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EXEMPTIONS from obligations to government are as old as Scripture.[1] It is not strange, therefore, that the public interest in humane government should dictate numerous exemptions from the income tax levy, particularly when one considers that the income tax has long ceased to be simply a revenue producing vehicle. The regulation of inflation or deflation, the control of corporate financial structures, the distribution of wealth, all these and many other concern of government have entered into the formula of our income tax laws.[2] The selection of those who are to be benefited by the tax exemption is, of course, made in the first instance by Congress. But here, as elsewhere in law, the process of interpretation leaves ample room for the expansion or contraction of the area of exemption.

Since the adoption of the Sixteenth Amendment and the consequent Income Tax Law of 1913,[3] there has been a series of exemptions from the tax, which has varied but little through the years. Recently, however, expansion of large commercial activities of exempt organiza-

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[1] Leviticus 19:10; Deuteronomy 24:9; Mishna Terumoth 1.3, Danby's Tr., p. 52.

[2] It is now well established that Congress may use the taxing power as a vehicle for the promotion of general welfare provided only that the purpose of the particular act lies within the power of Congress. This proposition was not always clear, and even after the Head Money Cases [Edye v. Robertson, 112 U.S. 580, 5 S.Ct. 247 (1884)] doubts persisted. The Supreme Court, in Helvering v. Davis, 301 U.S. 619, 57 S.Ct. 904 (1937), settled this heretofore contentious problem. In that case, the Court, per Cardozo, J., said, at p. 640:

"Congress may spend money in aid of the 'general welfare.' Constitution, Art. I, section 8; *United States v. Butler,* 297 U.S. 1, 65; *Steward Machine Co. v. Davis,* . . . [301 U.S. 548, 57 S.Ct. 883 (1937)]. There have been great statesmen in our history who have stood for other views. We will not resurrect the contest. It is now settled by decision. *United States v. Butler, supra.* The conception of the spending power advocated by Hamilton and strongly reinforced by Story has prevailed over that of Madison, which has not been lacking in adherents. Yet difficulties are left when the power is conceded. The line must still be drawn between one welfare and another, between particular and general. Where this shall be placed cannot be known through a formula in advance of the event. There is a middle ground or certainly a penumbra in which discretion is at large. The discretion, however, is not confided to the courts. The discretion belongs to Congress, unless the choice is clearly wrong, a display of arbitrary power, not an exercise of judgment."

See also Hill v. Wallace, 259 U.S. 44, 42 S.Ct. 453 (1922).

[3] 38 Stat. L. 166 (1913) Part 1.

tions has posed both legal and economic problems to the Government, which must sooner or later be squarely faced by both courts and legislature.

Several aids to an analysis of these problems can be found in the history of our income tax law and its administration and judicial interpretation.

The Congressional Act of 1913[4] enumerated a number of exemptions from the income tax.[5] While these exemptions were more carefully delineated in subsequent acts and somewhat expanded in scope, they, nevertheless, remain in essence and principle the same to the present day.[6] Congress has said, in brief, that associations which are in existence for the purpose of promoting the public interest without gain to individual entrepreneurs—in a word, to do those things which government itself might, could or should do—are exempt from the tax.

Naturally, the first problem is to determine which associations come within the statutory definition of exculpated receivers of revenue. The current statute lists nineteen categories of exempt associations.[7] The common denominator of all these is the devotion of the enterprise to a purpose involving either a general public advantage or at least a benefit to a large membership; and, in addition thereto, the requirement that the income shall not enure to the benefit of any individual.

Clear though these standards may seem to be, they have not always been easy to apply in practice. Decisions by courts, even by the Supreme Court of the United States, have been solicited both by the Government and those claiming exemption under the statute. Ordinarily, tax laws, in spite of judicial statements to the contrary, are

[4] Ibid.

[5] Id. at 172: "Labor, agricultural, or horticultural organizations, . . . mutual savings banks . . ., fraternal beneficial societies, orders, or associations operating under the lodge system for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and providing for the payment of life, sick, accident, and other benefits to the members of such societies, orders, or associations and dependents of such members, . . . domestic building and loan associations, cemetery companies, organized and operating exclusively for the mutual benefit of their members, . . . corporation or association organized and operated exclusively for religious, charitable, scientific or educational purposes, no part of the net income of which enures to the benefit of any private stockholder or individual, . . . business leagues, . . . chambers of commerce or boards of trade, not organized for profit and no part of the net income of which enures to the benefit of the private stockholder or individual; . . . any civic league or organization not organized for profit, but operated exclusively for the promotion of social welfare."

[6] I.R.C. §101.

