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Taxation -- Depreciation and Inclusion in Equity Invested Capital -- Assets Transferred to Attract Industry

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Taxation—Depreciation and Inclusion in Equity Invested Capital—Assets Transferred to Attract Industry

Transfers of property and cash from community and civic groups have become a common method of inducing industry to locate and do business in areas seeking to progress industrially and commercially. Even courts adopting a stringent view of these transfers for the purpose of settling connected taxation questions do not deny the validity and necessity of supporting them legally. Such transfers benefit both the transferor, by improving the community financially, and the transferee, by easing the burden of organization and location expenses.

Recently, in *Brown Shoe Company v. Commissioner,*[1] the United States Supreme Court clarified its position in regard to tax problems arising from these transfers. Petitioner, pursuant to the terms of written contracts, had received land, cash, and buildings and equipment from civic groups in twelve communities, and had agreed to perform various promises in return, *e.g.*, enlarging existing plants, or building new ones, and maintaining them at minimum payrolls for a stipulated numbers of years. Only one transaction, a donation of $10,000 cash for "organization expenses," was without any contractual basis. In every instance where cash was involved, the cash received was less than the outlay required to perform the contract. Two problems were presented by these transfers: First, whether the company could deduct depreciation on buildings transferred and on buildings and equipment acquired or enlarged with cash received; and second, whether the company could include in its equity invested capital credit for purposes of excess profits taxation the total amount of cash and property contributed.[2] The court allowed both the deduction for depreciation and the inclusion in equity invested capital.

This decision eliminated a trend in the cases which had been a matter of concern to businessmen and the accounting profession since the decision of *Detroit Edison Company v. Commissioner.*[3] The Detroit Edison Company had charged its consumers for the cost of extending

[1] 70 Sup. Ct. 820 (1950).

[2] The 1940 excess profits tax, which had much in common with prior excess profits taxes, was aimed only at swollen profits which are caused by wartime conditions. Two bases for applying the tax were provided, after a specific exemption of $5,000. First, the taxpayer could deduct from the net income, subject to the ordinary income tax, the average of earnings for a given base period. Or it could take as a credit an amount equal to eight percent of its invested capital. In other words, Congress evidently considered a return of eight percent on invested capital a fair return under normal business conditions. It is obvious that if the latter basis is used, it is to the taxpayer's advantage to include as much as it could in invested capital, since the amount of the tax is in inverse proportion to the size of invested capital. The 1940 tax was repealed in 1945, but in view of present world conditions that or a similar tax may once again be imposed. REVENUE ACT OF 1940, 201, 54 STAT. 975 (1940).

[3] 319 U. S. 98 (1942).

electric current distribution facilities and claimed as a base for computing its depreciation the full cost of the installations.[4] The Court decided that the funds were neither a gift nor a contribution to capital, and the company was denied depreciation on that portion of the cost which it had shifted to its consumers.

Nothing in the *Detroit Edison Company* case should alarm a taxpayer who happened to be involved in the kind of transactions which were under consideration in the *Brown Shoe Company* case, because the situations are totally different. The funds received by the Detroit Edison Company were payments for service which would directly benefit the one making the payments. In no sense could it be contended that the purpose of the payments was to enlarge the capital of the company; while this was the desired result of the transactions in the *Brown Shoe Company* case. The only benefit to the civic groups was that which might ultimately arise from the financial betterment of the community. Only indirectly would there be any form of compensation for the funds expended.[5]

The disconcerting element, before the distinction made by the Court in the *Brown Shoe Company* case became binding upon all circuits, was that the Tax Court had considered itself bound by the *Detroit Edison Company* decision in the *Brown Shoe Company* case,[6] in *McKay Products Corporation v. Commissioner*,[7] and in *Downey v. Commissioner*.[8] It disallowed both depreciation and inclusion in invested capital. The Tax Court was reversed by the Third Circuit Court of Appeals in the *McKay* case,[9] but was affirmed by the Eighth Circuit Court of Appeals in the *Brown Shoe Company* case[10] and the *Downey* case.[11] This conflict was the basis for the Court's granting certiorari in the *Brown Shoe Company* case.[12] Had the Court chosen to adopt the view of the Eighth Circuit, an immediate result would have been the diminution in value of such transfers to the transferee, and possibly to the transferor, who might finally be forced to make up the difference. However, the Court's adoption of the view of the Third Circuit has limited the *Detroit Edison Company* case to its factual context, and the way is now clear for the full realization of the value to be derived.

