14 T.C. 1136 (1950)

Property donated to a corporation as an inducement for business development is includable in the corporation's equity invested capital at its fair market value at the time of acquisition, but distributions from depreciation reserves reduce equity invested capital unless paid out of accumulated earnings and profits.

Summary

Douglas Hotel Co. sought to include the value of donated land in its equity invested capital for excess profits tax purposes. The Tax Court held that the land donated for the hotel site was includable in equity invested capital at its fair market value when acquired. However, the court also ruled that cash distributions to the sole stockholder from depreciation reserves, not paid out of accumulated earnings and profits, reduced the equity invested capital. Finally, the court rejected the hotel's claim for exemption from excess profits taxes because it had no income from sources outside the United States.

Facts

A group of Omaha businessmen organized Douglas Hotel Co. in 1913 to build a first-class hotel. Arthur D. Brandeis, a local businessman, donated land as a building site to incentivize the project. Douglas Hotel Co. was capitalized at $1,000,000. Brandeis conveyed the land to the company by deed in January 1913. In April 1913, Brandeis donated an additional strip of land, with the Hotel assuming a $15,000 mortgage. Rome Miller acquired all of the hotel's stock in 1923 and subsequently withdrew significant funds, including depreciation reserves.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Douglas Hotel Co.'s excess profits taxes for 1942 and 1943. The Commissioner initially included the land in invested capital but later amended the answer to argue it should not be included. The Tax Court consolidated the proceedings for both years.

Issue(s)

1. Whether the value of land donated to Douglas Hotel Co. is includable in its equity invested capital.
2. If the land is includable, what is its value at the time of acquisition.
3. Whether the distribution of depreciation reserves to the sole stockholder reduces the equity invested capital.
4. Whether Douglas Hotel Co. is exempt from excess profits taxes under Section 727(g) of the Internal Revenue Code.

Holding

1. Yes, because the Supreme Court in *Brown Shoe Co. v. Commissioner* established that property donated to a corporation by non-stockholders is includable in equity invested capital.
2. The fair market value of the land at the time of acquisition was $125,000, because this was the price Brandeis paid for it in an arm's length transaction shortly before the donation.
3. Yes, because the distributions were not made out of accumulated earnings and profits as required by Section 718(b)(1) of the Internal Revenue Code.
4. No, because Section 727(g) requires that 95% or more of the corporation's gross income be derived from sources outside the United States, which was not the case for Douglas Hotel Co.

Court's Reasoning

The court relied on *Brown Shoe Co. v. Commissioner*, stating that property donated to a corporation is a contribution to capital. The value of the land was determined by its fair market value at the time of acquisition, which the court found to be the price Brandeis paid for it shortly before donating it. Regarding the distribution of depreciation reserves, the court found that because Douglas Hotel Co. had no accumulated earnings and profits, the withdrawals reduced equity invested capital. The court noted, "It is true, of course, that a distribution by a corporation to its stockholders of its depreciation reserve is not a taxable dividend and would be applied to a reduction in the cost basis of the stock. This is true because a depreciation reserve represents a return of capital." Finally, the court dismissed the claim for exemption under Section 727(g) because the company had no income from sources outside the U.S., and the statute requires that 95% of income be from foreign sources to qualify for the exemption.

Practical Implications

This case clarifies how to treat donated property and depreciation reserves when calculating equity invested capital for tax purposes. It reinforces that donations intended to spur business growth are capital contributions valued at their fair market value when received. Further, it illustrates that distributions of depreciation reserves are generally considered a return of capital that reduces invested capital. This case emphasizes the importance of accurately tracking earnings, profits, and the source of distributions to properly calculate a corporation's tax liability. It's also a reminder that tax exemptions have specific requirements, all of which must be met to qualify.