Charitable Organizations and Federal Taxation

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In times of heavy government spending and huge revenue bills, it is inevitable that harried legislators and weary taxpayers should cast about for new sources for tax dollars. One new source under attention has been those non-profit organizations traditionally exempted from income taxation under Section 101 of the Internal Revenue Code. That is, organizations such as educational institutions, hospitals, mutual savings banks, and farm cooperatives.

In the Revenue Act of 1950, Congress more narrowly defined the tax-exempt status of certain of these organizations, particularly in regard to certain "business activities." The principal organizations with which Congress was concerned were charitable organizations exempted under Code Section 101 (6). The Revenue Act of 1951 has added a few amendments to the 1950 Act and, further, has limited the exempt status of certain other organizations such as farm cooperatives and mutual savings banks. This article, however, is primarily interested in the present tax-exempt status of charitable organizations as defined by the present Internal Revenue Code. Therefore, references in this article will be principally to the 1950 Act.

*This article is a revision of Chapter III, Part 2, of Modernizing the Federal Estate and Gift Taxes (1951), a thesis submitted by the writer in partial completion of work required for the J.S.D. degree at Yale Law School.


2 Pub. L. No. 183, 82nd Cong., 1st Sess., approved October 20, 1951. It marks the passage of the bill introduced as H.R. 4473, 82nd Cong., 1st Sess. Henceforth the two revenue acts will merely be cited as the Revenue Act of 1950, or 1951, or the 1950, or 1951, Act.

3 For other discussions of these problems under the 1950 Act see Eaton, Charitable Foundations and Related Matters Under the 1950 Revenue Act, 37 VA. L. REV. 1, and 253 (1951); Comment, Colleges, Charities, and the Revenue Act of 1950, 60 Yale L.J. 851 (1951); Note, Taxation of Sale and Leaseback Transactions, 60 Yale L.J.
The attack upon the "business activities" of charitable organizations has been accompanied by considerable fanfare, but little factual evidence.\(^4\) Prior to the Revenue Act of 1950, charitable organizations were under fire because of two types of activities engaged in by some organizations. First, they were criticized because of investment policies: their purchase and operation of commercial enterprises, and their participation in a number of sale and leaseback transactions. Second, instances arose where funds of the organization were allegedly being used primarily for the benefit of those controlling the organization, rather than for charitable beneficiaries.

An example of the operation of a commercial business by a charitable organization may be found in the case of the C. F. Mueller Co., acquired for the benefit of the Law School of New York University.\(^5\) Friends and alumni of the law school purchased all the outstanding stock of the company (which manufactures macaroni and allied products), formed a charitable corporation, and merged the old corporation into it. The purchase was made by borrowing money from lending institutions. The loan is to be repaid out of the company's net profits, and after the loan has been liquidated all profits will go to the law school. It will be noted here that the company is not owned directly by the university, but by a so-called "feeder corporation," the charter of which requires net profits to be distributed to the law school of the university. A number of Tax Court and Circuit Court cases arising before the 1950 Act have held such organizations to be tax-exempt.\(^6\) The Tax Court, however, denied exemption to the present C. F. Mueller Co. But its decision was reversed by the Third Circuit.\(^7\) Congress has recently declared that in cases where the "feeder

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\(^4\) See note 10, infra.

\(^5\) For the factual background of this transaction see C. F. Mueller Co., 14 T.C. 922 (1950), Rev'd, 190 F.2d 120 (3rd Cir. 1951). Aside from the Mueller Co., New York University controls the Ramsey Corp., a manufacturer of piston rings, the American Limoges China Co., and the Howes Leather Co. See testimony of John Gerdes in Hearings before the Committee on Ways and Means on Revenue Revisions 1947-48, 80th Cong. 1st Sess. 3529, 3540 (1948).


\(^7\) See note 5, supra. Despite the Third Circuit's reversal in the Mueller case, the Tax Court reaffirmed its position regarding the tax status of "feeder organizations" in Joseph B. Eastman Corp., 16 T.C. No. 187 (June 29, 1951). And in United States v. Community Services, Inc., 189 F.2d 421 (4th Cir. 1951) the court held a "feeder organization" non-exempt under INT. REV. CODE § 1462(b)(8), (Social Security Act), the language of which is the same as INT. REV. CODE § 101 (6).
corporation's" net income inured to an educational institution, this income is exempt from tax as far as years prior to 1951 are concerned.

Although educational institutions have received the most publicity in regard to owning or controlling tax-exempt business enterprises, they are not the only ones interested in such investments. Before the 1950 Act not a few taxpayers and their counsel were considering the formation of a family-controlled charitable foundation to purchase a business owned by the family. Under this plan the vendors could be paid for their interests from the foundation's tax-free income. And the family would still control the business through their control of the foundation. In spite of the claimed advantages in these transactions, however, accurate figures showing the extent to which charitable organizations in general own commercial enterprises directly or indirectly are not available.

A sale and leaseback transaction usually involves a sale of land and buildings to an investor, generally a university or life insurance company, with the investor immediately executing a long-term lease in favor of the vendor. The lease usually contains an option to renew the lease or to repurchase the property. And the rental payments are generally sufficient to insure the repayment during the original leasehold period of the full amount of the purchase price, plus a sum which is somewhat in excess of interest rates on a loan of a similar amount.

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8 Revenue Act of 1951, § 601.


10 The Treasury presented its figures to Congress in executive session because the information was taken from returns. Treasury officials admitted, however, that their information was incomplete since not all charitable organizations have been required to file informational returns. Hearings on Revenue Revision, 1950, before the House Committee on Ways and Means, 81st Cong., 2d Sess. 174 (1950). The Treasury estimated that the revenue which would be gained from the proposals for taxing unrelated business activities and the charitable trusts and foundations would amount on an annual basis to approximately $100,000,000." Id. at 175. Apparently the tax on unrelated business income would account for the majority of this revenue. A survey conducted by the American Council on Education is in violent contrast to the Treasury's estimate. The Council found that for the fiscal year ending June 30, 1947, 455 colleges and universities received gross income of $150,000,000 from sources other than tuition, governmental grants, gifts, and investment income. Only $12,000,000 of this amount represents net income, the Council estimated. Id. at 572, and see the review of this material in Comment, supra note 3, 60 YALE L. J. 851-2. Of course, the Council's survey does not include all colleges and universities, nor does it include other organizations exempt under INT. REV. CODE § 101(1), (6), and (7). But there is a vast difference between the revenue potential of the two estimates. Writers in popular periodicals side with the Treasury's estimate, or go even beyond. See e.g., The Abuse of Tax Exemption, FORTUNE, May, 1950, p. 74; Mezerik, The Foundation Racket, NEW REPUBLIC, Jan. 30, 1950, p. 11.

11 The type of financing has received extensive discussion. See Cary, Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax and Policy Con-
Some writers and businessmen see genuine business advantages for the vendor in sale and leaseback transactions. For example, a business may obtain the equivalent of a loan based upon the full market value of its real property, instead of only two-thirds of that value as under the ordinary mortgage, and yet not be under the restraints usually imposed by a corporate mortgage. And there may be definite tax advantages to the vendor. He may be allowed a loss deduction upon the sale of the real property. Furthermore, he may be able to deduct the full amount of the rental payments under the leaseback, rather than be restricted to depreciation deductions upon the buildings alone. Against these advantages, of course, must be weighed the loss of the title to the property.

The principal attack against the sale and leaseback transaction has not been levied at tax advantages enjoyed by the vendor, but against participation in the transaction by exempt organizations. Of course, if a university

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purchases with its own funds the real property of a business, and then leases the property back to the original owner, there would seem to be no objection to the transaction. The renting of real property has long been a recognized source of investment of charitable organizations. Criticism of the leaseback transaction has not been aimed primarily at this manner of concluding the transaction, but against the practice followed by a few exempt organizations (principally universities) of borrowing money to obtain the purchase price. Probably the most spectacular instance of this variation of the leaseback transaction is that entered into between Allied Stores, Inc., and a subsidiary organized and wholly owned by Union College.

Allied sold substantially all its real estate, buildings and equipment to Union for $16,150,000. Union immediately leased the property to Allied for a thirty year term with an option to renew for a second thirty year period. Union borrowed $16,000,000 of the purchase price from a bank and an insurance company. It was contemplated that the loans would be completely repaid from the rental income within thirty years.

The problem of the alleged diversion of a charitable organization's funds for the benefit of those in control was highlighted by the Textron affair. Here a group of charitable trusts were controlled by persons interested in the expansion of the textile empire of Textron, Inc. The principal and income of these trusts were devoted for a period of time principally to the expansion of Textron, Inc., through participation by the trusts in the purchase from and sale to Textron of securities and other properties.

It has been argued, however, that leasebacks are generally unfair because its exemption permits a charitable organization to pay more for the property than would a non-exempt investor, and to take back larger rental payments, thus allowing the vendor larger deductions. See *Hearings on Revenue Revision*, supra note 10 at 214. No facts have been adduced, however, to support such an argument. One investigator found in 1948 that exempt organizations were charging higher rates than they received in interest on comparable loans. See Cary, supra note 11, 62 HARV. L. REV. 1, 8; and also McPherson, *supra* note 11 at 482. See further the testimony of King E. Fauver, appearing for Oberlin College, in *Hearings on Revenue Revision*, *supra* note 10 at 554.