[7] Ibid.

construed, where doubts exist, in favor of the Government;[8] but in this field the Supreme Court has said that "the exemption of income devoted to charity . . . were begotten from motives of public policy, and are not to be narrowly construed."[9] And in one of the circuits, the court pointed out that "under this law, in view of the fact that bequests for public purposes operate in aid of good government and perform by private means what ultimately would fall upon the public, exemption from taxation is not so much a matter of grace or favor as rather an act of public justice."[10]

These criteria of interpretation have nevertheless not eliminated difficulties in practical application. The mere fact, for example, that the profits of an association do not enure to the benefit of any individual is not sufficient by itself to exclude the organization from the tax under the statute. Thus, the Supreme Court of the United States has denied exemption to the Better Business Bureau of Washington, D.C.,[11] under the Social Security Act,[12] although none of its profits enured to the benefit of any individual but its function was to teach business men how to increase their profits by the utilization of ethical standards and scientific methods. Again, in the matter of social clubs where individual profit is likewise absent, and which are in the main exempted under the statute,[13] conflicts of opinion between the circuits have appeared. Sometimes, it is held that where the social club, ordinarily exempt from tax, derives profit either from business or the sale of its property or from fees received from non-members, such income is nevertheless subject to tax.[14] In other cases, the exemption has been allowed to stand in spite of such revenues.[15] In the second circuit, the court has noted a more narrow interpretation of the exemptions in favor of clubs organized for social or pleasure purposes than other ex-

[8] The expressed opinion of the Court can be found in: Gould v. Gould, 245 U.S. 151 at 153, 38 S.Ct. 53 (1917); Hecht v. Malley, 265 U.S. 144 at 156, 44 S.Ct. 462 (1924). But in practice, the Government is usually favored. See Finkelstein, "Corporate Entity and the Income Tax," 44 YALE L. J. 436 at 449-450 (1935).

[9] Helvering v. Bliss, 293 U.S. 144 at 150-151, 55 S.Ct. 17 (1934).

[10] Harrison v. Barker Annuity Fund, (C.C.A. 7th, 1937) 90 F. (2d) 286 at 288.

[11] Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 66 S.Ct. 112 (1945).

[12] Social Security Act, §811(b)(8), 42 U.S.C.A. 409(8). The language of this section is practically identical with the exemption from the income tax in I.R.C. §101(6).

[13] See I.R.C. §101(9).

[14] Aviation Club of Utah v. Comr. of Internal Revenue, (C.C.A. 10th, 1947) 162 F. (2d) 984.

[15] Scofield v. Corpus Christi Golf & Country Club, (C.C.A. 5th, 1942) 127 F. (2d) 452; Coeur D'Alene Country Club v. Viley, (D.C. Idaho, 1946) 64 F. Supp. 540.

emptions listed in the statute.[16] These are cases in which the courts have divided on the precise meaning of the phrase "benefit to an individual."

Even where there clearly is no benefit to an individual on any interpretation of the facts, there is sometimes a doubt as to whether the purpose of an organization is within the class exempted by the statute. Thus, the Circuit Court in the Second Circuit was of the opinion that a corporation organized primarily for the maintenance at high sportsmanlike level of the sport of dog shows and field trials is not an association organized for scientific purposes;[17] and cemetery corporations, likewise specifically exempt under the statute,[18] are from time to time denied exemption where the profits from the sale of cemetery plots are not entirely used for cemetery purposes.[19]

We have not, however, in this country, as strictly as have the English courts, attempted, in applying the statute, to weigh the social advantage of the particular public interest sought to be promoted.[20] In England, for example, the Anti-Vivisection Society was denied exemption from income tax because the court thought its purpose was anti-social rather than in the public interest and that the achievement of its goal would probably hinder scientific progress.[21]

The problems enumerated above are, however, of comparatively minor importance in the application of the tax exemption features of

[16] "We have construed statutory exemptions somewhat narrowly in the case of social clubs and have treated income derived by them from outside sources, if considerable in amount and recurrent, as destroying the exemption." Per A.N. Hand, J., in Bohemian Gymnastic Assn. Sokol of City of N.Y. v. Higgins, (C.C.A. 2d, 1945) 147 F. (2d) 774 at 777; see also, Jockey Club v. Helvering, (C.C.A. 2d, 1945) 76 F. (2d) 597; West Side Tennis Club v. Comr. of Internal Revenue, (C.C.A. 2d, 1940) 111 F. (2d) 6. But where the club makes a profit from a single commercial transaction, it does not thereby lose its exemption. Santee Club v. White, (C.C.A. 1st, 1936) 87 F. (2d) 5.

[17] American Kennel Club v. Hoey, (C.C.A. 2d, 1945) 148 F. (2d) 920.

[18] I.R.C. §101(5).

