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FOUNDATIONS AND THE PATMAN COMMITTEE REPORT

*John E. Riecker**

"The object of our study is to determine whether legislation is needed in order to provide effective supervisory controls over tax-exempt foundations and protect the public."¹

WITH the above words, written at the wintry beginning of 1963, Congressman Wright Patman of Texas launched the first installment of a report to the Select Committee on Small Business of the United States House of Representatives. The report, despite its blunt invective and frequent emotionalism, is very likely to have far-reaching practical, if not legal, consequences in the laws and ethics relating to tax-exempt foundations and charitable trusts. Congressman Patman had much to allege with respect to his Committee's accumulated evidence of foundation dominance of small corporate business, as well as foundation abuse of the sanctuary of income tax exemption. "Unquestionably, the economic life of our Nation has become so intertwined with foundations that unless something is done about it they will hold a dominant position in every phase of American life," the Report stated.² It continued, "the multimillion-dollar foundations have replaced the trusts which were broken up during the Theodore Roosevelt administration."³ "Never before," the Report declared, "have the economic factors of the complex and rapidly expanding foundation business been put under the microscope of public scrutiny."⁴

Chairman Patman went on to recommend an immediate moratorium on the granting of tax-exempt privileges to foundations. In an omnibus indictment of some of the practices of the 534 foundations investigated by the Committee, Congressman Patman charged that a concentration of economic power, coupled with laxness of Internal Revenue Service enforcement of certain United States Treasury regulations pertaining to foundations, had culminated in "possible exploitation of the people's respect and admiration for

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1. CHAIRMAN OF HOUSE SELECT COMMITTEE ON SMALL BUSINESS, 87th Cong., 2d Sess., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY at v (Comm. Print 1962) (hereinafter cited as REPORT). All references to the INTERNAL REVENUE CODE shall mean the 1954 statute, unless otherwise stated. Relevant changes made by the Revenue Act of 1964 will be noted in the text or footnotes.

2. REPORT at v.

3. *Ibid.*

4. *Id.* at vi.

charitable acts and gifts.”⁵ “How can the Treasury Department possibly justify continuing to wring heavy taxes out of the farmer, the worker, and the small businessman,” the Report asks, “knowing that people of large means are building one foundation after another, and—for all the Treasury knows—for the purpose of decreasing their taxes, eliminating competition and small business, subsidizing antidemocratic propaganda, and otherwise working a hardship on the Nation?”⁶ Calling the posture of such tax-exempt organizations a “mess,” Congressman Patman proceeded to assail American taxpayers—the “stockholders” providing the subsidy for foundations—for permitting to continue unchecked the existence of this new breed of monopolistic power groups. A second installment of the Patman Report, issued in October 1963, concluded that “it is evident that nonfeasance on the part of Treasury officials has fostered tax-free commercial activities, violations of law and Treasury regulations, and tax avoidance through the device of foundations.”⁷

One cannot dispute the Patman Report’s emphasis on the tremendous growth of tax-exempt foundations vis-à-vis the American economy in general. According to the Report, there were 45,124 foundations at the end of 1960, up from 12,295 at the end of 1952.⁸ The 534 foundations under study by the Committee (a group composed of most, but not all, of the largest foundations) had assets of over ten billion dollars, gross receipts during the period 1951-1960 of seven billion dollars, and aggregate gifts and grants during the same period of 3.5 billion dollars.⁹ One hundred eleven of the organizations studied each owned over ten per cent of the outstanding stock of various large and small domestic corporations, many owning in excess of seventy per cent of particular corporations; the whole group under scrutiny by the Committee received, during 1951-1960, over two billion dollars in dividends from securities and 1.5 billion dollars from gains on sale of assets.¹⁰ Expenses alone consumed over ten per cent of aggregate receipts.¹¹ At the end of 1960, the Report states, the net worth of the 534 foundations was twenty-three per cent greater than the total capital funds of the nation’s fifty largest com-

5. *Id.* at 1.

6. *Id.* at 2.

7. CHAIRMAN OF HOUSE SELECT COMMITTEE ON SMALL BUSINESS, 88th Cong., 1st Sess., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY at iii (Comm. Print 1963).

8. REPORT at v.

9. *Ibid.*

10. *Ibid.*; see also *id.* at 4.

11. *Id.* at 51.

mercial banks and twenty-six per cent greater than the invested capital of the fifty largest merchandising firms.¹² Such figures give some credibility to the Committee's charges that foundations possess the power to compete with small business, with commercial banks and lending institutions, and even with proper state and federal government functions. One can almost feel a Sherman Act analogy arise from the Report.

While startling in its content, the Patman Report's review of the activities of tax-exempt organizations in the 1950's and early 1960's is only the latest in a long series of inquiries into private charity which have dotted the historical landscape ever since the English Statute of Charitable Uses (1601).¹³ Indeed, just a decade or so ago, intensive congressional investigation of foundation activities led to the most drastic change in the applicable tax law in over three hundred years: the Revenue Act of 1950.¹⁴ Actually, the Patman Report, as it has taken shape through its second installment (released late in 1963), is unusual in that, until now, it has been exclusively the report of a committee chairman to his committee members. No real public hearings were held until July 1964, and full Committee participation presumably has been minimal. The Committee's subpoena power has been limited primarily to obtaining reports and data from some negligent, and occasionally recalcitrant, organizations. Moreover, it has already been claimed that the Committee has exceeded its granted authority.¹⁵ The Report is pregnant with redundancies and, at least in its first installment, is partially taken up with nothing more than a simple, but very useful, directory of the 534 foundations and charitable trusts studied.¹⁶ Nevertheless, its allegations and findings are provocative of the most careful notice by tax lawyers. The gauntlet is thrown down to foundation trustees and directors, to corporation stockholder-donors, and to charitable

12. *Id.* at 71. The *Report* also notes that true statistics are obscured in many instances because foundations show their assets at a "carrying value," which is normally lower than current market value.

13. 43 Eliz. 1, c. 2.

14. 64 Stat. 906, 953 (1950), as amended, 42 U.S.C. § 411 (Supp. IV, 1963). See Finance Committee Reports: H. R. REP. NO. 2319, 81st Cong., 2d Sess. 36-37, 41-42 (1950); S. REP. NO. 2375, 81st Cong., 2d Sess. 28 (1950); see also Brown, *The New Restrictions on Charitable Exemptions and Deductions for Federal Tax Purposes*, 13 U. PITT. L. REV. 623 (1952); Eaton, *Charitable Foundations and Related Matters Under the 1950 Revenue Act*, 37 VA. L. REV. 1, 253 (1951).

15. See the remarks of Roger K. Powell, N.Y.U. 22ND INST. ON FED. TAX 921-45 (1964).

16. The second installment of the REPORT, cited *supra* note 7, released October 16, 1963, contained a study in depth of alleged abuses by three related foundations. The remainder reiterated the findings and conclusions of the first installment, cited *supra* note 1.

donees all over the country. All persons critical of the content of the Report have been challenged to justify both the legal and the socio-political role of the modern, tax-exempt charitable corporation.

It is the purpose of this article to evaluate the major points of the first, and main, installment of Congressman Patman's Report in the light of existing Internal Revenue Code provisions, Treasury regulations, and the more significant federal court decisions and Internal Revenue Service rulings. While the Report itself is more inclusive, space limitations dictate that this article be confined to section 501(c)(3) organizations—chiefly foundations, tax-exempt funds, and charitable trusts. Although the writer will strive to be objective, it is difficult to avoid some of the political gloss in which the Report is cast and impossible to discuss the ramifications of the Report without wallowing in the cross-currents of public policy.

To be exempt from income tax liability, and to afford private donors the benefit of an income or estate tax deduction for contributions, a foundation must be *both* organized and operated for an exempt purpose.¹⁷ Thus, a look at the modern application of this aged test will be necessary in order to give perspective to Congressman Patman's allegations. This being done, we will next determine the extent to which the law permits tax-exempt foundations to operate businesses for profit even though their charters point to a charitable purpose. This second inquiry relates to Congressman Patman's charge that foundations not only divert funds to non-charitable business ventures, but also compete unfairly with legitimate businesses. Third, we shall examine Congressman Patman's claim that the earnings of many charitable foundations are wrongly inuring to the benefit of their own donors, trustees, and other private persons. Fourth, the Report charges that some foundations hoard most of their exempt income. We shall attempt to determine whether a tax-exempt organization may successfully defend such a charge by showing long-range plans of charitable expenditures or whether the Service does (and should) require prompt application of all charitable funds. Must all foundations in the future become active, functional charities, or may they operate as conduits to other educational and charitable organizations? If the latter, how long and tortuous a conduit will be permitted? Fifth, we will see which foundation practices criticized by the Report are, in fact, now prohibited by the Internal Revenue Code; and, we will examine whether the guidelines of Code

17. Treas. Reg. § 1.501(c)(3)-1 (1959).

prohibitions are sufficiently definite for the Service to enforce them. Finally, if serious abuses can be proved against tax-exempt foundations, it is relevant to ask whether these abuses can be solved and corrected by enforcement of existing laws, or whether new, more stringent laws are necessary. Implicit in these inquiries is an even more poignant question—should charity be a private or a public concern? This paper cannot, with any degree of wisdom, answer such questions of “oughtness,” but the Patman Report surely dramatizes the need for asking them.

I. THE “ESTABLISHMENT” OF FOUNDATIONS

A. The “Organizational” Test

Any corporation that aspires to become tax-exempt under section 501(c)(3) of the Internal Revenue Code must file an application on Treasury Form 1023 with the Internal Revenue Service, establishing, *inter alia*, that it is “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals”¹⁸ No corporation may safely assume exemption unless such a determination has been made by the Service. Once made, however, the determination can be relied upon continuously by the corporation, provided there are no substantial changes in its character, purpose, or operation and provided the corporation does not engage in a so-called “prohibited transaction.”¹⁹ Even though the United States Supreme Court early stated that “charities are the ‘favorites’ of the law,” a rule of strict construction is followed by most courts in this country, with the result that the taxpayer must prove it comes within the language of the exempting statute.²⁰

The more modern view is that the term “organized” refers to the “real substance and intent of the organization, and not to its mere form.”²¹ At one time, exemption status was determined almost

18. This language from INT. REV. CODE OF 1954 § 501(c)(3) has remained substantially unchanged since the Revenue Act of 1928. Approved applications for exemption on Form 1023, together with any allied papers, are available for inspection at the Internal Revenue Service's Washington, D.C., office. See Rev. Proc. 62-30, 1962-2 CUM. BULL. 512 on the procedure governing requests for exemption, superseding in part Rev. Proc. 56-8, 1956-1 CUM. BULL. 1024.

19. Treas. Reg. § 1.501(a)-1(a)(1) (1958); see also Rev. Rul. 58-617, 1958-2 CUM. BULL. 260, stating that any changes in corporate purposes or operations must be reported promptly.

20. *Helvering v. Bliss*, 293 U.S. 144 (1934), *affirming* 68 F.2d 890 (2d Cir. 1934). Cf. 6 MERTENS, FEDERAL INCOME TAXATION § 34.02 (1957 ed.).

21. *Ibid.*

exclusively by looking at the formative papers of an organization—its articles and by-laws.²² Certainly, an organization's charter is still an important evidentiary fact to consider, but obtaining an exemption is no longer so "cut and dried." Beginning in 1938 with the celebrated case of *Roche's Beach, Inc. v. Commissioner*,²³ the courts have indicated that extrinsic evidence of the intent of the organization, as shown by its motives, acts of charitable donation, and management, is just as important as what appears in its charter. Thus, in the second *Commissioner v. John Danz Charitable Trust* decision,²⁴ where a charitable trust operated active businesses (a hotel and three candy shops) and obviously did not satisfy the "operational" test which will be discussed later, the court still found that the "organizational" test was met because the motive of the trust was to aid the "humanist" movement. What this newer approach means is simply that the "organizational" test is becoming merged with the "operational." To provide sufficient time for the Service to study the acts as well as the charter of an applicant, the Service has long required that organizations (except those of a "community or public type") actively operate (not merely exist) for twelve months before submitting Form 1023 for approval.²⁵ Only at the end of 1963 was this rule lifted; a determination letter will now issue in advance of twelve months of operation, providing the applicant organization can describe its proposed exempt operations in sufficient detail.²⁶ It is doubtful that Congressman Patman will look with favor on this latest relaxation of procedure.