The growth of Textron, Inc. is a phenomenal tale. It rose from a company with a modest net worth of $1,765,000 and net sales of $8,000,000 in 1941 to a concern with an estimated $80,000,000 of net sales and net worth of $40,000,000 in 1950. The importance of the charitable trusts in this vast expansion program is difficult to appraise from available facts. But their significant aid at crucial periods is readily apparent. Congressional investigations of Textron may be found in *Hearings before the Subcommittee of the Senate Committee on Interstate and Foreign Commerce*, 80th Cong., 2d Sess. (1948); the subcommittee's report, *SEN. REP. NO. 101, 81st Cong., 1st Sess. (1949)*; and *Hearings on Revenue Revision*, *supra* note 10 at 506-554. Among the law review discussions see, Eaton, *Charitable Foundations, Tax Avoidance and Business Expediency*, 35 VA. L. REV. 809, 987 (1949).
Little other evidence is available of similar use of charitable organizations by persons controlling them. Evidence has appeared, however, that a relatively large number of private foundations are being established by wealthy or moderately wealthy individuals. As distinguished from the older, well-known foundations such as those established by Carnegie and Rockefeller, little public information has been available on these new organizations. Suspicions have been aroused that most of these recent foundations are doing little charitable work, but are serving principally as havens for tax-free funds under the management of the creator and his family.\textsuperscript{17} Certainly this situation was easily possible under the Code prior to the Revenue Act of 1950, for there was no requirement that a charitable organization ever distribute any of its income. And the donor and his family could continue to control the organization, even to the extent of paying salaries and annuities to family members.\textsuperscript{18}

In the Revenue Act of 1950, Congress attempted to solve each of the problems outlined above. The "unrelated business net income" of a charitable organization earned through its direct operation of a commercial enterprise is subjected to tax under the Act.\textsuperscript{19} The so-called "feeder organizations" are denied exemption under the Act and their incomes, therefore, are fully subject to tax.\textsuperscript{20} The rental payments received by a charitable organization under a sale and leaseback are also subjected to tax under the Act, where the organization has borrowed funds to secure the purchase price.\textsuperscript{21} Finally an attempt is made under the Act to prohibit the use of charitable organizations for the private ends of those in control and the unlimited accumulation of income by such organizations, and to supply some public information on the work of these organizations by permitting public inspection of their informational returns.\textsuperscript{22}

\textsuperscript{17} See articles cited supra note 14, and Note, \textit{The Use of Charitable Foundations for Avoidance of Taxes}, 34 VA. L. REV. 182, 183 (1948); \textit{How to Have Your Own Foundation}, FORTUNE, Aug., 1947, p. 108.

\textsuperscript{18} See Latcham, supra note 6 at 623 et seq. Cf. The Cummins-Collins Foundation, 15 T.C. 613 (1950).

\textsuperscript{19} Revenue Act of 1950, § 301, adding INT. REV. CODE §§ 421-424, and amending INT. REV. CODE § 101; Revenue Act of 1950, § 321 (a), adding INT. REV. CODE § 162 (g) (1). See also Revenue Act of 1951, §§ 339, 347, 348, and 601.

\textsuperscript{20} Revenue Act of 1950, § 301 (b), amending INT. REV. CODE, § 101; Revenue Act of 1951, § 601.

\textsuperscript{21} Revenue Act of 1950, § 301 (a), adding INT. REV. CODE §§ 422 and 423; Revenue Act of 1950, § 321, adding INT. REV. CODE § 162 (g) (1).
We shall consider the substance of the Act, following the outline of its provisions as given in the previous paragraph. Next an attempt will be made to evaluate the policy determinations of Congress and to test the merits of those determinations.

1. **Taxing the "Business Income" of Charitable Organizations and Other Institutions Exempt Under the Code.**

The provisions of the 1950 Act with which we are here concerned attempt to do the following things: (1) to define an "unrelated business activity" of a charitable or other exempt organization; (2) to determine the organization's "unrelated business net income" from such activity; and (3) to apply the corporate income tax rates, or in some cases (if a trust) the personal income tax rates, against such net income. Generally speaking, under the Act a charitable organization is engaged in an unrelated business activity if it operates a commercial enterprise, or if it derives rent under a leaseback transaction where the lessor has borrowed money to purchase the property. But general definitions are easy. One of the real difficulties under the Act comes when one attempts to determine whether specific transactions are unrelated business activities. The difficulty inheres in the Act because of the Congressional policy determination that certain types of investment by charitable organizations in income producing activities are permissible and certain types of investment are not. The following paragraphs will largely be devoted to the understanding of the attempt by Congress to make this distinction clear.

The new provisions taxing unrelated business income are numbered Sections 421 through 426 of the Code. Because they are inserted in lieu of the obsolete provisions of Supplement U of the Code, the new sections are referred to in the Committee Reports to the 1950 Act as the "Supplement U Tax." They are generally effective for taxable years beginning after December 31, 1950.

A. **Organizations Subject to Tax Under the Act.**

In this article we are concerned solely with charitable organizations, but the 1950 Act makes the Supplement U tax applicable to organizations exempt under Code Sections 101(1) (labor, agricultural, and horticultur-
tural organizations), 101(6) (charitable, scientific, literary, educational, and religious organizations, other than a church or a convention or association of churches, and organizations for the prevention of cruelty to children or animals), 101(7) (business leagues, chambers of commerce, real estate boards, and boards of trade), and 101(14) (corporations organized for the exclusive purpose of holding title to real property and turning over their income to one of the above listed organizations or to a church or a convention or association of churches) 26 The new taxing sections also apply to any trust which, except for Supplement U, is exempt from taxation under Section 101(6), and which, if it were not for such exemption, would be subject to tax under Supplement E.26 Organizations exempt under Sections 101(1) and 101(7) apparently were brought within the scope of the new legislation because of the fear that these organizations might be utilized for the operation of business enterprises in the future. There was no evidence before Congress that such exempt organizations owned any commercial enterprises at that time.27 Congress apparently believed that other organizations exempt under Section 101 would not be likely subjects for the control of a commercial enterprise. This is perhaps true except for organizations exempt under Section 101(9) (clubs organized and operated exclusively for pleasure, recreation, and other nonprofit purposes). They have already been engaged in a number of cases involving alleged profit-making operations.28 And there has been at least one similar case under Section 101(8) (civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare) 29 In an effort for completeness, at least organizations exempt under these paragraphs of Section 101 should be subjected to the new tax. Congress did not see fit to make such an amendment in the 1951 Act although under the Act building and loan associations, cooperative banks, mutual savings banks, and cooperatives will be subject to the corporate income tax, generally, on their retained earnings.30 And furthermore, the unrelated business income of state colleges and universities will be subject to the Supplement U tax.31

26 INT. REV. CODE § 421(b) (1), added by Revenue Act of 1950, § 301.
26 INT. REV. CODE § 421(b) (2), added by Revenue Act of 1950, § 301.
28 See, e.g., Jockey Club v. Helvering, 76 F.2d 569 (2d Cir. 1935); West Side Tennis Club v. Commissioner, 111 F.2d 6 (2d Cir. 1940); Bohemian Gymnastic Ass'n Sokol v. Higgins, 147 F.2d 774 (2d Cir. 1945).
29 Debs Memorial Radio Fund, Inc. v. Commissioner, 148 F.2d 948 (2d Cir. 1945).
30 Revenue Act of 1950, §§ 313, 314.
31 Revenue Act of 1951, § 339, amending INT. REV. CODE § 421(b). The tax will apply whether the business is operated directly by the university or through a wholly-owned subsidiary. Congressional intent, of course, was to equalize the tax burden as between privately owned educational institutions and those owned by the state.
It will be noted that the Act continues the exemption of the income of churches, or a convention or association of churches, even though income is from unrelated business activities—a possibility Congress apparently believed unlikely. The word "church" is to be strictly construed, however, for the Committee Reports state that "religious organizations" and charitable educational organizations under church auspices are subject to the Supplement U tax. Similarly, as indicated above, the new tax will also apply to a Section 101(14) corporation holding property for a church, or a convention or association of churches.

All organizations when taxed are subject to tax at the corporate income tax rates—with one important exception: trusts are taxable at the individual income tax rates.

It is apparently the intent of Congress to tax the unrelated business income of charitable trusts at the individual rates because a private trust is taxed at the individual rates where its income is not distributed to beneficiaries. As a policy matter, however, there would seem to be no reason for taxing charitable trusts without private beneficiaries at a different rate from that applicable to charitable corporations. Unless Congress eliminates this discrimination against charitable trusts, persons creating charitable organizations should consider the tax advantages of the corporate form of organization.

B. Taxing Unrelated Business Net Income.

The Supplement U tax applies only to the "unrelated business net income" of an organization. Section 422(a), added to the Code by the 1950 Act, defines "unrelated business net income" as "the gross in-
come derived by an organization from any unrelated trade or business regularly carried on by it " less the Section 23 deductions which are directly connected with the operation of such trade or business. Thus we must also define an "unrelated trade or business regularly carried on by " an organization, and this will be considered under the next heading.

(1). Unrelated Trade or Business Defined.

First, what is "regular" as opposed to "sporadic" business activity? The Committee Reports illustrate the difference between the two concepts by citing an occasional dance to which the public is charged admission as a sporadic activity, whereas the operation of a public parking lot, if for only one day a week, would be a regular business activity. Continuity is the touchstone for decision.

But after such continuity of operation is established, other requirements for liability to taxation must be present. The organization must be engaged in a "trade or business," a phrase which the Committee Reports state has the same meaning here as it does elsewhere in the Code. The Committee Reports should have added, however, that it is a phrase which has never been adequately defined under the Code. But more important than determining the meaning of this phrase, is the finding of the scope of the further requirement that the trade or business be "unrelated." The general definition given by new Code Section 422 (b) is not very helpful. An unrelated trade or business, according to the new section, is one not substantially related to the organization's exempt purposes, aside from the need of such organization for income or funds. But the new section does list three instances where business activity is "related." The first is where substantially all the work in carrying on the business is performed without compensation to employees. The second is that of a business operated by a Section 101 (6) organization primarily for the convenience of its members, students, patients, officers, or employees. The third is that of selling merchandise, substantially all of which has been donated to the organization — the instance of the so-called "thrift-shop."

87 SEN. REP. 106-7; H.R. REP. 109.
89 The Committee Reports give the example of an orphanage operating a second-hand store through employees who volunteer to work without compensation. SEN. REP. 108; H.R. REP. 110. An example would be a laundry operated by a college to launder dormitory linen and the clothing of students. SEN. REP. 109; H.R. REP. 110. Compare Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578, 44 Sup. Ct. 204 (1924).
90 SEN. REP. 29. This example of a "related" business was added by the Senate Bill, H.R. 8920, 81st Cong., 2d Sess., as passed by the Senate.
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It should be noted here, furthermore, that the income from certain research activities is not taxable, although Section 422 does not list these activities as those of a related trade or business. Rather, the section states that such income shall be excluded in determining unrelated business net income. Thus all income is excluded when derived from research for the United States, or any of its agencies or instrumentalities, or for any state, or its political subdivisions. Similarly, there shall be no tax upon the income received by a college, university, or hospital for "research performed for any person." And this exclusion likewise applies to an organization operated primarily for the purposes of carrying on fundamental research the results of which are freely available to the general public.

