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IN 1895 Joseph Choate, a distinguished leader of the American Bar, arguing before the Supreme Court of the United States said: "The Act of Congress [the income tax law] which we are impugning before you is communistic in its purposes and tendencies, and is defended here upon principles as communistic, socialistic—what shall I call them —populistic as ever have been addressed to any political assembly in the world. . . . I have thought that one of the fundamental objects of all civilized government was the preservation of the rights of private property."[1]

While the great advocate no doubt exceeded the proper limits of the case by ascribing communistic motives to the enactors of the income tax law, few will doubt that its tendencies have increasingly become socialistic. With income tax rates rising to the staggering heights of almost 92 per cent in the top brackets, production for profit loses the significance that it had in days of old. As a matter of fact, revenue production is not the only purpose of the great increases in income tax rates. It is frankly admitted that the tax is also needed as a necessary brake on inflation or, in other words, a step in the ever widening pattern of economic planning.

While what has been said is a commonplace, few have recognized that the exemptions from the income tax as well as from other taxes are likewise in tendency, although surely not in purpose, socialistic. For these exemptions, with but a few exceptions, are not given to individuals,[2] but rather to corporations, organizations and associations and public bodies which serve the public interest in various ways and which in effect do the work which government itself would, could or should

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[1] See argument of Mr. Joseph H. Choate in Pollock v. Farmer's Loan & Trust Co., 157 U.S. 429 at 532, 534, 15 S.Ct. 673 (1895). Justice Field re-echoed the views of Mr. Choate in his separate opinion (p. 607): "The present assault upon capital is but the beginning. It will be but the stepping-stone to others, larger and more sweeping, till our political contests will become a war of the poor against the rich; a war constantly growing in intensity and bitterness."

[2] See I.R.C., §25. Exemptions from normal tax but not surtax are allowed with respect to certain interest on United States bonds and interest paid by instrumentalities of the United States; from both normal and surtax an exemption of $600 for the taxpayer and each of his dependants of a certain class, a like exemption of $600 to a taxpayer who is over the age of 65, or blind.

do, if occasion demanded.[3] Public funds in the form of exemption from taxation not only of the income of these organizations but also of the donors thereto are used to maintain these quasi public services. It is not too far fetched to call this siphoning of a substantial portion of the profits of industry into the public service a tendency toward socialism, a tendency which began in this country more than seventy-five years ago, and has gathered momentum in recent years.[4]

Prior to 1950 there occurred an extension of the area of income tax exemption by the entry of tax exempt institutions into so-called private industry.[5] Attention of public bodies was called to the fact that more and more tax exempt bodies were taking over rent producing realty, and manufacturing and other profit producing companies and utilizing these profits for their tax exempt purposes. In effect this was a slight step in the direction of the socialization of industry—American instead of English style. No one, however, in public life, recognized this aspect of the affair. The hue and cry against the new trend was raised for other reasons. The result was that the Revenue Act of 1950 has put obstacles—some of which are insurmountable—in the path of the taking over of industry by tax exempt associations. *Facilis decensis avernis* and each of us, just as each generation, has its own path to its ultimate destiny. But it is saddening to note that both the creation of the tax exemptions and their partial repeal have been accomplished without consideration of the basic elements of public policy involved.

In the main, the 1950 revision of the income tax exemptions were undertaken to plug loopholes in the tax law and to prevent dishonest manipulation.[6] Essentially the Treasury regarded the entry of tax exempt bodies into industry as a loophole in the tax law.[7] No attention

[3] Finkelstein, "Freedom From Uncertainty in Income Tax Exemptions," 48 MICH. L. REV. 449 at 450 (1950).

[4] Among the first of these efforts in this country to enlist the aid of government on behalf of private economic woes was an organization founded in 1867 by Oliver H. Kelley called "Patrons of Husbandry."

[5] Finkelstein, "Freedom From Uncertainty in Income Tax Exemptions," 48 MICH. L. REV. 449 at 450 (1950).

[6] "Some tax loopholes also have been developed through the abuse of the tax exemption accorded educational and charitable organizations. It has properly been the policy of the Federal government since the beginning of the income tax to encourage the development of these organizations. That policy should not be changed. But the few glaring abuses of the tax exemption privilege should be stopped." From the message of the President of the United States to Congress, Jan. 23, 1950, S. Doc. No. 451, 81st Cong., 2d sess.