[19] I.R.C. §101(5); West Laurel Hill Cemetery Co. v. Rothensies, (C.C.A. 3d, 1943) 139 F. (2d) 50; cf. Comr. of Internal Revenue v. Kensico Cemetery, (C.C.A. 2d, 1938) 96 F. (2d) 594.

[20] The English courts removed from the orbit of administration the power to determine whether a given purpose is within the statutory exemption. Trustees of Sir Howell Jones Williams Trusts v. Inland Revenue Comrs., [1945] 2 All E.R. 236; Inland Revenue Comrs. v. National Anti-Vivisection Society, [1945] 2 All E.R. 529; The Corporation of Foreign Bondholders v. Inland Revenue Comrs., [1944] 1 All E.R. 420; Royal Choral Society v. Comrs. of Inland Revenue, [1943] 2 All E.R. 101; The Trustees of Sir Harold A. Wernher's Charitable Trust v. Inland Revenue Comrs., [1937] 2 All E.R. 488; Peterborough Royal Fox Hound Show Society v. Comrs. of Inland Revenue, [1936] 1 All E.R. 813.

[21] Inland Revenue Comrs. v. National Anti-Vivisection Society, [1945] 2 All E.R. 529; but see contra, Pennsylvania Co. v. Helvering, (App. D.C. 1933) 66 F. (2d) 284.

the statute. Of growing consequence has been the recent increase in commercial and profit producing enterprise of associations whose tax exemption is clear from all doubt. Colleges, universities, churches and other organizations whose tax exemption is specific have in recent years entered into the field of commerce, employing some of their capital for the purpose of trade and manufacture in order to produce profits to be used in carrying out the basic religious, educational or charitable purposes of the several institutions.[22] That this movement, which has recently attracted public attention, is of the utmost significance to the economics of the nation is, of course, evident. Objections to the tax exemptions[23] have come from those who see in them a danger to the economic welfare of the nation.[24] It is argued that the entry of tax exempt institutions into business gives them an advantage over their competitors if tax exemption is to be allowed to the enterprises organized and operated by them. This advantage can derive from only two possible sources: on the one hand, it is said that a tax exempt business is in a favorable position to compete, by way of lowering prices, for the business in which it is engaged; and, on the other hand, not being subject to income tax, such companies are in a better position to accumulate large surpluses during good years with which to weather the periodic crises of business.[25]

Here is presented a definitive challenge to legislative and judicial formulation of principles of tax exemption which requires most careful consideration and understanding if the fears of those who oppose tax exemption are to be avoided.

The basis of the current judicial view that corporations organized and operated by tax exempt associations are themselves free from the income tax under the statute is found in the decision of the Supreme Court of the United States in *Trinidad v. Sagrada Orden de Predicadores*.[26]

22 Some concept of the extent of this activity can be gleaned from a study conducted by the *New York Times*. See article under by-line of Benjamin Fine, N.Y. TIMES, §1, p. 1 (Dec. 13, 1948).

23 These exemptions, as we shall see below, are fairly established, at least in the Circuit Courts.

24 THE NATION, p. 414 (April 9, 1949); THE WALL STREET JOURNAL, p. 1 (May 4, 1949); Hearings before House Ways and Means Committee on Proposed Revisions of the Int. Rev. Code, 80th Cong., 1st sess., pt. v, pp. 3560-1 (1948); see statement of Rep. Mason of Illinois, reported in N.Y. TIMES §1, p. 65 (Nov. 27, 1949), estimating that fifty billion dollars in annual revenue is subject to exemption under these provisions of the act.

25 Hearings before House Ways and Means Committee on Proposed Revisions of the Int. Rev. Code, 80th Cong., 1st sess., pt. v, p. 3527 (1948).

26 263 U.S. 578, 44 S.Ct. 204 (1924).

An examination of the opinion in that case as well as of the briefs of counsel, submitted to the Court, reveals, however, that nothing definitive on this subject was there decided or even claimed by the parties. In that case, a corporation sole, whose purposes were clearly tax exempt, was met by a claim of the Treasury that its revenues were subject to taxation because a large part of them were derived from rents of real property, dividends and interest on stocks and bonds in companies over which the religious association had no control, and from an insubstantial revenue derived from the sale of wine, chocolate, and other articles within the taxpayer's own organization.

