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TAX EROSION AND THE "BOOTSTRAP SALE" OF A BUSINESS—I*

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I. INTRODUCTION

The Bootstrap Problem

The term "bootstrap sale" has come to mean a transaction in which a business, in effect, purchases itself. The owner of the business "sells" it at a highly favorable price, often millions of dollars, to a newly organized corporation which often has only a few thousand dollars in assets. Since the purchase is not made out of independent funds by a financially responsible purchaser, payment can only come out of the income and assets of the business transferred. Indeed, the cash for the small down payment is frequently pulled directly out of the business, immediately before or after the transfer.

The owner receives capital gains treatment on the proceeds of this "sale"—for what had previously been ordinary income. And yet he continues to occupy much the same economic position after the transaction as before, retaining substantial ownership rights and liabilities, including control for a period of years and the risks of the business. Because the new entity acquires the business with tax-free funds—via

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either a charitable exemption or a net operating loss carry-over¹—it is able to offer a higher price than an ordinary purchaser and to provide greater assurance of ultimate payment.

The original bootstrap cases were based on the use of the charitable exemption granted by section 101(6) of the Internal Revenue Code of 1939.² After the 1939 Code provisions were tightened by the Revenue Act of 1950,³ tax planners cast bootstrap sales in the form of leases so as to make use of various loopholes in the 1950 legislation.⁴ A still more recent use of the bootstrap technique is seen in the transfer of profit cemeteries to "nonprofit" cemetery companies. The latest and most complicated bootstrap technique has been the combined employment of bootstrap sales, net operating loss carryovers and affiliation in a consolidated return.⁵

It is the object of this Article, first, to study the sources, development and probable future evolution of the bootstrap device;⁶ and second, thereby to present a case history of what has been described as the "erosion" of the progressive income tax.⁷ Because a great many tax doctrines, many of them in conflict with supposed general theories of progressive income taxation, have gone into the evolution of the bootstrap mechanism, it affords a graphic illustration of the gap erosion has created between the theory and actual practice of our tax process.

¹ The term "bootstrap sale" is sometimes applied to a simpler form of this transaction, such as the sale of a business to a purchaser without assets, or on terms calling for payment only out of earnings. For convenience the term will be here applied to the more complex transactions listed in the text accompanying notes 34-40 *infra*, all of which make use of tax-free funds.

² Ch. 1, 53 Stat. 33, as amended (now INT. REV. CODE OF 1954, § 501(c)(3)).

³ Ch. 994, 64 Stat. 906.

⁴ See the detailed discussion of the shortcomings of this legislation in Comment, *Colleges, Charities and the Revenue Act of 1950*, 60 YALE L.J. 851 (1951).

⁵ This device was successfully used by Botany Mills, Inc., a detailed description of which appears in Murphy, *Sonnabend's Sackful*, Fortune, Sept. 1958, p. 133. See also *Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code Before the House Committee on Ways and Means*, 86th Cong., 1st Sess. 885, 893-94 (1959) [hereinafter cited as *1959 Advisory Group Hearings*] (statement of George E. Lent); Lent, *Net-Operating-Loss Carryovers and Corporate Mergers*, in *1959 Advisory Group Hearings* 899.

⁶ Of the four general types of bootstrap cases, only one, the "original" bootstrap, has as yet been litigated. The litigated cases include *Caldwell v. Campbell*, 218 F.2d 567 (5th Cir. 1955); *Knapp Bros. Shoe Mfg. Corp. v. United States*, 142 F. Supp. 899 (Ct. Cl. 1956); *Estate of Howes*, 30 T.C. 909 (1958), *aff'd sub nom. Commissioner v. Johnson*, 267 F.2d 382 (1st Cir. 1959); *W. H. Truschel*, 29 T.C. 433 (1957), *order amended*, 17 CCH Tax Ct. Mem. 110 (1957); *Emanuel N. Kolkey*, 27 T.C. 37 (1956), *aff'd*, 254 F.2d 51 (7th Cir. 1958); *Ohio Furnace Co.*, 25 T.C. 179 (1955) (*gov't appeal withdrawn*).