Although corporate articles have been reduced in relative importance, current regulations demonstrate that they must still be carefully drafted for exemption. The articles, charter, or constitution must:

- "(a) Limit the purposes of such organization to one or more exempt purposes [enumerated in section 501(c)(3)]; and
- "(b) . . . not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes."²⁷

Draftsmen must be careful of powers as well as purposes. The

22. See, e.g., *Sun-Herald Corp. v. Duggan*, 73 F.2d 298 (2d Cir. 1935), *cert. denied*, 294 U.S. 719 (1935).

23. 96 F.2d 776 (2d Cir. 1938); see also *Dillingham Transp. Bldg., Ltd. v. United States*, 137 Ct. Cl. 389, 146 F. Supp. 953 (1957).

24. 284 F.2d 726 (9th Cir. 1960), *affirming*, 32 T.C. 469 (1959).

25. Rev. Proc. 62-30, *supra* note 18.

26. Rev. Proc. 63-30, 1963-2 CUM. BULL. 769.

27. Treas. Reg. § 1.501(c)(3)-1(b)(1)(i) (1959).

"organizational" test is not met if the corporate articles *empower* the organization to carry on activities of a business or commercial nature, even though such organization is limited by its articles to an exempt *purpose* no broader than those listed in section 501(c)(3).²⁸ In composing articles of incorporation, it is easy to miss the passage between this Scylla and Charybdis and to run aground on taxable shoals by including the dangerous stock phrases for "carrying on business" which are part of the boilerplate of many corporate articles. One other point needs mention with respect to drafting. The 1959 Treasury Regulations further circumscribed the "organizational" test by providing that the purposes expressed in the corporate articles cannot be broader than the purposes enumerated in section 501(c)(3). Evidence *aliunde* the articles will not correct this fault.²⁹

Although the presence of a single, substantial contrary purpose in foundation articles will cause disqualification,³⁰ and the articles cannot be broader than the purposes listed in section 501(c)(3), the Patman Report contends that these rules are not effectively enforced. It also makes a more profound allegation which, if not directly stated, is certainly implied in Congressman Patman's conclusion that any profit-making activity of tax-exempt groups reveals a non-charitable, noneleemosynary intent. If foundations are to have any *lebensraum* in the future, there must be some determination of what constitutes permissible income activity.

The problem is best illustrated by the Report's general conclusion that foundation ownership of, and receipt of profits from, such "active" sources as the operation of rental facilities, buildings, offices, garages, hospitals, and the like is bad. The Report also concludes that loans by foundations, when secured by income-producing mortgages on such active facilities (some of which inevitably are owned by "interested parties"), are indicative of non-charitable purposes.³¹ Assuming a continuum of passive to active sources of income, on one end is receipt by tax-exempt organizations of dividends from common stocks and interest from bonds. If this is profit-making

28. Treas. Reg. § 1.501(c)(3)-1(b)(1)(iii) (1959).

29. Treas. Reg. § 1.501(c)(3)-1(b)(1)(iv) (1959). The last three regulations cited were effective for taxable years after July 26, 1959.

30. See the following illustrative Tax Court cases, holding that *one* wrong purpose taints the whole organization: *American Institute for Economic Research v. United States*, 302 F.2d 934 (Ct. Cl. 1962); *Stevens Bros. Foundation*, 39 T.C. 93 (1962), *aff'd in part, rev'd in part, remanded in part*, 324 F.2d 633 (8th Cir. 1963); *Leon A. Beeghly Fund*, 35 T.C. 490 (1960), *aff'd on other grounds*, 310 F.2d 756 (6th Cir. 1962); *Best Lock Corp.*, 31 T.C. 1217 (1959) (appeal dismissed).

31. REPORT 15-16.

activity at all, it is certainly unimpeachable as far as the tests of exemption are concerned, and, as a federal district court once expressed, the financial "power" of an organization to make wise investments of this nature ought never to be viewed as a "purpose" which must meet the organizational test.³² The area of controversy begins as we move from the passive end of the continuum to such items as rents, mortgages, and leasebacks. For example, the Report cites with disapproval the activity of three foundations in purchasing gasoline service stations and leasing them back, together with some other commercial buildings, to the sellers.³³ Such an investment is not really much different from the purchase of common stocks. It assures the receipt of regular income through rent charges, and it can be almost as passive as the collection of interest. Of course, if the example foundations were engaged in such management duties as supervising the normal operations of the gasoline stations, they would be involved in commerce and in a trade or business. However, the mere receipt of rent, without supervisory duties, ought not to threaten loss of exemption.

Much of the difficulty with the Report's conclusions in this area lies in its failure to distinguish between the charter purpose of a tax-exempt foundation and its sources of income.³⁴ Thus, if the articles of an exempt corporation stated the operation of a particular business or businesses as a *purpose*, the "active" end of the continuum would be reached, and exemption would not be justified under the organizational test. But, if the articles impose on the trustees *duties* to retain, invest in, or derive income from rents, mortgages, partnerships, etc., the organization should not be condemned for carrying out the founder's desires to assure a flow of dollars for charitable donation. This point was illustrated in *Eugene S. Lewis v. United States*.³⁵ That case involved a testamentary trust that had been set up by the donor to provide medical care and educational opportunities for the youth of Sheridan County, Wyoming. The donor's will contained an administrative clause giving the trustees power to engage in business. The trust corpus included a ranch formerly owned by the donor, which was maintained by the trust for a short time after his death and then sold. In answer to the Internal Revenue Service's claim that the trust had

32. *Samuel Friedland Foundation v. United States*, 144 F. Supp. 74 (D.N.J. 1956).

33. REPORT 14.

34. This distinction was ably drawn in *Bright Star Foundation v. Campbell*, 191 F. Supp. 845 (N.D. Tex. 1960).

35. 189 F. Supp. 950 (D. Wyo. 1961).

the carrying on of a trade or business as a purpose and, thus, fell within the prohibition of Treasury Regulation 1.501(c)(3)-1(b)(1)(iii), the court held that under the will the trustees were given the power "to carry out the express purpose of the trust," that the power to engage in business was not a "purpose" on which exemption could be judged, and that the organizational test was otherwise satisfied. It would seem that the organizational test is not enforced as severely in testamentary charitable trust cases for the very reason that the creating instrument often imposes duties upon the trustees that are more easily subsumed under the category of administrative powers than under the designation of ultimate purposes.

Perhaps we could make peace with Congressman Patman's criticism of some foundations' sources of income by adopting a handy rationale used by the Third Circuit in *Francis E. McGillick Foundation v. Commissioner*.³⁶ Construing section 101(6) of the 1939 Code, the predecessor of section 501(c)(3), the court stated that, when the "predominate purpose" for which a foundation is organized is, "in its broadest sense," religious, charitable, or educational, exemption should be granted.³⁷ *Scripture Press Foundation v. United States* stated the rule another way: if the profit-making activity is "incidental" to the organization's main charitable purpose, the demands of the organizational test are met.³⁸ Of course, these decisions are not fully on point, for they speak also of what standards must be met in order for a foundation to be organized "exclusively" for an exempt purpose—still another qualifying test. This writer believes that, if the distinction between the purposes of a tax-exempt foundation and its sources of income were given more sway, many of Congressman Patman's objections would disappear.

B. The "Operational" Test

This second criterion for determining tax exemption under section 501(c)(3) cannot be separated naturally from its brother, the "organizational" test, "for the true character of an organization must be drawn in the final analysis from the manner in which it has been operated."³⁹ The applicable Treasury Regulations state:

"An organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages primarily

36. 278 F.2d 643 (3d Cir. 1960), *affirming in part, reversing in part* 30 T.C. 1130 (1958).

37. 278 F.2d at 646; see also *Lederer v. Stockton*, 260 U.S. 3 (1922).

38. 152 Ct. Cl. 463, 285 F.2d 800 (1961), *cert. denied*, 368 U.S. 985 (1962).

39. 6 MERTENS, *op. cit. supra* note 20, at § 34.07.

in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if *more than an insubstantial part* of its activities is not in furtherance of an exempt purpose.”⁴⁰

At this point, it should also be noted that organizations are not “operated exclusively” for an exempt purpose if their net earnings inure in whole or in part to the benefit of a private individual, or if their activities attempt to influence legislation.⁴¹

Much of what has been said about the organizational test also applies to the operational test. No discussion of either would be complete, however, without mentioning briefly a doctrinaire dispute which, before 1950, raged among the federal circuits. The dispute centered upon the question of how far a foundation may justify dubious activity (*i.e.*, active profit-making) by dedicating all the fruits of that activity to a clearly exempt purpose. Almost all the landmark cases in the area of charitable tax-exemptions were aligned on one side or the other of this dispute. The “grandfather” case was *Trinidad v. Sagrada Orden de Predicadores*, a 1924 decision of the United States Supreme Court.⁴² It involved a nonprofit religious corporation which derived ten per cent of its income from a minor business activity—the selling of chocolates and sacramental wine. Even had this quasi-commercial activity constituted a larger fraction of its income, however, it is doubtful that the Supreme Court would have denied the exemption, for the Court found that, since the “destination” of the business income was gifts to religious recipients, the organization was “operated exclusively” for religious purposes. Commercial sales of wine were held perfectly within its permissible operations. This pronouncement became known, not surprisingly, as the “destination test.” Under its auspices, in *Roche’s Beach, Inc. v. Commissioner*,⁴³ a nonprofit corporation having charter-given duties of operating a bathing beach (an outright commercial activity) was nevertheless held exempt on the ground that the ultimate destination of the revenue was charity. “No reason is apparent to us,” the court stated, “why Congress should wish to deny exemption to a corporation organized and operated exclusively to feed a charitable purpose when it undoubtedly grants it if the corporation itself administers the charity.”⁴⁴ The “destination of income” approach of

40. Treas. Reg. § 1.501(c)(3)-1(c)(1) (1959). (Emphasis added.)

41. See Treas. Regs. §§ 1.501(a)-1(d) (1958) and 1.503(c)-1 (1959).

42. 263 U.S. 578 (1924).

43. 96 F.2d 776 (2d Cir. 1938).

44. *Id.* at 779.

the Second Circuit was followed by the Third,⁴⁵ Fifth,⁴⁶ Sixth,⁴⁷ and Seventh Circuits,⁴⁸ and by the Court of Claims.⁴⁹

On the other side of the dispute, the Fourth and Ninth Circuits refused to accept the "destination" test as a justification for the commercial competition of a foundation with other taxable businesses. The origin of tax-exempt income, not its destination, was the test they applied. *Ralph H. Eaton Foundation v. Commissioner*⁵⁰ provides an example. There, a foundation, organized exclusively for charitable and religious purposes, operated farming, real estate, and even sports clothes businesses, turning over the profits to exempt organizations. The court reasoned that, although such dedication of business profits might be an "activity," it was certainly not the exclusive, or even the principal, activity of the foundation. Instead, the court held the principal activity was retail sales in the stream of commerce, and funds originating from this kind of income-producing activity should not be exempt. Decisions of this nature remind us once again of the tightrope courts must walk when judicial classifications are made. Since most income of most foundations is derived from the profits of some business, it is often difficult for courts to draw the line between a permissible origin of income and an improper one. To get around the difficulties of such a balancing act, some courts have settled the classification of exempt income on the grounds of the "exclusivity" of the tax-exempt's operations. This rationale holds that, if the organization actually does operate a business, the business or activity itself must be exclusively (meaning "primarily") charitable, educational, or religious in character.⁵¹

The battle of the circuits was resolved in favor of the Fourth and Ninth Circuits by the Revenue Act of 1950,⁵² which expressly abolished the "destination of income" approach. This important legislation provides what may be the most effective machinery presently existing for the enforcement of many of Congressman Patman's conclusions.

45. *C. F. Mueller Co. v. Comm'r*, 190 F.2d 120 (3d Cir. 1951), *reversing*, 14 T.C. 922 (1950).

46. *Willingham v. Home Oil Mill*, 181 F.2d 9 (5th Cir.), *cert. denied*, 340 U.S. 852 (1950).

