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Taxation-Federal Income Taxation-The Three-Party Sale and Lease-back

Lawrence R. Velvel S.Ed.
University of Michigan Law School

TAXATION—FEDERAL INCOME TAXATION—THE THREE-PARTY SALE AND LEASE-BACK—The so-called sale and lease-back device has long been the subject of judicial and governmental scrutiny.[1] The Internal Revenue Service has recently decided to begin a more active campaign of enforcement against a certain three-party variation of the sale and lease-back device. The structure of this variation can be best understood by considering the following hypothetical situation.

Assume that *A*, the sole owner and manager of a small corporation, approaches a tax-exempt charitable foundation and presents this proposition: *A* is to sell all of his stock to the foundation at a price high above the fair market value of the business. The foundation will give *A* a nominal down payment, and the remainder of the purchase price will be secured by mortgages upon the assets of the business, with *A* waiving any right to sue the foundation for the balance due. After acquiring the stock, the foundation will liquidate the corporation and receive the assets. An operating company will then be organized and the foundation will lease the assets to the new corporation. The stock of the new corporation will be owned by individuals unconnected with either *A* or the foundation;[2] however, *A* is to run the business under a long-term management contract with the new corporation. The new corporation will pay eighty percent of its income to the foundation as rent for the leased assets. In turn, ninety percent of the rental that the foundation receives from the operating company will be paid to *A* as installments in discharge of the balance due on the purchase price. The payments to *A* are to continue until the entire balance is paid out.

The financial advantages to all the parties involved in such a scheme, if each can obtain the desired tax treatment, are attractive indeed. *A*, the seller, receives an inflated price and is

1 On sale and lease-back devices generally, see Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations*, 62 HARV. L. REV. 1 (1948); Cary, *Current Tax Problems in Sale, or Gift, and Lease-Back Transactions*, N.Y.U. 9TH INST. ON FED. TAX. 959 (1951).

2 Occasionally, however, *A*'s accountant or lawyer will own the stock of the new corporation.

taxed at capital gains rates. The foundation invests nothing and risks nothing, but nevertheless emerges from the transaction owning a profitable business after *A* has been paid off.[3] The shareholders in the new corporation invest relatively little and receive in return twenty percent of the income of the business while the corporation deducts the large rental payments. For obvious reasons, the Internal Revenue Service is deeply interested in effecting at least a partial destruction of this tax avoidance scheme.

Typically, the attack of the Service upon this device has been three-pronged. First, it claims that the transaction was not a sale to the foundation, and that *A* remains the real owner. And, it asserts, since he is the owner, *A* must be taxed at ordinary income rates, just as if he were receiving dividends. Second, the Service asserts that the foundation has either lost its exempt status entirely, or, failing in this, that it must at least be taxed as to the rents received from the operating company. Third, the Service takes the position that the operating company should not be allowed a deduction for the amounts paid the foundation in the guise of rent, since these payments are not truly rent, but are indirect payments of dividends to the true owner, *A*. The purpose of this comment is to examine separately the merits of each of these lines of attack, and to suggest a possible resolution of the conflicting interests of the taxpayer and the government.

I. THE NATURE OF THE TRANSACTION

The Service has suffered a notable lack of success in its attempts to tax the seller at ordinary income rates.[4] Given certain factual conditions, the seller will prevail.

A. *Change in Economic Interests*

The Service often argues that the seller has retained control of the business by virtue of being the manager of the new corporation and by virtue of holding mortgages on the purchased assets.[5] This contention has been accepted in only one case, *Emanuel N. Kolkey*.[6] Three directors who had not been pre-

[3] The foundation would claim that the rentals it receives are tax-exempt under § 501(c)(3) of the Internal Revenue Code of 1954.

[4] See Union Bank v. United States, 285 F.2d 126 (Ct. Cl. 1961); Clay B. Brown, 37 T.C. 461 (1961); Estate of Ernest G. Howes, 30 T.C. 909 (1958), *aff'd*, 267 F.2d 382 (1st Cir. 1959); Estate of Cordie Hawthorne, 29 P-H Tax Ct. Mem. ¶ 60-146 (1960); Estate of James G. Hawley, 30 P-H Tax Ct. Mem. ¶ 61-038 (1961).

[5] See cases cited note 4 *supra*.

[6] 27 T.C. 37, *aff'd*, 254 F.2d 51 (7th Cir. 1958).

viously associated with the sellers were elected to the board of the new corporation. But these directors were extremely inactive, whereas the sellers continued to wield the real power over the business. Thus, although the presence of new directors would ordinarily demonstrate that control had been at least partially removed from the sellers' hands, here their presence was felt to be a mere ruse designed to disguise the actual locus of control.