⁷ An exhaustive study of tax erosion and its implications is beyond the scope of this Article. The writer, in a recent presentation on tax reform to the House Ways and Means Committee (*Some Realities of Tax Reform*, in 1 HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., TAX REVISION COMPENDIUM—COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 19 (Comm. Print 1959) [hereinafter cited as *1959 TAX REVISION COMPENDIUM*]) attempted a general outline of

The Role of General Principles

It has been suggested that social reality is too complex for men to grasp and that it is presumptuous and futile to attempt broad general theories in the social sciences.⁸ Thus it is contended that no one man can fully consider the innumerable factors affecting even the decision to start a municipal slum clearance project, and that, a fortiori, the search for effective general theories at the level of an entire nation is illusory. It is urged that the decisions which structure society (the area of the social sciences, in brief) are not arrived at on the basis of preconceived general theory, but merely reflect a series of short range compromises between competing, pluralistic interests.

It is true that in practice our present tax structure appears to reflect many special decisions in favor of individual interests and groups. But if the overall public interest is to prevail, then an important weapon is an integrated general tax theory consistent with the basic goals of our particular democracy. These goals, as a minimum, must emphasize a democratic society based on human dignity in which there is the widest possible sharing of such values as power, wealth, enlightenment, respect and similar fundamental human preferences.⁹

We profess already to have such a general tax theory in our proclaimed doctrine of progressive income taxation: that income shall be taxed, and at progressively increasing rates, to the taxpayer who earned it.¹⁰ Progressive taxation is justified not by abstract economic theories of "ability to pay" or by the comparative "marginal utility" of having

some of the major factors behind tax erosion. The present Article seeks to offer a case history in a specific area. Aspects of judicial, administrative or legislative erosion that bear upon the bootstrap technique will be considered. However, the major attention will be devoted to the judicial component, which has been particularly important in the bootstrap area.

The term tax erosion is often used in several ways. It may mean the failure of the income tax system to give effect in practice to the principle that income shall be taxed, and at progressively increasing rates, to the person who earned it. Paul, *Erosion of the Tax Base and Rate Structure*, 11 TAX L. REV. 203 (1956), and Pechman, *Erosion of the Individual Income Tax*, 10 NAT'L TAX J. 1 (1957), are two of the writers who have emphasized the discrepancy between the steep statutory tax rates and the way the taxing system actually operates in practice. See also authorities cited note 14 *infra*.

"Erosion" may also refer to the deviation of the progressive tax from its supposed objective of securing and broadening the democratic shape of our society. The term is often used here in both of these senses for they are frequently synonymous. Where they are not, then the preference basic to this paper will be for the use of the term in the second sense. The distinction sets off two of the major approaches to tax reform. It is discussed at some length in *Some Realities of Tax Reform*, *supra*.

⁸ Lindblom, *Policy Analysis*, 48 AM. ECON. REV. 298 (1958).

⁹ See Lasswell & McDougal, *Legal Education and Public Policy: Professional Training in the Public Interest*, 52 YALE L.J. 203 (1943).

¹⁰ INT. REV. CODE OF 1954, §§ 1, 61(a). See *Lucas v. Earl*, 281 U.S. 111 (1930).

one's top dollar taxed¹¹ but by its relevance to the goals of a liberal democracy. The real merits of progressive taxation lie in its ability to provide and maintain the essential conditions for such a democracy—the avoidance of great extremes of wealth and poverty, the broader sharing of all of a society's values and the prevention of a degree of concentration of wealth and power fatal to democratic processes.

We claim that our present tax system reflects the principles of progressive income taxation. But while the statutory rates climb sharply upward to a high of ninety-one per cent,¹² the effective rates of taxation are far lower,¹³ many taxpayers are paying at rates substantially lower than the general public has come to anticipate, and many forms of income are escaping taxation.

A number of contemporary commentators attribute this process of tax "erosion" to an ever-growing network of "preferential provisions" in the statutes.¹⁴ Frequently cited examples of such relief provisions include the special treatment for capital gains, percentage depletion, special executive compensation such as expense accounts and stock options, fringe benefits generally, the income splitting privilege available to married couples, the many exemptions and deductions for personal expenditures not related to the cost of producing income, tax exempt interest on local and state bonds, the dividend exclusion and credit, the ability to accumulate income in a closely held corporation and so forth.

But the processes of tax erosion cannot be so simply described as the label "preferential provisions" implies. The taxing process reflects a basic political struggle as to the overall allocation of the tax burden—

¹¹ BLUM & KALVEN, *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1953), discusses progressive taxation, listing many of the economic theories advanced in support of progressive taxation and providing a detailed bibliography of the area.

¹² INT. REV. CODE OF 1954, § 1.

¹³ Paul, *supra* note 7, Pechman, *supra* note 7.