Other than these examples, we must rely on the Committee Reports, and the regulations when they appear, for a more concrete definition of an unrelated trade or business. According to the Committee Reports, the operation of a wheat farm by an exempt agricultural college would not be considered an unrelated business. Nor would the income from charging admissions to athletic activities of a college; nor would the income from a university press "in the ordinary case." All these activities are "substantially related" to the purposes of the college or university. This would not be true, however, of the manufacture and sale by a college of automobile tires. The fact that the college makes some "incidental use" of the tire business such as having some students perform minor clerical or bookkeeping functions as part of their educational program would not make the tire business a "related" activity. Presumably, if a substantial part of the employees were students working without compensation, the income would be exempt.

(2). Exceptions and Limitations to the Term "Unrelated Business Net Income."

Once an unrelated trade or business is defined, and its gross income determined, Section 422(a) provides further exceptions, limitations, and

43 Int. Rev. Code § 422(a) (7), added by Revenue Act of 1950, § 301.
44 Int. Rev. Code § 422(a) (8) (A), added by Revenue Act of 1950, § 301.
47 Id. 29; 37. Revenue Act of 1951, § 347, adds to Int. Rev. Code § 422(b) an amendment relating to the operation of a publishing business. The amendment provides generally that if the exempt organization operates a publishing business, its income shall not be taxable if it becomes a "related" business within three years from the taxable year. The amendment is applicable to taxable years beginning after December 31, 1950 and prior to January 1, 1953.
additions which must be considered. Thus the income of an organization from dividends, interest, annuities, royalties, and, in general, rents from real property, and the deductions directly connected therewith, are excluded from the concept of unrelated business net income. Whether or not these exclusions necessarily imply that the investment activities of an exempt organization giving rise to such types of income are "unrelated business activities" is unimportant, apparently, to a construction of Section 422. But the exclusions do point up the illogic of the unfair competition argument. If a tax-exempt organization can be an unfair business competitor, it can also compete unfairly as an investor. The distinction between "business" income and "investment" income is further sharpened by the comments on these exclusions in the Committee Reports. Rents from real property (including personal property leased therewith) are not taxed, but rents from the "business" of renting personal property are taxed. Similarly, rent from real property does not include income earned from the operation of a hotel, but does include rental payments received from the lease of the hotel. And, even more illogically, income from the operation of a business is taxed, but income received in the form of interest upon overdue open accounts receivable is not taxed.

Section 422 also excludes from the scope of "unrelated business net income" all gains or losses upon the sale, exchange, or other disposition of property other than stock in trade or property held primarily for sale to customers in the ordinary course of trade or business.

This section also provides special limitations upon allowing the net operating loss and charitable contribution deduction in the case of an organization receiving unrelated business net income. Provision is further made for computing unrelated business net income where an organi-
zation is a member of a partnership if the business of the partnership is an unrelated trade or business with respect to such organization.\(^{54}\)

The 1951 Act adds a special deduction from "unrelated business net income" where two or more educational institutions are engaged as partners in an unrelated business acquired before January 1, 1950. If such are the facts the partners are permitted to deduct for the years 1951 to 1953, inclusive, amounts used or irrevocably set aside within the tax year to pay for a business acquired before January 1, 1950.\(^{55}\)

C. Taxing the Income of "Feeder Organizations"

It should be emphasized that the above sections dealing with unrelated business net income have no application to the so-called "feeder organizations" of the C. F. Mueller Co. type. Under Section 301 (b) of the 1950 Act, they are simply declared to be non-exempt organizations, and are, therefore, subject to taxation as ordinary corporations or trusts. Of course, dividends or gifts from the "feeder organization" to the parent charitable institution would not be taxed to the parent as Supplement U income since these items are expressly excluded under the Code from taxable gross income.\(^{56}\) As we have seen, the 1951 Act has solved the pre-1951 tax status of "feeder organizations" where their net income is payable to educational institutions by declaring them exempt.\(^{57}\)

D. Taxing the Income from a Leaseback Transaction

We have noted before that exempt organizations were criticized before Congress, and elsewhere, not only for operating commercial enterprises, but also for investing through so-called sale and leaseback transactions. Congress has attempted to solve the problem under the Act by defining rental income from a specified type of lease or leaseback as taxable unrelated business net income. Such a lease or leaseback is called by the Act a "Supplement U lease." Again, only those organizations exempt under Code Sections 101(1), 101(6), 101(7), and 101(14) are subject to tax on such rental income.\(^{58}\)

What is a "Supplement U lease"? It is defined generally as a lease of

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\(^{56}\) Int. Rev. Code § 422(a)(1), added by Revenue Act of 1950, § 301(A), and Int. Rev. Code § 22(b)(5)

\(^{57}\) See note 8 supra and supporting text

\(^{58}\) See notes 25 and 26 supra and supporting text.
real property for a term of more than five years by one of these organiza-
tions, if at the close of the lessor's taxable year there is an unpaid indebted-
ness respecting the property as defined by Section 423(b)\(^6\) (The in-
debtedness is termed by the Act a "Supplement U lease indebtedness.")
Again, as we have seen before the chief criticism of the sale and lease-
back transaction was that exempt organizations were borrowing money
to purchase the property and paying the purchase price out of the rental
income. And so Congress has specified that there must be an unpaid bal-
ance on the purchase price for rental income to be taxable.

The general definition of a Supplement U lease, however, is subject to
a number of exceptions. In the first place, it applies only to leases of
real property, a term including personal property if it is leased in connec-
tion with the real property.\(^6\) Thus, the income from the following trans-
action might be tax-free to a college: assume the college purchases an ex-
pensive machine on an installment contract, leases it to a factory, and
pays the purchase price out of the rental payments;\(^6\) provided that the
machine can be classified as personal property and not as a fixture, the
lease would not be a Supplement U lease. But the rental income might
nevertheless be taxable as unrelated business net income under Section
422. Rent from personal property is not exempt under Section 422(a).

A second exception involves the term of the lease: it must be for more
than five years. In computing the term, however, the period for which a
lease may be extended or renewed by reason of an option is considered a
part of the term.\(^6\) A three year lease renewable for a like period is con-
sidered a six year lease from its inception.\(^6\) Even a one year lease with
an option to renew for one year would be included within the definition
where the parties renew each year, but only at the inception of the fifth

\(^{6}\) \textit{Int. Rev. Code} § 423(a), added by Revenue Act of 1950, § 301.
\(^{6}\) \textit{Int. Rev. Code} § 423(c), added by Revenue Act of 1950, § 301.
\(^{6}\) For descriptions of similar transactions, see Blodgett, \textit{TAXATION OF BUSINESSES
CONDUCTED BY CHARITABLE ORGANIZATIONS, N.Y.U. FOURTH ANNUAL INSTI-
TURE ON FEDERAL TAXATION} 418 (1946).
\(^{6}\) See Fackler v. Commissioner, 133 F.2d 509 (6th Cir. 1943) (attorney owning an
apartment house held in trade or business); Leland Hazard, 7 T.C. 372 (1946) \textit{acq.}
(attorney renting former residence in trade or business in regard to the property).
See further, N. Stuart Campbell, 5 T.C. 272 (1945) \textit{acq. Compare Deputy v. Du-
\(^{6}\) \textit{Int. Rev. Code} § 422(b), added by Revenue Act of 1950, § 301. See discussion
\textit{supra} p. 108.
\(^{6}\) \textit{Int. Rev. Code} § 423(a), added by Revenue Act of 1950, § 301.
year. The lease would then have been effective for five years and there would be an option for a sixth year. If property is acquired subject to a lease, the term of the lease is stated to begin on the date of acquisition.

The "substantially related purpose" clause forms a third exception. Section 423(a) eliminates from the definition of a Supplement U lease any lease entered into primarily for a purpose substantially related to the organization's exempt functions. The Senate Committee Report gives as an example a case where a hospital leases a clinic to an association of doctors if the lease is made for purposes substantially related to carrying on hospital functions. As a corollary to this exception, Section 423(a) also states that a lease of premises in a building primarily designed for occupancy by the organization shall not be considered a Supplement U lease.

The case of a "split lease" provides the final exception or limitation. Thus if a portion of the premises is leased to one tenant for a term of more than five years and to another for a term of less than five years, what portion of the rental income, if any, will be subject to taxation? Under Section 423(a) only the income from leases of more than five years if subject to tax, and only under one of the two following conditions. First, the rents obtained from the more-than-five-year leases must represent fifty per cent or more of the total rents received for the taxable year from the premises; or the area of the property occupied by tenants under such leases must represent, at any time during the taxable year, fifty per cent or more of the total area of the property rented at such time. Or, second, the rent derived from any one tenant or a group of tenants specifically defined by the Act must represent more than 10 per cent of the total rents derived during the taxable year from the property, or the area occupied by any one tenant or a group of tenants specifically defined by the Act must represent at any one time during the taxable year more than 10 per cent of the total area of the property rented at such time.

(1). Definition of Supplement U Lease Indebtedness.

The definition of the Supplement U lease indebtedness is of fundamental importance for the debt incurred by the lessor in acquiring the property subject to the lease has been made the primary basis for taxing

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66 Ibid.
67 Ibid.
68 SEN. REP. 111. This exception and the one described in the following sentence in the text (premises primarily occupied by the exempt organization) were added to INT. REV. CODE § 423(a) by the Senate Bill, H.R. 8920, 81st Cong., 2d Sess., as passed by the Senate.
69 The exception applies if a group of tenants who are under more than five year leases are members of an affiliated group as defined in INT. REV. CODE § 141, or are partners.
the rental payments in leaseback transactions. Section 423(b) of the Code defines "Supplement U lease indebtedness" to mean, with respect to a lease of real property for more than five years, the unpaid amount of

1. the indebtedness incurred by the lessor in acquiring or improving such property;

2. the indebtedness incurred prior to the acquisition or improvement of such property, if such indebtedness would not have been incurred but for such acquisition or improvement; and

3. the indebtedness incurred subsequent to the acquisition and improvement of such property, if such indebtedness would not have been incurred but for such acquisition or improvement, and the incurrence of the indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

This definition of an indebtedness incurred in a sale and lease transaction attempts to cover not only the traditional purchase of the leased property by an exempt organization through a bank or insurance company loan, but foreseeable variations of that transaction. Thus the indebtedness comes within the definition if incurred in improving, as well as acquiring, the property. And, if it is reasonably connected with the acquisition or improvement of the property, the indebtedness is covered if it was incurred at a time before or after such acquisition or improvement. Furthermore, the section defining Supplement U leases reaches cases where the money is borrowed without placing a mortgage on the leased property. The Committee Reports give the example of a university which pledges some of its securities with a bank for a loan to purchase business property which is leased back to the vendor. The bank loan would constitute a Supplement U indebtedness incurred prior to the acquisition of the property.\textsuperscript{70}

The new section not only attempts to tax the organization, if through any means it borrows money to acquire the leased property, but it also taxes the rental income from the property if the organization acquires property (whether by gift, devise, or purchase) subject to a mortgage, whether it assumes the mortgage or not.\textsuperscript{71} Thus if a college is given business property subject to a mortgage, which the college does not assume, the rental income from the property will be subject to tax as long as the mortgage is in existence. Special exceptions to this rule are provided, however, in the case of property subject to a mortgage acquired prior to July 1, 1950.\textsuperscript{72}

\textsuperscript{70} SEN. REP. 112; H.R. REP. 113.

