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

MEMORANDUM FOR ASSOCIATE AREA COUNSEL

Attn:

FROM: Steve Hankin
Senior Technician Reviewer, CC:CORP:6

SUBJECT:

FSA-N-157975-01

This Chief Counsel Advice responds to your memorandum dated September 20, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parent =
Taxpayer =
Corporation =

Subsidiary =
Businesses =
Area =
AB Services =
Product =
Year 1 =
Year 2 =
Year 3 =
Agreement =
aa =
bb =
cc =

X =

Clients =
M&M =

ISSUES

1. Whether the amounts Subsidiary received from Corporation pursuant to certain Agreements constitute nontaxable shareholder contributions to capital under Code § 118 or taxable payments for goods and services.

2. Whether the amounts Subsidiary received from Corporation pursuant to certain Agreements constitute nontaxable non-shareholder contributions to capital under Code
§ 118 or taxable payments for goods and services.

CONCLUSIONS

1. The amounts Subsidiary received from Corporation pursuant to certain Agreements are not excludable from income as shareholder contributions to capital under § 118(a); rather they are payments for goods and services.

2. The amounts Subsidiary received from Corporation pursuant to certain Agreements are not excludable from income as non-shareholder contributions to capital under § 118(a); rather they are payments for goods and services.

FACTS

Parent is a corporation exempt from federal taxation under Code § 501(c)(3), whose exempt purpose is the provision of AB Services. Parent has several subsidiaries, two of which are Taxpayer (a taxable corporation) and Corporation (a tax exempt entity). Corporation's exempt purpose is the same as the Parent's.

Taxpayer is the common parent of a for-profit consolidated group (the "Group"). Subsidiary is wholly owned by Taxpayer and is also a member of the Group. Subsidiary is in the business of providing X services and X practices generally to its community. In furtherance of its business purpose, Subsidiary purchases X practices and employs Xs.

Corporation operates Businesses in Area. Corporation apparently had an insufficient number of Xs on its staff and wished to increase that number. It also wished to fulfill its purposes and mission of providing quality Product to members of

its community. In order to meet its needs and fulfill its purposes, Corporation entered into a number of virtually identical Agreements with Subsidiary. In these Agreements, Subsidiary agreed to provide X practices and Xs to Corporation, which agreed to reimburse Subsidiary for: (1) all items of cost and expense related to the employment of Xs, and (2) the amount of cost and expenses of each X practice which exceed the net operating revenues of that practice. Under the Agreements, Subsidiary is entitled to keep cc% of the profits generated by X practices and must pay to Corporation the remaining bb% of the monthly net income generated by X practices. Each Agreement relates to the provision of one X and/or one X practice.

Also under the terms of each Agreement, Corporation agreed to extend to Subsidiary "a line of credit" equal to the amount by which monthly cash disbursements exceed the amount of monthly gross cash collections of the X practice. The Agreements generally provide that monies advanced by Corporation to Subsidiary pursuant to the line of credit constitute "short-term loans" and bear interest at a rate of prime plus one percent. They also provide that such loans shall be repaid solely from cash collected by X practice.

Each Agreement provides that the parties make monthly determinations of the amounts to be paid or received by each party. That is, if in one month, the parties determine that X practice shows a profit (net operating revenues exceed the cost and expenses), Subsidiary remits bb% of that month's profit to Corporation. If in the next month, the parties determined that X practice shows a loss (cost and expenses exceed net operating revenues), Corporation remits the amount of loss to Subsidiary as reimbursement of the latter's expenses. The Agreements provide that, prior to determining the monthly profit or loss, Subsidiary will first repay the line of credit, including interest owed, out of gross practice receipts, the amount of gross receipts remaining will be used to determine whether there is a profit or loss that month.

In practice, it appears that Subsidiary obtained loans from a local bank and Corporation reimbursed Subsidiary for the principal amount of the loan, as well as any interest accrued thereon. The loans were secured by the assets of the X practice and any mortgage thereon and by assignment of the Agreement relating to that X practice. Generally, after Subsidiary acquired the practice, Subsidiary and X who owned the practice would enter into an employment agreement and X would become an employee of Subsidiary. These employment agreements provide that Subsidiary will pay X a salary and X will provide Product to Corporation and become a member of Corporation's staff.