47. *Lichter Foundation v. Welch*, 247 F.2d 431 (6th Cir. 1957) and 269 F.2d 142 (6th Cir. 1959); *Comm'r v. Orton*, 173 F.2d 483 (6th Cir. 1949), *affirming*, 9 T.C. 533 (1947). The *Lichter* case, *supra*, however, was based on pre-1950 facts.

48. *Arthur Jordan Foundation v. Comm'r*, 210 F.2d 885 (7th Cir. 1954).

49. *Dillingham Transp. Bldg., Ltd. v. United States*, 137 Ct. Cl. 389, 146 F. Supp. 953 (1957).

50. 219 F.2d 527 (9th Cir. 1955).

51. This appears to have been the rationale in *United States v. Community Servs., Inc.*, 189 F.2d 421 (4th Cir. 1951), *cert. denied*, 342 U.S. 932 (1952).

52. 64 Stat. 906, 953, as amended, 42 U.S.C. § 411 (Supp. IV, 1963).

II. THE "UNRELATED BUSINESS INCOME" PROBLEM

A. *Competition of Foundations With Private Business*

If the Patman Report has a single leading finding, it is that tax-exempt foundations are entering the sphere of private business, particularly small business, and, with untaxed money, are driving out of business corporate enterprises which must make do with forty-eight per cent of their real income. This is a seemingly well-intentioned and emphatic charge, and the Report goes to great lengths to document it.

The Report observes that many foundations operate "testing services," which are used by the organizations not only to assist in studies and the granting of funds but also to attract the interest and subscriptions of commercial corporations. It is pointed out that seven of these tax-exempt groups grossed over 100 million dollars from research and testing business during 1959.⁵³ In offering tests, data, or services to schools and businesses all over the country, exempt testing organizations obviously occupy the same field as private testing services which sell similar techniques, information, and know-how to the same groups of customers. An exempt testing corporation (often the subsidiary of a larger foundation) is able, in many instances, to outbid a private concern by quoting break-even or even loss figures.

The attack is not confined to testing. The Report claims that several scientific research foundations, including a well-known national society which has a net worth in excess of 26 million dollars,⁵⁴ have, in part, jumped from "basic" research into "applied" research. In the latter activity, specific problems are solicited from private persons or from the federal government.⁵⁵ Not being restrained by the economic necessity of paying taxes, of showing a profit, of paying cash dividends, or indeed of answering to any stockholders, the exempt groups have several built-in advantages which could insure success in the competitive arena. The same argument is extended by the Report to tax-exempt metropolitan planning commissions, to consulting engineers, to national defense contractors, and to food and dietary researchers. All of these compete with private, taxable counterparts.⁵⁶

It is surprising that Congressman Patman does not cite, or even

53. REPORT 9.

54. REPORT 13.

55. *Ibid.*

56. REPORT 10-13.

appear to notice, the limiting definitions of "testing for public safety" and "scientific research" (as well as "educational," "charitable" and "religious") contained in the governing regulations under section 501(c)(3). "Scientific research," for example,

"... does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, as, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc."⁵⁷

Instead, that term will give rise to an exemption only

"... if the results of such research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a nondiscriminatory basis."⁵⁸

Certainly, the emphasis given to noncommercial, nondiscriminatory research by the above definitions ought to provide a guideline of sorts for Internal Revenue Service policing of some alleged unfair competition between exempt and nonexempt organizations. Moreover, the same regulations circumscribe the permissible activity of other tax-exempt "scientific organizations." For example, such organizations may not limit the fruits of their research to their creators (often the "creators" are profit corporations in the same line of business), and they may not retain ownership of more than an insubstantial portion of the patents, formulae, etc., resulting from their research.⁵⁹

B. "Feeder" Corporations

Although the Code definitions of such terms as "scientific research" and "testing for public safety" seem to exclude the abuses Congressman Patman talked about, specific sanctions to prevent these abuses appeared in the 1950 legislation. By that year, actual instances of unfair competition between exempt and nonexempt organizations had mounted to such a point that Congress determined to correct the situation.⁶⁰ A nationwide vendor of macaroni, for example, could receive its profits free of tax because they were destined for an educational institution.⁶¹ A commercial beach operator en-

57. Treas. Reg. § 1.501(c)(3)-1(d)(5)(ii) (1961).

58. Treas. Reg. § 1.501(c)(3)-1(d)(5)(iii)(a) (1961).

59. Treas. Reg. § 1.501(c)(3)-1(d)(5)(iv) (1961).

60. See, e.g., H.R. REP. No. 2319, 81st Cong., 2d Sess. 36 (1950); S. REP. No. 2375, 81st Cong., 2d Sess. 28-29 (1950); see also *Veterans Foundation v. United States*, 281 F.2d 912 (10th Cir. 1960), *affirming* 178 F. Supp. 234 (D. Utah 1959).

61. See *C. F. Mueller Co. v. Comm'r*, 190 F.2d 120 (3d Cir. 1951), *reversing* 14 T.C. 922 (1950).

joyed the same advantage over its competition because it directed its net profits to charity.⁶² As a result of such inequities, some basic safeguards calculated to control active business competition by tax-exempts were enacted. No longer could the excuse of charitable destination of income secure a free ticket to tax exemption.

First, the Revenue Act of 1950 provided (by what is now section 502, Internal Revenue Code) that an organization operated for the "primary purpose of carrying on a trade or business for profit" is not exempt merely because all of its profits are payable to some organization that is exempt.⁶³ Such so-called "feeder corporations" were thenceforth taxable at full corporate rates, just as any nonexempt corporation in the same line of business. Second, even though a corporation's primary purpose was within one of the section 501 (c)(3) exemptions, if it did in fact carry on a trade or business "unrelated" to its exempt purpose, the new legislation (now section 511 of the Code) imposed the regular corporate tax on the income derived from the "unrelated business."⁶⁴ Corporations in this second classification, however, were still exempt provided they carried on substantial charitable activities to which, by definition, their trade or business activity could be "unrelated." The tax imposed on the unrelated activity was to have no adverse effect upon the organization's exempt status. Only one concession was made to pre-1950 rules. If an exempt corporation owned *active* income-producing property (as distinguished from stocks, bonds, or other intangibles), such income remained exempt under the 1950 changes, provided the corporation was organized for the *exclusive* purpose of "holding title to [the] property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which is itself exempt. . . ."⁶⁵ Such "title-holding corporations" are to be clearly distinguished from corporations actually carrying on some trade or business.⁶⁶

Section 513(a) of the Internal Revenue Code defines an "unrelated trade or business" as follows:

" . . . any trade or business the conduct of which is not sub-

62. See *Roche's Beach, Inc. v. Comm'r*, 96 F.2d 776 (2d Cir. 1938).

63. Treas. Reg. § 1.502-1(a) (1958). The 1950 legislation referred to in the text became §§ 421-24 of the Internal Revenue Code of 1954 and was known as "Supplement U." A good discussion of this statute can be found in Sugarman & Pomeroy, *Business Income of Exempt Organizations*, 46 VA. L. REV. 424 (1960).

64. However, "unrelated business income" of a church is still exempt from income taxation. For the definition of a "church," see *De La Salle Institute v. United States*, 195 F. Supp. 891 (N.D. Cal. 1961).

65. INT. REV. CODE OF 1954, § 501(c)(2); Treas. Reg. § 1.501(c)(2)-1(a) (1958).

66. *Ibid.*

stantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function. . . ."

However, a trade or business engaged in by the exempt organization without compensation, or which the organization carries on for the convenience of its members, officers, or employees, or which involves the sale of merchandise donated to the organization, is not "unrelated" and, therefore, is within the pale of permissibility.⁶⁷ Two conditions are required for taxability of such business income. First, the "unrelated trade or business" must involve activity substantially different from that authorized by the exempt corporation's articles. Second, the "unrelated trade or business" must be "regularly carried on" by the corporation.⁶⁸

Sporadic, intermittent, or isolated business activity engaged in by a foundation is not considered enough of a deviation from exempt operations to cause imposition of tax. Nor, of course, is the receipt of dividends, interest, royalties from natural resources, bald rents from real estate, or capital gains from non-inventory property called "unrelated income";⁶⁹ all of these items are sufficiently passive in character to demonstrate that their mere receipt is not the same as the carrying on of a trade or business.⁷⁰ Similarly, the purchase or ownership of oil production payments is not treated in the same way as oil prospecting or active participation in oil drilling.⁷¹ And, all income derived by fundamental research organizations from research performed for any person is not "unrelated" if the results are made freely available to the public.⁷² The same is true of research performed for the federal government or for any state or political subdivision.⁷³

It must be emphasized that the term "trade or business" (which is common to sections 502 and 512) must be read with the requirement that such activity be a *primary* purpose of the organization

67. INT. REV. CODE OF 1954, § 513(a)(1)-(3). Nor does the term "trade or business" include the renting out by an exempt organization of its own real property. The latter activity is governed by the provisions of INT. REV. CODE OF 1954, § 514, which deal with business leases and business lease indebtedness. Generally, rental income from real estate is taxable to otherwise exempt organizations, with the exception of churches, to the extent that the property is purchased with borrowed funds. See INT. REV. CODE OF 1954, § 511(a).

68. See Treas. Reg. § 1.513-1(a)(2) (1958); see also INT. REV. CODE OF 1954, § 512(a)-

69. INT. REV. CODE OF 1954, § 512(b)(1)-(3), (5).

70. See *Samuel Friedland Foundation v. United States*, 144 F. Supp. 74 (D.N.J. 1956).

71. *Force Foundation v. United States*, 63-1 U.S. Tax Cas. ¶ 9115 (N.D. Tex. 1962).

72. INT. REV. CODE OF 1954, § 512(b)(9).

73. INT. REV. CODE OF 1954, § 512(b)(7).

before the organization can be written off as a feeder. All circumstances, including the size and extent of the trade or business, as well as the comparable size and scope of the exempt activity, must be taken into account in determining a primary purpose.⁷⁴

C. Enforcement in the Courts

There is a practical answer and an answer grounded on policy to the question of whether the existence of the rules regarding feeder corporations and unrelated business income refutes the Patman Report's conclusion that the penalty of loss of exemption should be imposed upon a foundation engaging in business, even indirectly. The practical, demonstrable answer is found in the enforcement courts have given to the 1950 legislation. An example is provided by the recent Court of Claims decision in *SICO Foundation v. United States*.⁷⁵ Plaintiff in that case was a nonstock, charitable corporation that had owned controlling stock interests in several other corporations engaged in the sale and distribution of petroleum products. Through their dissolution, plaintiff acquired the assets of these subsidiaries and commenced direct operation of their businesses. In an earlier decision, the court had ruled plaintiff exempt despite this take-over, because the destination of its profits was an educational scholarship program.⁷⁶ Indeed, plaintiff had continued to distribute all its income in this manner. But, once the 1950 Revenue Act became applicable, plaintiff found itself back before the court, again defending its right to an exemption. On this second confrontation, the court found plaintiff to be a nonexempt feeder corporation, saying:

"That it [plaintiff] gave all its profits to an educational institution availeth it nothing in the mundane field of taxation, however much the children in our schools have profited from its beneficence."⁷⁷

Plaintiff's argument that, instead of losing its exemption, it should be taxable only on its unrelated business income also was found to "availeth it nothing," since plaintiff had no direct charitable or educational activities to which such income could be "unrelated." Significantly, the court persevered in its holding despite the foundation's claim that not all of its income originated from the petroleum business, but that substantial passive income in the form of interest

74. Treas. Reg. § 1.502-1(a) (1958).

75. 155 Ct. Cl. 554, 295 F.2d 924 (1961).

76. *SICO Co. v. United States*, 121 Ct. Cl. 373, 102 F. Supp. 197 (1952).

77. 295 F.2d 924, 925 (1961).

and rent was earned. The answer to this, the court remarked, is that Congress did not limit the scope of section 301(b) of the 1950 Revenue Act to organizations whose *exclusive* purpose was the conduct of a trade or business; the effect of that section extended to those whose *primary* purpose was such activity.⁷⁸

During the same year as the *SICO* decision, the Court of Claims reinforced its viewpoint. In *Scripture Press Foundation v. United States*,⁷⁹ plaintiff foundation had succeeded to the business of an Illinois profit corporation that prepared and sold religious literature and received large profits therefrom. The court conceded that large profits did not necessarily mean that the organization was non-charitable, although such commercial success was certainly some evidence of a business character. However, despite the meritorious goals of the foundation, its improvement of Sunday Schools, and its furnishing of religious materials, the court held that the test of exemption was not met—the sale of religious literature was not incidental to the foundation's religious activities but was, instead, its primary activity. In so holding, the court also noticed that, in 1957, the foundation had 1.6 million dollars in accumulated capital and surplus and only 72 thousand dollars in expenditures.