\textsuperscript{71} INT. REV. CODE § 423(b), added by Revenue Act of 1950, § 301.

\textsuperscript{72} Exceptions under INT. REV. CODE § 423(b), are provided where the property subject to a mortgage was acquired by gift, devise, or bequest prior to July 1, 1950; or where the property was acquired prior to that date subject to a lease requiring improvements upon stated contingencies occurring, and indebtedness is incurred to
The extension of the tax to the income from rental property subject to a mortgage where the property is merely donated to an educational institution would seem to be a questionable policy, even if one agrees to the taxation of leaseback transactions. Certainly a gift of property subject to a mortgage is a pure windfall to the organization. The fact that the property has a mortgage on it has in no way benefited the organization in obtaining the property. Its efforts to pay off the mortgage should not be a reason for taxation when no tax will apply once the debt is repaid.

Section 423, dealing with Supplement U leases and indebtedness, is peculiarly important in the case of Section 101(14) subsidiary corporations. Since the existing provisions of Section 101(14) require corporations exempt under it merely to hold property for another exempt organization and not to engage in any active business enterprise, the only type of unrelated business income which such a corporation could have would be income from a Supplement U lease. Corporations exempt under Section 101(14) are covered by Section 422, defining unrelated business net income, and thus if an exempt organization creates a subsidiary to hold property subject to a Supplement U lease, the income from the lease will be taxable to the parent as unrelated business net income.

(2). Computation of Taxable Supplement U Lease Rents and Deductions.

It has been indicated above that Section 423 provides a formula for determining the amount of rent received under a Supplement U lease which is includible in computing the unrelated business net income for an otherwise exempt organization. The amount of rent to be included...
is "the same percentage (but not in excess of 100 per centum) of the total rents derived during the taxable year under such lease as (A) the Supplement U lease indebtedness, at the close of the taxable year, with respect to the premises covered by such lease is of (B) the adjusted basis, at the close of the taxable year, of such premises."  

Thus, if a college purchased a building of $500,000 out of its own funds and leased the building for more than a five year term to a business concern, the rental payments would not be taxable. If, however, the college borrowed $200,000 to make the purchase, a percentage of the rental payments would be taxable according to the amount of the outstanding debt and the adjusted basis of the property at the close of the taxable year. Assuming the debt is $200,000 and the adjusted basis $500,000, two-fifths of the rent will be taxable income. Of course, the adjusted basis of the premises would have to be changed each year to account for allowable depreciation, deductions, capital improvements, and other capital adjustments. Under the above formula where the adjusted basis is the denominator and the indebtedness the numerator, yearly reduction of the denominator through depreciation adjustments may result in a higher percentage of the rent being taxed in the following year unless the indebtedness is also reduced.

Where only a part of the premises is subject to a Supplement U lease and there is an outstanding indebtedness with respect to the whole property, Section 423(b) provides that an allocation of part of the indebtedness must be made to the part of the property subject to the lease. Thus the adjusted basis of that part of the premises subject to the lease must be determined. This amount will be the denominator in the above formula. And to that part of the adjusted basis must be allocated a proportionate part of the total indebtedness. This amount will be the numerator.

Section 423 also sets forth the deductions which may be taken into account with respect to a Supplement U lease in computing unrelated business net income. They include, generally, taxes and other expenses

76 INT. REV. CODE § 423 (d) (1), added by Revenue Act of 1950, § 301.
77 The term "adjusted basis" is defined in INT. REV. CODE § 113 (b) (1).
78 See SEN. REP. 114; H.R. REP. 115.
79 The allocation of the total indebtedness could be accomplished as follows:

\[
\text{Adjusted basis of part of property subject to lease} \times \text{Total Indebtedness.}
\]

The formula for determining the percentage of rent includible in computing unrelated business net income could be represented as follows:

\[
\frac{\text{Allocable part of Supplement U lease indebtedness}}{\text{Adjusted basis of Supplement U leased premises}} \times \text{Rent.}
\]

See SEN. REP. 114; H.R. REP. 115.
incurred with respect to the property, interest on the Supplement U lease indebtedness, and an allowance for depreciation and obsolescence. The sum of the deductions is subject to the same percentage reduction as that discussed above for determining taxable rental income. If only a portion of the property is subject to a Supplement U lease, Section 423(d) provides that only those deductions properly allocable to the part of the premises covered by the lease may be taken into account.

E. Exemption for Prior Years of Organizations Engaged in Business Activity.

The Senate Bill to the Act added Section 302, dealing primarily with the exemption of organizations in past years. The section was amended to its present form in conference. The first paragraph of Section 302 assures that for years beginning prior to January 1, 1951, no organization shall be denied exemption under Section 101(1), (6), or (7), merely because it was during those years deriving income from a trade or business if this income would not be taxed in future years under the Act as unrelated business income, or merely because the income from such trade or business is rental income from real property. This would not afford much relief to an organization operating a manufacturing plant for years prior to January 1, 1950. But the provision would seem to mean, at least, that rental income from a sale and leaseback shall not be taxed as income from a trade or business for prior years.

Under the second paragraph of Section 302, the filing of an informational return (Form 990) is to be considered the filing of a return for the purpose of starting the three-year period of limitations on the assessment of deficiencies with respect to organizations which are exempt under Section 101 except for the operation of a trade or business. If an organization was not required to file an informational return, it will be deemed to have done so. This second provision does not apply, however, in cases where prior to September 30, 1950, a deficiency has been assessed against an organization, or taxes have been assessed or paid.

The third paragraph of Section 302 assures that an income, estate, or gift tax charitable deduction for a gift or bequest to an organization prior to January 1, 1951, will not be denied, if under the limitations of the

80 INT. REV. CODE § 423(d) (3), added by Revenue Act of 1950, § 301.
81 INT. REV. CODE § 423 (d) (2), added by Revenue Act of 1950, § 301.
82 SEN. REP. 115-119.
83 See Summary of H.R. 8920 as agreed to by the Conferences, 96 CONG.REC. 1638, 1646-7 (September 22, 1950).
84 Revenue Act of 1950, § 302(a)
85 In regard to other possible bases for taxing the income of a sale and lease-back transaction, see articles cited supra note 11, and note 13.
86 Revenue Act of 1950, § 302(b).
above first and second paragraphs, the exemption of such organizations could not be denied.\textsuperscript{87}

As has been stated before, Section 303 of the Act makes the sections taxing unrelated business income applicable only to years beginning after December 31, 1950. This section also adds a statement of Congressional intent with respect to the pending litigation involving the exempt status of so-called "feeder organizations." The effect of the provision is that no inferences shall be made as to prior years from the fact that the business income from feeder organizations is specifically taxable under the Act.\textsuperscript{88} And, in addition, Section 601 of the 1951 Act specifically exempts "feeder organizations" for years prior to 1951 where their income inured to an educational institution.\textsuperscript{89}

2. Limitations on Family Control of Charitable Organizations.

As we have noted, the 1950 Revenue Act, as it affects charitable organizations may be divided into two grand divisions: (1) sections taxing the business income of such organizations; and, (2) provisions denying exemption to such organizations if the grantor or his family retain certain controls over the administration of the organization.\textsuperscript{90} Related to these second provisions is a section limiting the amount of income which the organization may accumulate,\textsuperscript{91} and related to both provisions is a section requiring the organization to file informational returns open to public inspection.\textsuperscript{92}

Insofar as administrative control by the grantor or his family is concerned, the Act does not go far beyond the limitations of prior law. Before the passage of the 1950 Act, the creator, his family, or associates could act as trustees and officers of the charitable organization. Reasonable salaries could be paid by the foundation to employees, including the creator and members of his family for services performed. Even annuities payable to private individuals out of the organization's net income were permissible if the annuities were merely "incidental" to the main charitable purposes of the organization.\textsuperscript{93} The further limitations, enunciated

\textsuperscript{87}Revenue Act of 1950, § 302(c).
\textsuperscript{88}On this matter § 303 states specifically, "The determination as to whether an organization is exempt under § 101 of the Internal Revenue Code from taxation for any taxable year beginning before January 1, 1951, shall be made as if § 301(b) of this Act had not been enacted and without inferences drawn from the fact that the amendment made by such section is not expressly made applicable with respect to taxable years beginning before January 1, 1951."
\textsuperscript{89}See note 8 supra.
\textsuperscript{90}Revenue Act of 1950, §§ 321, 322, 331, adding INT. REV. CODE §§ 162(g) and 3813.
\textsuperscript{91}Revenue Act of 1950, §§ 321, 331, adding INT. REV. CODE §§ 162(g)(4) and 3814.
\textsuperscript{92}Revenue Act of 1950, § 341, adding INT. REV. CODE § 153.
by the courts and Treasury as a part of the Clifford doctrine, apply specifically to trusts but there is no reason why they could not be applied to corporations. Under these limitations, the grantor is still liable for tax upon trust income unless certain conditions are met. The trust term must be for a duration of at least 10 years if the grantor retains a reversionary interest. The grantor, his family, or anyone without a substantial adverse interest, however, can still control the disposition of income to charitable beneficiaries. They can hold the power to vote the stock held in trust, to direct the investment of trust corpus, and to substitute property of an equivalent value for trust property, if these powers are held in a fiduciary capacity. But neither the grantor, nor his family, nor anyone without a substantial adverse interest can hold the power to purchase, or sell, trust property for less than an adequate consideration. Nor may they have a power which enables the grantor to borrow trust income or corpus without the payment of reasonable interest in any case, or, generally, without the giving of adequate security. And, further, the grantor may only borrow trust corpus or income for periods shorter than one year.