On the other hand, the government's position has been rejected in a number of cases.[7] In most of these the seller has not owned stock in the new operating company. Such lack of ownership is considered indicative of a change in control; moreover, the courts have further held that the fact that it may be the seller's accountant or attorney who owns the new corporation is not conclusive as to whether the seller has retained control[8]—certainly a debatable proposition. The boards of directors of the new corporations were usually composed either exclusively of persons unconnected with the original business or partly of such individuals and partly of the seller and his associates. In either case control has passed from the seller, to some extent at least, and the boards have not been mere tools of the seller, as was the situation in *Kolkey*. And in cases where the sellers have withdrawn from their management positions before the case arose, it has been difficult to conclude that there has been no change of ownership and control.[9]

A second critical question in determining ownership is, normally, who bears the risk of profit or loss.[10] In our hypothetical situation it is clear that the seller alone bears the risk of a decline in earnings and/or value. The tax-exempt foundation puts up no assets. The stockholders in the new corporation risk only nominal amounts. Nevertheless, the courts have continually held for the taxpayer despite the fact that the seller alone bears the risk, and such holdings make it evident that the location of risk is not treated, in this context, as the important criterion of ownership which it is in other contexts.[11]

The chance of gain, on the other hand, should continue to be instrumental in determining ownership. Since the price is usually a stipulated sum (even though the payments are computed with

7 See cases cited note 4 *supra*.

8 Clay B. Brown, 37 T.C. 461 (1961); Estate of Cordie Hawthorne, 29 P-H Tax Ct. Mem. ¶ 60-146 (1960).

9 See Union Bank v. United States, 285 F.2d 126 (Ct. Cl. 1961) (implicit); Clay B. Brown, *supra* note 8.

10 See *ibid.*

11 *Ibid.*

respect to net earnings), an increase in the business's earning power and/or value will eventually benefit the buying foundation. An increased earning power means that the seller will be paid off in less time, but it does not mean that he will obtain more money. Once the seller is fully paid, the foundation will have the benefit of the increased value of the business, and the transaction, therefore, possesses one of the hallmarks of an actual sale.

It is proper to question what the result should be if the contract of purchase not only calls for a stipulated amount of money, but if it further states that the seller is to receive a percentage of any future increase in profits, *i.e.*, a percentage over and above the stipulated sum. Here the seller will not only be paid faster; he will be paid more. And, since he also shares in the chance of future gain, it is quite conceivable that a court would be likely to find that ownership is still in the seller. Such a decision would, it seems, be justified, especially by the need to maintain some reasonable standard of judgment. Thus, where payments are computed with respect to earnings, the location of the risk of loss will not be determinative of whether a sale has occurred; on the other hand, it is very likely that the courts will insist that gain inure to the buyer only.

The question of who will be the *eventual* owner of the business is another crucial factor in determining whether a sale has occurred.[12] If the seller has been entirely paid, or nearly so, by the time of trial, it is highly unlikely that a court would conclude that the transaction was not a bona fide sale.[13] At the other extreme is the situation where the seller has reacquired full ownership of the assets. Such evidence can be quite damaging to the taxpayer, as in *Kolkey*, but it is not necessarily conclusive. In *Estate of James G. Hawley*,[14] the new operating company was reorganized after having met with financial setbacks. As a result of the reorganization, one of the original sellers was given all the common stock of the reorganized company. The other original sellers obtained all of the Class B preferred stock and the independent group that had owned the original new corporation was given the Class A preferred stock of the reorganized company. The Class A stock was to be retired and thus the eventual ownership was to reside in the original sellers. Nevertheless, the court

12 See Union Bank v. United States, 285 F.2d 126 (Ct. Cl. 1961); Estate of Cordie Hawthorne, 29 P-H Tax Ct. Mem. ¶ 60-146 (1960).

13 *Ibid.*

14 30 P-H Tax Ct. Mem. ¶ 61-038 (1961).

held that a sale had occurred. Such a decision is certainly justifiable where other facts indicate that the transaction was a sale. In the ordinary installment sale of a business, where the price is to be paid regardless of how much income the buyer earns, the seller may have to foreclose his mortgage because of a default in payment. The seller may then reacquire the business, yet the fact that there had been a sale would not be questioned. It is true that, in a situation like that in *Hawley*, the fact that the seller reacquired the business is more indicative of something less than a sale than in a more normal case. Still, it is but one factor to be weighed. In addition, there was one fact apparent in the *Hawley* case which made it nearly impossible for the court to say that, as to the petitioner himself, there had been no sale. The petitioner was the only one of the original sellers who did not obtain any stock in the reorganized business. Since he did not reacquire his part of the business, it was clear that, at least as to him, there had been a change of ownership.