Before the Supreme Court, the Treasury claimed that the statute did not apply to any tax exempt association which to any extent derived revenue from commerce because, as the Government claimed, it was in that case not operated *exclusively* for religious purposes. The Government argued: "The inquiry therefore arises as to what is the test by which we are to determine whether or not a particular association or corporation is or was organized and operated exclusively for one or more of the specified purposes. Is it the dominant purpose in the use of the property or in the performance of the transactions? Or, is it the expenditure of the income or profits for the purposes for which the particular institution was organized or incorporated? We say the former, regardless of how or for what purpose the revenue or profits are expended or are to be expended. The respondent says the latter, provided only that the revenue or profits are obtained by the association or corporation from the use of its own property or by its own transactions."[27]

In support of its position, the Government pointed to a uniform series of Treasury Department rulings and regulations holding that the exemption does not apply to exempt corporations which receive revenue from commercial enterprises.[28] "We take it," they argued, "that no one could claim that the United States Steel Corporation would be changed to a charitable institution by devoting its entire profits to charitable purposes."[29]

[27] Government's Brief on the Merits, at p. 6.

[28] Treas. Reg. 45 (1920 ed.) art. 517; Treas. Reg. 62 (1922 ed.) art. 517; O.D. 953, 1921–4 Cum. Bul. 261; Sol. Mem. 952, 1919–1 Cum. Bul. 207; O.D. 508, 1920–2 Cum. Bul. 207; O.D. 60, 1919–1 Cum. Bul. 193. The reference to these administrative rulings was urged upon the Court as a practical guide to statutory interpretation, under the rule that the practical construction of a statute by those charged with carrying it into effect is entitled to great weight. In support of this, the Government cited Schell's Executors v. Fauche, 138 U.S. 562, 572, 11 S.Ct. 376 (1891); Maryland Casualty Co. v. United States, 251 U.S. 342, 349, 40 S.Ct. 135 (1920).

[29] Petition and Brief on Application for Writ of Certiorari, p. 12.

Interestingly enough, the respondent did not challenge the proposition that an exempt corporation which operated a business would thereby lose its exemption. All that was claimed by the respondent in that case was that where a corporation, exempt from taxes, received revenues from capital invested in commercial enterprises, it did not thereby lose its exemption. It is pointed out by the respondent that

> "The income from dividends does come, it is true, from commercial activities, in the broad sense of the term, but it has no bearing in the present instance for the simple reason that the corporations that inure this income pay the income tax directly to the Government, in conformity with the provisions of the law. . . . The mere circumstance of A being a stockholder does not mean that he is a merchant; the most that can be granted is that he is an owner. . . .
>
> "It would be a different proposition if A had bought a sufficient number of shares to control the business and in this way make himself the manager of the company. . . . Then and under these circumstances A could probably be called a businessman. . . ."[30]

In other words, all that the exempt corporation argued in that case was that the *ownership* of commercial properties from which it derived income and the insubstantial revenues derived from the sale of wines and chocolate within its organization did not affect its tax exempt status. It was admitted by the respondent in that case that where the corporation, operating a profitable enterprise, was under the control and management of the tax exempt association, as distinguished from mere ownership, it might very well lose its tax exemption. Nor did the Supreme Court of the United States, in upholding the tax exemption in that case, go much further. There is language in the opinion of the Court, however, which has given color and basis to the subsequent decisions in the circuit courts, granting exemption to business corporations organized and operated by tax exempt associations. Thus, the Court said, referring to the statute:

> "Two matters apparent on the face of the clause go far towards settling its meaning. First, it recognizes that a corporation may be organized and operated exclusively for religious, charitable, scientific, or educational purposes, and yet have a net income. Next, it says nothing about the source of the income, but makes the destination the ultimate test of exemption."[31]

This language, left by itself, might be broad enough to include the

[30] Respondent's Brief on the Merits, pp. 16-18.

[31] Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 at 581, 44 S.Ct. 204 (1924).

hypothetical case suggested in the petitioner's brief, to wit, the exemption of the United States Steel Corporation from tax if all of its profits were devoted to a tax exempt purpose. But the Court found it necessary to add:

> "As respects the transactions in wine, chocolate and other articles, we think they do not amount to engaging in trade in any proper sense of the term. It is not claimed that there is any selling to the public or in competition with others. The articles are merely bought and supplied for use within the plaintiff's own organization and agencies,—some of them for strictly religious use and the others for uses which are purely incidental to the work which the plaintiff is carrying on. That the transactions yield some profit is, in the circumstances, a negligible factor. Financial gain is not the end to which they are directed."[32]

In the context of the full opinion, it would seem that the declaration of the Court, that the source of the income was not the test, did not imply that it was likewise immaterial whether or not the exempt institution itself *carried on* and *operated* the business which was the source of the income. To read into the statute an exemption to business organizations actually carried on and operated by exempt institutions, even though organized for that purpose, requires a further extrapolation of the language of the Supreme Court. The opinion of the Court, therefore, leaves open the specific problem with respect to a business corporation organized, owned and operated by a tax exempt institution, and no definitive determination by the Supreme Court in the *Trinidad* case was either asked or made on this question. Nevertheless, a whole series of decisions of recent vintage in the circuit courts have laid down the proposition that where a business corporation is organized and operated as a subsidiary of a tax exempt institution, or for a tax exempt purpose, its income is exempt from the income tax levy under section 101 of the Internal Revenue Act.[33]

Two subdivisions of section 101 are here involved. Subdivision 6 excludes from taxation "[c]orporations . . . organized and operated *exclusively* for religious, charitable, scientific, literary or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual. . . ."[34] And subdivision 14 exempts "[c]or-

[32] Id. at 582.