These limitations left the grantor and his family with broad powers of control over a foundation. Of course, there is the question under the Clifford regulations of what is a "fiduciary capacity," but as long as the grantor, or anyone, holds the powers as a trustee, he is presumed to hold them as a fiduciary. The limitations on sales and purchases, or loans, between the grantor, his family, and the foundation may be summarized in the phrase: such transactions must be carried on at arms length. There is, however, nothing to prevent sales or loans between the trust and the grantor or members of his family.

The 1950 Act is a step forward in solving the family control problem if only for the fact that its provisions are directly aimed at meeting the problem, whereas the cases and regulations forming the Clifford doctrine do not deal primarily with charitable trusts. The Act is concerned with prohibiting the same types of condemned administrative powers in the hands of the grantor as the Clifford regulations, although the act does not require that the power to vote securities of the organization, to direct investment of those securities, or to substitute the organization’s property for other property of an equivalent value be held in a “fiduciary capacity.”

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94 Latcham, supra note 6, 98 U. OF PA. L. REV. 617, 639-643.
95 See Helvering v. Clifford, 309 U.S. 331, 60 Sup. Ct. 554 (1940); U.S. TREAS. REGS. 111, § 29.22(a)-21,22 (the Clifford Regulations).
96 Latcham, supra note 6, 98 U. OF PA. L. REV. 617, 626-630.
97 Id. at 624-626. The limitations enumerated were adopted by the Treasury in the Clifford Regulations, U.S. TREAS. REGS. 111, § 29.22(a)-21(c)-(e).
98 Latcham, supra note 6, 98 U. OF PA. L. REV. 617, 623, 624.
are also specifically covered by the Act. Presumably, the *Clifford* regulations will still apply to charitable trusts for they are intended to solve a problem somewhat different from that with which the Act is concerned. That is, the regulations deal with the issue of when the settlor of a trust has retained such control over the trust that, for tax purposes, he should be taxed upon the trust income. The provisions under the Act are concerned with whether the charitable organization is exempt, or not, after considering the creator's retained powers. The Act would naturally supersede the regulations in resolving the exemption problem.

In summary, the Act attempts to control family domination of foundations by defining prohibited transactions and denying exemption to the organization, and denying charitable deductions to donors of gifts to the organization, if the prohibited transactions are consummated. The provisions which deny exemption and charitable deductions will be considered in the following paragraphs—after some preliminary considerations.

At the outset, it should be noted that the Act is only concerned with completed transactions whereas under the *Clifford* regulations if a person has the power to exercise a proscribed power that factor alone is sufficient to invalidate the trust for tax purposes. Secondly, the Act is broader than the regulations in that it limits transactions between the organization and the creator (if a trust), a substantial contributor, members of the family of the creator or substantial contributor, or a corporation controlled by the creator or substantial contributor. The House Bill went even further and regulated transactions between the organization, and its officers or trustees and their families.

The first transactions disallowed by the Act are loans by the organi-

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90 See *Clifford* Regulations, ¶ (e).
91 Sections 3813 and 3814 of the Code, which define prohibited transactions and unreasonable accumulations in the case of organizations exempt under section 101 (6), are not applicable to (1) a religious organization (other than a trust); (2) an educational institution with a regularly maintained faculty, curriculum, and student body; (3) an organization receiving substantial governmental support; (4) an organization operated by a religious organization (other than a trust); (5) an organization the principal purposes of which are medical care, education, or research. See *Int. Rev. Code* § 3813(a) These exceptions are taken from *Int. Rev. Code* § 54(f), which requires informational returns from exempt organizations. See also *Sen. Rep.* 38, 123.
92 Prohibited transactions are defined in *Int. Rev. Code* § 162(g) (2) (B) for trusts and § 3813(b) for organizations exempt under § 101(6).
93 "Family" under *Int. Rev. Code* §§ 162(g) (2) (B) and 3813(b) means the term family "as defined in § 24(b) (2) (D) " Section 24(b) (2) (D) has a somewhat narrow definition of the term family. "The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."
94 "Control" is defined by the Act as "the ownership, directly or indirectly, of 50 per centum or more of the total combined voting power of all classes of stock entitled
zation to the persons or corporation above listed without adequate security and a reasonable rate of interest. This measure is less restrictive than the Clifford regulations in the sense that loans may be made for any period of time, whereas under the Clifford regulations loans to the grantor must be for a period of less than twelve months. Loans of this character were entirely prohibited in the House Bill.

The next two proscribed transactions are merely enunciations of prior law as far as they go. The persons or corporation above listed may not receive compensation for personal services unless it is reasonable in amount and is paid for services actually rendered; nor may they receive services of the organization on a preferential basis. There is no reason why these transactions should be restricted to the grantor or a substantial contributor, their families and controlled corporations. Cases arising before the passage of the Act had interpreted Code Section 101(6) to prohibit paying to anyone compensation unreasonable in amount or for services not actually rendered, and to prohibit services to anyone on a preferential basis. The payment of unreasonable salaries or the rendering of services on a preferential basis was held to violate the requirement that "no part of the net earnings [may inure] to the benefit of any private shareholder or individual," found in all the charitable deduction and exemption sections. A question may now arise as to whether the narrower language of the new Act should prevail. A clarifying amendment seems in order to prevent an interpretation permitting anyone to receive an unreasonable salary or preferential services.

The Act also forbids an organization to make "any substantial purchase of securities or any other property for more than an adequate consideration in money or money's worth," from the grantor or a substantial contributor, their families or controlled corporations. And in a similar vein, the Act prohibits the sale of "any substantial part of [the organization's] stock to vote or 50 per centum or more of the total value of shares of all classes of stock of the corporation." INT. REV. CODE §§ 162(g) (2) (B), 3813(b)

Note that in the case of trusts, the prohibited transactions apply only to "income or corpus of the trust which has been permanently set aside or is to be used exclusively for charitable or other purposes described in [Sec. 162(a)]." INT. REV. CODE § 162(g) (2) (B). This restriction was apparently believed necessary because a trust may have both private and charitable beneficiaries, and yet receive the benefits of the total charitable deduction under § 162(a).

See U.S. TREAS. REGS. 111, § 29.22(a)-21(e) (3)

§§ 321(a), 331(a), H.R. 8920, as passed by the House, June 28, 1950.

§ 321(a), 331(a), H.R. 8920, as passed by the House, June 28, 1950.

INT. REV. CODE §§ 162(g) (2) (B), (ii), (iii); 3813(b) (2),(3), added by Revenue Act of 1950, §§ 321, 331.

tion's] securities or other property, for less than an adequate consideration to such persons or corporations. These provisions appear to mean that an organization may sell a substantial part of its assets to a large contributor, for example, as long as an adequate consideration is paid. And, similarly, for a substantial purchase by the organization from a large contributor: it is permissible if not more than an adequate consideration is paid. It would seem obviously incorrect to interpret these sections as prohibiting substantial sales or purchases between the organization and the named persons or corporation as did the corresponding sections of the House Bill.

Finally, the Act prohibits the grantor or a substantial contributor, their families or controlled corporations from engaging "in any other transaction which results in a substantial diversion of the [foundation's] income or corpus". This paragraph is apparently intended to protect against improper diversion of funds in ways other than through the sale and purchase of property.

The provisions limiting sales and purchases may be questioned as to the policy behind them in regard to "insubstantial" sales or purchases. Although the implication may be there, it would seem improper to construe these sections to mean that insubstantial sales or purchases may be consummated for an inadequate consideration.

As we have noted above, the Act imposes two sanctions for an organization's engaging in a prohibited transaction: the denial of exemption to an organization exempt under Section 101(6), or of an unlimited charitable deduction to a trust under Section 162(a), and the denial of a charitable deduction to a donor making a gift to the organization or trust.

The organization's exempt status (or unlimited deduction privilege) is only affected for the year of its dereliction and following years, with one exception. The exception occurs where the organization entered into such prohibited transaction with the intention of diverting income or corpus from its exempt purpose "and such transaction involved a substantial part of such corpus or income." Apparently, if this is the case, exemption may also be denied for any number of prior years. The Senate Finance Committee Report gives the illustration of a foundation losing its exempt status for the taxable years 1955 through 1960 and future years where the organization was created in 1955 and the prohibited transaction occurs in 1960.

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109 INT. REV. CODE §§ 162 (g) (2) (B) (iv), (v), 3813 (b) (4), (5), added by Revenue Act of 1950, §§ 321, 331.
110 §§ 321 (a), 331 (a), H. R. 8920, as passed by the House, June 28, 1950.
111 INT. REV. CODE §§ 162 (g) (2) (B) (vi), 3813 (b) (6), added by Revenue Act of 1950, §§ 321, 331.
112 See SEN. REP. 123.
Once it is lost, the privilege of exemption or unlimited deduction may be regained by filing a claim, under regulations to be issued by the Treasury, in any taxable year following the taxable year in which notice of denial of exemption was received. The claim for exemption is to be granted if the Secretary of the Treasury, pursuant to such regulations, is satisfied that such organization "will not knowingly again engage in a prohibited transaction."116 The new privilege of exemption or unlimited deduction will begin with the taxable year subsequent to the year in which such claim is filed.

Donors are also denied charitable deductions under appropriate Code sections for gifts to the organization in the taxable year in which the organization has lost its exemption or its privilege for an unlimited deduction.117 Furthermore, the deduction may be disallowed for the year in which the prohibited transaction occurred, or for prior years, if the donor, or any member of his family, was a party to a prohibited transaction, where there was the purpose to divert a substantial part of the organization's income or corpus from its charitable activities.117 Apparently here, as under the previous exemption paragraph, an "intent" to divert for private ends must be shown.

3. Accumulation of Income and Informational Returns.

There might not seem to be a particularly close relationship between restricting the accumulation of income by charitable organizations and requiring them to file public informational returns. But the two matters may conveniently be considered together because Congress in the 1950 Act attacked the accumulations problem by enacting a generally worded provision limiting accumulations, and by providing for the filing of public informational returns.