¹⁴ Blum, *The Effects of Special Provisions in the Income Tax on Taxpayer Morale*, in JOINT COMM. ON THE ECONOMIC REPORT, 84TH CONG., 1ST SESS., *FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY—PAPERS SUBMITTED BY PANELISTS APPEARING BEFORE THE SUBCOMMITTEE ON TAX POLICY 251* (Joint Comm. Print 1955) [hereinafter cited as 1955 COMPENDIUM]; Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws*, 68 HARV. L. REV. 745 (1955); Groves, *Special Tax Provisions and the Economy*, 1955 COMPENDIUM 886; Hellmuth, *Erosion of the Federal Corporate Income Tax*, 1955 COMPENDIUM 888; Hess, *The Gentle Art of Tax Avoidance*, *The Reporter*, April 16, 1959, p. 12; Lubar, *A Plan for Tax Reform*, *Fortune*, March 1959, p. 92; Mills, Curtis, Ruttenberg, Heller, Rudick, Thomson, all in Mills & others, *What Can We Do About Taxes*, *Fortune*, July 1959, p. 90; Paul, *supra* note 7; Pechman, *supra* note 7; Surrey, *The Federal Income Tax Base for Individuals*, 58 COLUM. L. REV. 815 (1958); Thompson & Silberman, *Can Anything Be Done About Corporate Taxes?*, *Fortune*, May 1959, p. 121; *Hearings on the General Revision of the Internal Revenue Code Before the House Committee on Ways and Means*, 85th Cong., 2d Sess. (1958). Many of the 170 papers contained in 1959 TAX REVISION COMPENDIUM, particularly those in the first volume, take this position.

briefly, "Who Shall Bear What Burden of Which Taxes?" As such, the erosion of the progressive income tax can be analyzed only in terms of all the processes, legislative, judicial and administrative, whereby tax decisions are made.

II. SUBSTANCE OVER FORM AND TAX EROSION:

THE ROLE OF LEGAL MYTHS

The judicial process and its traditional ways of legal thought have been one important factor in the growth of tax erosion upon the framework of the bootstrap device. Several assumptions are basic to an analysis of this development. The most fundamental lies in the preferences that have been indicated for a society based on human dignity in which there is the widest possible production and sharing of basic values—a society that is profoundly democratic. Closely tied to this is the role of "Truth" or "rational inquiry" or "scientific method" or "substance over form"—the label matters not. This problem of method is intimately related to the achievement of a broader democracy and to the role of progressive taxation in that achievement.

To tie many large truths in a very small bundle, there is, perhaps, one distinctive feature which marks off democracy from other forms of society. That feature is the rejection of privilege in any form as an organizing principle for society. And there is nothing that plays a larger role in that rejection than Truth or rational inquiry or scientific method.

One convenient way to illustrate this may be to consider the role of social and legal concepts or myths.¹⁵ There is a tendency for the legal mind to rely upon concepts or myths. The bootstrap litigations and their many related judicial doctrines focus upon whether a particular transaction can be fitted within a choice of labels—"sale" or "no sale," "notes" or "stock," "assignment" or "license," "sale" or "lease"—rather than upon examining the substance of the relationships behind such concepts. Much of the gulf between our claimed system of progressive taxation and the actual pattern of decision can be described by, or even attributed to, such an effort to force complex transactions into an inappropriate legal concept.

¹⁵ The analysis that follows was the source for a similar discussion of the role of legal myths in Lanning, *Some Realities of Tax Reform*, *supra* note 7. However in the congressional paper there was an effort to tie this analysis in with some of the general problems of tax erosion, as compared to the more detailed study of a specific legal problem essayed here. The earlier paper offers a general framework and perspective for the present study.

To greatly oversimplify for purposes of this discussion: external reality is always more complex than the words and ideas with which men seek to understand, organize, and communicate their ideas about reality. Even so simple a concept as "table," or "chair," leaps many gulfs, bridges many unanswerable questions, and is only a rough, shorthand approximation of the reality which it seeks to describe. This complexity and ambiguity is multiplied many times over when we seek to describe not merely the physical universe, but social, political and legal relationships. Nevertheless, neither society nor rational action would be possible without some form of generalization.

Each of us has a different general perspective or *Weltanschauung* from which we view the universe, that is, organize reality. These perspectives will vary with the various predispositions of culture, class, interest, and personality characteristic of the particular individual and his environment, and with the stability of his particular society.¹⁶ Thus we all use general ideas, concepts, labels with which to understand, to organize and communicate.