The Tenth Circuit came to a like conclusion in *Veterans Foundation v. United States*,⁸⁰ wherein plaintiff claimed exemption for profits gained from thrift sales of used clothing and other merchandise in two Utah stores. The sales operation was held to be the primary purpose of the foundation, making it a classic feeder corporation. The Ninth Circuit had an even more obvious violation of tax-exempt purposes before it in *Randall Foundation, Inc. v. Riddell*.⁸¹ There, a nonprofit corporation had been formed with a rather vague charitable design. Actually, the organization's chief activity was the buying, selling, and trading of oil stocks and other securities, an occupation which paralleled similar individual activity of its donor to the extent that the same brokers were often used by both. Although the profits and gains of the corporation did not inure directly to the donor, the court found that the chief purpose of the foundation was to engage in highly speculative business transactions. With little difficulty, the feeder corporation provisions were invoked.

78. *Id.* at 928.

79. 152 Ct. Cl. 463, 285 F.2d 800 (1961), *cert. denied*, 368 U.S. 985 (1962); *cf.*, A. A. Allen Revivals, Inc., 22 CCH Tax Ct. Mem. 1435 (1963).

80. 281 F.2d 912 (10th Cir. 1960), *affirming* 178 F. Supp. 234 (D. Utah 1959).

81. 244 F.2d 803 (9th Cir. 1957).

The Court of Claims, whose decisions figure most prominently in this area, in 1962 decided a case, the language of which somewhat clairvoyantly furnishes an example of the kind of judicial vigilance Congressman Patman now asks. In *American Institute for Economic Research v. United States*,⁸² plaintiff education corporation's articles properly limited it to economics study and the dissemination of economic information to the general public. In operation, however, it published two periodicals that gave investment advice, analyses of certain traded securities, and even pointers on how subscribers should vote on pending corporate mergers. Plaintiff further provided a continuous supervision service for some three hundred clients, charging one-fourth of one per cent of the capital involved as a service fee. Insurance advice and estate planning were other aids made available. In 1957 and 1958, plaintiff had received almost half a million dollars from subscriptions to these services. The court found that such services were those commonly associated with commercial enterprises and held that, since plaintiff had chosen to compete with business firms offering similar services, it was a feeder corporation and must bear the tax consequences of its acts.⁸³

To be sure, loopholes have arisen in the interstices among the above holdings and among the controlling regulations. A foundation may freely create a wholly-owned subsidiary that does nothing but engage in commercial activity. While the subsidiary itself is taxed, the income later passed on to the exempt parent corporation is not "unrelated" business income to the parent.⁸⁴ Conceivably, the door is open for a foundation to create several small business subsidiaries within the lower normal tax bracket; favorable overall tax results would thereby be achieved, provided the overriding organizational and operational tests were met. Another avenue of escape from the feeder corporation rules is illustrated by the Court of Claims decision in *Hospital Bureau of Standards and Supplies, Inc. v. United States*.⁸⁵ There, the plaintiff bought supplies at a discount and performed research and other technical services for several charitable hospitals that took memberships in plaintiff. All of plaintiff's net income from dues and discounts was returned to the members as patronage dividends. Plaintiff was held not to be a feeder, the court pointing out that it performed services for its

82. 302 F.2d 934 (Ct. Cl. 1962).

83. *Id.* at 938.

84. See *Amon G. Carter Foundation v. United States*, 58-1 U.S. Tax Cas. ¶ 9342 (N.D. Tex. 1958).

85. 141 Ct. Cl. 91, 158 F. Supp. 560 (1958).

members that they otherwise would have had to assume themselves. Plaintiff's operations, even though commercial, were excused on the basis that they bore a "close and intimate relationship" to the very functioning of the exempt hospitals. A third route around the unrelated business income provisions lies in Internal Revenue Code section 501(c)(4), which deals with civic organizations and organizations operated exclusively for the promotion of social welfare. Tax lawyers will agree that often the purposes of a section 501(c)(3) educational or charitable organization spill over into those of an organization for social welfare. While contributions to the latter are not deductible by the donor,⁸⁶ a social welfare organization does not pay a tax on unrelated business income.⁸⁷ Thus, a choice of taxable consequences is open to organizations having this dual identity.

D. Policy Considerations

Wholly aside from the monitoring of foundations' business activities by the courts, are there reasons why foundations should be divorced from commercial activity altogether—even if such activity leads only to a tax on unrelated business income? Congressman Patman deplors all degrees of business activity by foundations. We should look briefly at the arguments on each side of this question.

Foundation trustees can be expected to maintain that often an unrelated business provides a valuable source of charitable funds at higher yields than more passive investments. They question the validity of a distinction between stock in the business and the business itself. Moreover, many organizations are simply given or bequeathed such businesses by some donor, and they have no possible alternative but to assume control and run the enterprise in the best manner possible. To confiscate or even penalize such inheritance, it is argued, would often work a hardship on the exempt organization and cause it, particularly if it is a charitable trust, to act in violation of the donative intent. Finally, it is contended that there is persuasive analogy in the fact that profit corporations freely carry on exempt activities and have exempt appendages (qualified pension trusts are an obvious example).

But Congressman Patman makes a definite point in his assertions. To a small commercial operation, the incidental benefits in being operated by a large and rich foundation are weighty enough

86. Such organizations are excluded from the benefits of INT. REV. CODE OF 1954, § 170(c).

87. See *Veterans Foundation v. United States*, 178 F. Supp. 234 (D. Utah 1959).

to be anti-competitive in many instances. Imagine the effect of the name, publicity, and resources of the Ford Foundation behind a small profit operation selling reference books. To be sure, the business income derived would form an infinitesimal part of the Foundation's gross income, but the weight of the Foundation's name and reputation, maintained by tax-free funds, would be magnified greatly among competing reference book firms. In many instances, the commercial activity carried on by the foundation is not "inherited" or thrust upon it, but rather is entered into out of free choice and in near oblivion to countless profit corporations that could perform the same activity for hire. The danger to foundations—all foundations—in such practice is the danger of swinging too far off the base of functional charitable activity. A charitable hospital can rightly open its doors to sick and infirm indigents, but it should not use its capital, its plant, its accumulated equipment, and its generally tax-free overhead to treat those who have adequate funds and hospitalization insurance. Of course, the "organizational" test would certainly permit a hospital to charge fees covering its costs and expenses. The activity of an economics research institute in selling or giving out advice on the stock market is in a different category. Even if this service "flows naturally" from exempt activity, the presence of thousands of profit-making taxable investment and stock analysis firms suggests that a foundation which engages in such activity is roaming far beyond its functional charitable or educational base.

Distinctions in this area are admittedly arbitrary at times. Criteria defining correct practices are often penumbral. Perhaps a "charitable purpose" doctrine, similar to the "business purpose" test of tax law jurisprudence, would serve to cull out the desirable incidental foundation competitiveness from that which might have a more predatory purpose and effect. On the one hand, no tax-exempt organization that has an active business thrust upon it (as by gift or inheritance) should be forced to incur the hardship of a sacrificial divestiture, particularly when the donor's basis must be assumed. On the other hand, purchase by a foundation of a hotel, an office building, a retail bookstore, or a manufacturing plant points as much to a purpose of active business engagement as it does to a purpose of securing a higher yield of income for charitable purposes. Voluntary acquisitions of this nature should result in a heavy burden of proof being placed on the acquiring foundations to show a predominant charitable purpose behind the acquisition.

III. INUREMENT OF FOUNDATION FUNDS TO PRIVATE BENEFIT AND THE "PROHIBITED TRANSACTIONS" RULE

A. *The Problem*

To this point we have discussed the face that foundations turn to the public—how much participation in non-charitable commercial activities courts will allow tax-exempt organizations. What is lesser known, and in this writer's opinion far more important, is the private life of foundations within and among their own donors, trustees, and related profit corporations. The balance of this article is devoted to this interior problem—how it is manifested in inner-dealings between foundations and their creators, in so-called "prohibited transactions" engaged in by foundations, and in foundation accumulation or "hoarding" of income. For analytical purposes, it is impossible to put these three practices into neat categories; they overflow upon one another both in the Code and in actual occurrence. Perhaps as good a way as any to begin is by discussing the inurement of foundation funds to private persons (*e.g.*, donors, trustees, donors' relatives, etc.). A prohibition against such inurement first appears in the definitional section of the Code, section 501(c)(3). But the regulations implementing this section are not as enlightening as the standards set forth in section 503, dealing with "prohibited transactions" which, if violated, will result in revocation of exempt status. Our inquiry must bridge both sections of the statute because the various "prohibited transactions" are really specific examples of how foundation income can wrongly "inure" to the benefit of private persons. The charges made by the Patman Report in this area provide a good introduction.

Indeed, one need not read far into the Report before encountering cited instances of inner-dealing between tax-exempt groups and other interested parties. One instance cited involved a bank (Bank X) which held control (with another bank) of a large dealer in United States Government bonds, bankers acceptances, and negotiable time certificates. It had gradually acquired stock in the dealer from 1918 to 1959. Bank X's cost basis for the stock was 1.548 million dollars. Bank X established a charitable trust and contributed to it the stock in the dealer at a time when the stock was worth 2.493 million dollars on the market. Eight months later, the charitable trust sold the same stock to foundations and institutional investors. After the sale, the trust filed for and received a Treasury letter granting tax-exemption *retroactively* to a date before

the sale. The Report criticized Bank X for avoiding a capital gains tax on almost one million dollars, calling the charitable trust a handy medium for the shelter of an otherwise taxable profit.⁸⁸

Other abuses are cited. Foundations are said to be "agents of concentration," often holding over ten per cent of the outstanding stock of a corporation.⁸⁹ Control of such a corporation can then be managed by an easy, casual alliance between the foundation's holdings and the holdings of the donor's family members. Nonvoting stock held by a family foundation can sometimes be converted to voting stock.⁹⁰ Private individuals, often the donor or the donor's family, may receive annuities from a tax-exempt organization. And aside from gifts, related persons or corporations may receive loans of money from foundations that they have either created or supported.⁹¹ The Report cites one large foundation loan to a private corporation which bore an interest rate of only 2.65 per cent.⁹² Finally, donors have been known to repurchase assets from their foundations, getting a stepped-up cost basis free of tax in the process.⁹³ Too often, it seems, foundations have been the wheel horses for quick recapture of securities—at higher cost bases and with no tax on double or even triple appreciation of values.

The Patman Report also cites transactions between corporation-created foundations and the same corporation's employees—particularly transactions involving scholarships, fellowships, and other educational benefits. Another use made of the characteristic liquidity of foundations is the payment of heavy federal estate taxes owed by the donors' executors.⁹⁴ Indeed, in all such instances, collusion and inner-dealing have been charged by the Report as being rampant, uncontrollable, and yet perfectly within existing law and regulations.

B. *The Statute*

Regulations implementing section 501(c)(3) state: "An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals."⁹⁵ The words "private shareholder or individual" refer to persons who have a personal and private interest

88. See REPORT 8-9.

89. See *id.* at 8.

90. *Ibid.*

91. Loan abuses are cited in *id.* at 80.

92. *Id.* at 79.

93. *Id.* at 81.