An analysis of the factors and theories involved in these decisions discloses three major divisions of approaches to the problem of invested capital. One approach may properly be termed the "purchase" theory.

[4] INT. REV. CODE §§113(a)(2), 113(a)(8)(B).

[5] This distinction is utilized in both the principal case and in McKay Products Corporation v. Commissioner, 178 F. 2d 639 (3rd Cir. 1949).

[6] 10 T. C. 291 (1948).

[7] 9 T. C. 1082 (1947).

[8] 10 T. C. 837 (1948).

[9] 178 F. 2d 639 (3rd Cir. 1949).

[10] 175 F. 2d 305 (8th Cir. 1949).

[11] 172 F. 2d 810 (8th Cir. 1949).

[12] 70 Sup. Ct. 820 (1950).

Under this theory, the consideration furnished by the company for the transfer is regarded as payment for the property. Accordingly, the property could not be considered invested capital, any more than the general assets could be. This approach overlooks the intent of the framers of the 1940 Excess Profits Tax Act.[13] In comparing this statute with the previous act of 1917,[14] it will be noted that the italicized words were added: "The equity invested capital . . . shall be the sum of the following amounts, reduced as provided in subsection (b) . . . (2) . . . Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, *or as a contribution to capital*."[15] Congress probably thus indicated an intention to adopt the view that invested capital was no longer to be confined to funds received from persons with a proprietary interest in the company, because such funds were already includible as paid-in surplus.[16] In the *Brown Shoe Company* case the point is made that such assets are additions to "capital" as that term has long been understood in business and accounting practice.[17]

The second approach is the "gift" theory. It is based upon the concept that the transaction between the transferor and the transferee is a "gift subject to a condition."[18] To support this classification it has been urged that the bargain element is lacking, and that the transferor is saying, in effect, "Move here, and we will *give* you valuable property." (Emphasis supplied.)[19] While such an interpretation may be very desirable to a promisor wishing to avoid legal liability, if followed to its logical conclusion it would have a company spending large sums to locate and build a plant on the mere chance that it will receive a "gift" of land or other property, subject to the whim or caprice of the promisor. While it is useless to argue intent without a given situation, it will suffice to point out that the usual profitable, desirable business enterprise could hardly be supposed to have based such a substantial expenditure of the stockholders' funds on the hazards of a promise which is legally unenforceable. If the reply is made that the gift is to occur before the outlay, then it will forever remain in the realm of speculation as to how this "Alphonse and Gaston" routine will end: one

[13] REVENUE ACT OF 1940, §201, 54 STAT. 975 (1940).
[14] REVENUE ACT OF 1917, §200, 39 STAT. 1000 (1917).
[15] REVENUE ACT OF 1940, §201, 54 STAT. 975 (1940).
[16] One case where funds contributed by stockholders would be neither money paid in for stock nor paid-in surplus would arise where stockholders contribute funds to erase a capital deficit. But in view of the broad language used in adding to the definition of invested capital in the statute, it can hardly be supposed that Congress intended so narrowly to restrict the addition. Such restrictive language could easily have been inserted instead of the inclusive phrase, "contributions to capital."
[17] 70 Sup. Ct. 820, 823 (1950).
[18] 27 TAXES 741 (1949).
[19] 27 TAXES 741, 744 (1949).

party saying, "After you give, Alphonse"; the other saying, "After you move, Gaston." It cannot be denied that only two interpretations are reasonable. Either there is a bilateral contract, with the company promising to move, build, and maintain the plant for a certain period at a certain minimum payroll and the civic group promising to convey the property; or there is a unilateral contract, which came into existence upon the company's performance of the conditions contained in the offer, *i.e.*, moving and building. The former has the advantage of greater probability. The gift theory seems insupportable when examined with regard to the intent of the parties and the rules of contract which govern their relations.