[33] Comr. of Internal Revenue v. Orton, (6th Cir. 1949) 173 F. (2d) 483; Debs Memorial Radio Fund v. Comr. of Internal Revenue, (C.C.A. 2d, 1945) 148 F. (2d) 948; Roche's Beach, Inc. v. Comr. of Internal Revenue, (C.C.A. 2d, 1938) 96 F. (2d) 776.

[34] I.R.C. §101(6). Italics added.

porations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax. . . ." A distinction, therefore, is drawn in the statute between corporations which are organized and operated exclusively for exempt purposes and corporations which are organized to own and hold title to property, collect income and turn the "entire" income over to an exempt corporation.

Nothing in the express language of the statute either includes or excludes the judicial determination that a corporation, subsidiary to a tax exempt organization, which engages in trade or operates a commercial venture is necessarily exempt under subdivision 6 or 14 even if in fact it has been organized and is operated for the purpose of devoting its profits to an exempt purpose. It has been recognized that under section 101(14) only corporations "owning and holding" property are exempt.[35] And despite the statement by the Supreme Court in the *Trinidad* case, supra, that section 101(6) makes the destination of income, and not its source, the controlling factor in determining tax exemption, a study of that case, as we have seen above, reveals that the proposition was not directly involved in the decision and that it falls far short from holding that industrial companies, operated for profit, are exempt from the tax, even where such companies are organized and operated for a tax exempt purpose.

Judge Learned Hand recognized, in a dissenting opinion,[36] the limitations of the decision in the *Trinidad* case in this respect and was of the opinion that in spite of the language in the *Trinidad* case, in which the destination of the income is said to be the test, at least as far as subdivision 14 was concerned, the purpose of the statute was to "tax all business income, however destined, unless the company was not in business at all."[37] Judge Learned Hand did, however, recognize the possibility that "an exempt corporation may go into business not strictly germane to its charter powers without losing its exemption."[38] But he indicated the opinion that there are several checks upon this possibility. These, he listed as follows:

[35] Gagne v. Hanover Water Works Co., (C.C.A. 1st, 1937) 92 F. (2d) 659; Sun-Herald Corporation v. Duggan, (C.C.A. 2d, 1934) 73 F. (2d) 298, cert. den., 294 U.S. 719, 55 S.Ct. 546 (1935).

[36] See Roche's Beach, Inc. v. Comr. of Internal Revenue, (C.C.A. 2d, 1938) 96 F. (2d) 776 at 779.

[37] Ibid.

[38] Ibid.

"... first, the business must be small, if the corporation is to retain its classification under its appropriate subdivision; second, in many cases it will wince at exposing its funds to the hazards of business; third, its charter will often forbid such excursions. But I believe that when, however actuated, an exempt parent does resort to a business subsidiary, any income so obtained becomes taxable."[39]

The majority of the court, however, disagreed with Judge Learned Hand and held that a corporation formed under the Stock Corporation Law of the State of New York was exempt from the income tax although it was engaged in a competitive business since all of its stock was held by, and the corporation itself was dedicated to, trustees for the purpose of establishing a fund for the relief of destitute women and children.[40] The court pointed out that the findings of fact established that the corporation was organized as a medium to collect income and devote the same to the charitable purpose, and departed from earlier decisions of the court in which it was indicated that the purpose, that is, whether charitable in nature or not, must necessarily be found in the charter, holding that the charter is not the only source from which the fact that the corporation was organized and operated for an exempt purpose could be derived. Nor did the majority, then or thereafter, in any way adopt the various limitations on the tax exemption set forth by Judge Hand in the passage from his dissent quoted above.[41]

Subsequent decisions in the circuit courts have gone far to support the views of the majority in the *Roche's Beach* case. In the same circuit,[42] for example, it was held that a radio station operated for civic purposes was entitled to an exemption as a civic league under subdivision 8 of section 101 of the Internal Revenue Code; and, more recently, the Circuit Court in the Sixth Circuit[43] reiterated this proposition of law and held that a corporation formed to sell pyrometric cones for profit where the profit was being devoted to educational purposes was exempt under section 101(6) of the Internal Revenue Code.