[7] "I suggest the consideration of legislation to eliminate the abuse of tax exemption by charitable and educational organizations. . . . Some colleges and other institutions are engaging in a wide variety of business undertakings, including the production of such items as automobile parts, chinaware, and food products, and the operation of theatres, oil wells, and cotton gins." From the statement of the Secretary of the Treasury to the House Committee on Ways and Means, Feb. 3, 1950, pp. 18, 19.

was paid to the fact that the exemption was available only "where no personal benefit to any individual" obtained.[8] Moreover, stirred by the revelations of the Textron inquiry,[9] Congress felt that the tax exempt foundation was rapidly becoming a vehicle through which public funds could be put to the use of private purposes. Under these circumstances it was perhaps inevitable that severe limitations in the area of tax exemptions should result.

The 1950 Act attacked the problem on three fronts. It specifically taxed certain income of bodies otherwise exempt from taxation.[10] It denied tax exemption, previously enjoyed, to certain foundations and trusts,[11] and finally denied deductions for income, gift and estate tax purposes to donors to organizations which failed to meet certain standards.[12]

A new concept—that of the "unrelated income"[13] of a tax exempt body—was created by the 1950 statute. Courts will no doubt someday have to struggle with the precise meaning of the phrase "unrelated income," inasmuch as, with some few exceptions, such income is under the act subjected to taxation. To illustrate, if *A* and *B* are engaged, let us say, in the shoe manufacturing business and determine to give all of its profits to a tax exempt institution, the money would be received by the tax exempt institution without being called unrelated income since, no matter how measured, it is merely a contribution by a public-spirited citizen to a tax exempt purpose.[14] If *A* and *B* should transfer their ownership of the shoe manufacturing business to the tax exempt institution directly, the income would at once become "unrelated" and be taxable in full to the recipient. In the former case we have private philanthropy. In the latter, a step toward socialization. In both cases, how-

[8] Thus I.R.C., §101(6) defining exempt bodies includes the requirement that "no part of the net earning of which enures to the benefit of any shareholder or individual."

[9] Finkelstein, "Freedom From Uncertainty in Income Tax Exemptions," 48 MICH. L. REV. 459 at 461, note 51 (1950); see also statement of Royall Little, President of Textron, Inc., before House Committee on Ways and Means, Feb. 3, 1950, p. 505.

[10] See Summary of H.R. 8920, "The Revenue Act of 1950" as agreed to by the Conferees. September 1950. See also Revenue Act of 1950, §301.

[11] Revenue Act of 1950, §322.

[12] Revenue Act of 1950, §331. See very illuminating detailed analysis of tax exemptions in Eaton, "Charitable Foundations and Related Matters Under the 1950 Revenue Act," 37 VA. L. REV. 1, 253 (1951) and also prior articles by same author in 35 VA. L. REV. 809, 987 (1949).

[13] "The problem at which the tax on unrelated business income is directed is primarily that of unfair competition." Report of the Committee on Finance, U.S. Senate No. 2375, Revenue Act of 1950, p. 28. It would seem therefore that the test of whether income is or is not "unrelated" will depend on whether or not it is derived from sources in competition with private industry.

[14] Of course, if the amount thus contributed by *A* and *B* exceeds 15% of their taxable income, they will have paid the tax on such excess. But the recipient would pay no tax.

ever, the income is utilized by the tax exempt institution for its tax exempt purposes. In that sense the income has a very definite relation to the purposes of the recipient. Moreover, the source of the income is the same in both cases. It is difficult, therefore, to say that the income in either case can be subsumed under the phrase "unrelated income."[15]

But not all unrelated business income meets this fate. It is not taxable if the income is earned by a "church, a convention or association of churches."[16] The precise definition of the words "church" and "convention or association of churches" is not given in the statute. No doubt, what is meant is to indicate associations maintaining places of worship. Since at the moment such associations are not too deeply involved in the production of what the statute refers to as "unrelated income" this special treatment of churches does not factually constitute a loophole in the tax law or a threat to competitive industry. On no other assumption can we explain this special provision. Should they ever, however, become a threat to competitive industry, there will be ample time to remove the special favor presently enjoyed by them under this act.

Some effort is made in the statute to delimit the meaning of the phrase "unrelated income." Thus the income derived by a college from athletic contests, from book publishing or selling, from dormitories, or the income derived by a thrift shop is not considered "unrelated income." In addition, certain exemptions are provided by the statute for income derived by colleges, universities, hospitals and other organizations for special research, the results of which are freely available to the general public.[17]

Most important of all, the income derived by a tax exempt organization from dividends, rents or royalties is not unrelated income and is specifically exempt from taxation.[18] In this respect it is important to note that dividends are exempt even if the tax exempt institution owns all the stock of the dividend paying corporation. Presumably there are

[15] The statutory definition of "unrelated income" in the Revenue Act of 1950 is contained in §422 (a) and (b). It includes "income derived by any organization from any unrelated trade or business . . . regularly carried on by it . . ." by which is meant "any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational or other purpose or function. . . ."