By the same token any organized society depends upon a high degree of consent and a relatively limited use of power and force to maintain its structure. And in every society there are individuals and groups whose actual or conceived self-interest lies along lines which are not mutually harmonious. To use a narrow example, the industrialist usually has a quite different idea of the proper function of a taxing system from that of a farmer, or a workingman.

In order to seek their own self-interest within the framework of an organized society, most groups and individuals alike tend to rationalize what they conceive to be their self-interest in terms of a broader community interest—so as to achieve the broadest possible range of acceptance. Thus the businessman will emphasize the public interest in stimulating economic "incentives," while lower income groups may stress the "equity" of high income or estate taxes. But when the tax myths are said and done, they still turn upon "Who Shall Bear What Burden of Which Taxes."

In a society operative at an ideal level of democracy there would be little or no special privilege, and no group would find it necessary to rationalize its own self-interest in terms of a claimed general interest. That situation we are unlikely to see. But the more any society is dominated by special interests, rather than by a broad-based emphasis on the general public welfare, the greater the discrepancy between its social, political and legal myths and the social reality they purport to

¹⁶ See Lasswell & McDougal, *supra* note 9.

describe.¹⁷ And by the same token, the more vulnerable are those myths to Truth and rational inquiry. The Russians offer dramatic illustration of this. They pose as a classless, popular democracy. Behind this facade is a grim police state in which power and privilege are held by a relatively few. The extent to which the communist myth lacks reality is a corollary of the high degree of force they need to maintain their society—and of the accompanying high level of censorship which conceals the fact that their society is run by the few in the interest of the few.

Conversely, the more democratic a particular society is, the less dominant will be its special interests, and the more its social, political and legal myths can withstand rational scrutiny. Thus the test of legal ideas must first be whether they accurately describe the underlying social adjustments they are used to effectuate or whether they are merely rationalizations for a different posture of affairs. This becomes a primary question when one comes to examining the so-called preferential provisions in the tax law.

By legal myths or concepts is meant not only ideas with a particular form or content, but also the way those ideas are employed within the tax and other legal decision processes. Thus you may have a tax concept such as "sale" or "reorganization" or "gift" or "dividend" which may have, at least definitionally, some ascertainable factual content—either now or when it originally developed. But if it is continually applied to situations not really encompassed by its basic notion, or if it is not applied to situations where it is appropriate, then its use becomes more and more artificial or conceptual, and it may come to rationalize special interests in a general context.

This may in part represent a process of economic evolution. The "sale" concept initially comprised such a relatively simple transaction as the purchase of a pig in a market. With such a limited relationship, there was no great difficulty in determining if and when a "sale" had occurred and criteria such as the "passage of title" were almost workable. But with the growing complexity of present day transactions, in many of which a transferor may retain some indicia of ownership and transfer others, as with the many transactions to be considered ranging from the "sale and leaseback" to an oil and gas lease, the "sale" concept may not be readily applicable. The very insistence on applying it may be a form of conceptualism.

¹⁷ See ELLIOTT, *THE PRAGMATIC REVOLT IN POLITICS* (1928); FRIEDRICH, *CONSTITUTIONAL GOVERNMENT AND POLITICS* (1928); MANNHEIM, *IDEOLOGY AND UTOPIA* (1936); PARSONS, *THE STRUCTURE OF SOCIAL ACTION* (1937).

There also may be concepts which are inconsistent with the factual criteria which they purport to embody. Such legal labels as "corporate contraction"¹⁸ or "capital asset"¹⁹ illustrate this type of mythology. Neither term has any discernible rational content and both serve almost exclusively as rationalizations for special tax advantage. There are a number of other types of legal myth to be considered as part of this analysis. Thus a concept may be so ambiguous as to be readily subject to manipulation—as witness the "property" concept. Almost anything can be labeled "property." But that may not afford a very useful guide for legal decision. Part of the stock option problem turns on the claim that an option is "property." Then, if you deal in "property," *ergo*, you get capital gains treatment. Yet once such mechanical solutions are abandoned, the problem assumes a different hue.²⁰