94. *Ibid.*

95. Treas. Reg. § 1.501(c)(3)-1(c)(2) (1959).

in the activities of the organization.⁹⁶ To discover what constitutes such inurement and who might have such a private interest, we must turn to the regulations under section 503 of the Code. Those regulations outline certain transactions that are prohibited if they inure to the private advantage of any of the following:

1. The creator of the organization (if a trust),
2. Any substantial contributor to the organization,
3. A member of the family of the creator or substantial contributor, or
4. A corporation in which at least fifty per cent of the outstanding voting stock is owned by the creator or substantial contributor.⁹⁷

In pertinent (and oversimplified) part, the prohibited transactions are:

1. Loans to the persons or corporations enumerated above "without receipt of adequate security or a reasonable rate of interest."⁹⁸ "Adequate security" means something more than a mere promise to pay. Security cannot be the stock of the corporate borrower, but a mortgage on other property of the borrower of sufficient value so that foreclosure would liquidate the debt can be adequate security.⁹⁹
2. Payment of any compensation in excess of a reasonable allowance for salaries for personal services actually rendered (presumably not blanket retainer fees) to the persons or corporations listed above,
3. Furnishing any services on a preferential basis to such persons or corporations,
4. Purchasing a substantial amount of securities or other property at more than an adequate consideration from such persons or corporations,
5. Selling a substantial amount of the foundation's own securities or other property for less than an adequate consideration to such persons or corporations,
6. Engaging in any other transactions which cause a substantial diversion of income or corpus to such persons or corporations.¹⁰⁰

In gauging the Patman Report criticism in this area, it is significant to note that none of the above items prohibit inner-dealing

96. Treas. Reg. § 1.501(a)-1(c) (1958).

97. See Treas. Reg. § 1.503(c)-1(a) (1959). Family membership is determined by the rules of INT. REV. CODE OF 1954, § 267(c)(4).

98. Treas. Reg. § 1.503(c)-1(a) (1959).

99. See examples given under Treas. Reg. § 1.503(c)-1(c) (1959). See also Donald G. Griswold, 39 T.C. 620 (1962).

100. These six types of transactions have been substantially copied from INT. REV. CODE OF 1954, § 503(c). Except for § 503(c)(1), the remaining paragraphs are not elaborated or further explained in the regulations.

per se. Indeed, the pre-enactment materials relating to section 503 (section 331 of the Revenue Act of 1950) show that at first it had been proposed to deny deductions to donors if any substantial fraction of the recipient organization's assets were used to purchase securities or other property from the donors or from other trustees. However, the committee that reported on the bill believed that such a provision would have been too harsh, and no objection was seen to inner-dealings provided they were conducted at arm's length.¹⁰¹ Such has been the rule since 1950. One would have to bar dealings between foundations and interested parties completely to change it.

While the prohibitions listed above appear fairly inclusive, there are at least two gaping lacunae in the statute. The first is that a tax-exempt organization, if acting incidentally to its charter purpose, is not prohibited by this statutory language from furnishing preferential services to, giving securities to, or paying an honorarium or some unearned gratuity to a private person or corporation which is not within one of the four categories of recipients spelled out in the regulations under section 503(c).¹⁰² Thus, at this juncture, the statute would seem justifiably exposed to the criticism that exempt funds can find their way into individual, nonexempt hands, unless interpretative cases and commentary have narrowed this apparent liberality.

The second area excepted from the "policeman" requirements of section 503 is composed of those organizations listed in section 503(b)—religious organizations, schools with regular faculties and curricula, federal, state or public-supported organizations, and medical care, medical education, or medical research organizations. As to these broad exceptions, the six types of prohibited transactions enumerated above are not limitations. Nevertheless, it has been held that even these more unfettered groups are still subject to the general, and more basic, standard of section 501(c)(3)—the injunction that net earnings may not inure to private benefit.¹⁰³

101. See S. REP. NO. 2375, 81st Cong., 2d Sess., 36-37, 123 (1950); 1950-2 CUM. BULL. 483, at 510-511, 571; and CONF. REP. NO. 3124, 81st Cong., 2d Sess. 36-37 (1950), 1950-2 CUM. BULL. 580, 591. Cf., Revenue Act of 1964, P.L. 88-272, § 209(d)(1), 26 U.S.C.A. § 170 (1964), which amends INT. REV. CODE OF 1954, § 170 by adding § 170(g). Section 170(g)(4) provides that even arm's-length purchases or sales of securities by foundations to donors, family members, donors' employees, and officers or employees of controlled corporations will result in disqualification of such foundations from the "unlimited charitable contributions deduction" unless the transaction involves only "a minimal amount of securities or other property." Query: will this specific disqualification become a more general "prohibited transaction" at some future time?

102. See materials cited note 97 *supra*.

103. For a recent case, see *Kenner v. Comm'r*, 318 F.2d 632 (7th Cir. 1963), *affirming*

Before discussing how the courts have interpreted these provisions, it should be noted parenthetically that the section of the Internal Revenue Code that deals with individual deductions of charitable contributions from income subject to tax—section 170(c)(2)—also contains the section 501(c)(3) standard of inurement and adds the further prohibition that no substantial part of the activities of a tax-exempt organization may be used to carry on propaganda or attempt to influence legislation. This latter activity also amounts to a prohibited transaction; but the Patman Report does not emphasize any political role that foundations may be playing. The writer will omit further mention of this activity in the interest of space limitation.

C. Significant Cases

The sweep of the general checkrein on inner-dealing—that foundation earnings may not inure to the benefit of private shareholders or individuals—has been broadened in scope by at least one learned commentator:

“[I]f a particular individual or limited number of individuals reap commercial benefits from the operation of the instrumentality, though they do not do so by direct acquisition or payment over to them of its earnings, the earnings may nevertheless ‘inure’ to their ‘benefit’. . . .”¹⁰⁴

But several courts have given the general inurement standard of section 501(c)(3) a very literal interpretation and have permitted a variety of inner-dealing, thus adding some justification to Congressman Patman’s criticism. In *Boman v. Commissioner*,¹⁰⁵ a foundation which owned a clinic building leased the furnishings and equipment to a partnership of practicing physicians who controlled the foundation. The court observed that the partner-physicians received no free services from the foundation and that they paid an adequate rental for the facilities, even though, as trustees of the foundation, they controlled the rental rate. In upholding exemption, the court quoted a 1938 case, *Northwestern Municipal Association v. United States*, on “incidental benefits”:

“If its [the charitable corporation’s] main purpose is to benefit its shareholders or individuals it is not exempt. On the

20 CCH Tax Ct. Mem. 185 (1961) (the donor-physician had loaned money to the hospital but had also at later times withdrawn substantial sums from hospital accounts to pay his own bills).

104. 6 MERTENS, FEDERAL INCOME TAXATION § 34.13 (1957 ed.).

105. 240 F.2d 767 (8th Cir. 1957), reversing 26 T.C. 660 (1956).

other hand, if benefit to the individuals is secondary and incidental, it is exempt."¹⁰⁶

This principle was carried even further in *Huron Clinic Foundation v. United States*,¹⁰⁷ a very liberal decision. The plaintiff foundation in that case had leased a building to an association of physicians. The Commissioner argued that the rental paid by the physicians (and hence their expense deduction) was high and that the charitable contributions made by the foundation were small, so small that a surplus of three times the foundation's annual gross income had accumulated. Despite this, and despite the power of the foundation to set the rent, the court held there was no improper inurement.

Nor does favoritism or "selectivity" of beneficiaries necessarily result in a finding of inurement as long as the selectivity is among charitable objects. For example, a recent charitable trust specified that contributions to a country hospital district for free hospital rooms should go first to the specific trust beneficiaries, then to such other persons (presumably unrestricted) as the hospital directors might choose. Although this manner of disposition of benefits was held not exclusively charitable, the court's decision conceded that, had all the trust beneficiaries been needy or indigent, there would be no illegality.¹⁰⁸ Indeed, the word "charitable" implies a service or a gift for the benefit of an indefinite number of persons.¹⁰⁹ If the donor's relatives or other interested parties are incidentally members of that general class, inurement to them of benefits is not fatal to tax exemption. Thus, while class membership will permit receipt of benefits, the donor, his trustees, or family members may not be disproportionate recipients and obviously may not stand out in the class. For example, where a taxpayer's son was one of a number of free patients in a tax-exempt crippled children's organization, the taxpayer was still allowed a deduction for his contribution.¹¹⁰ But, where a corporation organized an educational foundation to provide educational opportunities to its employees' children, a director of the corporation was not allowed to deduct his contribution to the foundation while his own child was receiving thirty per cent of the total funds.¹¹¹

106. 99 F.2d 460, 463 (8th Cir. 1938).

107. 212 F. Supp. 847 (S.D.S.D. 1962), remanded by 324 F.2d 43 (8th Cir. 1963).

108. *United States v. Bank of America Nat'l Trust & Sav. Ass'n*, 317 F.2d 859 (9th Cir. 1963).

109. Rev. Rul. 56-138, 1956-1 CUM. BULL. 202; Rev. Rul. 56-304, 1956-2 CUM. BULL. 306.

110. *Marshall v. Welch*, 197 F. Supp. 874 (S.D. Ohio 1961).

111. *Charleston Chair Co. v. United States*, 203 F. Supp. 126 (E.D.S.C. 1962).

Nor is a charitable foundation precluded from making grants or distributions to individuals who are not members of a class, provided the distributions are made on a true charitable basis and in furtherance of the foundation's exempt purposes.¹¹² Adequate case histories must be maintained showing personal information with respect to the recipient and his relationship (if any) to members, donors, or trustees of the foundation.¹¹³ This result is eminently sound. Individuals, as much as groups, are legitimate objects of charity. An indigent, needy, uneducated, or diseased individual is one of an unlimited class of persons which in Judaeo-Christian society has been traditionally assisted by the kindness and generosity of those more fortunate.

Situations involving a foundation dominated by a single individual have occasioned the greatest controversy and have presented a strong appearance of inurement to private benefit. The entertainment industry provides dramatic examples. In *The Bob and Dolores Hope Charitable Foundation v. District Director of Internal Revenue*,¹¹⁴ the donor had assigned to the foundation all of his rights in his life story. The foundation then entered into publication agreements for the story. It was held that this was not a business activity, but rather, that the foundation was simply converting its rights, a valuable asset, to cash in order to more easily carry out its exempt purpose. Nor was this of substantial benefit to the donor, since he was a public figure anyway. But, in *Horace Heidt Foundation v. United States*,¹¹⁵ the Court of Claims found that the donor's foundation had taken over the business of merchandising souvenir programs that were inspired by the donor's entertainment tours of the country. The profits were dedicated to young entertainers located by talent scouts and served to furnish them with food and lodging. However, because all the beneficiaries were employed by Heidt and helped in presenting the Heidt shows, the profits were held to have inured to the donor's direct benefit.

Much the same relationship is often involved between a foundation and a profit corporation where common directorships may or may not be involved. In *Science and Research Foundation, Inc. v. United States*,¹¹⁶ a foundation contracted with a corporation, the latter agreeing to print and distribute books for the foundation and to pay back to it a royalty. The arrangement resulted in con-

112. See 2 CASNER, ESTATE PLANNING 880 n.10 (1961 ed.).

113. See Rev. Rul. 56-304, 1956-2 CUM. BULL. 306 for procedure.

114. 61-1 CCH U.S. Tax Cas. ¶ 9437 (S.D. Cal. 1961).

115. 145 Ct. Cl. 322, 170 F. Supp. 634 (1959).

116. 181 F. Supp. 526 (S.D. Ill. 1960).

siderable profit to the corporation, causing the challenge that the foundation was actually subsidizing the corporation. The foundation held no proprietary interest in the corporation. It was held that the profits were merely payment for services rendered and that, in the area of payment for services, foundations have obligations common to any other purchaser or contractor. The relationship was not nearly as disinterested, however, in the recent decision of *Stevens Brothers Foundation, Inc. v. Commissioner*.¹¹⁷ There the four founders were also partners in a contracting firm which, in turn, owned two-thirds of the stock of a construction company. The latter company needed cash in order to purchase a large construction bid bond. The foundation advanced the money in exchange for one-half of the profits expected from the construction contract plus repayment of the advance. Subsequently, the foundation's advance was extended on a like basis to other construction contracts, and ultimately the advance exceeded three-quarters of a million dollars (for which interest was deferred). The court held the foundation's resulting profit clearly was not "incidental" to its exempt activities. An appreciable amount of its funds had been used in a manner which, while beneficial to it financially, also resulted in the rescue of a profit corporation at a time when the latter had not been able to get additional financing (an act of charity, but not consistent with tax exemption!).

It is worth noting that, when a tax-exempt organization is found to have engaged in one of the section 503 "prohibited transactions," it is denied exemption only for taxable years after the year of official notification that it has engaged in a prohibited transaction, unless it entered into such transaction *with the purpose* of diverting corpus or income from its exempt purpose *and* such transaction involved a substantial part of its corpus or income.¹¹⁸ This rule places quite a duty of vigilance on the Service. On the other hand, it also recognizes that disinterested donors may be the last to discover that the recipient of their gifts has violated the Code; thus, it protects the deductibility of their contributions in the year made.