The recognition of an enforceable contract between the parties gives rise to the third theory, which may be called the "contract-cost" theory. This theory requires the inclusion of the assets in invested capital. It recognizes the obvious fact that there is "cost" to the taxpayer, in that there is an expenditure consequent upon performance of that contract. But the fact that the assets "cost" the taxpayer does not prevent their being invested capital any more than the issuance of stock keeps the funds paid in from being so regarded. It is true that the contributor of the assets may profit, even if only remotely, but so may the purchaser of stock through the increase in value of the stock.

The "contract-cost" theory has the best of the legal logic. It says, in effect, "Of course there is 'cost' to the taxpayer, but that does not prevent the assets from being 'contributions to capital,' since the intent of the parties was that they be such, and since there is no inherent reason why 'contributions to capital' may not arise from a contract. The application of this theory is unnecessary to resolve the inclusion in invested capital of cash or property truly donated, as was one of the amounts in the *Brown Shoe Company* case, since there is no problem of actual cost to the taxpayer. If the premise that "contributions" to capital may originate from outside the business is conceded, then the conclusion is inescapable that the term "contribution" includes by its plain meaning genuine gifts, be they cash or property.

As to depreciation, the irreconcilable decisions of the courts simply reflect the deeply rooted conflict over the true nature of depreciation. This conflict transcends legal considerations, and has long been a matter of controversy among accountants, businessmen, and scholars. The older school of thought regards depreciation's true function as the charging off of the original investment; in other words, the "return of the investment." The newer viewpoint is that depreciation allowances are made to provide for the replacement of the asset, leaving the original investment as representative of the equity of the original stockholders.

Fortune, in the guise of an enlightened Congress, has saved the courts from the necessity of having to adopt either viewpoint as correct. In providing for a corporation income tax, Congress clearly indicated that the replacement theory should be used. Only this interpretation can explain the provisions for a substituted depreciation basis in certain situations. That is, in cases where depreciation clearly should be allowed, as in the case of a gift or donation, but no actual cost basis exists, the donee-taxpayer is allowed to use the basis of the donor, limited to the fair market value at the time of the transfer.[20] If Congress had intended the older view of depreciation to prevail, the taxpayer would be held to a strict cost basis, and having no cost, would be denied depreciation in many instances where his right to take it is undisputed today. In the light of this conclusion, how realistic is the argument that depreciation should be denied because there is no ascertainable cost to the taxpayer?

No distinction should be made taxwise between property acquired directly and property purchased with funds acquired. In each instance the Brown Shoe Company was required to perform certain obligations concerning the property, thus plainly contemplating that the company already owned such property, or would purchase it with the funds acquired, or would receive it by the terms of the contract. Any distinction made merely goes to the form of the transaction, and not to its substance. If this distinction were permitted to effect a different treatment from a tax standpoint, the only result would be a change in the form of all subsequent transactions. Such a result would benefit neither the government nor the taxpayer.

The Court in the *Brown Shoe Company* case adopts a liberal attitude in allowing depreciation on the assets and their inclusion in equity invested capital. The type of transaction involved serves a useful purpose in community development, and this helpful attitude on the part of the Court should go far in preserving the value of such transactions for both the community and the industries which it seeks to attract.

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Taxation—Exempt Organizations—Income Derived from Unrelated Business

Under §101 of the Internal Revenue Code certain organizations have been granted exemption from the income tax. These exemptions remained substantially unchanged from the original Act of 1913,[1] until the Revenue Act of 1950.[2] During the interim an increasing number

[20] INT. REV. CODE §113(a)(2).

[1] 38 STAT. 166 (1913).
[2] Pub. L. No. 814, 81st Cong., 2d Sess. §301 (Sept. 23, 1950).