Taxpayer, as the common parent of the Group of which Subsidiary was a member,

reported the amounts paid to Subsidiary by Corporation and amounts paid by Subsidiary to Corporation as taxable income and deductions, respectively, on the Group's consolidated returns for taxable Years 1, 2 and 3. Now Taxpayer seeks refunds and has filed amended returns for Years 1, 2 and 3. The amended returns show that Taxpayer has excluded the payments to Subsidiary by Corporation from taxable income and removed the deductions for monies Subsidiary paid to Corporation. Taxpayer now alleges that the amounts paid to Subsidiary by Corporation were not payments for services rendered, rather they were contributions to Subsidiary's capital.

On its books, Subsidiary recorded the payments it received from Corporation as revenue and recorded as expenses monies it expended in the acquisition of X practices. Its balance sheet does not reflect any of these amounts as paid in exchange for stock or contributions to capital. Corporation, on its books, treated the payments it made to Subsidiary as expenses and the monies it received from Subsidiary as income. Parent, on its consolidated financial statements, eliminated these back and forth payments between Subsidiary and Corporation because Corporation and Subsidiary were affiliated for financial reporting purposes.

In response to certain IDRs, Taxpayer states that Parent's CEO wanted to show Subsidiary making profits because, at the time Subsidiary was formed, various governmental laws and regulations governing M&M payments made it economically desirable that Subsidiary be formed as a for-profit corporation. Taxpayer further states that it was initially expected that Subsidiary would make a profit from these Agreements. Additionally, Taxpayer stated that, contrary to the express terms of the Agreements, it was never the intention of the parties that Subsidiary repay Corporation the amounts due with respect to the loans.

LAW AND ANALYSIS

1. The payments to Subsidiary were taxable payments for goods and services.

Taxpayer alleges that the payments were not taxable payments for goods and services, rather they were contributions to Subsidiary's capital. Corporation owns no stock in Subsidiary and received no equity interest in exchange for its payments, therefore, it is difficult to envision these payments as "shareholder" contributions to capital, unless the payments *in effect* (as opposed to *in fact*) flowed as a series of distributions from Corporation to Parent followed by a series of contributions of the same amounts to Taxpayer followed by further contributions of the same amounts by Taxpayer to Subsidiary. If there is convincing evidence showing that the Agreements were entered into and the payments were made at the direction of the Parent, then we might recognize that Taxpayer has a basis for its position that

these payments were made by a "shareholder."[1] We note, however, that if this was in fact the case, then the "shareholder" who makes the contributions to Subsidiary's capital would be Taxpayer, not Corporation.

Even if it is established that Taxpayer *in effect* made these payments to Subsidiary, it does not end the inquiry because not all money transfers from a shareholder to his corporation are contributions to capital. See Washington Athletic Club v. United States, 614 F.2d 670 (9th Cir. 1980) (membership fees and dues paid to an athletic club by members, who were deemed to be the club's shareholders, were held to be conditions of entitlement to the club's facilities and were not exempt as capital contributions); Oakland Hills Country Club v. Commissioner, 74 T.C. 35 (1980) (Tax Court denied a country club's motion for summary judgment, holding that a "proprietary interest" is not sufficient to turn a membership fee into a capital contribution); United Grocers, Ltd. v. United States, 308 F.2d 634 (1962) (court concluded that the members had no investment motive in paying dues to a grocery-buying cooperative, because memberships were not transferable, and there was no way that members could recover their investments in the corporation).

But it is premature to determine at this point in our analysis whether Taxpayer made nontaxable contributions to Subsidiary's capital. It would be putting the cart before the horse. Rather, we must first determine whether these payments constitute taxable payments for goods and services. We find that these payments are taxable payments for goods and services and, therefore, they cannot be contributions to capital. Hence, it is unnecessary for us to further determine whether these payments constitute under the case law factors nontaxable contributions to Subsidiary's capital. (To be thorough, however, we do in fact make this subsequent analysis. See 2. below).

If the payment serves a specific *quid pro quo* then the payments must constitute taxable payments for goods and services. See United Grocers, supra. Here, Corporation made these payments to Subsidiary, whose for-profit business purpose is the provision of X and X practices. Corporation made these payments either to facilitate the hiring of additional X for its staff and/or to facilitate getting additional Clients referrals. Under the terms of each Agreement, Subsidiary was to provide Xs who would serve on Corporation's staff. In exchange for these payments, Corporation received direct benefits, e.g., Xs to serve on its staff and the expectation that these Xs would refer Clients to Corporation's businesses.

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[1]Taxpayer's representative states that Parent, Taxpayer, Corporation and Subsidiary all had the same CEO and CFO and all had the same key members as trustees and directors. We do not believe that this, in and of itself, sufficiently establishes that the parties entered into these Agreements at the direction of the Parent.