D. *Some Observations on Inurement*

Do the above decisions indicate an "appearance of evil" which would justify the Patman Report's charges of wrongful inner-dealing within foundations and among interested parties? As we have

117. 39 T.C. 93 (1962), *aff'd in part, rev'd in part*, 324 F.2d 633 (8th Cir. 1963).

118. See INT. REV. CODE OF 1954, § 503(a)(2).

seen, nowhere does the Internal Revenue Code prohibit arm's-length transactions between a donor, his foundation, and the foundation's trustees. And it is fair to say that, when courts have found such dealing to be at less than arm's length, the boom of exemption denial has almost always been lowered. But, in many instances, courts have judged the ingredients of the situation too formalistically, without much regard for very real collusion or identity of interest between the parties.¹¹⁹ "Indirect" benefits can often lead in indirect ways to redounding direct benefits. This is particularly true among foundations that hold controlling stock interests in profit corporations. A corporation so controlled is assured of a friendly, often accommodating (even at arm's length) major stockholder. The foundation, in turn, may contribute to causes, persons, or institutions who will not be unfriendly to the commercial interests of the corporation. An environment is thus created in which collusive power, even though unexercised, can exist. Similar potential exists between the donor and his family-controlled foundation. Inner-dealing of this type may remain superficially objective and disinterested; yet loan arrangements between the foundation and its founder, even at the going interest rate, automatically exclude the bidding of commercial banks. And the statutory permission to pay reasonable salaries for services actually rendered may lead to payments to qualifying family members. We may well ask the question so familiar to students of antitrust law and policy—is the existence of the power per se evil?

On the other hand, one should think twice before advocating unnecessary chastity between substantial donors and recipient tax-exempt groups. Despite the power of abuse that inheres in the regulations and rules we have just discussed, there is danger in penalizing a foundation merely because of its fortuitous (and often enviable) connection with a productive and talented donor or trustee, or because of the high yield it may receive from securities it may hold in a close, controlled corporation. Good as well as bad results may derive from such associations. The services a foundation receives from or through its founder could be unique and far better than those otherwise available to it. This is to say that the rules of section 503 should not be tightened too arbitrarily for the sake of removing anti-competitive influence; rather, a burden of going forward with evidence of justification should be placed on founda-

119. The decision in *Huron Clinic Foundation*, 212 F. Supp. 847 (S.D.S.D. 1962), remanded by 324 F.2d 43 (8th Cir. 1963), is an example.

tions having inner-dealings with interested parties. In this connection, it should be noted that questions concerning all six of the prohibited transactions of section 503(c) are asked of all reporting foundations on Parts I and II of Treasury Form 990-A (the annual information return required of section 501(c)(3) organizations), and positive answers must be explained. It is believed that full answers to these questions would go a long way toward satisfying Congressman Patman's objections.

One final point needs mention with respect to inner-dealings of charitable inter vivos and testamentary trusts. Often, one finds a trust of this type carrying on its exempt purpose in good measure, but also paying out part of its net income as an annuity to, or retaining the personal services of, a related or interested individual. This seemingly nepotistic practice is defensible on the basis of the so-called doctrine of "prior charge." For example, suppose a testamentary charitable trust instrument directs that there be paid an annuity for life to a grandniece of the testator. Such payment is not really a "condition" imposed upon the existence of the trust, but merely the liquidation of a legacy. In such a situation, payment of the necessary sum (out of principal if need be) has been upheld.¹²⁰ Likewise, when property is transferred inter vivos to a private foundation with a present charge that a life income be paid to a designated private individual, quite clearly the foundation receives a vested remainder interest which is ascertainable, capable of valuation, and in all respects immune from any charge that favoritism or inner-dealing is the motive.¹²¹ Readily distinguishable from these situations, of course, would be *voluntary* private payments by the tax-exempt organization when there is no prior charge. It has been suggested that segregation of the necessary assets within the trust or foundation will prevent a prior or present charge from being challenged.¹²² This doctrine of segregation was extended in an interesting way by the Court of Claims in *Wells & Wade, Inc. v. United States*.¹²³ By their wills, a donor and his wife provided that their stock in two operating, profit corporations would go to a foundation. Upon the death of the donor, one of his co-executors borrowed a large sum of money from a bank in order to pay the estate administration expenses. In response to the bank's demand for security, the foun-

120. These were the facts and holding in *Eugene S. Lewis v. United States*, 189 F. Supp. 950 (D. Wyo. 1961).

121. *Wm. L. Powell Foundation v. Comm'r*, 222 F.2d 68 (7th Cir. 1955), *reversing* 21 T.C. 279 (1954).

122. *Wm. L. Powell Foundation v. Comm'r*, *supra* note 121, at 74.

123. 150 Ct. Cl. 819, 280 F.2d 825 (1960).

dation executed an indemnity contract. Although there was no prior charge placed on the foundation by the donor's will, the court in effect excused allegations of inner-dealing by holding that, since the foundation was the residuary legatee of the estate, it was justified in guaranteeing the loan rather than risking the sale of some of the estate corpus to satisfy it.¹²⁴ The loan could later be repaid out of the operating profits of the two corporations.

IV. ACCUMULATIONS

A. *The Problem*

Congressman Patman indicts foundations for another kind of practice that is even more obscure to the observer than the inner-dealing we have just discussed. This is the accumulation of funds from unexpended income by a tax-exempt organization—a state of affairs which can be detected only by an x-ray of the foundation's balance sheet. The 534 foundations studied by the Patman Committee held over 900 million dollars in accumulated income at the end of 1960.¹²⁵ According to the Report, they paid out only fifty per cent of their aggregate receipts during 1951-1960.¹²⁶ The writer would agree that even a casual survey of Schedule 6 of the Report shows many foundations have accumulated income to the extent of one-third to three-quarters of their 1960 net worth (based on market value, not cost). To some extent these figures evidencing accumulation are the result of a static, rather than a dynamic, look at foundation balance sheets. Obviously, the click of a camera shutter will catch some foundations with money in the till, whereas a running three-to-four-year time exposure might disclose that the funds were later paid out and even that indebtedness was incurred. Another distortion in the Patman Report is that, oddly, all capital gains are classified as additions to income.¹²⁷ Apparently this was done without regard for the dictates of state laws, trust instruments, sound accounting practice, and, as we will soon see, the Internal Revenue Code itself, all of which generally classify such gains as accretions to capital or principal. If capital gains are added to net income, it is easy to see how some of the most scrupulous organizations would show accumulations.

It is safe to assume that many foundations have been and are

124. The Court of Claims relied on an earlier decision which allowed a charitable corporation to pay off its debts before making any gifts. See *Knapp Bros. Shoe Mfg. Corp. v. United States*, 135 Ct. Cl. 797, 142 F. Supp. 899 (1956).

125. REPORT 4.

126. *Id.* at 51.

127. The REPORT expressly so states at 6.

accumulating true income—rents, interest, dividends, and fees and charges. However, legal measures are already available to the Internal Revenue Service that empower it to force out of these entities funds destined for charitable, educational, religious, or other exempt uses. Also, under certain circumstances, foundations are legally justified in accumulating income.

B. Governing Statutory Provisions

Section 504 of the Internal Revenue Code (also a part of the Revenue Act of 1950) deals exclusively with accumulations.¹²⁸ The restrictions of section 504, as well as the prohibited transactions of section 503, are *in addition to and not in limitation of* the restrictions contained in section 501(c)(3). To paraphrase the statutory language, section 504 provides that exemption shall be denied for the taxable year if the amounts the tax-exempt organization has accumulated during that year “and not actually paid out” by the end of the taxable year are:

1. Unreasonable in amount or duration in order to carry out the exempt purposes of the organization, or
2. Used to a substantial degree for purposes other than its exempt purpose, or
3. Invested in such a manner as to jeopardize the carrying out of the exempt purpose.

Section 642(c) and section 681(c) contain slightly different language. They govern the deduction from income allowable to certain trusts that make charitable contributions. In section 642(c) it is provided that any part of the gross income that, by the terms of the governing trust instrument, is “paid or permanently set aside” for an exempt purpose during the taxable year is allowable to the trust as a deduction. Section 681(c) adds that, if these amounts “paid or permanently set aside” are of the same nature as the three prohibited categories above, the amount otherwise allowable to the trust as a deduction shall be limited to the amount actually paid out and shall not exceed 20 per cent of taxable income, computed without any charitable contributions deduction. The addition of the language “or permanently set aside” in these sections gives greater leeway to permissible accumulations by trusts than is given to private foundations. The reason for the added liberality would seem to be to allow a donor through a trust instrument, whether testamentary or inter vivos, to express a charitable intent

128. See also INT. REV. CODE OF 1954, § 681(c)(2) for limits on charitable contributions in instances of unreasonable accumulations of certain trusts.

that funds be "set aside" to accumulate for a major goal or end which, at the time of the trust's creation, is not attainable because of limited assets. Trusts, it seems, may even contain mandatory accumulation provisions, provided they point to a specific charitable project.¹²⁹

The regulations, by excluding most capital gains, define the term "accumulated income" in a manner different from the Patman Report. The regulations state:

"For the purpose of section 504, the term 'income' means gains, profits, and income determined under principles applicable in determining the earnings or profits of a corporation. The amount accumulated out of income during the taxable year or any prior taxable year shall be determined under the principles applicable in determining the accumulated earnings or profits of a corporation. In determining the reasonableness of an accumulation out of income, there will be *disregarded* the following:

"(1) The accumulation of gain upon the sale or exchange of a donated asset to the extent that such gain represents the excess of the fair market value of such asset when acquired by the organization over its substituted basis in the hands of the organization.

"(2) The accumulation of gain upon the sale or exchange of property held for the production of investment income, such as dividends, interest, and rents, where the proceeds of such sale or exchange are within a reasonable time reinvested in property acquired or held in good faith for the production of investment income."¹³⁰

Had these standards been applied to the statistical summary of the Report, the problem of foundation accumulations would have been considerably ameliorated.

Another criticism made by the Patman Report in this area is that foundations are substantial stock traders. During the period of the sharp market break in 1962, thirty-eight foundations marketed 146 million dollars worth of securities.¹³¹ If the suggestion from these statistics is that some foundations are speculators, the criticism is valid. This is obviously a practice which can become (and has been ruled to be) a primary, nonexempt purpose.¹³² Were foundations and charitable trusts not to exchange securities from time to time, however, one could suppose that they would be open

129. A good illustration of this exact point is *Erie Endowment v. United States*, 316 F.2d 151 (3d Cir. 1963), discussed in text accompanying note 142 *infra*.

130. Treas. Reg. § 1.504-1(c) (1958). (Emphasis added.)

131. REPORT 129.

132. See *Randall Foundation v. Riddell*, 244 F.2d 803 (9th Cir. 1957).

to the equally valid criticisms that they were keeping income-producing property from the market place and that the ends of charity were suffering from the failure of foundations to upgrade their holdings. The imposition of new legal restrictions on such trading could conceivably do more overall harm than good by freezing foundation holdings and totally blocking their activity during market swings.

C. *Illuminating Cases*

No one case found in the writer's research has proved more illuminating on the subject of unreasonable foundation accumulations of income than *Samuel Friedland Foundation v. United States*.¹³³ There a foundation was established with a two per cent holding of stock in a large corporation of which the donor was chairman. The foundation's trustees wanted to build and donate a medical research building estimated to cost five hundred thousand dollars, a sum far in excess of the foundation's income resources at the time. In order to build up its annual return, the foundation, aided by interest-free loans from its creator, bought second and third mortgages and even some construction mortgages. During the time of this build-up, the foundation made small annual gifts, but the bulk of its income was accumulated and invested for the trustees' main objective. The Commissioner challenged the whole program on the basis of the accumulations rule, adding that the borrowing by the foundation was not a permissible "reinvestment" of income under the applicable regulations.¹³⁴

The court found that the accumulation was reasonable and that the foundation's borrowing of money to build up its income-producing assets was tantamount to a "reinvestment in property acquired and held in good faith for the production of investment income" under the regulations. The true test of reasonableness, the court added, is this: "Does the charitable organization have a concrete program for the accumulation of income which will be devoted to a charitable purpose and in the light of existing circumstances is the program a reasonable one?"¹³⁵ Answers to these searching questions were found in the purpose of the accumulation, the ultimate dollar goal, the funds available at the beginning, the likelihood of new funds becoming available from contributions, and the extent of time required to reach the goal. As to the latter, the court indicated that under proper circumstances a six, seven, or

133. 144 F. Supp. 74 (D.N.J. 1956).

