) and ignore everything after row 4 (in italics), the end result of capitalization and exemption is $100. But column (B), which did not exempt the income yield, came up with the identical $100 end result. Therefore, the ability to exempt the capital invested is as valuable as the privilege of paying no tax on the profit.

The results of Table 1 can be generalized by algebra if the tax rate at the start of the investment (row 2) is the same as at the end (row 7), if the pretax return is the same on both sides, and if the amount invested is sensitive to the upfront tax cost of column 2:

(A) End Value: Exempting IRR	=	(B) Section 118 Exempt Investment
$\$100 * (1-t) * (1+R)^n * (1-0)$	=	$\$100 * (1-0) * (1+R)^n * (1-t)$
where $100 is unit investment, t is tax rate, $(1+R)^n$ is compound growth at rate R over n periods, and (1-0) denotes no tax.		

The equivalence is an application of the commutative law of the multiplication, which says that the order in which (1-t) and (1-0) appear doesn't matter.

Accordingly, whether we assume that the corporation pays out the value of the contribution as greater wages and taxes or captures the value of the contribution in the form of greater business profits, the tax exemption of the contribution is a privilege or subsidy more generous than ordinary income tax. Contributions to capital are not a

[38]Cary Brown, ''Business-Income Taxation and Investment Incentives,'' in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hanson*, 300 (1948).

meritorious enough transaction to deserve an advantageous tax treatment, whether it amounts to a subsidy or negative tax or merely amounts to the equivalent of tax exemption for business profit.

C. Explanation of the Provision

The proposal would tax contributions to the capital of a corporation or partnership from nonowners. The FMV of any cash or property contributed by the nonowner would be taxable. The proposal would tax both corporations and shareholders.

1. Camouflaged contributions. Ordinarily, the taxable event would be the transfer of ownership. However, to prevent subterfuge, contributions to capital would include the FMV of the economic benefits the corporation receives without receiving title. For example if a municipality kept title ownership of a factory used exclusively by the taxpayer, the taxpayer would be taxed on the economic benefits of the value of the factory. If a municipality built a football stadium and let the football franchise use it for a price less than FMV rent, the football team would have income from the below-market-value use. Economic benefit can be an annual taxable amount without precluding taxation in future years. In general, the tax law rules governing compensation would be useful precedent from which to determine the taxable amount from a contribution to capital, absent a justified distinction.

2. In exchange for stock or stock enhancement. The proposal would generally continue the exemption available under current law for contributions in return for stock or partnership interests.[39] The proposal would also continue the corporate exemption when the corporation issues no new stock, but only as long as the contributions are pro rata to stock holdings and the shareholder recaptures the value given up by an enhancement in the value of the shares held at the end of the transaction. When contributions are pro rata to stock holdings, issuance of new stock would be a ''meaningless gesture'' because what counts is the fractional ownership of the corporation (including votes, dividends, and redemption share) and not the number of certificates. A pro rata contribution leaves each shareholder with the same fractional ownership whether or not new shares are issued. Contributions to a partnership would continue to be tax exempt if the partnership gives the contributor a partnership capital interest entitling it to a share of income and capital expected to have a value equal to the contributed property.

3. Non-pro-rata shareholder and partner contributions.

a. Taxation of the non-pro-rata portion. Current law treats contributions from shareholders who are ''not acting as such'' as if they were contributions from an outsider in full to determine the corporation's basis.[40] The proposal would split a single non-pro-rata contribution into segments. To the extent of pro rata contribution, the shareholder has not even really made an expenditure, because the enhanced value of his shares recaptures the value of the transferred property in indirect form. The corporation or partnership would not pay tax on the pro rata portion of a contribution recaptured by enhancement of shares. But it would identify contributions from a shareholder ''not acting as such'' as the excess amount transferred and not recaptured by enhancement of shares. As to that portion, the shareholder has given up value and the other shareholders have received value.

The rule taxing value not recaptured by percentage ownership of shares deters subterfuge by preventing a municipality from buying a few shares in the corporation to avoid the relocation incentive payments being taxed to the corporation. But more generally, the continued exemption requires a pooling in which the shareholders or partners have not given up their value in the transferred contribution, but instead have kept the value indirectly by reason of their interest in the shares.

For example, if a 51 percent shareholder transfers property worth $1,000 to a corporation with no new stock issued, $510 of the value would not be taxed to the corporation. The shareholder has recaptured the $510 by enhancement of the value of his shares and has not even made an expenditure or cost of the $510. But $490 would be taxable because the shareholder has given up $490 not recaptured by his shares and has transferred that value to other shareholders, as if the shareholders were an unrelated party.

If the entity were a partnership, the same $490 would be taxable to the partnership, but the $490 would have to be allocated under section 704 to the noncontributing partners. There would be no taxation to the partner or partnership for the $510 interest. If the contributing owner gets preferred stock or some special class not representing a straight percentage interest in the entity, the amount treated as made by an owner could not exceed the value of the interest distinguished in return. Moreover, in partnerships, shares of income shift without tax, even retroactively when the agreement is after the close of the tax year. To prevent subterfuge, contributions from a partner would always be taxable to the extent the property transferred exceeds the value of the partnership interest paid in return.

b. Collateral effects. Section 362(c) now gives the corporation zero basis for contributions from nonshareholders or from shareholders not acting as such. With repeal of the exemption, however, the corporation needs to get basis for amounts it has included in income.[41] Once through the system is enough. A corporation might have a compound basis for non-pro-rata contributions because a contribution is both tax exempt and taxable. Assume, for example, a 51 percent shareholder contributes property worth $1,000 and with a basis of $10 to the corporation. The corporation would need $490 extra

[39]Section 1032 (corporation has no income or gain from sale of its own stock); section 721 (neither partner nor partners has gain or loss from a contribution to a partnership in return for a partnership interest).