¹⁸ The case of *Joseph W. Imbler*, 11 T.C. 836 (1948), *acq.*, 1949-1 CUM. BULL. 2, is a primary source of the doctrine that where there is a "contraction" of a part of a corporation's business (in *Imbler* there was a fire and the insurance money was not reinvested), this is a "partial liquidation." Consequently, a distribution to the shareholders is not taxed as a dividend, even though it represents a pro rata distribution out of earnings and profits. Every dividend distribution includes some "contraction" of the corporate assets. But there is no logical relationship between whether a corporation "contracts," and whether its distributions of earnings are a dividend. *Cohen, Gelberg, Surrey, Tarleau & Warren, Corporate Liquidations Under the Internal Revenue Code of 1954*, 55 COLUM. L. REV. 37, 52, n.61 (1955): "There is grave doubt . . . whether the concept of partial liquidation in general has any sound basis." See *ALI, FEDERAL INCOME, ESTATE, & GIFT TAXATION—INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS* (1958); *Cohen, Surrey, Tarleau & Warren, A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 COLUM. L. REV. 1, 36-38 (1952).

¹⁹ See the discussion of "capital assets" in note 299 *infra*.

²⁰ A stock option represents a type of continuing relationship between a corporation and its shareholders or employees. The option holder is given the risk-free, interest-free use of the corporate capital invested in the optioned property so that he may—as dividend or compensation—take advantage of the possible future appreciation of that property. The transaction is not really closed until the option is exercised. At that point the option holder's receipt of the appreciated property represents a completed dividend or compensation. To say that the option is "property" and so to treat its original distribution as a closed event ignores the facts. The whole transaction is centered on the continuing relationship, whereby the corporation continues to hold the optioned item at its own risk while awaiting the option holder's decision. It is a continuous, but contingent, flow of value between corporation and option holder. To use a "property" approach is to emphasize the label for the transaction, rather than its factual character.

A similar comment applies to the effort to gloss over the compensatory character of an option by saying it was "intended" to provide an "incentive" to employees by giving them a "proprietary" interest. The lower courts, perhaps influenced by the fact that a bargain purchase between unrelated parties at arm's length is held not to produce income, held that an employee realized no taxable income upon the exercise of an option "intended" to give him a "proprietary" interest. *Commission v. Straus*, 208 F.2d 325 (7th Cir. 1953); *Robert A. Bowen*, 13 CCH Tax Ct. Mem. 668 (1954); *Edward Eagan*, 12 CCH Tax Ct. Mem. 876 (1953); *Donald B. Bradner*, 11 CCH Tax Ct. Mem. 566, *aff'd per curiam*, 209 F.2d 956 (6th Cir. 1953); *James M. Lamond*, 5 CCH Tax Ct. Mem. 51 (1946); *Clarence L. Landen*, 1 CCH Tax Ct. Mem. 411 (1943); *Lyon, Employee Stock Options Under the Revenue Act of 1950*, 51 COLUM. L. REV. 1 (1951). This, unfortunately, ignores the actual relationships between the parties. Similarly, a group of older cases emphasizes whether the bargain purchase was "intended" to be compensation. *Van Dusen v. Commissioner*, 166 F.2d 647 (9th Cir. 1948); *Connolly's Estate v. Commissioner*, 135 F.2d 64 (6th Cir. 1943); *Ross-*

These brief remarks afford the framework for the most basic issue posed herein—the importance of rational inquiry to the achievement and maintenance of a broad democracy and to the progressive taxation which by its ability to restrict special privilege can serve to further such a system of society.

Such a technique of rational inquiry is known in the tax area as the doctrine of substance over form. To many, the search for “substance” and for “form” has represented a deep enigma, for they have assumed that these terms concealed some type of substantive answer to the great legal questions. Thus, Judge Learned Hand, in the case of *Commissioner v. Sansome*,²¹ called the doctrine that substance rather than form should be followed “an anodyne for the pains of reasoning.” And Professor Ralph Rice suggests that cases like *Gregory v. Helvering*,²² in relying on substance rather than form, are in fact being decided primarily by epithets such as “artifice above reality” and virtually signify the abandonment of a rational approach.²³

But substance versus form is not a mere nebulous proposition as to how far the literal language of the statute should be determinative or how far certain vague concepts of the equities of the situation should rule. Substance over form is *not* a doctrine of substantive law. It does not contain explicit answers to legal questions. It is a method of approach, a way of analyzing problems in the tax area and elsewhere. Rather than legal conclusions, an approach centered on substance over form embodies the insistence that in dealing with legal controversy a basic inquiry shall be as to the relationship between the form of the

heim v. Commissioner, 92 F.2d 247 (3d Cir. 1937); Dean Babbitt, 23 T.C. 850 (1955); Charles E. Sorenson, 22 T.C. 321 (1954); Abraham Rosenberg, 20 T.C. 5 (1953), *non acq.*, 1955-1 CUM. BULL. 8; Delbert B. Geeseman, 38 B.T.A. 258 (1938). Wages are wages, and dividends are dividends, no matter how desirable the intention with which they are distributed.

