DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE INDUSTRY COUNSEL TO THE SHIPPING TECHNICAL ADVISOR
CC:LM:HMT:PHI

FROM: ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS AND SPECIAL INDUSTRIES) CC:PSI

SUBJECT: CONTRIBUTIONS TO THE CAPITAL OF A CORPORATION

This Chief Counsel Advice responds to your memorandum dated March 26, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer:

Subsidiary:

Year 1:

Year 2:

ISSUE

Whether Taxpayer may exclude from income under § 118(a) cash payments it received from the Department of Transportation (DOT) under the Maritime Security Fleet Program.

CONCLUSION

Taxpayer may not exclude from income under § 118(a) cash payments it received from the DOT under the Maritime Security Fleet Program.

FACTS

Taxpayer through Subsidiary has contracted with the DOT under the Maritime Security Fleet Program. The operating agreements conform to the requirements of the Maritime Security Fleet Program statute described below.

Pursuant to the operating agreements, Taxpayer received cash payments in Year 1 and Year 2. Taxpayer did not include these cash payments on its income tax returns for Year 1 and Year 2. Taxpayer contends that the payments are excluded from income under § 118(a).

LAW AND ANALYSIS

Maritime Security Fleet Program

46 U.S.C. 1187(a) provides that the Secretary of Transportation shall establish a fleet of active, militarily useful, privately-owned vessels to meet national defense and other security requirements and maintain a United States presence in international commercial shipping. The Fleet must consist of privately owned, United States-flag vessels for which there are in effect operating agreements and shall be known as the Maritime Security Fleet.

To be included in the Maritime Security Fleet Program, a vessel must meet the vessel eligibility requirements in 46 U.S.C. 1187(b) and the owner or operator of the vessel must enter into an operating agreement with the Secretary of Transportation under 46 U.S.C. 1187a(a).

46 U.S.C. 1187a(b) provides that an operating agreement must require (1) the vessel to be operated exclusively in foreign trade or in mixed foreign and domestic trade and (2) the vessel to be documented under chapter 121 of Title 46 (i.e., a United States-flag vessel).

46 U.S.C. 1187a(d)(1) provides that an operating agreement may be effective only for one fiscal year, but is renewable, subject to the availability of appropriations, for each subsequent fiscal year through the end of fiscal year 2005.

46 U.S.C. 1187a(d)(2) provides that an operating agreement must require that the Secretary of Transportation pay each fiscal year to the contractor, for each vessel that is covered by the operating agreement, an amount equal to $2,100,000 for each fiscal year after 1996 in which the operating agreement is in effect. The amount shall be paid in equal monthly installments at the end of each month. The amount may not be reduced except as provided by this section.

46 U.S.C. 1187a(e) provides that as a condition of receiving payment for a fiscal year for a vessel, the contractor for the vessel must certify that the vessel has been and will be operated in accordance with 46 U.S.C. 1187a(b)(1) for at least 320 days

in the fiscal year. Days during which the vessel is drydocked, surveyed, inspected, or repaired are considered days of operation for this purpose

46 U.S.C. 1187a(f) provides that an operating agreement constitutes a contractual obligation of the United States government to pay the amounts provided for in the operating agreement to the extent of actual appropriations.

46 U.S.C. 1187a(g)(2) provides that the Secretary of Transportation must not make any payment for a vessel with respect to any days for which the vessel is not operated or maintained in accordance with an operating agreement.

46 U.S.C. 1187a(h)(3) provides that the Secretary of Transportation must make a pro rata reduction in payment for each day less than 320 in a fiscal year that a vessel covered by an operating agreement is not operated in accordance with 46 U.S.C. 1187a(b)(1), with days during which the vessel is drydocked or undergoing survey, inspection, or repair considered to be days on which the vessel is operated.

46 U.S.C. 1187b(a)(1) provides that the Secretary of Transportation shall include in each operating agreement a requirement that the contractor enter into an Emergency Preparedness Agreement with the Secretary.

46 U.S.C. 1187b(a)(2) provides that an Emergency Preparedness Agreement shall require that upon a request by the Secretary of Defense during time of war or national emergency, or whenever determined by the Secretary of Defense to be necessary for national security (including any natural disaster, international peace operation, or contingency operation), a contractor for a vessel covered by an operating agreement shall make available commercial transportation resources (including services).

Internal Revenue Code

Section 61 (a) provides that, except as otherwise provided in Subtitle A (Income Taxes), gross income means all income from whatever source derived.

Treas. Reg. § 1.61-1(a) provides that “[g]ross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services.”

The Supreme Court in Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955), held that gross income includes “instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”

The Supreme Court in New Colonial Ice Co., Inc. v. Helvering, 292 U.S. 435, 440 (1934), held that “[w]hether and to what extent deductions shall be allowed depends on legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.” “Obviously, therefore, a taxpayer seeking a deduction must

be able to point to an applicable statute and show that he comes within its terms." Id.

No provision of the Maritime Security Fleet Program statute exempts the DOT payments from income tax.