Additionally, Corporation made the payments and received a quid pro quo. *Quid pro quo* payments cannot be contributions to capital. *Cf.* Announcement 92-15, 1992-5 I.R.B. 51 (where an exempt organization performs valuable advertising, marketing, and similar services, on a *quid pro quo* basis, for the corporate sponsor, payments made to an exempt organization are not contributions to the exempt organization . . . .)

Taxpayer's representative makes much of the fact that X and X practices did not provide services *directly* to Corporation, rather he argues the X and X practices provided services to the members of Corporation's community. This is a distinction without a difference. Subsidiary provided Xs to Corporation to serve on Corporation's staff. It is reasonable to expect that Xs serving on Corporation's staff would refer Clients to Corporation's businesses.

We believe the above analysis alone is dispositive of the issue.[2]

The following analysis discusses various factors developed under the case law for distinguishing between taxable payment for goods and services and nontaxable contributions to capital cases where the distinction between the two is not as clear as it is here.

2. Payments are not shareholder contributions to capital.

Congress intended to exert "the full measure of its taxing power" and to "tax all gains except those specifically exempted." United Grocers, supra (citing the U.S. Supreme Court's holdings in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) and Commissioner v. LoBue, 351 U.S. 243 (1956)). Exemptions and deductions are matters of legislative grace and a taxpayer seeking either must show that he comes squarely within the terms of the law conferring the benefit sought. New Colonial Ice Co., Inc. v. Commissioner, 292 U.S. 435 (1934). A

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[2]We note an obvious contradiction in Taxpayer's position. Taxpayer states that Subsidiary was formed as a for-profit corporation and that it was expected that Subsidiary would show that it was making profits. However, if we treat these payments as capital contributions as Taxpayer requests, it seems a certainty that Subsidiary would have predominantly incurred losses during the entire period of these Agreements. The record of Subsidiary's financial performance under the Agreements appears to clearly prove this point. This belies Taxpayer's assertion that either the Subsidiary was formed to make a profit or that these payments were contributions to capital. Thus, this observation tends to further refute the idea that these payments were intended as capital contributions.

capital contribution is an exclusion from gross income and, therefore, it is a matter of legislative grace and must be narrowly construed. Nelson v. Commissioner, 30 T.C. 1151 (1958). Taxpayer has failed to show that it comes squarely within the terms of Code § 118.

Under Code § 118(a), capital contributions are excluded from a corporation's gross income. Contributions made in consideration for goods or services rendered are not excludable capital contributions. Treas. Reg. § 1.118-1 specifically provides, "[T]he 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 enticing the taxpayer to limit production." Here, as we determined above, these payments were payments made by Corporation in consideration for goods or services rendered by Subsidiary.

Section 118, as first included in the 1954 Code, "merely restate[d] the existing law as developed through administration and court decisions." S. Rep. No. 1622, 83rd Cong., 2d Sess. 190 (1954). The original legislative history discussed only non-shareholder contributions by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the transferee. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 17-18 (1954). However, the provision also applies to contributions by transferors owning a proprietary interest in the transferee. Treas. Reg. § 1.118-1; Board of Trade of the City of Chicago v. Commissioner, 106 T.C. 369 (1996). Similarly, reimbursement for operating expenses, even if a recipient is required by law to make capital improvements with the money, are not capital contributions. Rev. Rul. 73-566, 1973-2 C.B. 152 (per diem charges taxpayer received from the ICC, which money could only be used to purchase, build, or rebuild boxcars, were part of the consideration for taxpayer-rendered services).

The payments here were spent on the operation of Subsidiary's business. Under the Agreement, the amount Corporation pays to Subsidiary equals the amount of expense Subsidiary incurs in the employment of X and in the operation of X's practice. The Agreement, which refers to these payments as "reimbursements," expressly provides that the payments were to reimburse Subsidiary for its operating expenses. Reimbursement for operating expenses, even if recipient is required by law to make capital improvements with the money, are not capital contributions. See Rev. Rul. 73-566, 1973-2 C.B. 152. Here, the case for finding that the payments are not capital contributions is even stronger than that set forth in the revenue ruling because Subsidiary was not required by law or contract to make capital improvements with the money, nor did it make such improvements.