As we have noted, prior to the passage of the 1950 Revenue Act, the Code did not require an exempt organization (or a trust obtaining a complete deduction under Section 162(a), to distribute any of its income. Aside from the possibility of the attorney-general of the state of its creation forcing the organization to terminate an unreasonable accumulation, the organization could refrain from distributing its income for an indefinite period.118 The problem of accumulation by exempt organizations was brought to a head by the operations of the Textron organization.119 Dur-

113 Ibid.
115 Int. Rev. Code §§ 162(g)(2)(D), 3813(d).
116 Int. Rev. Code §§ 162(g)(2)(e), 3813(e).
118 See Latcham, supra note 6, 98 U. of Pa. L. Rev. 617, 650.
119 Note 16, supra.
ing the period of Textron's spectacular growth, little or no income was ever distributed to the charitable beneficiaries of its controlled trusts. Instead, the income was used for investment purposes beneficial to Textron. This use of the exemption privilege, together with other previously discussed uses inimical to the spirit of the "charities" sections of the Code, prompted proposals for remedial legislation.

Bills were introduced in the first session of the 81st Congress which would have required exempt organizations to distribute seventy-five or eighty-five per cent of their gross income for charitable purposes within the taxable year or shortly thereafter. As passed by the House, the 1950 Act contained elaborate and complex provisions taxing accumulated investment income of charitable organizations (as distinguished from unrelated business income) unless it was distributed within two and one-half months after the close of the taxable year. Certain exceptions to the tax were permitted in order that limited types of income accumulations could take place. The tax would not apply to a trust created before June 1, 1950, the terms of which required the accumulation of income. An accumulation provision covering property left in trust by will would also be permitted, but the period of accumulation could not exceed twenty-five years. An organization could also accumulate, tax-free, an amount equal to one year's investment income. And, furthermore, an organization could create a separate trust to accumulate income for five years if all of the income and corpus was payable to a specified charitable purpose.

The provision of the House Bill taxing accumulated investment income was eliminated by the Senate Finance Committee and in its place was substituted a requirement for the filing of informational returns open to public inspection. The conferees also added to the Act a measure denying exemption to an organization where its accumulation of income is unreasonably large, or used for unrelated purposes. Unfavorable testimony before the Senate committee influenced its decision to make the

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120 Note 118, supra.
122 The provisions were limited to so-called "private" charitable organizations (see note 99 supra) exempt under Int. Rev. Code § 101 (6), and trusts permitted an unlimited charitable deduction under Int. Rev. Code § 162 (a)
123 See discussion H.R. Rep. 115-123.
For example, a foundation with a relatively small endowment might depend to a large extent upon annual donations to maintain its activities, and, therefore, wish to accumulate the income from the endowment for years when such donations were not sufficient. Its efforts to accumulate income would be severely restricted by the House Bill. Furthermore, under this measure, an organization could not, in most instances, set aside a part of its income to endow future operations of its own, or those of another institution. Nor could a foundation set aside funds which, if subsequently matched by another organization, would be applied to a specific project. The five year trust provision was severely limited in regard both to time and to the fact that a specific use for the funds must be irrevocably specified in the instrument before income could be accumulated. While the effort to eliminate the abuse of unreasonable accumulation of income is undoubtedly laudable, the House Bill might unnecessarily have hampered worthwhile foundation activities. It would seem that until further study is made, the abuses can be reached through the measures of the present Act.

As was true of the House measure, the section of the present Act specifically condemning unreasonable accumulations applies only to "private" foundations and trusts—that is, the Act applies to charitable organizations other than those of a religious nature, or educational institutions with a regular faculty and student body, or institutions devoted to medical care and research. Exemption is denied (or charitable deduction under Section 162(a) disallowed) if income accumulated in the current or in prior years is unreasonably large, or is held for an unreasonable period of time, in view of the organization's exempt purposes. Exemption (or deduction) is likewise denied if accumulated income is used to a substantial degree for non-exempt purposes, or is invested in such a manner as to entail risk that the funds will be lost. Exemption is lost only for one year; a new determination of the factors condemned must be made the following year.

The section is generally worded and may be criticized for that reason. But it is difficult to enact anything other than a generally worded pro-

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126 See, e.g., Hearings before the Senate Committee on Finance on H.R. 8920, 81st Cong. 2nd Sess. 656, 682 (1950).
127 See SEN. REP. 34 for a list of objections.
128 INT. REV. CODE § 3814 applies only to organizations described in INT. REV. CODE § 101 (6), to which § 3813 is applicable. Section 3813 applies only to the so-called private charitable organizations. See Note 99, supra. Section 162(g) (4) applies similar restrictions against the income accumulations of trusts.
129 See Summary of H.R. 8920 as Agreed to by the Conferes, 96 CONG. REC. 1638, 1645-7, (Sept. 22, 1950).
vision, without producing an inflexible measure, in an area where it is hard to distinguish between foundations carrying on legitimate charitable activities and those maintained purely for the personal benefit of persons controlling the foundation. A generally worded measure places the burden upon the Treasury to administer it conscientiously and yet sympathetically. As we shall see, the provision could undoubtedly be used effectively against the Textron trusts. The measure could be sharpened in regard to specific details, however, without making it inflexible. For example, accumulations are disallowed which "are unreasonable in duration in order to carry out the purpose or function constituting the basis for such organization's exemption." Assume that a family foundation is chartered for the express purpose of accumulating income for fifty years, the accumulated income then to be used to erect an expensive dormitory on a college campus. In the meantime, the family members act as trustees of the foundation, controlling its investment policies, and, perhaps, receiving "reasonable" salaries. Presumably, that part of the provision quoted above would not prevent an accumulation of this nature. A restriction upon funds for such a length of time does not seem desirable. Therefore, it is suggested that a reasonable time limitation upon accumulations be added to this provision, requiring a private foundation to distribute its accumulated income every fifteen or twenty years despite its charter provision. If the income could not be distributed to the original beneficiary contemplated in the instrument creating it, then the provision could require payment to be made to a reasonably related purpose. A fifteen or twenty year period does not seem an unreasonably short time within which accumulations must be distributed. It would mean that income must be devoted to charitable purposes roughly within the generation following the creation of the foundation. The founder of the Rosenwald Foundation believed that both capital and income should be distributed within twenty-five years of the organization's creation, and he wrote this requirement into the charter of the organization he created. Future generations should not be restricted too heavily by the desires of their forebears.

It should be emphasized, in passing, that the problem of improper accumulation of income, and that of grantor domination of the foundation, are not synonymous. But once grantor control is severely limited, the accumulation problem assumes less importance.

The second provision attacking the problem of accumulation of in-

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220 See p. 132, infra.
222 Compare Hobhouse, The Dead Hand (1880); Scott, Control of Property by the Dead, 65 U. of Pa. L. Rev. 527 (1916).
TAXATION OF CHARITIES

come—that is, the provision relating to public informational returns will serve two purposes. First, public information will encourage distributions. Second, such information will reveal the extent of the accumulations problem and whether more extensive legislation such as the provision against accumulations contained in the House Bill is necessary. New Code Section 153, detailing the information required in returns from "private" foundations does not introduce a novel idea. Information returns were required by regulations for the taxable years 1941 and 1942, and have been required by Code Section 54(f) since 1943. The information required by the 1950 Act is not much more extensive than that required under Form 990, promulgated under authority of Section 54(f). Under the new provisions of the Act, however, trusts claiming a charitable deduction under Section 162(a) must file an information return similar to those filed by organizations under Section 54(f) unless all of the trust's net income for the taxable year is required, under principals of the law of trusts, to be currently distributed to the beneficiaries. And, of course, the Act adds a requirement that the information, or at least part of it, be made public.

A number of new forms for filing informational returns under the new Code provisions have replaced former Form 990. Exempt organizations, except those coming within Section 101(6), file returns on a new Form 990. Organizations exempt under Section 101(6) file returns on Form 990-A, and trusts claiming a charitable deduction under Section 162(a), on Form 1041-A. Unrelated business net income will be reported on Form 990-T, which has not yet been promulgated. Turning specifically to Forms 990-A and 1041-A, they call for most of the same information which former Form 990 required. A fairly detailed statement of the organization's sources of income, and its disposition of income, must be given. Expenses and compensation paid must be listed, as well as distributions of income or capital and the names of donees. A balance sheet

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Footnotes:
130 For a description of former Form 990, see Latcham, supra note 6, 98 U. Of Pa. L. Rev. 617, 651.
131 INT. REV. CODE § 153(b).
132 This exception to the reporting requirements of trusts was added by Pub. L. No. 35 (H.R. 3196), 82nd Cong., 1st Sess., approved May 17, 1951, as an amendment to INT. REV. CODE § 153(b). The measure seems reasonable and may encourage the creation of trusts requiring complete annual distribution of net income to charitable beneficiaries. Even where all the net income of a charitable trust must be distributed to beneficiaries, however, unreasonable salaries might still be paid to members of the settlor's family and the salaries would not be the subject to adequate reporting. For this reason, the amendment may not prove advantageous.
133 INT. REV. CODE § 153(c).
for the beginning of the year must be given. And if the organization holds more than ten per cent of the capital stock in any corporation, the name of the corporation and a description of the stock must be reported.

The chief new items which the forms require charitable organizations to disclose are their accumulations of income for the present year, and the total of their accumulations of income at the beginning of the year. And Form 990-A requires a "detailed statement" if any compensation has been paid by the organization to its creator, a contributor, their families or controlled corporations, or if the organization has bought property from them, or sold it to them, or has made services available to them, or has diverted income or corpus to them. This information need not be contained in the part of Form 990-A made available to public inspection.

The Secretary of the Treasury has broad discretion under New Code Section 153 in regard to the descriptive matter which the forms filed by charitable organizations must disclose. But there appears no reason why trusts taking a charitable deduction under Section 162(a) and filing on Form 1041-A should not have to detail compensation, et cetera, when paid to the creator, or his family, as do corporations filing on Form 990-A. Nor is there a reason why this information, in both forms, should not be made public. In the interests of minimizing family control, public information of such salaries and other transactions might well be required. Furthermore, there is a question under Section 153 whether all information which the Secretary requires to be filed must not be made public.

In fact, the names, relationship, and business association with the founder, of all trustees, officers, and members of any committee controlling investments of assets and distribution of income should be itemized, and their compensation separately listed. Furthermore, the foundation's assets and all major changes in assets during the year should be described. And these details should be made public information. These steps to broaden the return could be taken by the Secretary of the Treasury under the authority now given him by Sections 54(f) and 153, and in the interests of enforcement of the Code, they should be taken.