[40]Section 362(c).

[41]*Cf.* section 358(a)(1)(B) (increasing basis by the gain recognized by a shareholder on distributed property).

basis because that amount is considered to be a transfer from a shareholder not acting as such and is so taxed. Section 362(a)(2) also allows the corporation to use a carryover basis from a contribution to capital from a shareholder acting as such, and the shareholder is acting as a shareholder as to the pro rata portion when his share enhancement recaptures the value transferred — $510. If the shareholder had a $10 basis in the whole, the pro rata portion would have $5.10 basis. The corporation's total basis would be $490 from tax paid and $5.10 carryover under section 362(a)(2), for a total basis of $495.10.

A contribution to capital is inherently a capital expenditure, even when the contribution is not pro rata.[42] The stock is a separate and distinct asset.[43] In special circumstances, the $490 expended by the 51 percent shareholder that was not recaptured might be allocated as basis on some other asset. But the form of the transfer was a contribution or enhancement of the corporation, and treating the cost as extra basis in the stock follows the form chosen by the taxpayer for the transaction.

The pro rata segment of the contribution is appropriately treated as a nonrecognition event, because the taxpayer has no expenditure but recaptured everything given up by enhancement of shares. The excess over pro rata portion, it is tentatively concluded here, should just follow the nonrecognition allowed for pro rata contributions, since the non-pro-rata portion is giving the taxpayer even less than he got from the pro rata portion.[44] If full nonrecognition is adopted, the shareholder would just add the $10 basis in the property contributed to his basis for shares, without bifurcating the shares.

4. Lapse of warrants. The proposal would treat the lapse of a warrant issued by a corporation as a short-term capital gain to the issuing corporation equal to the amount collected for sale of the warrant. In general, a taxpayer issuing an option has a short-term capital gain when an option lapses without exercise or the issuer gets out of the obligation for any reason.[45] The price paid for an option is suspended as deferred income when received, but it is credited to income when the option lapses. The proposal would apply the general rule for options to warrants for the corporation's stock. If the warrant is exercised, the corporation is selling stock and the nonrecognition of section 1032 applies to the corporation. If the warrant expires unexercised, however, the holder never acquires any stock, and the corporation and owners are enriched by the price paid for the warrant. The lapse of an option is sufficiently like a contribution to capital by a nonowner that it should be covered by this proposal.

The proposal would return the treatment of expired options to the law as it was before 1984.[46] In 1984 Congress expanded section 1032, which gives the corporation nonrecognition for gains and losses in dealing with its own stock, to nonrecognition for warrants. The 1984 extension was given primarily to end ambiguity. With ambiguity, taxpayers would claim nonrecognition if there was gain but recognition of any loss.[47] This proposal would end the ambiguity, albeit by making the gain a short-term capital gain. The 1984 extension of nonrecognition was inappropriate because with the sale of stock, the purchasing shareholder gets a fractional interest in the corporation that fully offsets the burden of the purchase price, but with the lapse of the option, the holder gets nothing. On lapse, the corporation and its owners have an increase in net worth at the expense of symmetrical loss of net worth by the nonowner warrant holder.

The price paid for the lapsed warrant is not like a down payment on a subscription agreement, because the price paid for the option includes the value of the option privilege not to buy the stock if the purchase would be unprofitable. The gain from the lapse arises from a drop in stock price from what the warrant holder was hoping for — the corporation profits from the lapse by betting against itself. A corporation is generally helped by an increase in its stock price governed by section 1032 because it can get more cash or assets for its stock, so the warrant is the opposite of stock.

5. Drafting notes. In drafting a new section 118, subsection (a) would provide that gross income includes contributions to capital, except as otherwise provided in subsection (b). Subsection (b) would provide an exclusion for contributions in return for stock or partnership interests worth the value of the property contributed. Subsection (b) would also reduce the value of the amount taxable under subsection (a) by the fractional interest of the contributed property represented by the stock or partnership interest held by the contributor after the contribution.

The proposal would repeal the exemption for contributions in aid of construction of a water or sewage disposal public utility in subsection 118(c) as special interest legislation not justified by general principles of taxation.

The proposal would repeal section 362(c), now giving the corporation zero basis for contributions from nonowners, and replace it with language giving the corporation basis equal to the amounts included in income.

The proposal would repeal the second sentence of section 1032, which gives the corporation nonrecognition

---

[42]*See, e.g.*, *Ames v. Commissioner*, 14 B.T.A. 1067 (1929) *aff'd,* 49 F.2d 853 (8th Cir. 1931). Shareholders who pay corporate expenses are making a capital expenditure. *Markwardt v. Commissioner*, 64 T.C. 989, 995 (1975) (collecting the cases).

[43]Reg. section 1.263(a)-4(b) (capitalizing investments in intangibles that constitute separate and distinct assets).

[44]Johnson, "Tax Models for Nonprorata Shareholder Contributions," 3 *Va. Tax Rev*. 81, 119-122 (1983), relies on the argument that the non-pro-rata portion is giving the shareholder back something less than the pro rata portion, and nonrecognition is allowed for the prorated portion. Use of appreciated property to make an expenditure is ordinarily a realization event (*see, e.g.*, *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943)), so the nonrecognition conclusion is tentative.

[45]Section 1234(b)(1) and (2).

[46]Rev. Rul. 72-198, 1972-1 C.B. 223.

[47]*See* the excellent discussion in Michael Schler, "Exploring the Boundaries of Section 1032," 49 *Tax Lawyer* 543 (1996).

for gain on lapse of an option, and the cross-reference to section 1234(b), which makes the lapse a short-term capital gain.