The Board of Trade of the City of Chicago, supra, (hereinafter, "CBOT") is the governing authority for what constitutes contributions to capital in the shareholder/corporation context. In CBOT, the Tax Court stated that the correct characterization of a shareholder payment to a corporation depends on the capacities in which the shareholder and the corporation deal with each other in making and receiving payment.[3] The Court further reasoned that if the shareholder's primary motive for the payment is an "investment motive" (i.e., the payment will enhance the value of the shareholder's equity interest), then the payment will be deemed a contribution to capital. This "investment motive" test has considerable support in the case law. See United Grocers supra (court focused on whether contributor has an "investment motive"); Washington Athletic Club supra (court focused on whether contributor has an "investment motive").

The CBOT Court discerned three objective factors whose presence tends to support the existence of an investment motive: (1) the fee in question is earmarked for application to a capital acquisition or expenditure; (2) the payors are the equity owners of the corporation and there is an increase in the payor's equity interest by virtue of the payment; and (3) the payors have an opportunity to profit from the appreciation in their investment. Here, none of these three factors are present.

CBOT's first factor. There is no evidence that these payments to the Subsidiary were specifically earmarked or applied to capital acquisitions or expenditures. In fact, it is clear from the Agreements that the payments received by Subsidiary were for past operating expenses. All payments were reimbursements to Subsidiary for expenses arising from Subsidiary's employment of X and the operation of X practices. There is nothing whatsoever in the Agreement that would suggest that Taxpayer or anyone else transferred these funds to Subsidiary anticipating that they would be segregated in a capital improvements fund or that they would be used substantially for capital purposes.

CBOT's second factor. There is no increase in Taxpayer's equity interest in Subsidiary by virtue of the payments made by Corporation. These payments matched dollar-for-dollar Subsidiary's operating expenses. Thus, the payments

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[3]It is clear from the U.S. Supreme Court's holdings in both Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), and Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943), that the motive or purpose and intent in making the contributions is a dominant factor in determining whether the contribution was in reality a capital contribution. Both Brown and Detroit Edison were nonshareholder contribution to capital cases. The motive or purpose and intent in making the contributions is also a dominant factor in shareholder/corporate contexts. See Washington Athletic Club, supra.

could not and do not result in a positive increase in Subsidiary's equity capital. Neither Taxpayer nor anyone else received anything (other than the provision of Xs and X practices) in return for the purported investments in Subsidiary. See American Medical Association v. United States, 887 F.2d 760 (7th Cir. 1989) (Court stated that the problem with taxpayer's argument that the membership fees should be likened to capital contributions is that the AMA members receive nothing additional in return for their "investment" in the AMA).
CBOT's third factor. Taxpayer did not, nor did it have an opportunity to, profit from the appreciation in these purported "investments" because there was neither an increase in Subsidiary's capital nor an increase in Taxpayer's equity interest in Subsidiary by virtue of these payments. Since the payments did not increase Subsidiary's capital, there was no "increase" to appreciate and, therefore, no opportunity to profit from making these payments. See Oakland Hills Country Club, supra (court found as a factor against finding a "proprietary interest" that the members could not profit from appreciation in the value of the membership).

In conclusion, the payments do not constitute shareholder contributions to Subsidiary's capital because they do not pass the three factors set forth in CBOT.

3. Payments do not constitute non-shareholder contributions to Subsidiary's capital.

Section 61(a) and § 1.61-1 of the Income Tax Regulations provide that gross income means all income from whatever source derived, unless excluded by law. Section 118(a) provides that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

The legislative history of § 118 provides, in part, as follows:

> This [§ 118] in effect places in the Code the Court decisions on the 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. S. Rep. No. 1622, 83d Cong., 2d Sess. 18-19 (1954).

Section 1.118-1 of the Income Tax Regulations provides, in part, that § 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.

The Supreme Court has considered the issue of contribution to capital in the non-shareholder context. In Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943), the Court held that payments by prospective customers to an electric utility company to cover the cost of extending the utility's facilities to their homes, were part of the price of service rather than contributions to capital. The case concerned customers' payments to a utility company for the estimated cost of constructing service facilities (primary power lines) that the utility company otherwise was not obligated to provide. The Court determined that the customers had no intent to make contributions to the company's capital.

Later, the Court held that payments to a corporation by community groups to induce the location of a factory in their community represented non-shareholder contributions to capital. Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950). The Court concluded that the contributions made by the citizens were made without anticipation of any direct service or recompense, but rather with the expectation that the contribution would prove advantageous to the community at large. Id. at 591. The contract entered into by the community groups and the corporation provided that in exchange for a contribution of land and cash, the corporation agreed to construct a factory, operate it for at least 10 years and meet a minimum payroll. Id. at 586.