As we have seen, Congress in the 1950 Act was not interested in legislation directly limiting the charitable activities of any qualified, independent charitable organizations. The suggestion of placing a percentage

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139 INT. REV. CODE § 153(c) states: "The information required to be furnished by subsections (a) and (b), together with the names and addresses of such organizations and trusts, shall be made available to the public at such times and in such places as the Secretary may prescribe." Subsections (a) and (b) list the information which organizations exempt under § 101(6) or claiming a charitable deduction un-
limitation upon the estate and gift tax deduction of charitable donations, even to private foundations, apparently was not given any serious consideration. Instead, Congress followed rather closely the Treasury's suggestions\(^4\) that charitable organizations be denied the privilege of receiving tax-free income from certain investment activities, and that control by the creator or his family of a private foundation for their personal welfare, be prohibited. Out of these two fundamental objectives grew the provisions of the 1950 Act, and it is the intention of the author to consider the effectiveness of those provisions, and possible additions to, or substitutes for, those provisions in the ensuing pages.

A. Commercial Enterprises and Leaseback Transactions.

It is clear from both the Congressional hearings and the 1950 Act that the problems presented by exempt organizations in which Congress was primarily interested were the operation of commercial enterprises by charitable organizations and their investment through the sale and leaseback transaction. And since colleges and universities were the principal charitable organizations engaging in these income producing activities, Congressional attention was centered upon educational institutions. It is true, of course, that private individuals could, before the Act, sell their businesses to their controlled foundations which, in turn, could pay the purchase price out of tax-free income, and, after the "sale" the seller could still be in control of the business. But apparently no present examples of such activities were pressed upon the attention of Congress.\(^4\)

It is far from clear, however, that Congress placed the correct emphasis on the problems presented by exempt organizations. Privately endowed educational institutions must find new and more promising fields of investment if they are to remain strong and effective. Private charitable foundations must be established as independent organizations, freed from the stigma of being typified as tax avoidance devices, as well as from their possible use as such devices, if they are to be of real social benefit. A method was suggested to Congress for preventing charitable organizations from gaining any undue competitive advantage through the operation of a commercial enterprise, and yet permitting them to invest in this new and more promising field, but the plan was given little, if any, attention.\(^4\)

\(^{4}\) See Statement of the Secretary of the Treasury in I Hearings before the House Ways and Means Committee, 81st Cong., 2d Sess. (Feb. 3, 1950).

\(^{4}\) See Roche's Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938) and related cases discussed in Latcham, supra note 6, 98 U. OF PA. L. REV. 617, 631 et seq.
The merit in this solution is that it takes away the advantage of accumulating tax-free income and, therefore, most of any claimed competitive advantage which a tax-exempt organization would have over its non-exempt competitor. The plan is to require the exempt organization which operates a business to distribute to its charitable purposes the amount that the foundation would otherwise have to pay in federal income taxes. A further provision might also be added requiring the distribution from net income of the equivalent to a reasonable dividend distribution.\textsuperscript{143} This amendment would not allow the exempt organization to accumulate a larger percentage of its net income than its non-exempt competitors. It would prevent the exempt organization from buying a business and repaying the former owner out of net income at a faster rate than could a non-exempt purchaser. It would also prevent the exempt organization from underselling competitors, although there is no evidence that this has occurred.\textsuperscript{144} The amendment, furthermore, would take away the advantage of selling a family business to a controlled foundation, because the foundation could not repay the former owners any more rapidly than could a non-exempt corporation.

Of course, care would have to be exercised in defining the exempt organizations to which payments in lieu of taxes might be made. They could not be merely other controlled foundations of the operating corporation but would have to be qualified, independent charitable organizations. Closely enforced standards would have to be established, and probably a list of qualified organizations maintained, by the Bureau of Internal Revenue. But the plan should not be too difficult to formulate, and it may be the only ultimate answer to financing private charitable institutions other than through direct government subsidy.

This solution to the problem can apply both to the operation of a business, and to the sale and leaseback transaction where the purchaser-lessee borrows money to finance the purchase. The difficulty with the solution from the charitable organization's point of view is that where the organization must borrow to purchase the income-producing property, the organization usually finds it necessary to use most of the income to repay the loan.\textsuperscript{145} If a substantial percentage of this income must be devoted to charitable activities, exempt organizations will have to use

\textsuperscript{142} See testimony of Mr. John Gerdes, Hearings on Proposed Revision of the Internal Revenue Code, H.R., 80th Cong., 1st Sess. pt. 5, 3527 (1947-48)
\textsuperscript{143} Eaton, supra note 3, 37 VA. L. REV. 253, 282.
\textsuperscript{144} Indeed, as Mr. Gerdes testified, most colleges and universities need all of the income they can scrape together. See note 142, supra.
\textsuperscript{145} For example, the indications are that the deal between Allied Stores and the Union College subsidiary could not have been consummated if the subsidiary had not been tax exempt. See Cary, supra note 11, 62 HARV. L. REV. 1, 30.
their own capital, or substantially their own capital, to purchase businesses or income producing property for investment purposes. This may not be an unreasonable compromise, however, to ask them to make for the privilege of experimenting in these new and more promising fields of investment. Critics of these new investment practices would undoubtedly never accept anything less than provisions similar to those which we have just outlined.

The Committee on Financial Support and Taxation of the American Association of Universities took a different position in a report issued in April, 1950.146 It believed that a university should not seek tax exemption for a "feeder organization" operating a commercial or manufacturing business. But the committee was further of the opinion that a university should not be subject to tax on any earnings which it might derive from an operation carried on directly by the university. It was the view of the committee, however, that the public interest was not being served when a university directly operated a commercial enterprise having no relation to the university's educational work. And the committee also thought it unwise for a university to engage directly or indirectly in a sale and lease-back transaction in which the university supplied no substantial part of the purchase price. Thus the committee believed that only "feeder organizations" should be actually subject to tax. And it made the significant point that taxing these entities would largely solve the problem as far as universities are concerned. Few boards of trustees, it stated, would be willing to accept the liabilities involved if businesses were directly operated by universities.

Of course, the problem of determining sound tax policy is difficult at best, in this area as in every other. But it does not seem that the complex provisions of the 1950 Act taxing unrelated business net income form the most logical or the most desirable answer to the problem. There seems no reason for penalizing socially useful, independent charitable organizations by classifying them in the same category as grantor-controlled foundations, and placing blanket prohibitions on both. To some it seems sinister for private universities to attempt to survive independent of government aid by seeking wider investment opportunities. And, yet, the facts are plain. Private universities and colleges cannot carry on their vast educational programs on private donations alone. If there is nothing menacing about their holding all of the outstanding securities of a corporation and thereby controlling its policies, there is nothing dangerous in their attempting to operate the business directly, as long as they are not permitted an undue advantage over non-exempt competitors. If pri-

vate businessmen are worried about government control of education, they should ponder the suggested amendments more carefully.

B. Control of Private Foundations by the Creator and His Family.

The problem of control of foundations by their creator, his family, and business associates, for their private purposes involves a number of fact situations ranging from a case like that of Textron, Inc., where charitable trusts were used to aid in a vast expansion program, to a situation like that planned by the Ford family, where a foundation was utilized to continue family control of a corporation, to instances where foundations are created as tax-free havens for family savings, and their income is used to some extent to aid family members, or to enhance family prestige through occasional charitable donations. If private foundations are to continue to be the source for worthy public benefactions and to serve as the impetus for new thought and research outside of government directed projects, they must be freed from the possibilities of manipulation for private ends. Has the 1950 Act accomplished this goal? Let us review the Act from the aspects of the three examples of family control noted above.

(1). The Textron Situation.

The Textron case must be considered as an aberration in surveying the general field of charitable organizations. It is an extreme example in that practically every variety of transaction for which charitable organizations have been criticized was consummated by these trusts. Congress apparently found, however, that in attempting to enact legislation severe enough to prevent similar use of charitable trusts in the future, it might materially hamper the flexible operation of charitable organizations of the traditional type. The result was a considerable amelioration of the scope of the legislation originally proposed in the House, to the point where only a few provisions survived which may be effectively used by the Commissioner against a recurrence of the Textron affair.

The principal reason for the tremendous effectiveness of the Textron trusts, according to Congressional hearings, was that they could accumulate and reinvest tax-free income without annually distributing the income to the beneficiaries. Therefore, the early measures introduced to check the operations of these trusts were principally provisions requiring charitable organizations to distribute a large percentage of their income annually to charitable purposes.\(^{147}\) As we have seen, the House version of the 1950 Revenue Act contained an elaborate provision requiring so-called private charitable organizations to distribute annually substantially all of their net income. Because of the complexity of the provisions, however, and their

\(^{147}\) See Latcham, supra note 6, 98 U. OF PA. L. REV. 617, 650, n. 153.
general lack of flexibility, the Senate was persuaded to eliminate the section and the House conferees concurred after a generally worded substitute provision was added.\textsuperscript{148}

The substitute provision is specifically aimed at cases like Textron. And, despite the generality of its language, if the provision is vigorously enforced it could prohibit that manner of using trust funds without endangering proper accumulation of income by all charitable organizations. The section,\textsuperscript{149} as noted above, denies exemption for the taxable year to a so-called "private" charitable organization where its accumulations of income from past years, or from the present year, (1) are unreasonable in amount or duration in order to carry out the organization's charitable purposes; (2) are used to a substantial degree for purposes other than those constituting the basis of its exempt functions (or deduction if a trust), or (3) are invested in such a manner as to jeopardize the performance of its charitable purposes constituting the basis for its exemption, (or its deduction if a trust) The provision applies, of course, to both charitable corporations and trusts.

The measure will require charitable organizations to persuade the Bureau of Internal Revenue that their accumulation of income is a reasonable amount necessary for their exempt activities. Furthermore, they must show that their investment of income will not jeopardize those activities. Clearly in the case of the Textron trusts their large accumulated incomes and their continued investment of accumulated income in Textron's ventures could hardly have been so justified.\textsuperscript{150} This provision should give the Commissioner sufficient authority to check such operations as those involving the Textron trusts. And yet the general language of the statute requires that it be sympathetically administered so that the legitimate requirements of qualified organizations will not be hampered.

The strengthening of the informational return requirements, while still not of sufficient breadth, will also tend to hamper further cases like the Textron affair both by affording additional information to the Commissioner and by making the information public knowledge.

It is perhaps ironic that the restrictions in the 1950 Act against transactions between the grantor and his private foundation are not, in them-

\textsuperscript{148} See discussion p. 124, supra.

\textsuperscript{149} There are really two sections, INT. REV. CODE § 3814, applying to organizations exempt under § 101 (6), and INT. REV. CODE § 162 (g) (4), limiting the charitable deduction permitted trusts.