134. Treas. Reg. § 1.504-1(c)(2) (1958).

135. 144 F. Supp. 74, 92 (D.N.J. 1956).

even an eight-year accumulation period could be reasonable. The court also held that the choice of second and third mortgages as an investment medium did not come within the prohibitions of section 504(a)(3) as an investment likely to jeopardize the foundation of the organization. Private foundations, in the absence of contrary charter provisions, are not held to trust fund investment standards. What is unusual about the case is that the court approved of the foundation borrowing money in order to add to the corpus more stock in the same corporation. At the time of this borrowing, the foundation had a net worth of 110 thousand dollars. It borrowed funds from the donor and a bank to acquire 55 thousand shares at a time when the market for one unit was twenty to twenty-one dollars. Even though a decline in market price of three dollars would literally have wiped out the foundation, the court accepted as a satisfactory ground the donor's testimony that he, as chairman of the corporation, was sure at the time of the investment that the stock would not decline.

A similar holding is found in a 1962 decision by another district court.¹³⁶ There, the principals of the foundation were also the principals of a company that had advanced and loaned money to the foundation. When the net worth of the foundation grew to almost four million dollars, the trustees determined to repay the outstanding loans before embarking on the ultimate purpose of the foundation—the construction and endowment of a civic building for Terre Haute, Indiana. The donor's family neither received loans from the foundation nor collected interest on loans advanced; the objective of the family was to "beef up" the foundation's financial ability to construct the civic building. Not surprisingly, the Commissioner again argued that the retiring of indebtedness incurred in the acquisition of property is the equivalent of accumulating income.¹³⁷ But again, it was held that the accumulation was reasonable in view of the foundation's specific goal. To what extent this holding stemmed from the testimony of foundation officials at trial, rather than from the foundation's charter purposes, is not made clear in the opinion of the court. It is submitted that the charter purposes would provide a far more unimpeachable source than advised courtroom testimony rendered after the fact.

Another instance of this permitted "bootstrapping" is found in *Commissioner v. Leon A. Beeghly Fund*,¹³⁸ a case dealing with the

136. *Hulman Foundation v. United States*, 217 F. Supp. 423 (S.D. Ind. 1962).

137. The Commissioner cited Rev. Rul. 54-420, 1954-2 CUM. BULL. 128.

138. 310 F.2d 756 (6th Cir. 1962), *affirming* 35 T.C. 490 (1960).

accumulation standards applicable to charitable trusts. There, the court stated: "[T]he use of any such (foundation) income to pay for the assets which produced it or to pay for other assets which will produce more income would, under the terms of the trust agreement, be used exclusively for charitable purposes at some time."¹³⁹ The *Beeghly* rationale would seem particularly well adapted to trusts since, as we have seen, gifts to such entities are deductible if their income is paid or "permanently set aside" for exempt purposes.¹⁴⁰

The standards that were applied in the *Friedland* decision produced an opposite result in a very recent decision of the Third Circuit, *Erie Endowment v. United States*.¹⁴¹ The court there observed:

"[Erie Endowment] has no natural right to tax exemption, but rather a Congressional balm granted because losses in tax revenues were deemed compensated for by the value of its charitable work. Absent a sufficient amount of charitable work commensurate with the total amount of Erie's available charitable funds, exempt status must cease or, in fact, never come into existence."¹⁴²

The court found that, by mandatory accumulation provisions contained in its charter, the Erie Endowment trust had reached the point in 1958 where its net income was twenty-six thousand dollars and its accumulated income was 390 thousand dollars. Even considering the language of direction in the trust instrument, this accumulation was felt to be too flagrant to justify honoring the donor's vague desire to do something "very substantial."¹⁴³

"The standard to be applied is whether the taxpayer can justify the total accumulation of income at the end of the taxable year, in terms of both time and amount, on the basis of a rational total program of charitable intent."¹⁴⁴

The court concluded that by this standard the trustees had been given no program of expenditures nor any specific projects that would justify the accumulation. The trust was judicially reminded that its program must be prospective in direction and not occur expeditiously to the organization "after the Commissioner's shadow becomes visible."¹⁴⁵

139. 310 F.2d 756, 761 (6th Cir. 1962).

140. For a holding almost as liberal with respect to private foundations, see *A. Shiffman v. Comm'r*, 32 T.C. 1073 (1959).

141. 316 F.2d 151 (3d Cir. 1963), *affirming*, 202 F. Supp. 580 (W.D. Pa. 1961).

142. 316 F.2d 151, 153 (3d Cir. 1963).

143. *Id.* at 155.

144. *Ibid.*

145. *Ibid.*

D. *Some Conclusions on Accumulations*

Foundations should not be required to spend their income as fast as they receive it, even in the absence of a specific and rational total program of charitable intent. The measure of the accumulation is, of course, the income of the taxable year and all prior years that is not paid out.¹⁴⁶ It would be surprising if an organization were directed to find use for all income in the very year of its receipt. Even functional charities are seldom put to such a rigorous standard. It is submitted that the regulations governing this aspect of foundation activity presuppose an intelligent, searching placement of foundation funds among the many possible charitable recipients. One of the natural advantages of a private foundation is that it may serve as a reservoir from which donations can be made with more care and investigation than is the case with the typically hurried and unsystematic giving that characterizes the month of December for many individual donors. One thing that the Patman Report does not strongly criticize is the worth and value of foundation gifts once they are made or committed. Placing foundation giving on too fast a racetrack could result in just this criticism, however, and would strike at the very *raison d'être* of foundations as instrumentalities of charitable support.¹⁴⁷

V. THE PATMAN REPORT'S RECOMMENDATIONS

Congressman Patman proposes certain remedies for the list of abuses his report cites. Particularly pertinent to the content of this article are the following recommendations of the report:

1. Limitation of twenty-five years on the life of foundations;
2. Prohibition of foundations from engaging in business either directly or indirectly;
3. Prohibition of any commercial money lending or borrowing by foundations;
4. Prohibition of foundation grants to employees of any company the foundation controls through stock ownership;
5. Limitation of foundation stockholdings to not more than three per cent of the stock of any one company, and prohibition of the right to vote stock;
6. Stricter regulation of foundation holdings and investments. In this connection the Report states: "Our study shows sizable stock market losses for a number of foundations during

146. 6 MERTENS, FEDERAL INCOME TAXATION § 34.17 (1957 ed.).

147. The reader is referred to the following revenue rulings on the scope of permissible foundation accumulation of income: Rev. Rul. 54-137, 1954-1 CUM. BULL. 289; Rev. Rul. 54-227, 1954-1 CUM. BULL. 291; Rev. Rul. 54-420, 1954-2 CUM. BULL. 128; Rev. Rul. 55-674, 1955-2 CUM. BULL. 264.

the ten-year period of 1951 through 1960. Did the directors or trustees reimburse those foundations for such losses? I believe that the answer would be negative."¹⁴⁸

7. Taxation of income derived from assets acquired by foundation borrowing;

8. Denial of charitable deduction for any amount given by a contributor to a foundation he controls unless and until the foundation puts the contributed money or property to direct charitable use;

9. Elimination of the "tax profit" on gifts of appreciated property to foundations;

10. For purposes of figuring the accumulation of income, all contributions to a foundation and all capital gains from its operations should be classed as "income";

11. Amounts unreasonably accumulated in private corporations should be added to the accumulation of any foundation that holds a controlling amount of stock in the corporation, and corporations controlled by foundations should be subject to the unreasonable accumulation earnings tax of section 531 of the Code;

12. A regulatory agency for the supervision of tax-exempt foundations should be considered¹⁴⁹

The Report contains other recommendations that deal with gift and estate taxes, notably the suggestion that gifts to foundations should not be deductible from the taxable estates of decedents.¹⁵⁰ Finally, the concluding chapter of the Report summarily criticizes lax enforcement procedures of the Treasury Department. By repeating a series of questions propounded by Congressman Patman to the Commissioner of Internal Revenue,¹⁵¹ the Report seeks to show that the Internal Revenue Service has no formal procedure for public challenge of the exempt status of an organization, that there are no personal penalties against trustees of foundations that engage in prohibited transactions, that no specific time is given a foundation in which to distribute each year's income (subject, of course, to the rules of section 504), and that there is no prohibition against family members staffing, and being compensated by, family foundations. Of course, none of these lapses is due to a lack of enforcement; there are simply no regulations that would have allowed more definite answers by the Commissioner to the questions.

The work of the Committee is not finished. In a chapter entitled

148. See REPORT 133.

149. For an extended discussion of these recommendations, see the excellent comment, Krasnowiecki & Brodsky, *Comment on the Patman Report*, 112 U. PA. L. REV. 190 (1963).

150. REPORT 134.

151. *Id.* at 73-74.

"Unfinished Business," Congressman Patman promised further investigation of stock sales and stock trading by foundations, of foundation credit arrangements in the purchase of securities, of a possible conflict of interest between an individual's advisory role as a foundation trustee and his personal business interests, and further analysis of foundation expenditures—including administrative and operating expenses.¹⁵² In fact, as a harbinger of investigations and reports yet to come, a questionnaire letter has recently (January 1964) been sent out by the Committee asking foundation trustees for their views on the several subjects covered by the first installment of the Report.

As this paper is being written, there is evidence that the Patman Committee is already following through on some of the investigations it earlier promised. Its Report has stirred the Senate Finance Committee to request from Treasury Secretary Dillon a "study of possible abuses of private foundations under internal revenue laws."¹⁵³ And, testifying before the Committee on July 21, 1964, during the first of its public hearings, Secretary Dillon made it clear that he will offer recommendations at the end of the year or in early 1965, concerning "self-dealing between a contributor and the foundation he controls" and the competitive effects of foundation-controlled corporations on tax-paying companies.¹⁵⁴ To Congressman Patman's repeated questions as to whether foundations are eroding the tax base, however, the Treasury Secretary answered "that even massive contributions to foundations generally support worthy causes which, absent such tax-exempt groups, would have to be either abandoned or taken over by federal and state governments."¹⁵⁵

Congressman Patman has also continued his charge that the Internal Revenue Service has been extremely lax in the enforcement of regulations governing foundations. According to Committee allegations, the Service was "lethargic" in auditing the returns of a large New York foundation because it assessed the foundation for only 1952 and 1953 taxes even though the challenged practices continued afterwards and the matter was not settled until 1963. Appearing before the Committee on July 22, 1964, Mortimer Caplin, then the Commissioner of the Internal Revenue Service, declared that all 534 of the foundations studied by the Patman Committee have undergone audits, and the tax exemptions of eight have been

152. *Id.* at 130-131.

153. *Wall St. J.*, July 17, 1964, p. 3, col. 2.

154. *Id.*, July 22, 1964, p. 3, col. 2.

155. *Ibid.*

revoked.¹⁵⁶ Moreover, the Internal Revenue Service, he said, has established an Exempt Organizations Council to "eliminate administrative obstacles."¹⁵⁷ The Commissioner at the same time added to Congressman Patman's recommendations by promising that his department would propose legislation to prohibit donor-foundation transactions, to require foundations to give all their assets to charity and go out of business within twenty-five years after organization, to place a limit on the amount of stock one foundation may hold in a single company, and to put restrictions on speculative stock market transactions.¹⁵⁸

VI. A SUMMING UP

It is easily seen that some of the Patman Report's recommendations are wholly arbitrary. Clearly in this category are the recommendations limiting to three per cent the amount of stock a foundation may hold in any one corporation and compelling complete distribution of all assets at the end of twenty-five years of existence. Also, it has recently been remarked that such supposed reforms would be much too sweeping for the evil they are designed to curb—namely, the undesirable impact of tax-exempt foundations on our market economy.¹⁵⁹

Up until now, we have skirted a real policy issue: whether private funds and foundations should be permitted to continue to exist side by side with schools, hospitals, churches, and other functional charities. The Patman Report is not a criticism of charitable ends. Its attack is against the device by which, in the name of those ends, taxpayers establish a reservoir of tax-free income which then travels an often delayed, tortuous route before emerging in the hands of the operating donees. The Report presumes, too unfairly, that in many such organizations the motive of tax avoidance predominates over the motives of good will and good works. Indeed, in sections of the Report this presumption is so overtly cynical that it tends to undermine and discredit many sincere suggestions which it contains. Consider, for example, the attack on a famous chemical fortune destined for a family foundation:

"Once again, the 'cream' from one of our nation's great fortunes will go completely tax free. Once again, the 'skim milk' incomes of the hardworking majority of the American people

156. *Id.*, July 23, 1964, p. 2, col. 3.