Section 118(a) provides that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

Treas. Reg. § 1.118-1, published in 1956, provides as follows:

> In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. Section 118 also applies to contributions to capital made by persons other than shareholders. For example, 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. See section 362 for the basis of property acquired by a corporation through a contribution to its capital by its stockholders or by nonstockholders. (Emphasis added.)

Section 118(a) was enacted in 1954 as part of Public Law 591.

Regarding § 118, H.R. Rep. No.1337, at 17 (1954) states the following:

> Your committee's bill provides 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. It deals with cases 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. In many such cases because the 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. (Emphasis added.)

Regarding § 118, S. Rep. No.1622, at 18-19 (1954) states the following:

> The House and your committee's bill provides 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. It deals with cases 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. In many such cases because the 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. (Emphasis added.)

One of the court decisions on this subject referred to in the committee reports is Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943). The facts involved the payment of cash to the taxpayer by prospective customers to cover the estimated cost of construction of the extension of the taxpayer's electric utility service facilities to the prospective customers. The taxpayer contended that the payments were gifts or contributions to capital. The Court disagreed, holding that "[t]he payments were to the customers the price of the service." Id. at 103. The Court reasoned that "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. The transaction neither in form nor in substance bore such a semblance." Id. at 102.

Another court decision on this subject is Brown Shoe Co., Inc. v. Commissioner, 339 U.S. 583 (1950). The facts involved the payment of cash and the transfer of other property to the taxpayer by certain community groups as an inducement to the location or expansion of the taxpayer's factory operations in the communities. The taxpayer contended that the properties so acquired were gifts or contributions to capital. The Court agreed, holding that " the assets transferred to petitioner by the community groups represented 'contributions to capital.'" Id. at 589. The Court reasoned that "[t]he contributions to petitioner were provided by citizens of the respective communities who neither sought nor could have anticipated any direct service or recompense whatever, their only expectation being that such contributions might prove advantageous to the community at large." Id. at 591.

The Court in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973), explained its decisions in Detroit Edison and Brown Shoe. The

decisional distinction between Detroit Edison and Brown Shoe rested upon the nature of the benefit to the transferor, rather than to the transferee, and upon whether that benefit was direct or indirect, specific or general, certain or speculative. Where the transfers were made with the purpose, not of receiving direct service or recompense as in Detroit Edison, but of obtaining advantage for the general community as in Brown Shoe, the result is a contribution to capital.

In addition, the Court stated that other characteristics of a contribution to capital are implicit in the two cases that do focus upon the use to which the assets transferred were applied or upon the economic and business consequences for the transferee corporation. The Court listed the following characteristics of a nonshareholder contribution to capital:

> [1] It certainly must become a permanent part of the transferee's working capital structure. [2] It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. [3] It must be bargained for. [4] The asset transferred foreseeably must result in benefit to the transferee in an amount commensurate with its value. [5] And the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

Id. at 413.

In the present case, the transferor's motive for the payment is to contractually insure the availability of transportation services by United Sates-flag vessels during war and national emergency. The availability of transportation services pursuant to the operating agreements is a direct benefit to the transferor. Accordingly, the payments by the transferor made to secure availability of transportation services is compensation to the transferee. Moreover, Taxpayer may use the government payments for the payment of dividends, of operating expenses, of capital charges, or for any other purpose within the corporate authority, just as any other operating revenue might be applied. The payments therefore fail to become a permanent part of Taxpayer's working capital structure.

The present case is also similar to Texas & Pacific Railway Co. v. United States, 286 U.S. 285 (1932). During World War I, most of the railroads in the United States were under the control of the United States government. Following the war, the railroads were returned to private operation. To help the railroads adjust to post-war operation, Congress enacted the Transportation Act of 1920. The statute guaranteed a minimum operating income for six months after relinquishment of government control. The taxpayer received payments pursuant to the statute, but did not include the payments in income, claiming that the payments were a gift or a contribution to capital.

The Court disagreed, holding that "[t]he sums received under the act were not subsidies or gifts, –that is, contributions to the capital of the railroads." Id. at 289. The Court reasoned that the taxpayers "were bound to operate their properties in order to avail themselves of the Government's proffer. Under the terms of the statute no sum could be received save as a result of operation." Id. In addition, the Court reasoned that the payments "might be used for the payment of dividends, of operating expenses, of capital charges, or for any other purpose within the corporate authority, just as any other operating revenue might be applied." Id. at 290.

In Texas & Pacific Railway Co., the purpose of the government payments was to help the railroads get back on their feet after several years of government control during World War I. The government needed rail transportation services during the war. Here, the purpose of the government payments is to keep Taxpayer on its feet as an operator of United States-flag vessels in foreign trade in the event the government needs international shipping transportation services during a national security emergency.

Here, as in Texas & Pacific Railway Co., under the terms of the statute no sum could be received save as a result of operation. Taxpayer receives a payment at the end of each month based on the operation in foreign trade of specific vessels during that month. The payment is reduced for each nonoperating day.

CONCLUSION

Accordingly, we conclude that Taxpayer may not exclude from income under § 118(a) cash payments it received from the DOT under the Maritime Security Fleet Program.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We believe that our case is very strong.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

By: /s/ Walter Woo
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