\textsuperscript{150} See note 16, supra. The Textron trusts do not provide for the compulsory accumulation of income, although the trusts provide specific dates when principal and accumulated income, if any, must be distributed. See Hearings before Subcommittee of Committee on Interstate and Foreign Commerce, U. S. Senate, 80th Cong., 2d Sess. 319, 477, 511, 553.
selves, of sufficient scope to prevent further cases like that of Textron. The provision containing these restrictions generally denies exemption where the foundation loans money without adequate security or interest, or where it sells or purchases property without receiving or giving adequate consideration. But such transactions are prohibited only when they are between the organization and its creator (if a trust), or person who has made a substantial contribution, the family of such creator or person, or a corporation controlled by such creator or person through the direct or indirect ownership of fifty per cent or more of its voting stock, or fifty per cent or more of the total value of all classes of its stock. The Textron trusts entered into very few transactions with their creators, except for a small initial contribution or loan by the creator to the trust. The sales and purchases of property and securities were between the trusts and Textron, Inc., or its subsidiaries. Royall Little, who created two of the trusts, and his family held less than four per cent of Textron's outstanding stock in 1950. Furthermore, three of the trusts were created by business associates of Little who do not appear to be large holders of Textron shares or shares of its subsidiaries. In order to prohibit transactions of the Textron variety, the definitions of control would have to be much more generally worded. For example, the Code could be rewritten to prohibit transactions between a charitable organization and another organization, where one organization or the other "directly or indirectly controls" the other or they are "under direct or indirect common control." And then the issue would revolve around the Commissioner's claim that from all the facts "direct or indirect control" or "common control" of the two organizations is proved.

It appeared from the various Congressional hearings that sales were made between the trusts and Textron, or its subsidiaries, for a lesser consideration than the market value of the property, and that loans were made between them without adequate security. The present Code would not prevent the consummation of such transactions by organizations similar to those of the Textron type. If the Commissioner finds that the provision preventing unreasonable accumulations discussed above is not suf-
efficient to prevent operations such as the Textron case, the provision preventing transactions at less than arms length will have to be strengthened along the above illustrated lines to make them more inclusive.

It should be noted, also, that in some cases Textron trusts engaged in sale and leaseback transactions through borrowing money, or obtaining credit, from the seller, and that they may have operated commercial enterprises. To the extent that income from such leases and business would be subject to tax under the 1950 Act, these operations would be limited. But the examples of sale and leaseback and business operations in the Textron affair would hardly justify taxing all sale and leaseback transactions and business activities as the present Code does.

(2). Protection of the Family Corporation.

The House version of the 1950 Act would have denied a charitable income, estate, or gift tax deduction for a gift of stock to a foundation where the donor or his family controlled both the foundation and the corporation which issued the stock. The evident purpose behind the provision was to prevent members of a family from escaping or minimizing estate tax by bequeathing stock in a family owned corporation to a family controlled foundation. If the stock is left to the foundation it is not subject to estate tax, and yet the family can continue to control the corporation by their domination of the foundation which holds the stock. If the stock is included in the decedent's gross estate, part of it may have to be sold to pay estate tax and, therefore, outsiders may gain a minority, or perhaps, majority interest in the corporation.

In order for the gift of stock to be denied a charitable deduction under the House Bill, either the contributor or his family must have comprised a majority of the trustees, officers, or directors of the foundation, or have had a right to fill vacancies in a majority of such offices, or have retained the right to vote or dispose of such stock. Moreover, the stock had to be stock in a corporation in which the contributor, his family, or both, owned at least fifty per cent of the voting stock, or fifty per cent of the value of the outstanding stock of the corporation. Both of these, control of the foundation and the corporation, had to be present to deny a charitable deduction.

The House report was of the opinion that this provision was necessary to prevent tax avoidance. But the Senate Finance Committee did not concur and struck out the measure. The Senate report stated that outweighing tax avoidance in the view of the Committee is the fact that

127 See Hearings, op. cit. supra, note 149 at 538-9; SEN. REP. op cit. supra, note 151 at 17
128 Section 331, H.R. 8920, as passed by the House June 23, 1950.
129 Ibid.
if these deductions are not allowed still larger funds would be lost to private charity." The House conferees receded.

There was no evidence presented to the Congressional committees that this type of tax avoidance is presently a serious problem. Undoubtedly the wills of Henry and Edsel Ford present the most spectacular instances of this type of avoidance technique. In this case, Ford Motor Company stock was split into two classes: class B voting stock having a relatively small value, and class A non-voting stock representing 90 per cent of the total equity interests in the Ford Motor Company. Both Henry and Edsel Ford bequeathed their class B voting shares to surviving family members, and most of their class A to the family controlled Ford Foundation. The estate tax upon their separate estates was nominal compared to what it would have been if the class A stock had been included in their gross taxable estates. And the Ford family continued to control the Ford Motor Company. The House Bill provision would have prevented any tax advantage in these transfers by denying an estate tax charitable deduction to the estates of Henry and Edsel Ford.

If there is an avoidance problem here, it arises through possible family domination of the foundation. One way to prevent it is through tightening the Code "charities" provisions against unjustified family control. If this method does not prove effective against recurring instances of this technique, then a provision similar to that in the House Bill should be adopted. Certainly this avoidance method should not be permitted in order that the family corporations may be "saved" from the inroads of the estate tax. If this is a real problem, it should be carefully investigated and adequate measures taken for general relief.

101 H. R. REP. 131. The Minority Report recommended that action on this provision "await an opportunity to explore this important problem and its ramifications more fully."

102 SEN. REP. 39.


105 Of a total of 172,645 Class B voting shares, and 3,280,255 Class A shares, the Foundation owns 3,082,949 Class A shares. NEWSWEEK, May 5, 1947, p. 71.

106 Of course, the family would still control the Company because the members hold all the Class B voting stock. But Class A stock would probably have had to be sold to pay estate tax. See BUSINESS WEEK, Nov. 13, 1948, p. 24.

107 See Harris, Estate Taxes and the Family-Owned Business, 38 CALIF. L. REV. 117 (1950) See also INT. REV. CODE § 115(g) (5), added to the Code by Revenue Act of 1950, § 209, purporting to give relief to family corporations by making the provisions of INT. REV. CODE § 115(g) inapplicable where a corporation redeems stock held by an estate and more than 50 per cent of its assets consisted of the corporation's stock. The relief provision is limited to the amount of death taxes which the
(3). Other Problems of Family Control.

As we have seen, the 1950 Act still permits the creator of a foundation and his family to sell property to the foundation, and to buy property from it, in arms length transactions. They may also borrow money from the foundation if they provide adequate security and pay a reasonable rate of interest. Members of the creator's family, or the founder himself, may still be employees of the foundation, drawing salaries. And, more important, the creator and his family may be trustees, directors, or officers controlling foundation policy. Should the creator and his family (or others he might dominate, for that matter) be permitted to engage in these transactions with the foundation, or remain in a controlling position?

The goal which Congress seems to have had in mind originally in exempting private charitable foundations, and certainly which it was striving for in the 1950 Act, is that of an independent, charitable organization carrying on socially useful work for the public welfare. This is a great ideal and one worthy of striving for. Assuredly it is not being accomplished as long as wealthy taxpayers may use foundations as havens for tax avoidance.

Permitting the creator and his family to transact sales and purchases at arms length with the foundation does not necessarily destroy that goal. As a matter of fact, there may be situations where the creator is the only person who will purchase certain frozen assets from the foundation at a fair price. For example, the foundation may hold securities in a family owned business which do not have a ready market, but which the creator or members of his family might be willing to buy because of their interest in the family corporation. As long as the transactions are at arms length, and adequately reported to the Bureau, there seems no reason for not permitting them. The same is probably true of reasonable salaries paid to family members for work actually performed. If salaries of a similar amount would have to be paid anyway, no great difficulty seems to be present.

Less can be said for permitting the creator and his family to borrow from the foundation, even for adequate consideration and reasonable interest. Any transaction between the foundation and the creator, or his family, raises the possibility that foundation funds are being used for personal rather than charitable purposes. It seems that such transactions

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\[3^7] INT. REV. CODE §§ 3813, 162 (g) (2) (B).

\[5^7] On its face, the section is not limited to stock in family corporations. It encourages the retention of securities until death that might better be sold. A more comprehensive and better reasoned answer than this section will have to be found. (Revenue Act of 1951, § 320, reduces the 50 per cent requirement noted above to 35 per cent.)
should not be permitted unless there exists a reason which may benefit the foundation. The foundation would not seem to gain in any material way by making such loans. The money could always be invested elsewhere. And repayment of loans to the family, even though supported by adequate security, and for reasonable interest, may be difficult to enforce for obvious reasons. The provision permitting the creator and his family to borrow from the foundation should be eliminated.

The right of exclusive control in the hands of the creator and his family, however, is something of a different nature. This is the heart of the problem. For it depends upon the trustees, directors, or other controlling officers to determine whether a foundation shall have an independent, dynamic program, or whether it will merely be a source of preserving family funds from the inroads of income and transfer taxes. Trustees chosen entirely from members of the creator's family, or their intimate social or business associates, may, nevertheless, produce a program for the foundation of vital social significance. But the chances are much smaller that such a program will be developed under the leadership of such a group than if the trustees have a more diversified background. Some method should be determined for encouraging, if not requiring, tax-exempt, private foundations to place independent, qualified persons on their boards of trustees, and in other policy making positions. A number of community foundations attempt to achieve this goal by providing in their charters that a certain number of their trustees must be chosen by prominent members of the community such as the mayor, the probate judge, and so forth.

Perhaps a provision could be added to the Code to require that a private charitable foundation have a certain number of qualified, independent trustees, or directors, (not necessarily a majority) before it can qualify as an exempt organization. This would not necessarily be an assurance that the foundation would strive for socially beneficial goals. But it would mean a step in that direction — perhaps all that can be done through amendments to the Internal Revenue Code. The next step would have to be made through campaigns by such bodies as educational groups, learned societies, and associations of artists and musicians to encourage foundation trustees to appoint scholars, artists, and musicians, for example, to their boards, so that an invigorated, independent program could be encouraged.


See Chambers, CHARTERS OF PHILANTHROPIES 18, 19 (1948); Harrison and Andrews, AMERICAN FOUNDATION FOR SOCIAL WELFARE 32 (1946)