10 T.C. 291 (1948)

Cash and property received from community groups as an inducement to operate a factory are not considered 'accumulated earnings and profits' or a 'contribution to capital' for excess profits tax purposes, but the taxpayer can depreciate assets bought with their own unrestricted funds, even if they also received community contributions.

Summary

Brown Shoe Co. received cash and buildings from community groups to induce the company to operate factories in their towns. The Commissioner of Internal Revenue reduced Brown Shoe's equity invested capital for excess profits tax purposes, arguing that the cash and buildings weren't includible. The Tax Court held that these transfers were not 'accumulated earnings and profits' or a 'contribution to capital.' However, the court allowed Brown Shoe to depreciate buildings and machinery purchased with its own funds, even if it received community contributions, because the funds were not specifically earmarked for those purchases. The court reasoned that denying depreciation on the buildings and machinery the company purchased with its own unrestricted funds was an error.

Facts

Brown Shoe Co. manufactured shoes in multiple towns across several states. From 1919 to 1939, Brown Shoe received $885,559.45 in cash and $85,471.56 in buildings from community groups in 12 towns. Contracts generally required Brown Shoe to acquire and operate a factory in the town for a specified period. If the conditions weren't met, the amounts were to be refunded. Brown Shoe fulfilled all contract conditions. The cash received was deposited into Brown Shoe's general bank account and was not earmarked for specific purposes.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Brown Shoe's excess profits tax for the fiscal years ended October 31, 1942, and 1943. The Commissioner reduced Brown Shoe's equity invested capital by $971,031.01, representing the cash and buildings received. Brown Shoe petitioned the Tax Court, arguing that the cash and buildings should be included in its equity invested capital. The Tax Court ruled in favor of the Commissioner regarding the classification of the contributions but allowed depreciation on assets purchased with Brown Shoe's own unrestricted funds. Decision to be entered under Rule 50.

Issue(s)

1. Whether cash and buildings received from community groups to induce a company to operate a factory constitute 'accumulated earnings and profits' under Section 718(a)(4) or a 'contribution to capital' under Section 718(a)(1) and (2) for

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excess profits tax purposes?

2. Whether Brown Shoe is entitled to depreciation deductions on buildings and machinery purchased with its own funds, despite having received cash from community groups?

Holding

1. No, because the cash and buildings received from the community groups do not constitute 'accumulated earnings and profits' or a 'contribution to capital' within the meaning of Section 718(a)(4), 718(a)(1) and (2) respectively, as no profit or income was shown to result from the transfer, and the transferors were not stockholders.

2. Yes, because Brown Shoe paid for the buildings and machinery out of its unrestricted funds, giving the assets a cost basis for depreciation purposes.

Court's Reasoning

Regarding the first issue, the court emphasized that 'accumulated earnings and profits' under Section 718(a)(4) require a showing of actual earnings or profits resulting from the transfer, which Brown Shoe failed to demonstrate. The court cited *McKay Products Corporation, 9 T.C. 1082*, to support the conclusion that such transfers do not constitute a contribution to capital when the transferors are not stockholders. For the second issue, the court noted that the cash received from the communities was not earmarked for specific purchases. Therefore, Brown Shoe's use of its own unrestricted funds to purchase buildings and machinery entitled it to depreciation deductions based on the cost of those assets. The court stated, 'The petitioner paid for the buildings and machinery out of its own unrestricted funds, those buildings and that machinery had cost to it, as shown on its books and records, and it is entitled to depreciation thereon.'

Practical Implications

This case clarifies the tax treatment of incentives provided by communities to attract businesses. It establishes that such incentives are not automatically considered equity for excess profits tax purposes. Businesses cannot treat these incentives as accumulated earnings unless they can demonstrate actual profit or income derived from the transfer. However, businesses are still entitled to depreciate assets acquired with their own unrestricted funds, even if they received community contributions, provided the funds were not specifically earmarked for those assets. This ruling informs tax planning for businesses receiving such incentives, emphasizing the importance of documenting the use of funds and distinguishing between contributed and self-generated capital. Subsequent cases may distinguish themselves based on whether the funds were earmarked or whether the transferors were stockholders.