[16] Neither the report of the Senate Finance Committee nor that of the House Ways and Means Committee, nor the Summary published by the conferees contains the slightest indication that any special policy is being served by the elimination of churches from the modification of the tax exemption law.

[17] Revenue Act of 1950, §422.

[18] Ibid. Subsections (a) (1) (2) (3).

still some advantages to be gained, taxwise, by the acquisition of industrial concerns by tax exempt bodies.[19]

For example, if our aforementioned shoe manufacturing concern were a corporation, its stock could command a better price if sold to a tax exempt institution than if sold to individual taxpayers, since the individual taxpayers would be compelled to pay income tax on the dividends, whereas the tax exempt institution would not. Therefore, this loophole has only been partially plugged. To be sure, the corporation, itself, would be subjected to taxation, as a feeder corporation,[20] but the exemption of the dividends from taxation gives the tax exempt organization a great advantage. Moreover, there seems to be nothing in the statute that would prevent the stock of the corporation from being acquired with borrowed capital and the dividends used to retire the loan, at least in part.[21] The not too distant future, therefore, holds forth the distinct possibility that private industry may again be invaded by tax exempt organizations for tax reasons.

Rents from realty owned by tax exempt bodies are still not subject to the tax, unless the realty is acquired with borrowed funds and the rents are derived from long term leases. Both conditions must exist concurrently before the exemption is lost. Thus a tax exempt body may still acquire an apartment building with borrowed funds and the rents would continue to be tax exempt, provided there were no long term (five year or more) leases; and even the rents from long term leases would be tax exempt provided the property is acquired without the

[19] See testimony of Mr. Thomas J. Lynch before House Ways and Means Committee, 81st Cong., 2d sess., 1950, vol. I, p. 176.

"Mr. Boggs. Of course, I realize that it is a very difficult and very serious problem. I have no preconceived notion. I am simply trying to get information and I am genuinely concerned, because it seems to me that if you can start off with unrelated business activities, that the logical extension is to say that the revenue derived from owning real estate or stocks and bonds is also an unrelated business.

"Mr. Thomas J. Lynch. I would not agree to that. We would have it specifically provided that as to investment income, rents and royalties there is no question whatever. This is not a question either of the extent of the ownership of stock or controlling interest; the university might own 100% of the stock in a particular business enterprise.

"Mr. Boggs. And you said that any legislation that emanates from this Committee, that be specifically so stated?

"Mr. Thomas J. Lynch. That is our recommendation, Mr. Congressman."

[20] Revenue Act of 1950, §424(b).

[21] A tax exempt corporation could acquire the stock of an industrial concern and use the dividends, which would be tax exempt, either to pay the purchase price, or to repay a loan, or for its tax exempt purpose. In other words, tax exempt bodies enjoy freedom from double taxation of corporate income.

necessity of borrowing funds for the purpose. The sale and lease back arrangement, thus effectively slain by Congress, still lives in other forms.[22]

As is stated above, the impact of the inquiry into the Textron Trusts,[23] led Congress to enact certain safeguards to insure that tax exemption provisions are not used for private gain. This led to the enumeration of certain prohibited transactions on the part of charitable trusts and foundations, which, if engaged in, would result in the loss of tax exemption.

These prohibited transactions include: (1) the lending of all or any part of its income or principal to the donor of the charitable fund, any member of his family or any corporation controlled by him at unreasonable rates of interest or on inadequate security; (2) the payment of compensation to any such persons in excess of a reasonable amount for services rendered; (3) giving preferences in services to any such persons; (4) purchasing securities or property from such person at higher than adequate price; (5) or selling securities or property to such persons at lower than the fair price; (6) or in sum, engaging in any transaction which results in a diversion of its property to any such persons. In addition to the foregoing, exemption is likewise lost if the income of a charitable trust or foundation is unreasonably accumulated.[24]

The third elimination of tax exemption was aimed at donors who contribute to institutions otherwise tax exempt which engage in any of the prohibited transactions referred to above, including unreasonable accumulations of income.[25] This effectively prevents a taxpayer from claiming deductions for charitable contributions made to his family foundation or trust in the event that the foundation or trust engages in the activities which Congress regarded as improper and which were considered to be engaged in for the private benefit of the individuals who establish these foundations or trusts. It is an open question whether the income of such a foundation can be used for the payment of the foundation's debts incurred in the acquisition of property, including securities. The provision against the unlawful accumulations prohibits accumulations which are (1) unreasonably large or held for unreasonable periods; (2) used to a substantial degree for purposes other than the organization's exempted purpose; and (3) invested in such a man-

[22] Revenue Act of 1950, §423 (a), (b) for definitions of "supplement U lease" and "supplement U lease indebtedness."