A third situation may exist, falling between the extremes of full payment and reacquisition of ownership. Where the seller has not been fully paid, yet has not reacquired the business, the courts must, to a greater extent, view the evidence subjectively.[15] The mere fact that the seller has not been paid is not conclusive, since it is still possible that the buyer will eventually own the business outright. Thus, it cannot be flatly asserted that the seller is still the owner. On the other hand, the seller certainly does not have all the rights of a normal creditor since he does not have an unconditional right to payment—he is to be paid only from such income as may be earned by the business. Despite this lack of any conclusive legal characterization of the seller, however, the courts have gone so far as to suggest that a record of steady payment indicates that the seller will, in due course, be fully paid and that the buyer is, therefore, the owner of the business.[16]

B. *Price and Method of Payment*

The price factor has not weighed as heavily in the decisions as have those factors relating to changes in economic interests.[17] In almost all cases the price paid was far above the fair market value of the business. The courts have felt this to be justified,

15 See Clay B. Brown, 37 T.C. 461 (1961).

16 Estate of Cordie Hawthorne, 29 P-H Tax Ct. Mem. ¶ 60-146 (1960).

17 See Clay B. Brown, 37 T.C. 461 (1961); Estate of James G. Hawley, 30 P-H Tax Ct. Mem. ¶ 61-038 (1961).

pointing out that, since the buyer pays only out of earnings, it can afford to pay a price greater than fair value.[18] The *Kolkey* case is the only one in which the extreme disparity between price and value contributed to the taxpayer's defeat. The price there was almost four times the fair value. On the other hand, the presence of actual price negotiations is viewed as good evidence of a bona fide sale despite the inflated purchase price.[19] Arguably, however, the Tax Court, in *Clay B. Brown*,[20] may have set some limit on how inflated the price can be, since it said that a "somewhat" high price is acceptable.

The fact that it is possible for the seller to receive an inflated price and yet be taxed at capital gains rates on his entire gain has created a danger that the seller will be able to milk the past and future profits of the business at capital gains rates. Although this problem is aggravated by the courts' steadfast position that a sale either did or did not occur, and that the tax must be wholly at capital gains rates or wholly at ordinary income rates, nevertheless it is improbable that any court would accept a different theory of taxation. The milking problem is especially acute where, as in *Kolkey*, the amount of the down payment was quite close to the amount of the company's retained earnings. In that case there was a clear attempt to withdraw the retained earnings at capital gains rates while retaining control of the business. However, the fact that the down payment approximately equals retained earnings should not be enough to invalidate the transaction where other factors indicate that a sale has occurred. Since the seller could have sold on a more normal type of installment contract, taking a down payment equal to retained earnings and paying tax at capital gain rates, there is little reason why the same result should not be allowed in an otherwise bona fide sale to a tax-exempt foundation.

C. *Business Purpose*

The existence of valid business purposes is evidence of a bona fide sale. Thus, in *Estate of Ernest G. Howes*,[21] the desire of the sellers to put their estate in more liquid form so as to be able to pay death taxes was held to constitute a valid business purpose. *Clay B. Brown*, however, seems to indicate that the Tax Court

18 Union Bank v. United States, 285 F.2d 126 (Ct. Cl. 1961). A buyer can afford a higher price where he is obligated to pay only out of such profits as may arise than where he is unconditionally obligated to pay.

19 Estate of Ernest G. Howes, 30 T.C. 909 (1958), *aff'd*, 267 F.2d 382 (1st Cir. 1959).

20 37 T.C. 461 (1961).

21 30 T.C. 909 (1958), *aff'd*, 267 F.2d 382 (1st Cir. 1959).

will be generally quite reluctant to find a lack of sufficient business purpose (with the exception of *Kolkey*-type cases). Indeed, the court in *Brown* felt that the very nature of such a transaction insures that all the parties are possessed of valid business purposes. The fact that the price was high provided the seller with a purpose for selling; that the foundation was to keep eight percent of the income initially, and was eventually to obtain complete ownership, gave it sufficient reason; that the shareholders of the new corporation were to obtain twenty percent of the income gave them a valid purpose. Since these motives will always exist in the typical case, it appears that very little difficulty will be encountered in attempting to show that valid business purposes exist. There may be, however, aberrant cases in which the factors involved in *Brown* are not all present. In *Kolkey*, for example, the extremely unrealistic price made it quite unlikely that the buyer would ever own the entire business; also, there was no third party receiving twenty percent of the income.

The fact that the seller may have entered the transaction primarily to escape taxes will not be conclusive in the presence of certain other conditions.[22] Examples of such conditions are, *inter alia*, the presence of good faith negotiations, and/or control in the buyer. But if the seller can show that he did not enter the transaction primarily for tax avoidance purposes, but rather for valid business reasons, as in *Howes*, he will have good evidence of a bona fide sale. The buyer's intent is more crucial. Where it is shown that the buyer intended to acquire the outright ownership of the business and that it was possible that he might succeed, the sale appears to be bona fide even though the seller may end up reacquiring the business because of the vagaries of a declining market for the company's product.[23] The buyer's actual intent can be partially determined from evidence that he was careful to protect his investment[24] or that substantial payments have been made.[25]

The presence or absence of serious and determined arm's-

22 See Clay B. Brown, 37 T.C. 461 (1961); Estate of Cordie Hawthorne, 29 P-H Tax Ct. Mem. ¶ 60-146 (1960).

23 Estate of James G. Hawley, 29 P-H Tax Ct. Mem. ¶ 60-038 (1960). See also Estate of Ernest G. Howes, 30 T.C. 909 (1958), *aff'd*, 267 F.2d 382 (1st Cir. 1959). *But see* Emanuel N. Kolkey, 27 T.C. 37 (1956), where the business was of such a speculative nature that it was apparent, at the time of the sale, that the market could collapse at any time.