While these cases, at least as far as the circuit courts are concerned, establish the exemption of corporations engaging in industry or manufacture for profit, if they are organized for the exempt purpose and

[39] Ibid.
[40] Id. at 778.
[41] Ibid.
[42] Debs Memorial Radio Fund v. Comr. of Internal Revenue, (C.C.A. 2d, 1945) 148 F. (2d) 948.
[43] Comr. of Internal Revenue v. Orton, (6th Cir. 1949) 173 F. (2d) 483.

operated for a like purpose, nevertheless, it does not follow that the mere ownership of all of the stock of a corporation by an exempt corporation will entitle the subsidiary to exemption. On the contrary, it seems fairly clear that mere stock ownership without more will be deemed insufficient to justify the exemption even under the extremely liberal view of the majority in the *Roche's Beach* case.[44] In order to justify the exemption under the doctrine of that case and those which have followed it, it is necessary to show that the corporation claiming the exemption was itself "organized" for the exempt purpose.[45] To be sure, it is no longer necessary to find the organizing aim within the four corners of the corporate charter. Other evidence demonstrating the inextricable intertwining between the exempt corporation and its trading subsidiary may be adduced and if present will be sufficient to extend the exemption to the operating company.[46] This proposition answers in full the fears expressed by counsel for the Government in the *Trinidad* case with respect to the hypothetical situation that the United States Steel Corporation might claim exemption from income tax if all of its profits were devoted to an exempt purpose. It would not by that fact have become a corporation "organized" for an exempt purpose. The decisions of the circuit courts which have established the doctrine of the *Roche's Beach* case have likewise fixed this limitation thereon.

Under cover of the doctrine of law above expounded, an increasing number of commercial enterprises have already come under the control and operation of tax exempt organizations, and there is a great probability that this trend will continue to grow in the near future.

Two problems, therefore, present themselves to government for solution. On the one hand, there is the economic problem of whether this trend constitutes a danger to the economic system which has been built up in this country; and secondly, are the possibilities of its abuse as a vehicle for tax avoidance sufficiently large to justify curtailment of the exemption by statute or by the process of judicial "interpretation."

On the economic side it is argued by those supporting the tax exemption that competition is but little affected thereby.[47] The prices

[44] (C.C.A. 2d, 1938) 96 F. (2d) 776.

[45] Sun-Herald Corporation v. Duggan, (C.C.A. 2d, 1947) 160 F. (2d) 475 at 476.

[46] Ibid.

[47] Cary, "Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations," 62 HARV. L. REV. 1 (1948). See especially, statement of Mr. John Gerdes, referred to in note 79, at p. 37 of that article.

of commodities are said to be fixed by the inexorable laws of supply and demand and by the well known psychological fact that manufacturers and traders in commodities will always sell for the best price obtainable. The income tax, being a levy on profits, is not, it is argued, an element in the cost of production and hence will not affect the price at which the sellers of commodities are willing to offer their wares to the public.

Contrary views have been expressed by eminent authorities who hold that while it is true that the income tax is not an element in the cost of production, nevertheless, a manufacturer who knows that he will not have to pay any income tax can afford to fix his prices at a point where the profit would be smaller than that of his competitor who must pay the income tax.[48] People do not engage in business, it is argued, to gain less than a certain minimum profit or risk their capital to the hazards of trade for insubstantial returns. Profit itself, we are told, enters into the determination to undertake enterprises and is an element in the determination of prices; and if such be the case, it is obvious that a tax levy on profits would be an important element in the consideration of the price structure, and the exemption from the income tax would be a substantial benefit to a competitor.

Moreover, even if it is true that exemptions from income tax do not react disadvantageously against the non-tax exempt enterprise, it is nevertheless clear that the tax exemption enables the corporation to accumulate surpluses more rapidly than its competitors and thus to weather the lean years. Even here, however, the challenge to tax exemption is not conclusive for it can well be pointed out that under the highest rate of taxation a great many industries have nevertheless accumulated huge surpluses with which to expand production and to meet the onslaughts of possible depression. A more important and a more conclusive answer has been the suggestion made by tax authorities interested in preserving the tax exemptions: that Congress might equate the position of the tax paying and tax exempt corporations by requiring the tax exempt corporations to distribute to its exempt purpose a portion of its profits, at least equal to the amount of tax it would have paid had it not been exempt.[49] Indeed, legislation looking to this end has been recently introduced in Congress.[50]

[48] Id. at pp. 29-30.
[49] Id. at p. 19, note 43.
[50] H.R. 2976, 81st Cong., 1st sess. (1949).

