INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Year 1 =

ISSUE:

May Taxpayer treat as a contribution to capital under § 118(a) of the Internal Revenue Code the Continued Dumping and Subsidy Offset (Offset) it received from the federal government under the Continued Dumping and Subsidy Offset Act of 2000 (CDSOA)?

CONCLUSION:

Taxpayer may not treat as a contribution to capital under § 118(a) the Offset it received from the federal government under the CDSOA.

FACTS:

Taxpayer manufactures X. Taxpayer petitioned the federal government to stop the dumping of X by foreign manufacturers. The federal government imposed an antidumping duty order on foreign manufacturers of X. Antidumping duties are imposed after (1) a determination is made that a class of foreign merchandise is being (or likely being) sold at less than fair market value, and (2) a determination is made that an industry in the United States is materially injured or threatened with material injury or that the establishment of an industry in the United States is materially retarded by reason of the dumping.

Under the CDSOA, duties assessed pursuant to an antidumping duty order must be distributed on an annual basis to the affected domestic producers for qualifying expenditures. The distribution is known as the Offset. 19 U.S.C. § 1675c(a).

The term "affected domestic producer" is defined in 19 U.S.C. § 1675c(b)(1) to include any manufacturer that (A) was a petitioner with respect to which an order has been entered and (B) remains in operation.

The term "qualifying expenditure" is defined in 19 U.S.C. § 1675c(b)(4) to mean an expenditure incurred after the issuance of the order in any of the following categories: (A) manufacturing facilities; (B) equipment; (C) research and development; (D) personnel training; (E) acquisition of technology; (F) health care benefits to employees paid for by the employer; (G) pension benefits to employees paid for by the employer; (H) environmental equipment, training, or technology; (I) acquisition of raw materials and other inputs; and (J) working capital or other funds needed to maintain production.

Taxpayer received an Offset in Year 1. Once received, an Offset may be used for any purpose. Taxpayer used the payment to reduce its debt. Taxpayer did not include the Offset on its income tax returns for Year 1. No provision of the CDSOA statute exempts Offsets from income tax. Taxpayer contends that the Offset is excluded from income under § 118(a) as a nonshareholder contribution to capital.

LAW AND ANALYSIS:

Senator DeWine, for himself and other senators, made a statement in the Congressional Record when the CDSOA was introduced to the Committee on Finance. His statement included the following:

> As my colleagues know, the Tariff Act of 1930 gives the President the authority to impose duties and fines on imports that are being dumped in U.S. markets, or subsidized by foreign governments. Our bill would take the 1930 Act one step further. Currently, revenues raised through import duties and fines go to the U.S. Treasury. Under our bill, duties and fines would be transferred to injured U.S. companies as compensation for damages caused by dumping or subsidization.

. . .

> Current law also does not contain a mechanism to help injured U.S. industries recover from the harmful effects of foreign dumping and subsidization. These foreign practices have reduced the ability of our injured domestic industries to reinvest in plant, equipment, people, R&D, technology or to maintain or restore health care and pension benefits. The end result is this: continued dumping or subsidization jeopardizes renewed investment and prevents additional reinvestment from being made.

145 Cong. Rec. S497 (daily ed. Jan. 19, 1999) (statement of Sen. DeWine).

Section 118(a) provides that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. Section 118(a) was enacted in 1954.

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

> 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.

Regarding § 118, H.R. Rep. No.1337, at 17 (1954) and S. Rep. No.1622, at 18-19 (1954) state the following:

> [I]n 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.

One of the court decisions on this subject is <u>Texas & Pacific Railway Co. v. United States</u>, 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, the 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. Accord Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932) (a companion case).

Another court decision on this subject 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), 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.

For a transfer to qualify as a nonshareholder contribution to capital under § 118(a), the transferor must have the requisite motivation and the transfer must have the requisite economic effect on the recipient corporation. If either is lacking, then the transfer does not qualify as a contribution to capital.

Taxpayer contends that the Offset payments serve a public benefit by restoring fair trade (so that jobs and investments in the United States are not lost) through distributions to benefit affected domestic producers willing to produce and invest in the United States. This type of resulting indirect benefit is within the contemplation of § 118(a) nonshareholder capital contributions. Taxpayer distinguishes the Offset payments from the subsidies in Texas & Pacific Railway. Taxpayer states that the Offset payments are allocated among recipients based on certain expenditures made and not measured by deficiencies in operating income as was the case in Texas & Pacific Railway. In addition, a recipient of the Offset is not required to show damages suffered by the recipient.

We do not agree with Taxpayer's characterization of the Offset as a contribution to capital. The government's motive for the Offset is to assist Taxpayer in recouping losses suffered from illegal dumping involving X products entering the United States. The Offset was distributed to Taxpayer as compensation for damages caused by dumping and not as a contribution to the permanent working capital of Taxpayer. Affected U.S. industries are presumed to have been harmed by dumping.

The amount of the Offset is measured by reference to specified qualifying expenditures, including noncapital, operating expenses. Here, as in Texas & Pacific Railway, once Taxpayer receives the Offset, Taxpayer may use it for the payment of dividends, operating expenses, or capital charges, or for any other purpose within the corporate authority, just as any other operating revenue might be applied. Taxpayer used the Offset to reduce its debt. The Offset failed to become a permanent part of Taxpayer's working capital structure because it was not restricted to the acquisition of capital assets.

The present case is similar to Texas & Pacific Railway in other ways. In Texas & Pacific Railway, 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. Here, the purpose of the Offset is "to help injured U.S. industries recover from the harmful effects of foreign dumping and subsidization." 145 Cong. Rec. S497 (daily ed. Jan. 19, 1999). Here, as in Texas & Pacific Railway, under the terms of the statute no Offset can be received unless Taxpayer remains in operation. 19 U.S.C. § 1675c(b)(1)(B).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.