24 See Estate of Cordie Hawthorne, 29 P-H Tax Ct. Mem. ¶ 60-146 (1960).

25 *Ibid.*

length negotiations plays an important part in the courts' thinking.[26] The existence of proposals and counter proposals, the winning of some points of bargaining and the losing of others, and other evidences of hard bargaining are all most relevant in showing a bona fide sale.[27] The fact that the seller was genuinely concerned over the safety of his position shows an intent to become a creditor rather than to remain an owner.[28] Contrariwise, a failure by the seller to enforce his rights where a seller normally would will weigh heavily against him.[29]

A usual corollary of bona fide negotiations is a full-scale appraisal of the value of the business by the buyer.[30] Such an appraisal was made in most of the cases which have been won by the taxpayer, whereas it is significant that, in *Kolkey*, no such appraisal occurred.

II. THE TAX STATUS OF THE FOUNDATION

The position of the Internal Revenue Service with respect to the tax status of the foundation was disclosed in a revenue ruling handed down in 1954.[31] That ruling was based on facts identical to our hypothetical situation. The Service declared that the foundation would not qualify as an exempt organization under the forerunner of section 501(c)(3) of the Internal Revenue Code of 1954 because it was not exclusively engaged in charitable activities. Also, even if the foundation did qualify as an exempt organization, its income would be taxed as unrelated business income under the forerunner of section 511, and the statutory exception for rents would not apply because the foundation was not receiving rents, but was in reality enjoying a share of the profits of the business. Further, the Service asserted that the use of the income to pay the indebtedness and build up an equity was an accumulation of income within the meaning of the predecessor of section 504, and whether it was an unreasonable accumulation would depend on the circumstances. Finally, the entire transaction was felt to be of questionable validity for tax purposes; accordingly, the amounts received by the seller would not re-

26 See Clay B. Brown, 37 T.C. 461 (1961); Estate of Ernest G. Howes, 30 T.C. 909 (1958), *aff'd*, 267 F.2d 382 (1st Cir. 1959).

27 See Union Bank v. United States, 285 F.2d 126 (Ct. Cl. 1961).

28 Estate of Ernest G. Howes, 30 T.C. 909 (1958), *aff'd*, 267 F.2d 382 (1st Cir. 1959).

29 See Emanuel N. Kolkey, 27 T.C. 37 (1956), *aff'd*, 254 F.2d 51 (7th Cir. 1958).

30 See Clay B. Brown, 37 T.C. 461 (1961).

31 Rev. Rul. 54-420, 1954-2 CUM. BULL. 128.

ceive capital gains treatment. This last position has been treated in the preceding section. The remaining three assertions will now be examined, along with a fourth possibility.

A. *Requirements for Exempt Status*

Section 501(c)(3) establishes four requirements which must be met before an organization can be considered tax-exempt.[32] Only two of these are pertinent to the situation under discussion. These are (1) that the organization must be organized and operated exclusively for religious, charitable, educational or any one of a list of other similar purposes, and (2) that no part of the organization's net earnings may inure to the benefit of any private individual.

The first of the foregoing requirements has been considered in several cases. In *Ohio Furnace Co.*,[33] it was held that the fact that the income received by the foundation was not immediately turned over to the educational institution for whose benefit the foundation had been established did not require a finding that the foundation was not being operated exclusively for educational purposes. The thrust of the reasoning was that the amounts used to retire the obligation incurred on the purchase of the business were used for the eventual benefit of the educational institution. The implication involved is that every dollar used to retire the foundation's indebtedness builds up the foundation's equity in the business. This idea was later overtly expressed in *Knapp Bros. Shoe Mfg. Corp. v. United States*[34] and was confirmed by the Tax Court in *A. Shiffman*.[35] Clearly, then, the 1954 revenue ruling has been judicially repudiated insofar as the issue of *operation* is concerned. But the status of the law is not so clearly defined with regard to determining whether or not the foundation was *organized* exclusively for one of the required beneficial purposes.

The Treasury regulations state that an organization is not organized exclusively for the proper purposes if its articles empower it to carry on, otherwise than as an insubstantial part of

32 INT. REV. CODE OF 1954, § 501(c)(3), in describing the organizations exempt from taxation, provides: "Corporations and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, . . . literary or educational purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in . . . any political campaign . . . ."

33 25 T.C. 179 (1955).

34 142 F. Supp. 899 (Ct. Cl. 1956).