The problem with respect to the utilization of this exemption as a method of tax avoidance or, even more reprehensibly, tax evasion, is likewise of first importance in the determination of future policies. A recent investigation by a Senate Subcommittee revealed the utilization, on a comparatively large scale, of the exemptions in section 101 of the Internal Revenue Code as an instrumentality for personal gain.[51] Although the investigation was limited to but one case in which this method of tax avoidance had been attempted, the facts brought to light by the Senate Subcommittee should, no doubt, go a long way in clarifying the application of the legal principles involved in tax exemption to specific cases. It has long ago been established by the Supreme Court that mere adherence to the letter of the law in tax cases does not in and of itself result in the tax benefits contemplated. A most significant example of this is the development of the "business purpose" rule since the decision of the Supreme Court in *Gregory v. Helvering*.[52]

In that case, tax benefits were denied even though by an application of the strict letter of the statute it might well have been anticipated that the benefits would accrue to the taxpayer. The doctrine pronounced by Justice Holmes—that a line is drawn by the statute and everything on one side of the line is taxable and everything on the other side is non-taxable—has not been found workable in practice.[53] At best, the line must be gerrymandered to suit the general purposes of the law and to eliminate possibilities of tax avoidance not contemplated by the legislature. To paraphrase Justice Holmes himself, the right to exemption does not necessarily involve the right to avoid a tax, as long as the Supreme Court sits.[54]

We have not thus far, in this paper, considered the extent to which the tax exemption enjoyed by commercial companies organized and operated for the benefit of exempt institutions are a necessary incident in the promotion of the public interest. It is clear that a comparatively small segment of our industry has up to this time come into the hands

[51] Report of a Sub-Committee of the Committee on Interstate and Foreign Commerce, S.Rep. 101, 81st Cong., 1st sess. (1949). Investigation of Closing of the Nashua, N.H., Mills and Operations of the Textron, Inc.

[52] 293 U.S. 465, 55 S.Ct. 17 (1935).

[53] Bullen v. Wisconsin, 240 U.S. 625 at 630, 36 S.Ct. 473 (1916).

[54] See concurring opinion of Justice Frankfurter in Graves v. New York, 306 U.S. 466, 490, 59 S.Ct. 595 (1939). To the famous dictum of Chief Justice Marshall in McCulloch v. Maryland, 4 Wheat. (17 U.S.) 316 at 431 (1819): "the power to tax involves the power to destroy," Justice Holmes added the gloss: "not . . . while this court sits." Panhandle Oil Co. v. Mississippi, 277 U.S. 218 at 223, 48 S.Ct. 451 (1928).

of tax exempt institutions,[55] but the danger that this might increase beyond control and might in fact be used as a method of perpetuating control of industry in families by the use of the family foundation has been adverted to. How extensive this movement might become and how inimical, if at all, to the public interest it might ultimately be considered has not been studied either in this paper, or, as far as the author knows, elsewhere. It is interesting to note, however, that no such principle obtains in England where the income tax law is a relatively ancient institution. While the English statute exempts from the income tax hospitals, public schools, almshouses, or other charitable organizations, profits from any trade carried on by such institutions are exempt only if the profits are applied solely to the purpose of the exempt organization and either: "(1) The trade is exercised in the course of the actual carrying out of a primary purpose of the charity; or (2) the work in connection with the trade is mainly carried on by beneficiaries of the charity."[56] Moreover, as we have seen, the English courts treat as a legal question the determination of whether a particular purpose is charitable or educational, even with respect to the exemption of income not derived from trade.[57]

The mere comparison, however, of the English legislative scheme, as interpreted by its courts, and our own throws but little light on the problem here under consideration. Presumably, the exemptions from the income tax are here dictated by the necessity of encouraging private funds to enter into the field of social welfare and religious and educational progress. One would need to compare the extent of government participation in these matters in England with our own governmental efforts in those directions in order to form a judgment as to whether tax exemption, as a matter of governmental policy, is more important here than in England. In a sense, exempt corporations engaging in charitable and educational pursuits, and to some extent in religious activities, are doing the work of government and to tax them would be analogous to the taxation of government for the support of governmental functions. And while the Supreme Court has eliminated the bar to taxation of the salaries of public officials[58]—a bar which was

[55] It has been estimated that the activities of tax exempt corporations engaging in business cost the Government about $50,000,000 a year in taxes. No precise information, however, along these lines is available. The estimate referred to was made by Kenneth Fiester, editor of *Textile Labor*, published by the Textile Workers' Union of America, and is contained in the article published in THE NATION, p. 414 (April 9, 1949).

[56] Finance Act of 1921; Halsbury Statutes of England, p. 629.

[57] Supra, note 20.