[23] Supra note 9.

[24] Revenue Act of 1950, §321.

[25] Ibid.

ner as to entail the risk of loss. Under (2) above, if the income is used to pay the debts of the foundation incurred in the acquisition of property and not for its tax exempt purpose, the question remains whether the income is thus being used for purposes other than the organization's exempt purpose. This, of course, involves a judicial determination, or, perhaps, subsequent legislative clarification.

The purpose of the penalty, as stated above—that is, loss of exemption—was to prevent the use of the tax exemption privilege for individual benefit. The question is, has the purpose been accomplished? Surely the list of prohibited transactions, aside from the ban on accumulations were sufficiently tabooed by the former provisions of the statute that expressly required that no personal advantage must flow from an institution which sought and obtained tax exemption. Did the more specific enumeration of the personal benefit methods said to be employed by private foundations and trusts clarify the law in this regard and assure society that in the future funds dedicated for tax exempt purposes will in fact as well as in theory not be used for personal benefit? Only experience can answer these questions. A family foundation might indeed avoid all of these transactions which are specifically prohibited and yet be used for a benefit to its creators which is not patent. As where the foundation is owner of stock in a corporation to so great an extent that the donors are enabled thereby to control the corporation. In that way the suzerainty of a family over the destinies of a corporation might be continued for a long period of time through the medium of a tax exempt foundation—with the consequent financial advantages that flow therefrom—and no violation of the statute be involved that would result in the loss of tax exemption.[26] Is this an unplugged loophole or is it in the public interest? There are pros and cons. On the one hand it might be urged that charitable funds should be invested where they will do the most good for the body politic as well as for the particular philanthropy served. On the other hand encouragement given to the creation of such foundations by allowing such indirect control of corporate enterprise might release funds for public service that might otherwise not easily emerge. The balancing of these conflicting social claims is again a legislative problem which will grow in magnitude as time goes on.

[26] The Secretary of the Treasury of the United States called attention to this in his statement to the House Committee, supra note 7. He said, "Another closely related abuse of tax exemption involves the establishment of so-called charitable foundations or trusts which serve as a cloak for controlling business. The present law permits the transfer of business investments to tax exempt trusts and foundations for these purposes without payment of gift or estate taxes."

Have the uncertainties of the tax exemption law been clarified by the Revenue Act of 1950? When we consider the most recent decisions under the old law,[27] made after the enactment of the new law, it must be conceded that a great step forward in that direction has been made. On the other hand, as we have seen, new doubts and difficulties have been engendered by the new law which will require both judicial and legislative clarification.

It is suggested that the core of the difficulties arises from the absence of a clear cut properly enunciated economic philosophy in this field, a philosophy which requires a balanced study of the economic consequences of tax exemption, so that we may know—what we do not now know—the precise direction to which tax exemption policies, past and present, lead our economy.

The structure of modern institutions has grown so complex that it is becoming a truism that their nature and destiny are but little understood. At this tragic moment in world history when freedom and slavery face each other girt for what may ultimately be mortal combat one feels the enormous dearth of knowledge with which alone it is safe to enter the fray. Freud once said that there are three disciplines in which achievement is notably lacking, pedogogy, the science of healing, and the mystery of government.[28] To this we might add without much fear of contradiction the essential elements of economic planning.

[27] The Tax Court in Mueller v. Commissioner of Internal Revenue, 14 T.C. 922 (1950) denied exemption to a corporation concededly organized and operated exclusively for an exempt purpose, because its income was derived from trade. This holding was duly reversed by the Court of Appeals for the Third Circuit, June 20, 1951, 190 F. (2d) 120. That court took comfort in the fact that the provisions of the Revenue Act of 1950 deprived its decision of future significance but felt itself duty bound to follow the historical approach. With the same stuff for judgment before it, the Court of Appeals for the Fourth Circuit reached exactly the opposite conclusion. United States v. Community Service, Inc., (4th Cir. 1951) 189 F. (2d) 421. But the Tax Court continued to follow the line against exemption. Long ago, Justice Field in his opinion in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 at 595, 15 S.Ct. 673 (1895), said: "Where property is exempt from taxation, the exemption, as has been justly stated, must be supported by some consideration that the public, and not private, interests will be advanced by it. Private corporations and private enterprises cannot be aided under the pretence that it is the exercise of the discretion of the legislature to exempt them."

[28] See: Geleitwort by Sigmund Freud in AICHORN, VERWAHRLOST JUGEND (1931). For another version, see the English translation of the same book entitled, AICHORN, WAYWARD YOUTH, foreword by Sigmund Freud, page v (1935).