35 32 T.C. 1073 (1959).

its activities, activities which are not in furtherance of its exempt purposes.[36] Under this regulation, the foundation in our hypothetical situation would not meet the statutory test. It would not be plausible to assert that the transaction in question is an insubstantial part of the foundation's activities. Very often such foundations are organized for the sole purpose of entering into these transactions. The regulation has, however, been rejected by the courts. In *Commissioner v. John Danz Charitable Trust,*[37] the court ruled that it could look beyond the articles of incorporation and consider extrinsic evidence when ascertaining the purposes for which the foundation was organized. In addition to the fact that the benefactor ostensibly organized the foundation for the purpose of furthering certain philanthropic objectives, his record of ardent search for an existing organization that could suitably implement these objectives with the aid of money donated by the trust was indicative of the necessary charitable purposes. The Service contended that the broad powers given to the trustees to conduct businesses, and the fact that two businesses had in fact been conducted, showed a violation of the statutory requirements. The court responded by pointing out that powers are not purposes and the existence of such broad powers did not necessarily vitiate the exclusively charitable purposes for which the foundation was organized. Under the doctrine of the *Danz* case it is quite conceivable that the foundation described in our hypothetical situation would be considered as having been organized exclusively for educational or charitable purposes. The purposes of the foundation are clearly to support such activities, even though it has the power to carry on business.

The case of *The Marian Foundation*[38] occupies a ground somewhere between the positions taken by the regulations and the court in the *Danz* case. The court in *Marian* felt that the word "exclusively" means that the foundation must be organized *primarily* for the proper purposes; and the word "primarily" means that activities which do not directly further the tax-exempt purposes must be *minor in comparison* with the exempt activities. The *Marian* formula allows the taxpayer more latitude in carrying on activities of a non-exempt type than does the Treasury standard. This is evidenced by the following chain of reasoning: The Service contended that the foundation in *Marian* was not organized ex-

[36] Treas. Reg. § 1.501(c)(3)-1(b)(1)(iii) (1959).
[37] 284 F.2d 726 (9th Cir. 1960).
[38] 29 P-H Tax Ct. Mem. ¶ 60-018 (1960).

clusively for charitable purposes. Therefore, the Service must have felt that the foundation's non-exempt activities did not meet the Treasury's test of insubstantiality. The court, however, found that the foundation was organized exclusively for exempt purposes. Consequently, the "minor in comparison" test must allow more non-exempt activities than does the insubstantiality test.

On the other hand, the court in the *Marian* case seemingly did not employ the liberal standards laid down in *Danz. Marian* appears to stand for the proposition that the manner in which a foundation is operated partially determines the purposes for which it was organized. The Service had contended that the foundation was organized for the purpose of engaging in the business of buying and selling real estate. However, the court pointed out that the foundation had acquired but six properties in the two taxable years in question, that the circumstances of three of the acquisitions were not those normally associated with the conduct of a real estate business, and that the circumstances of the disposal of the properties were likewise not characteristic of typical real estate operations. These factors prompted the conclusion that the foundation was not organized primarily to engage in a trade or business, but to obtain funds for a valid charitable purpose. It is certainly arguable, however, that these factors could, under the court's own test, be interpreted as being unfavorable to the foundation. Such modes of operation evidence the fact that the organization was not established primarily for exempt purposes because the total non-exempt activities, regardless of whether they amounted to carrying on a trade or business, were not minor in comparison with the exempt activities. If the *Marian* court can be said to have used such an approach, the holding of *Marian* appears indistinguishable from that of *Danz*—the mere existence of a business does not necessarily preclude the foundation from enjoying tax-exempt status. But the more realistic view is that the *Marian* court decided that a determination that the non-exempt activities do not amount to a trade or business conclusively establishes that the non-exempt activities are minor in comparison with the exempt activities. Under this interpretation it seems clear that a finding of the existence of a trade or business will likewise conclusively establish that the non-exempt activities are *not* minor in comparison. The operative test thus becomes the presence or absence of a trade or business—far removed from the more liberal standard of the *Danz* case where, in fact, *two* businesses were carried on by the foundation.[39] Regardless of whether *Marian* and *Danz* are reconcilable, however, it is unquestionable that the *Marian* standard is widely divergent from that asserted in the regulations. Although the non-exempt activities in *Marian* might well be said to be "minor in comparison," it would be obviously improper to say that they were "insubstantial."

The flexible nature of the *Marian* test makes it difficult to assess the effect of that case upon the tax problems of our hypothetical foundation. Where the foundation's sole purpose is to raise money for a separate charitable institution through rental of the purchased business assets, it is arguable that the renting of the business is its primary, or indeed, its sole activity, and that therefore it fails to meet the requirements of section 501(c)(3). But where the foundation itself also engages in tax-exempt activities, the proper treatment is not so clearly indicated. It is conceivable that the sheer quantity of non-exempt activity might be determinative in a particular case, regardless of what proportion such activities bear to the total operations of the foundation. On the other hand, application of the dubious standards of the *Danz* case would seem to suggest that the foundation in our hypothetical situation should enjoy exempt status.