[58] Helvering v. Gerhardt, 304 U.S. 405, 58 S.Ct. 969 (1938); Graves v. New York, 306 U.S. 466, 59 S.Ct. 595 (1939). See also, illuminating historical and analytic discussion

based upon the implied limitation of the taxing power of government for the support of government—nevertheless, the taxation of exempt corporations presents a more difficult and less easily disposed of problem; for it may well be that the rise in the rates of our income tax might put a prohibitive burden upon the many thousands of institutions devoted to the public welfare which are now enjoying tax exemption.

In any event, no suggestion from any responsible quarter has in this country been made, that tax exemption in this field be eliminated. On the contrary, the subcommittee of the Senate Committee on Interstate and Foreign Commerce, which conducted the investigation into the operations of the Textron Trusts specifically stated that:

> "Section 101(6) of the Internal Revenue Code provides, generally, that a foundation which is organized and operated exclusively for charitable, educational, and other designated purposes shall be exempt from Federal taxation upon its income.
>
> "We feel that this provision of law is a fair one. A bona fide religious, charitable, or educational foundation which is operated exclusively for such purposes is properly exempt from such taxation."[59]

The only suggestion made by the subcommittee was that section 162(a) of the Internal Revenue Code be amended so that its benefits will be lost to a trust unless 85% of its gross income is actually paid in the taxable year to the beneficiary, and the subcommittee added that:

> ". . . such an amendment would not affect bona fide educational, charitable, and religious foundations which are in any event given total exemption under section 101(6) of the code."[60]

Until the Supreme Court speaks, or Congress further legislates, there will, of course, be no definitive determination of the issues involved in the exemption of companies organized and operating in industry which are owned by exempt organizations. Nor is the situation helped by the non-acquiescence of the Bureau of Internal Revenue in tax court decisions and their failure even to seek certiorari in the Supreme Court.[61] As time goes on, more complicated corporate struc-

in Boudin, "The Taxation of Government Instrumentalities," 22 GEO. L. J. 1 and 254 (1933 and 1934).

[59] S. Rep. 101, 81st Cong., 1st sess., p. 19 (1949).

[60] Id. at p. 20.

[61] In the recent case of Comr. of Internal Revenue v. Orton, (6th Cir., 1949) 173 F. (2d) 483, the Bureau filed a non-acquiescence to the tax court decision, but has thus far failed to apply for certiorari to the Supreme Court from the decision in that case in the circuit court, as it failed to do in Roche's Beach, Inc. v. Comr. of Internal Revenue [(C.C.A. 2d, 1938) 96 F. (2d) 776] and Debs Memorial Radio Fund v. Comr. of Internal Revenue [(C.C.A. 2d, 1945) 148 F. (2d) 948].

tures are involved in the dispute. For example, in recent years, a number of foundations or tax exempt corporations have been organized to purchase going business concerns and operate them for the benefit of a tax exempt institution. Frequently, in such cases, a portion of the revenues are employed in making payments, either on account of money borrowed for the purchase, or directly to the purchaser, of all or a portion of the unpaid purchase price. Here, new problems are presented for administrative as well as judicial review. There can be but little doubt that what is being done falls well within the exemption as set forth in the decisions by the courts of appeal in the various circuits above referred to.[62] But whether this new development should be seized upon as an opportunity to re-examine the whole fabric of the law of the tax exemption of such companies will not be decided by the mere filing of non-acquiescence by the Bureau. An opportunity should be presented to the Supreme Court definitively to settle the law in this respect; and if this is not done, then Congress itself will be obliged to pass clarifying amendments. A trend in our economic life which has begun to take on the proportions to which we have referred is entitled to that freedom from uncertainty as to its tax status which will make possible intelligent planning for the future.

Relying upon the several decisions in the circuit courts, substantial sums have been invested by tax exempt institutions in commercial and industrial endeavor. It is obviously unfair that determination of the tax status should remain long in doubt under these circumstances, particularly when one has in mind the slender reed in the language of the *Trinidad* case[63] upon which the decisions of the Circuit Court have been made to rest. Nor is it helpful that the regulations of the Bureau continue to deny exemptions which the Circuit Courts upheld.[64] Due regard for the importance of certainty in this field necessarily requires final clarification of the problems here discussed.

[62] Supra, note 33.

[63] 263 U.S. 578, 44 S.Ct. 204 (1924).

[64] In spite of the decision of the Trinidad case, and the various decisions of the circuit courts, which the Bureau has not sought to review in the Supreme Court, the regulations still provide as follows:

> "Since a corporation to be exempt under section 101(6) must be organized and operated exclusively for one or more of the specified purposes, an organization which has certain religious purposes and which also manufactures and sells articles to the public for profit, is not exempt under section 101(6) even though its property is held in common and its profits do not inure to the benefit of individual members of the organization." Treas. Reg. 111, §29.101(6)-1.