Finally, in United States v. Chicago, B. & Q. R. Co., 412 U.S. 401 (1973), the Court, in determining whether a taxpayer was entitled to depreciate the cost of certain facilities that had been funded by the federal government, held that the governmental subsidies were not non-shareholder contributions to the taxpayer's capital. The Court recognized that the holding in Detroit Edison Co., had been qualified by its decision in Brown Shoe Co. The Court in Chicago B. & Q. R. Co. found that the distinguishing characteristic between those two cases was the differing purposes motivating the respective transfers. In Brown Shoe Co. the contributors only expectation was that such contributions might prove advantageous to the community at large. Thus, in Brown Shoe Co. since the transfers were made with the purpose, not of receiving direct service or recompense, but only of obtaining advantage for the general community, such payments constituted non-shareholder contributions to capital.

Where a corporation makes payments expecting to receive a direct, as opposed to indirect or speculative benefits, then such payments are taxable payments for goods and services and not nontaxable contributions to capital. See John B. White, Inc. v. Commissioner, 55 T.C. 729 (1971) (payment by Ford Motor Company to relocate car dealership was not an excludable contribution to capital since Ford expected the direct benefit of increased sales of its cars). Here, Corporation made these payments expecting to receive a direct, as opposed to indirect or speculative, benefit. Corporation contracted with Subsidiary to provide Corporation with Xs to serve on its staff. Further, by making these payments, Corporation expected that Xs would refer their Clients to Corporation's businesses. This is analogous to making payments for referrals.

The Court in Chicago, B. & Q. R. Co., also stated that there were other characteristics of a non-shareholder contribution to capital implicit in Detroit Edison Co. and Brown Shoe Co. From these two cases the Court distilled some of the characteristics of a non-shareholder contribution to capital under both the 1939 and 1954 Codes:

1. It 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 must foreseeably result in benefit to the transferee in an amount commensurate with its value; and

5. The assets ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

In light of the above, for a transfer to be a non-shareholder contribution to the capital of a corporation there must be the proper motivation of the transferor as well as the requisite effects on the economic position of the transferee. Further, contributions that are available for the payment of dividends, interest, operating expenses, or other expenditures usually charged to profits are not contributions to capital because they are not restricted to asset acquisitions. See Helvering v.

Clairborne-Annapolis Ferry Co., 93 F.2d 875 (4th Cir. 1938); Springfield S. R. Co. v. U.S., 217 Ct. Cl. 89, 577 F.2d 700 (1978); G.C.M. 37354.

In the instant case, we conclude that the payments from the Corporation to Subsidiary fail the requisite tests for exclusion from income as non-shareholder contributions to capital under § 118(a). Specifically, the payments as described in your request for field service advice did not become a permanent part of Subsidiary's working capital structure. Rather, the payments were used for payroll and operating expenses.

Also, these payments were compensation to Subsidiary. The Corporation and Subsidiary entered into the Agreement whereby the Corporation agreed to reimburse expenses incurred by Subsidiary in exchange for Subsidiary employing Xs who would become members of Corporation's staff and perform services as needed for the Corporation. In return for the payments, the Corporation was also entitled to receive from Subsidiary bb% of the net income of the X practices. Accordingly, the payments made by the Corporation to Subsidiary were direct payments for a specific, quantifiable service provided for Corporation by Subsidiary and, therefore, not excludable from income as non-shareholder contributions to capital under § 118(a).

For these reasons, the payments can not be nontaxable non-shareholder contributions to capital.[4]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Our analysis focuses on the reasonable belief that Corporation entered into these Agreements because it needed additional Xs on its staff or it expected to receive increased referrals of Clients to its Businesses. It is clear to us that either of these two purposes is sufficient to establish that it made these payments for goods and services and that it expected to receive a specific *quid pro quo*. Taxpayer still

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[4]Finally, we note that you raise a question in footnote 2 on page 10 of your request for Field Service Advice. We are not sure whether you are asking us to opine about the Taxpayer's method of accounting. Nonetheless, we note that we do not have the original return and there are no details in the discussion as to Subsidiary's overall method of accounting. Further, we are not sure whether the field is questioning the method of accounting for payments through the X practices, reimbursements from Corporation, or any other item of income or deduction which might have been available for Subsidiary or Taxpayer. Therefore, we cannot properly address this issue.

fails under the tests set forth for shareholder and non-shareholder contributions to capital. Taxpayer failed to satisfy all of the CBOT factors and at least 2 of the Chicago, B. & Q. R. Co. factors. We recognize however, that

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Please call if you have any further questions.

cc: