

IRS WILL NOT EXTEND SECTION 118 CAPITAL CONTRIBUTION CONCEPTS TO NONCORPORATE ENTITIES

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Gross income generally includes all income from whatever source derived. At times, entities may receive amounts from nonowners that enhance its capital. For example, local government or groups may make contributions to encourage an entity to set up or expand business in a locality. Are such transfers gross income to the entity?

Code §108 provides that in “the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.” Thus, such capital contributions are not gross income to a corporation.

Contributions to noncorporate entities, like partnerships or LLC’s, are not expressly covered by Code §118. Outside of the statute, there are common law cases that provide situations when a capital contribution is not taxable. For example, in Edwards v. Cuba Railroad, 5 AFTR 5398 (S.Ct. 1925), third party contributions to capital of a corporation were not considered income.

This would lead one to believe that in the appropriate circumstances, similar contributions to capital by nonowners in noncorporate entities should not be taxable. However, IRS Appeals, in an Appeals Technical Guidance Program Settlement guidelines manual effective on March 2, 2011, has indicated that Code §118 exclusion concepts should not be applied to noncorporate entities.

There are several justifications given for this position. First, it is asserted that the common law rules were replaced by Code §118, and thus the exclusion applies only so far as Code §118 goes. Second, expanded definitions of gross income have effectively voided prior case law precedent of exclusion, such as in Cuba Railroad. Third, the IRS indicated that it is a taxpayer choice as to what form of entity to operate under, and they should be bound by the particular tax provisions that relate to the chosen entity.

Such positions are not law but are only the IRS' opinion in regard to analyzing its litigation strategy. Given the prior precedent, one can expect some taxpayers to challenge these positions in court even the the manual indicates that the chances of taxpayer success are "remote" and the government's hazards of litigation are *de minimis*.

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