The second pertinent requirement of section 501(c)(3) is to the effect that no part of the income may inure to the benefit of any private individual. This issue represents a reverse approach to the question of whether the seller made a bona fide sale. In both *Ohio Furnace Co.* and *Howes* the Tax Court indicated that, since the investments made by the respective foundations were sound in light of the circumstances existing at the time of the sale and since the prices were fair, the payments to the seller constituted consideration for the transfer of the business and were not an

39 It should be noted that the *Marian* court did not explicitly state that the taxpayer was not engaged in a trade or business *and therefore* that his non-exempt activities were minor in comparison with his exempt ones. But, that this was the implicit holding is evidenced by certain statements made by the court. The court first stated its "minor in comparison" test. It then went on to deal with the Commissioner's contention that the foundation was not organized exclusively for exempt purposes, but was organized to engage in the trade or business of buying and selling real estate. The court asserted the foundation was not engaged in the business of buying and selling real estate and that it was organized exclusively for charitable purposes. The implicit conclusion is that the court meant that the foundation met the "minor in comparison" test because it was not engaged in a trade or business. It would, of course, be logically possible to say that the foundation could meet the "minor in comparison" test even though it was in a trade or business (*i.e.*, to say "you are not in a trade and so you meet the 'minor-in-comparison' test, but even were you in a trade you could still meet that test under the proper conditions"). But the opinion apparently says something different—it seems to say "you cannot meet the 'minor-in-comparison' test if you are in a trade or business."

inurement of income to the seller. But these decisions seemingly raise the possibility of highly inconsistent results where a separate action is brought against each of the various parties to a single transaction. In many of the cases involving sellers the price was well above fair market value; nevertheless, it was held that a bona fide sale had occurred. Yet, if the price is really as important as *Ohio Furnace Co.* and *Howes* seemingly indicate, it would be quite possible for a court in a later case against the foundation to find that, because of the inflated price, the payments to the seller were inurements of income, *i.e.*, in effect, there was not a bona fide sale. Again, in a case against the seller there might be a finding of a bona fide sale based on business purpose, relinquishment of control, no chance of gain, etc. Yet, a separate action against the foundation might result in a finding that, because of an absence of evidence of arm's-length negotiations, or because the investment was unsound, no sale had occurred; even though the price was fair, the payments represented an inurement of income to the seller. The possibility of such inconsistent results is an undesirable shortcoming of the practice of litigating and deciding these cases separately.

B. *Other Relevant Provisions*

The Internal Revenue Service may also raise the question of whether the foundation is taxable as having received unrelated business income under section 511, as having received rents from a business lease under section 514, or as having accumulated an unreasonable amount of income under section 504. Before considering the statutory issues involved, it will be profitable to examine the congressional thinking behind these provisions. First, in dealing with unrelated income generally, the House report[40] stated that the problem aimed at was primarily that of unfair competition. Tax-free organizations were better able to expand their operations than were taxable businesses, since the latter have less profits available for expansion purposes. Also, certain exempt organizations had been using these "extra" profits to acquire business concerns. The purchases of such businesses were made with little or no initial investment, and the payments were made out of subsequent earnings—a practice which would not be possible if the organization were not tax-exempt. The report explicitly

40 H.R. REP. No. 2319, 81st Cong., 2d Sess. (1950), also found in 1950-2 CUM. BULL. 380, 409-11.

stated that the tax was not to apply to dividends, interest, royalties, and rents (other than certain rents on property acquired with borrowed funds), since these were passive investments long recognized as proper for a charitable organization.

The House report then turned to the specific problems presented by lease-back transactions. It was found that the use of lease-backs had become widespread, and that they were objectionable on three scores. First, the foundations were not attempting to invest their own funds at a reasonable rate of return, but were simply trading on their exemptions; they were taking advantage of their exempt status by purchasing property which they would not have been able to buy without the exemption. The second objection was that lease-back arrangements, if not checked, could conceivably cause the great bulk of commercial and industrial real estate to end up in the hands of these foundations in the not too far distant future. Third, lease-backs were objectionable because the exempt foundations were, in effect, selling a part of their exemption by offering a higher purchase price than the normal taxable entity could pay. The report then went on to point out that the tax would apply both to cases where the lessee is the vendor, which is typical of the general lease-back arrangement, and to cases where the vendor is not the lessee (such as in our hypothetical situation). Hence, the tax would apply to variations which raise the same anti-competitive problems as the standard lease-back arrangement.

The House report also dealt with the problem of accumulated investment income. Many charitable foundations were not promptly distributing exempt income for charitable purposes, and the time at which the ultimate recipient could expect to receive the income was often extremely remote. The committee felt the exemption should be restricted to that portion of the income distributed to the ultimate recipient as it is received by the exempt organization. Therefore, undistributed income consisting of interest, dividends, rents, royalties, etc., was to be subject to tax. However, the tax was not to apply to unrelated income already taxed under the other provisions of the bill.