When the lower courts started to force the option relationship within such labels as “proprietary option” or “property,” it took the Supreme Court to cut through the conceptual haze. *Commissioner v. LoBue*, 351 U.S. 243 (1956); *Commissioner v. Smith*, 324 U.S. 117 (1945). The Court applied the doctrine of substance over form in rejecting the “proprietary” option as a concept without meaning, and in holding that an option holder generally is taxed on the spread between the cost of an option and its value at the time of exercise. This last holding is inconsistent with a view that an option is “property.” It recognizes an option as a continuing relationship closed only at the time of exercise. But *LoBue* came too late, and *Smith* was not given adequate effect by the lower courts. (See the cases cited in note 299, *infra*). The use of stock options to convert compensation or dividends into capital gains had become well enough established so that Congress felt no hesitancy to codify this particular preferential provision. Int. Rev. Code of 1939, § 130A, added by ch. 994, § 218(a), 64 Stat. 942 (1950), as amended (now INT. REV. CODE OF 1954, § 421). See Lyon, *supra*.

²¹ 60 F.2d 931, 933 (2d Cir. 1932).

²² 293 U.S. 465 (1935).

²³ Rice, *Judicial Techniques in Combatting Tax Avoidance*, 51 MICH. L. REV. 1021 (1953).

transaction, that is, the way in which it is done, and its factual consequences.²⁴

Part of this inquiry must be into the appropriateness of applying particular legal myths to the controversy at issue. Is the concept used descriptive of what has occurred or is there a wide gulf between myth and reality—between the proclaimed principles of progressive taxation and the effective operation of the taxing process? It is at this point that the effectiveness, and the non-neutrality of substance over form becomes apparent. If a rationalization is just a rationalization it will not stand up under a piercing rational scrutiny. If, for example, a "corporate contraction" does not represent a real situation, the question becomes whom does it serve and how? Is it a mere formalism whereby corporate dividends are transmuted into capital gain?

There is another way in which a failure to apply a rational approach contributes to tax loopholes²⁵ and so to undemocratic patterns of privilege. That way lies in the impact of deviations from basic principle. If decisions in every part of the taxing process, judicial, administrative and legislative, adhere to the principle that income shall be taxed and at progressive rates to the person who earns it, there is little room for the type of tax planning that produces loopholes and so erosion. But frequently a court, an administrator or a legislator will indulge in a departure from principle—one that at the time may appear minor and innocuous. Yet it is the very fact of deviation from basic doctrine that often creates the loophole. A number of such situations are considered in this study: the early development of the "feeder" doctrine²⁶ proceeded from what, at the moment, must have seemed like a relatively trivial inconsistency in the application of a Supreme Court dictum; the unimportant seeming formalism of the "make, use, sell" formula for the patent area had ever spreading ramifications;²⁷ the doubtful logic of the "independent trustee" doctrine in the sale and lease-back area²⁸ has contributed to a spreading erosion; the aberrations of

²⁴ *E.g.*, *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Helvering v. Clifford*, 309 U.S. 331 (1940); *Griffiths v. Commissioner*, 308 U.S. 355 (1940); *Gregory v. Helvering*, 293 U.S. 465 (1935); *United States v. Phellis*, 257 U.S. 156 (1921).

²⁵ The term "loophole" is sometimes used in the narrow sense of an inadvertent oversight in the drafting of legislation. It frequently means a taxing provision of which the speaker disapproves. "Loophole" is here used to mean a taxing prescription, anywhere in the tax-decision process, which has the effect of giving a special advantage to any individual or group in a way that tends to produce a narrow, or narrower sharing of any important value. And "erosion" describes a process, of which loopholes are a symptom. See note 7 *supra*.

²⁶ Discussed at notes 225-35 *infra* and accompanying text.

²⁷ Discussed at notes 112-21 *infra* and accompanying text.

²⁸ Discussed at notes 209-12 *infra* and accompanying text.

the "bunching" doctrine in the capital gains area²⁹ built upon the foundation of what was initially a more limited inconsistency; the growing application of the "sale" concept to oil and gas transactions in which a substantial ownership interest was retained³⁰ developed from other, and more subtle inconsistencies; and so forth. In each case the pattern has been similar. A doctrine is uttered or applied in a way which by thorough-going application of substance-over-form principles would be seen to be inconsistent, and upon this inconsistency resourceful tax planners have been able to build.

