IRC SECTION 118, CONTRIBUTIONS TO CAPITAL

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The subject of contributions to the capital of a corporation continues to be the subject of dispute with the Internal Revenue Service (IRS). One of the more significant recent cases is the *Board of Trade of the City of Chicago and Subsidiaries vs. Commissioner US-CT-APP-2(May 29, 1996)*. In this 1996 decision, the Board of Trade of the City of Chicago, an IRC Section 277 membership organization, the taxpayer prevailed on the contribution to capital issue because the funds assessed were clearly earmarked for a specific capital purpose and would result in an increase in the members' equity in the organization. Further, the members had an opportunity to profit from their investment in capital because of the lack of restrictions on transferability of the membership interest.

Several additional important points were raised in this case:

1) The Court of Appeals clearly indicated that a payment by members/owners of an organization can be a contribution to capital even where the member/owners received goods or services from the corporation. This was also stated in the *Concord Village, Inc. vs. Commissioner* case. The IRS tends to hold that unless specifically earmarked and clearly constituting a contribution to capital that any payments to a membership organization are deemed to be fees paid in consideration for services to be rendered, and therefore would constitute membership income.

2) In the Chicago Board of Trade case, the taxpayer charged its members a separate transaction fee for operating activities from the fee that was charged for contribution to capital. This clearly indicated the separate nature of the transaction.

> ***The Board of Trade of the City of Chicago vs. Commissioner* case further refines the "Contributions to Capital" issue.**

3) The parties In the Chicago Board of Trade case agreed it is the payor's motive that controls whether a payment is a contribution to capital. If the payor is a shareholder, the Court of Claims also looks to see whether the payor has an investment motive in making the payment, and if so, then the payment is indeed a contribution to capital.

4) The Court also cited the *Washington Athletic Club vs. United States* case wherein the Court commented that the earmarking of payments for capital expenditures was relevant and pertinent, but not determinative of a contribution to capital.

5) The Court further cited the *Maryland Country Club, Inc. vs. United States* case wherein the Court determined that there were three basic conditions of earmarking. One, there must be a definite commitment to engage in capital construction. Two, at the time of the initial payment, both the Club and the member must be operating under the assumption that the funds so collected will be used for capital purposes. Three, the funds must be accounted for at the time the payment was held for that purpose and for no other purpose.

6) The Court concluded that Chicago Board of Trade's accounting procedures sufficiently earmarked that the "transfer fees" were for using and reducing the mortgage debt, a

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designated capital expenditure.

7) The last significant point made by the Court was "we fail to see a significant difference where petitioner's members make their capital contribution in installments or all at once." This issue is significant. While it is clear that one-time special assessments are contributions to capital, many have questioned whether regular monthly assessments to reserves qualify as contributions to capital.

Also, in Private Letter Ruling 9707004, the IRS held that "funds which are not restricted for capital purposes, of which the contributors are aware, do not qualify even if they are actually used for a capital purpose." The IRS referenced the case of *James Hotel Company vs. Commissioner*, a 1962 case in reaching this finding. The *Atlanta Athletic Club vs. United States* case held that accounting designations were sufficient to earmark funds since levies were based upon known existing needs and even though a specific capital purpose were not stated, and the funds were commingled operating funds, the designation to members of the levy being made for a capital purpose was held to be a legitimate contribution to capital. However, I feel this case is testing the extreme margin of acceptable practice and should be avoided if at all possible. If you're faced with this scenario, then you use it. But you can avoid the issue by clearly segregating the cash into separate bank accounts.

In Maryland Country Club, the Court stated "the regulations may not require a separate bank account for capital funds, but use of capital funds for operating expenses shows lack of intent to hold these funds solely for the purposes authorized by statute. This has the effect of invalidating the exemption of the entire capital contribution because an earmarking never took place." This language is very interesting because it indicates that although a separate bank is not required, but is certainly a very good idea. It also introduces the principle that even if funds are clearly earmarked, if they are used for another purpose, then the ultimate use of the funds violates the initial earmarking that took place and will invalidate the earmarking process. The second sentence of the above quotation indicates that the invasion of capital funds for operating purposes will indeed poison the entire capital amounts. The IRS in Hawaii recently held against an association in an audit on capital contribution issue simply because of the ability to use these funds for another purpose. The association had set forth a specific capital purpose, separately accounted for the funds, segregated the monies into a separate bank account, and expended funds for only the specific capital purpose that was intended. The IRS contended that the fact that the association's bylaws allowed it to invade the capital reserve funds for operating purposes invalidated the IRC Section 118 treatment.

These cases and rulings indicate that like many areas of tax law involving associations, the law is still evolving, and the law as we know it today may be changed by cases that are decided tomorrow. What this does for the association and the practitioner is place you into a defensive position before you even start. Obviously, the best way to comply with these rules is that if you are filing Form 1120, you must be very careful. Since there are cases that hold that you must clearly earmark funds, account for them separately, and maintain them in separate bank accounts, then that is what you should do. You should do this even though there are cases wherein a failure to segregate the money into separate bank accounts did not destroy the ability to treat it as a capital contribution. Why fight a battle if you don't have to fight it? It is easy to open a separate bank account for capital contributions. So do it just so you don't have to fight that battle. That way, if you are engaged in an IRS audit, the issues will not involve sloppy bookkeeping or sloppy compliance on the part of the taxpayer.

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