The foregoing seems to indicate with reasonable certainty that Congress intended to tax the type of foundation contemplated in our hypothetical situation. The transaction enables the foundation to expand more easily than taxable entities. There is no doubt that the foundation would be trading on its exemption. It would also be selling part of its exemption by offering a high purchase price, thus enabling the foundation to gain control of a good piece of industrial real estate. And, certainly, the ultimate recipient would not be obtaining the money as it is earned.

The statutory issues, however, are less easily resolved. The Commissioner's ruling stated that the foundation would be taxable as to its unrelated business income.[41] Clearly, amounts received from the rental of real property (and the personalty attached) are exempt from the reach of section 511.[42] The Commissioner contended, however, that the foundation is not receiving rents but is in reality obtaining a share of the profits. This proposition must be based on the conclusion that in fact it is the foundation which owns the operating business. Three arguments militate against such a conclusion. First, the operating company, which is earning the income, is owned by individuals who are entirely distinct from the foundation. Secondly, the House report calls the income received by the foundation "rentals," and the word "rentals," when considered in light of the circumstances of the House report, implies that the foundation is the owner of the assets, but not of the business. Lastly, the Service, in cases wherein the seller's tax liability was in dispute, claimed that the seller was the owner of the business. The Service thus takes alternative positions depending on whose tax liability is in question. It is quite conceivable that the Service could persuade a court that the seller is the owner in a case against the seller, and that the foundation is the owner in a case against the foundation—a result which could be avoided by consolidating the cases for trial. Ultimately, however, since it is clear that the foundation is receiving rents, it should be equally clear that it cannot be reached under section 511.[43]

On the other hand, the foundation should be reached under section 514 if the lease to the operating company is for a period of longer than five years.[44] The only major interpretative problem involved here is the question of whether the foundation is deriving

41 Rev. Rul. 54-420, 1954-2 CUM. BULL. 128.

42 INT. REV. CODE OF 1954, § 512(b)(3), states that unrelated business income does not include rents from real property or the personal property leased with the real property.

43 The type of income received by the foundation falls within the meaning of "rents" as that word is used in the statute. The Senate report states, "The term 'rents from real property' does not include income from the operation of a hotel but does include rents derived from a lease of the hotel itself." S. REP. No. 2375, 81st Cong., 2d Sess. (1950), also found in 1950-2 CUM. BULL. 483, 560.

44 The effect of § 514, in this regard, is to establish when rents derived from a lease will be taxed as unrelated business income. Rents derived from leases of less than five years' duration are exempted.

the income from a trade or business.[45] This issue has been litigated under other related sections, but the rationale of those cases applies to section 514. *Cooper Tire & Rubber Co. Employees' Retirement Fund*[46] involved facts analogous to our hypothetical situation. A trust purchased certain machines with borrowed money and then leased these machines to a manufacturing company. The court concluded that the rental income was received from a business activity. The court pointed to the following factors as indicating that the taxpayer was engaged in a business: (1) the machines would produce no income unless rented, used, or sold; (2) a great amount of money was invested; (3) a loan was obtained to finance the purchase; and (4) the lease covered many years. All of these factors, except the loan, are present in our hypothetical situation. The court also felt that the leasing of even one piece of improved real estate might amount to carrying on a trade or business. Clearly, then, the foundation in our hypothetical situation should be taxed under section 514 since it meets the other requirements of the section as well as the trade or business requirement.[47]

There has, however, been a variation from our hypothetical situation which serves to take the foundation beyond the reach of section 514. In the hypothetical transaction the new company takes a long-term lease of the assets. In the variation, the lease is for a period of less than five years and thus not subject to section 514. Nevertheless, it is clear that this variation possesses the attributes specifically condemned by Congress: the foundation is trading on its exemption; it is selling part of its exemption; there is an anti-competitive element present; the foundation is not investing its own funds, etc. It is possible, however, that section 504

45 It is clear that, if the foundation is receiving this income from a trade or business, it is receiving it from an *unrelated* trade or business. The House report said, at 459: "In general, rents from real property (including personalty leased therewith) . . . are also excluded. However, certain rent received from a Supplement U lease . . . is included as an item of gross income derived from an unrelated trade or business." H.R. REP. No. 2319, 81st Cong., 2d Sess. (1950), also found in 1950-2 CUM. BULL. 380, 459.

46 36 T.C. 96 (1961). This case involved an interpretation of the unrelated trade or business requirement of § 513(b).

47 Section 514 requires that a certain percentage of rents derived from a business lease be included in the organization's gross income as income from an unrelated trade or business if (1) the lease is given on property on which there is a business lease indebtedness, and (2) the lease is for longer than five years. It has been shown above that the rents received by the foundation are of the type Congress desired to tax and that the foundation is engaged in an unrelated trade or business. A business lease indebtedness exists where the lessor, as in our hypothetical case, incurs indebtedness in order to acquire the property. And our hypothetical situation does not fit into any of the statutory exceptions.

could be employed to close the loophole which exists for these short-term transactions.