This is not to suggest that form is necessarily meaningless or that differences of form may not have substantive consequences.³¹ Form is one of the important variables to be considered. But the approach called substance over form recognizes that form is only one of the variables, and that tax problems should be resolved upon all the variables and within the framework of our proclaimed principles of progressive income taxation.³²

²⁹ Discussed at notes 304-13 *infra* and accompanying text.

³⁰ Discussed at notes 96-98, 102-06 *infra* and accompanying text.

³¹ See BITTKER, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 15 (1959).

³² This discussion of substance and form has necessarily been abbreviated. Other aspects of the issues which it raises can be but briefly noted here and in note 33 *infra*. As a broad generalization, form on the one hand, and substance on the other, meet and serve two basic human desires. These are the desire for certainty and the desire for justice. Insistence on form provides a type of certainty that is helpful and useful to the conduct of business affairs. There are many areas of law where Holmes was perhaps correct, that it is better to have any rule, as long as we know what the rule is.

However, it is one thing to give weight to these considerations and another to rely upon form alone. The objection to determining the tax treatment of transactions solely by form is that too often it produces inequity. Thus, the decision in *Chamberlin v. Commissioner*, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954), by its exclusive reliance on form, may have brought certainty to the tax planner who now knew that he could distribute dividends at capital gains rates by the use of a "preferred stock bailout" (preferred shareholder "sells" to a third party, the corporation "redeeming" from the third party as part of the arrangement). But it was hardly fair to the great majority of ordinary stockholders who pay tax at ordinary rates on their dividends.

Indeed, there is grave doubt that the advantages and virtues of certainty, even if they are in fact achieved by formalism, are more important than the feeling that justice has been done. To make formal rules carrying eternal certainty was a major goal of the feudal scholasticism which was the intellectual predecessor of common-law formalism. Certainly a formal concept of contributory negligence—or the fellow servant rule—made the result of many tort cases very certain, but it was often extremely unfair to the injured plaintiff.

Furthermore, those who argue for form over substance because of the many advantages of "certainty" often overlook the fact that a formal approach to tax problems may bring only an artificial and unreal certainty. Many of the formal concepts considered in this analysis have seemed to promise a true "certainty": mathematical ratios of "debt" and "equity" indicate when there is "thin capitalization"; passage of title is a "sale"; an "assignment" but not a "license" receives capital gains treatment. But as will be shown, such certainty has often been illusory and fleeting at best, and particularly so where the certainty of such a formal concept concealed a distribution of the tax burden at odds with prevailing or proclaimed notions of justice.

In summary, it is because so many legal myths are a rationalization for particular interests, guised in the verbal claim to a broad community interest, that substance over form is so important a weapon for progressive taxation. As the detail of this study will emphasize, formalistic ways of legal analysis leave intact those legal myths that rationalize a structure of special advantage. Do we proclaim that every person shall be taxed on income earned and at the same progressive rates, and do we then indulge special preferences, shifting the tax burden in quite a different way behind a facade of legal myths? If so, the conflicting roles of formalism and of substance over form, and their relationship to tax erosion become more apparent. It is the detailed operation of this conflict that is the main thrust of this paper.³³

III. THE FOUR MAJOR FORMS OF THE BOOTSTRAP DEVICE

All of the bootstrap arrangements which we will consider pose a question of double import. First, is the transfer of ownership such as to receive tax recognition for several purposes including capital gains treatment? Second, do they make a permissible use of a source of tax-free funds? These two problems in turn depend on a complex combination of principles and analogies from several independent and major tax areas. For example, the capital gains issue turns not only upon the decisions and policies that lie behind capital gains treatment, but upon a general analysis of the transfer of ownership. This, in turn, depends upon the effect of a combination of principles, particularly the retention of risk and control, the relationship of the transaction to the accom-