157. *Ibid.*

158. *Ibid.*

159. Krasnowiecki & Brodsky, *supra* note 149, at 195.

will be forced to bear a still heavier share of the total tax burden. . . .

"Only after (the founder's) death . . . will the tax exempt . . . Foundation come into full flower. Then it will receive each year nearly all the income from the family estate's vast empire of banking, industry, railroads and real estate—and that income will wholly escape income taxes."¹⁶⁰

This is not so much an attack on foundations as it is a cavalier criticism of tax avoidance through donation to charity. It suggests that charity should no longer be a private concern, that it should no longer offer an alternative to the payment of income taxes, and that only the federal government could fairly operate in this field—suggestions beyond the original investigative mission of the Committee. This type of thinking adversely affects the more constructive parts of the Report.

We have already suggested that a main purpose of private foundations is to "systematize" charitable giving by providing an entity that will outlive the donor or creator and prolong an otherwise ephemeral scheme of donation. The availability of a private foundation also tends to speed charitable giving prior to death and avoids the inevitable delays attending a testamentary disposition of the same funds. That a donor or creator often chooses his family members to fill trusteeships initially is not ipso facto evidence of nepotism or bad faith. Nor is the bare fact that there is put into the created foundation large amounts of stock in a single company at all inimical to a charitable purpose. Often, a single block of securities is all a donor has to contribute. Indeed, Congressman Patman contradicts himself by simultaneously criticizing foundations for retaining large blocks of stock and complaining about the market volume of trading and exchange in which they allegedly indulge. It is submitted that, unless foundations are to be outlawed altogether, leaving nothing but operating charities, the personnel of their boards and the securities of their portfolios are a secondary consideration, deserving certainly of scrutiny but not of wholesale reform.

Perhaps Congress will ultimately place foundations under standards of trust and requirements of operation akin to those applied to banks and life insurance companies. In fact, the Report suggests that, if foundations were treated "the way the tax law now does trusts," a donor would be denied a charitable deduction for amounts

160. CHAIRMAN OF HOUSE SELECT COMMITTEE ON SMALL BUSINESS, 88th Cong., 2d Sess., *TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY* (Comm. Print 1964).

he contributes to his controlled foundation until such time as the foundation actually uses the money for charity.¹⁶¹ Similarly, income earned by the foundation would be taxable to the controlling donor until expended for one of the foundation's charitable purposes. However, this suggestion would be impossible to implement without rewriting the sections of the Code that deal with the taxability of creators of private trusts.¹⁶²

The Patman Report's criticism of the business and commercial activities of foundations as well as their accumulated, undonated income is more on point. The second concluding recommendation of the Report states that "tax exempt foundations should be prohibited from engaging in business *directly or indirectly*."¹⁶³ This article has cited abuses, both in the area of foundation competition with profit enterprises and in the area of foundation accumulation of income. In the first area, as present deterrents we have the "operational" test and the tax on unrelated business income. The difficulty, however, is that a large foundation may be operated *primarily* for eleemosynary purposes and yet engage in a relatively small activity which touches the area of competition of small businesses. It is submitted that more "relation" should be required of such so-called "unrelated" business activities. In other words, a qualitative test should be added to the present quantitative standards of the "operational" test. Such a test would require that foundations not only be operated *primarily* for their exempt purpose in order to maintain tax-free status, but also that any business income (*i.e.*, income earned from active, not passive, sources) be "related" to the accomplishment or furtherance of the charter purposes. Under this suggested test, "unrelated" business income would be taxed, and its receipt would become the equivalent of a prohibited transaction, resulting in loss of exemption. The latter result, or the threat of it, would constitute a far greater deterrent than the present subjection of unrelated activities to tax. Concurrent with such a revision should also come a closing of the "subsidiary loophole." As was earlier pointed out,¹⁶⁴ outright foundation ownership of a separately incorporated business subsidiary provides an escape from the prohibited transaction rules. This device also permits the business subsidiary

161. REPORT 133-34.

162. Specifically INT. REV. CODE OF 1954, §§ 673(a) (b), 676-778.

163. Emphasis added. Congressman Patman explained the word "indirectly" by stating: "Foundations controlling corporations engaged in business, through the extent of stock ownership in those corporations, should themselves be deemed to be engaged in that business." See Krasnowiecki & Brodsky, *supra* note 149, at 193.

164. See text accompanying note 85 *supra*.

to accumulate earned income free of the section 531 accumulated earnings tax since no motive of avoiding income tax can be attributed to a shareholder who is tax-exempt.

A third reform should be the tightening up of rules relating to accumulated income. The longer the route between donation of funds to a foundation and their application by the foundation to functional, charitable ends, the less reason the American taxpaying public has for granting tax shelter to those funds. It is difficult to formulate a proper policy here. While the initial bootstrapping of foundation assets by borrowing and then accumulating funds to retire the indebtedness is susceptible to abuse, the alternative would be for a donor to incur a personal indebtedness and acquire the property *before* establishing the foundation. But, this alternative would require the loan to be amortized with taxable income. One can make a good case for the proposition that the ends of charity are better served by permitting the nontaxed foundation to do the borrowing. One approach to this problem could be a strict application of the *Samuel Friedland Foundation* doctrine.¹⁶⁵ Foundations could be made to justify accumulations of more than, for example, two years' duration by "statements of intent" filed with their annual information returns (Form 990-A), a practice which is presently pursued by circumspect foundations. Rather than merely listing their year-beginning and year-ending aggregate accumulation as is now required by the return, foundations should be required to state the specific purpose of the accumulation and its intended duration in years. Any changes in the accumulated fund should be footnoted and explained. If this practice were followed, accumulations could be checked annually, and their purpose enforced, by the Internal Revenue Service. A change in the purpose of the accumulation, as well as an extension of its term, should require Internal Revenue Service approval.

In connection with accumulations, it should also be noted that private foundations—and those usually accumulating funds for at least one year or more—lost a point to publicly-supported foundations under the Revenue Act of 1964.¹⁶⁶ A new statutory distinction between the two types of exempt groups was there created which may emphasize to private foundations the importance of making speedier charitable application of their income. The law opened wider the category of charitable and educational gifts that qualify for the additional ten per cent (total of thirty per cent) charitable

165. 144 F. Supp. 74 (D.N.J. 1956), and see earlier discussion of case.

166. See P.L. 88-272, 26 U.S.C.A. § 170 (1964).

deduction by including, *inter alia*, gifts made to publicly-financed foundations.¹⁶⁷ The House Committee on Ways and Means explained why the enlarged deduction was not being extended to private foundations:

"Your committee is limiting the additional 10-percent deduction to organizations which are publicly or governmentally supported, however, and is not making this additional deduction available in the case of private foundations. These latter types of organizations frequently do not make contributions to the operating philanthropic organizations for extended periods of time and in the meanwhile use the funds for investments. *The extra 10-percent deduction is intended to encourage immediately spendable receipts of contributions for charitable organizations.*"¹⁶⁸

Still another distinction drawn by the 1964 Act will undoubtedly have a cathartic effect on private foundations, causing them to break up and discharge accumulated income. Subsection 170(g), added to the Code in the 1964 Act, restricts the "unlimited charitable contributions deduction" to gifts made to publicly supported organizations (those eligible for the thirty per cent limitation) and to certain "operating" private foundations. The latter are elaborately defined, and contributions to them will qualify for the unlimited deduction *only* if such private foundation,

1. Not later than the close of the third year after the taxable year in which the foundation receives the contribution, expends an amount equal to at least fifty percent of such contribution for:

- (a) Active conduct of its charter purposes;
 - (b) Assets that are directly devoted to such active conduct;
 - (c) Contributions to other qualifying organizations, or
 - (d) Any combination of the above;
- and

2. For said three-year period or less, expends *all of its net income* (determined without regard to capital gains or losses) for the purposes described above.¹⁶⁹

Private foundations that expect to receive charitable contributions from donors who seek to qualify under and stay within the "unlimited charitable contributions deduction" benefits will have to meet these strict terms. Section 170(g) is of further interest since it

167. INT. REV. CODE OF 1954, § 170(b)(1)(A)(vi) (1964).

168. REPORT OF THE COMMITTEE ON WAYS AND MEANS TO ACCOMPANY H.R. 8363, H.R. REP. NO. 749, 88th Cong., 1st Sess. 53 (1963). (Emphasis added.)

169. INT. REV. CODE OF 1954, § 170(g)(3) (1964).

may be a harbinger of future regulations. The three-year accumulations period could conceivably turn into a general rule of qualification for income tax-exemption of funds and foundations.

Nothing has been suggested here with respect to inner-dealing within and among foundations, their creators, and their trustees. Changes in this facet of foundation regulation may evolve in the next few years as a result of rules recently enacted with respect to self-employed individuals' retirement trusts. In the Self-Employed Individuals Tax Retirement Act of 1962, owner-employees who "control" the trade or business with respect to which the retirement plan is established are barred from engaging in any transaction with their own retirement trusts.¹⁷⁰ The act absolutely prohibits certain other transactions of the trusts, such as the lending of funds for any reason whatsoever, the paying of any compensation for personal services rendered, the making available of any services on a preferential basis, and the sale to or purchase from the trust of any assets. Whether these strict regulations will, by affinity, "rub off" on the more liberal private foundation requirements is uncertain; but the Patman Committee cannot be presumed to be unaware of this most recent parallel.

Of course, increased regulation by the several states would also be a corrective measure. A few states have passed the Uniform Supervision of Trustees for Charitable Purposes Act.¹⁷¹ Although the act does not apply to charitable corporations that are organized and operated primarily for educational, religious, or hospital purposes, it states with respect to charitable trusts: "It is hereby declared to be the policy of the state that the people of the state are interested in the administration, operation and disposition of the assets of all charitable trusts in the state . . ."¹⁷² The state attorney general is directed to maintain a register of trusts and trustees, trust instruments and inventories of trust assets must be filed, and sworn testimony from trustees may be required and documents subpoenaed. The stated purpose behind all of this is to ascertain whether the trusts "are being properly administered."¹⁷³ This legislation, even though requiring duplicate report filing and the consequent added paper work, tends to enforce upon charitable trusts an adherence to their stated purposes. Its thrust is more specific, more direct, and

170. NOW INT. REV. CODE OF 1954, § 503(j).

171. See, e.g., *Michigan*: MICH. COMP. LAWS §§ 14.251-266 (Supp. 1961); *California*: CAL. GOV'T CODE §§ 12580-96 (1963); *Oregon*: Ore. Laws 1963, ch. 583, pp. 1186-91 (1963).

172. MICH. COMP. LAWS § 14.251 (Supp. 1961).

173. MICH. COMP. LAWS § 14.256(b) (Supp. 1961).

more germane to charitable purposes and their execution than are many of the more ponderous recommendations of the Patman Report.

On balance, it is clear that Congressman Patman has initiated a debate that will continue for years, until either the excesses of some foundations are curbed voluntarily or the penalty of remedial legislation is suffered by all. If the writer has appeared critical of the Report, it is mainly because the Report tends toward negative and alarmist comment, rather than constructive suggestion. Little is said about the hundreds of private funds and charitable trusts and corporations that hew to the line, word, and letter of the regulations and whose charitable goals relieve the taxpayer of the less economical, and indeed questionable, administration of charity by the federal government. By highlighting the salient points of the Report against the background of existing laws and regulations, the writer has attempted to offer the opportunity of judgment to the reader. It is hoped that the final verdict on the future of tax-exempt organizations will not be reached until a carefully-made record has been presented to, and digested by, the American taxpayer. In the meantime, foundations will have to weather, as best they can, the close scrutiny that today attends tax exemption of major portions of the nation's wealth.