Insofar as is pertinent here, section 504 provides, in effect, that if the amounts accumulated out of income and not distributed are either unreasonable in amount or duration with respect to the exempt purposes of the foundation, or are used in substantial amounts for purposes other than those constituting the bases of the exemption, then exemption will be denied. This provision was involved in *A. Shiffman*.[48] In that case, the foundation bought real estate which it then leased. It had taken a loan to finance the purchase price and the loan was repaid primarily from its net income. The court assumed, but did not decide, that the use of the income to repay indebtedness constituted an accumulation of income. The court said that, since this use of income had been for exclusively charitable purposes, the accumulation was neither unreasonable nor used for purposes not constituting the bases of the exemption. This decision flies in the face of congressional intent. It will be remembered that the congressional report clearly stated that it was dealing with cases in which the time at which the ultimate recipient of the income will benefit is extremely remote. The committee further said that an exemption should be allowed only where the charitable foundation distributes the income to the ultimate recipient as it is earned. In *Shiffman*, as in our hypothetical situation, the charity would not receive the income as it is earned by the foundation and would not expect to benefit directly and substantially until a remote date. The *Shiffman* decision is especially unfortunate since it leaves open the tax loophole created by the five-year limitation of section 514. It would be far better to hold that the payments to the seller constitute an accumulation of income which, in substantial amount, is not being used to foster the purposes for which the foundation was granted an exemption.

III. THE OPERATING COMPANY'S TAX SITUATION

There are two possible lines of attack by which the Service might prevent the operating company from enjoying a rental deduction for the eighty percent of its income which is paid to the foundation. The first would be to assert that the rentals are not allowable as deductions under section 162.[49] A treatment of

48 32 T.C. 1073 (1959).

49 Section 162 deals with deductions for ordinary and necessary expenses incurred

the ramifications of such an argument is beyond the scope of this discussion. A second approach would be to claim that the amounts transferred to the foundation are payments of a share of the profits rather than rentals. However, even if this approach was successful, the Service would still be faced with the problem of showing that the foundation, and not the seller, is the *owner* of the business. The difficulty of meeting this burden has been demonstrated in the foregoing paragraphs. Moreover, the use of this approach once again raises the possibility of widely divergent results in separate trials involving the same transaction.

IV. The Need for Legislation

The foregoing discussion suggests that Congress deems lease-back transactions to be objectionable where they are entered into by charitable foundations. The congressional response to these lease-backs was to levy a tax on the foundation's unrelated business income. As a practical matter, such a tax, if wholly effective, would eliminate the entire problem: the transaction is of no value unless all the parties obtain the tax treatment they desire, and it will not be entered into where the foundation's unrelated business income is subject to tax. Conversely, the transaction can be a lucrative one where the foundation is not taxed—as is the case now where the lease is of less than a five-year duration. It is difficult to understand why a five-year limitation was placed on section 514. The only clue provided by the congressional reports and committee hearings is that the typical lease-back arrangement involved rather long leases at the time the forerunners of section 511 and section 514 were originally enacted.[50] Today, however, the lease-back problem has shifted to the setting of shorter-term leases, in an attempt to take advantage of the five-year provision of section 514. Furthermore, the *Shiffman* case has made it impossible to attack these transactions under section 504. The taxpayers will be able to circumvent the present statutory law as long as the *Shiffman* doctrine is maintained. It has been previously shown that the *Shiffman* rationale is dubious and should be judicially repudiated. Such a repudiation would certainly strengthen the existing law and preserve the integrity of sections 511 and 514.

in carrying on a trade or business. It is arguable that a rental amounting to 80% of the profits is neither ordinary nor necessary.

50 H.R. Rep. No. 2319, 81st Cong., 2d Sess. (1950); *Hearings on Revenue Revision of 1950 Before the House Committee on Ways & Means*, 81st Cong., 2d Sess. (1950).

Without such a judicial turnabout, sections 511 and 514, as presently written and construed, cannot be the effective combatants of anti-competitive practices which they were designed to be. In the absence of a judicial overthrow of *Shiffman,* it may become necessary for Congress to remove the five-year limitation from section 514. Perhaps such action would be desirable even if the judiciary were to respond to the need. Judicial overthrow is often a tentative solution at best, while legislation has the advantage of being more definite and certain. Moreover, so long as the five-year limitation remains, some courts may feel they are not justified in avoiding this limitation by the back-door route of section 504. This possibility is enhanced by the fact that the reason for the five-year limitation is so vague and uncertain. This uncertainty may cause courts to feel that there must have been some sound reason for the provision and that it should not be vitiated by the use of section 504. Nevertheless, it is clear that present use of the short-term lease involves the same problems which originally motivated congressional action. Therefore, it seems likely that Congress would desire to close the anti-competitive loophole left in the original statutory provisions.

Lawrence R. Velvel, S.Ed.