³³ Just as there is an ebb and a flow in the tendency of the courts to interpret laws strictly in favor of the Government or more leniently in favor of the individual, so the application of substance over form can be seen concurrently to wax and to wane. Thus most of the significant substance-over-form decisions appear in the late thirties and the early forties (see, *e.g.*, the cases cited at note 24 *supra*), while the current tendency is to emphasize matters of form—perhaps as a product of the current inclination towards conservatism and conformity. Certainly the Commissioner has had his arguments on substance rejected by many courts in the past few years in favor of an insistence on form and on the prerogative to minimize taxes. *Casale v. Commissioner*, 247 F.2d 440 (2d Cir. 1957); *Crowell Land & Mineral Corp. v. Commissioner*, 242 F.2d 864 (5th Cir. 1957); *Commissioner v. Gross*, 236 F.2d 612 (2d Cir. 1956); *McNamara v. Commissioner*, 210 F.2d 505 (7th Cir. 1954); *Chamberlin v. Commissioner*, 207 F.2d 462 (6th Cir. 1953); *C. F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951); *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947); *John Wanamaker (Philadelphia) v. Commissioner*, 139 F.2d 644 (3d Cir. 1943).

The doctrines most commonly used to stave off an analysis based on substance include the proposition that every taxpayer has a "right to minimize his taxes by every legal means," and corollary to that, that "avoidance" but not "evasion" is permissible. Similarly, the courts which wish to rely on form frequently inquire whether the taxpayer has a "dominant or principal purpose to avoid taxes." Or the argument may be advanced that the form of a transaction, or the amount of tax minimization involved, is permissible as long as there is no "sham" or "lack of bona fides" present. The practical functioning of such doctrines to defeat substance over form and so to further tax erosion is a key part of the present analysis.

panying use of a charitable exemption or loss carryover, and the application of the basic doctrine of substance over form. And the effect of the retention of risk, or of retention of control, in turn is illustrated by major doctrines within each of those areas such as the economic interest doctrine (retention of risk) or sale and leasebacks (retention of control).

But to trace these doctrines and analogies back through the several areas is to discover that not only do the "original" bootstrap decisions deviate from certain basic tax principles, but that those very principles have been subjected to a similar process of erosion, which contributed significantly to the bootstrap results. For example, the original bootstrap decisions fail to follow the supposedly basic doctrine that capital gains treatment is not extended to the recurrent receipt of ordinary business income. But when the relevant areas are examined it is seen that such proclaimed doctrines themselves have been substantially eroded.

The Original Bootstraps

Owner owns a going business whose transfer Owner negotiates with Charity, an organization exempt under section 101(6) of the 1939 Code.³⁴ Charity, usually an independent and reputable public charity, is to acquire the business at little or no cost and with no personal liability for any business risks.³⁵ Charity does not wish to be associated in the public mind with the operation of the competitive business acquired. Such an operation may also on occasion be prohibited by the terms of the Charity's charter. The solution is to employ Feeder, an intermediary corporation, usually organized either by Owner or by a group of friends of Charity. Feeder's charter ordinarily provides that its funds go only to Charity or to "charitable purposes," in the expectation that the business income will be held exempt under section 101(6).

The actual "purchase" is made by Feeder who may contract to acquire a business for a price as high as twenty or thirty million dollars, while having as assets equity capital of only a thousand dollars. Not only does Feeder lack substantial assets, but Charity does not assume liability for any of the obligations due to Owner. Feeder purchases the stock of the corporation which ran the old business with a down pay-

³⁴ Ch. 1, 53 Stat. 33, as amended (now 1954 Code, § 501(c)(3)).

³⁵ In ASS'N OF AMERICAN UNIVERSITIES, REPORT OF THE COMMITTEE ON FINANCIAL SUPPORT AND TAXATION 3 (1950), it is stated "Few boards of trustees of a university would be willing to accept the liability which would be involved in such business enterprises were they to be owned directly by the university, rather than by a separate corporation or foundation." Accord, Statement of Stuart Hedden, Trustee of Wesleyan College, *Hearings on H.R. 8920 Before the Senate Committee on Finance*, 81st Cong., 2d Sess. 567 (1950). See Comment, 60 YALE L.J. 851 (1951).

ment which is an unsubstantial percentage of the total price, often being under ten per cent. The purchase price is usually considerably in excess of fair market value, although valuation problems often make that difficult to prove. Even if valuation is based on a price-earnings ratio as of the time of the transaction, it is difficult to prove in the case of a closely held business.

Owner receives "notes" (or "bonds") payable over a ten to twenty-year period for the balance of the "purchase" price. The notes do not provide expressly that they shall be paid only from income if, as and when earned, but ordinarily no other source of payment is available. Frequently, almost all of the income from the business goes to Owner in the form of payments on the notes with little or nothing being paid immediately to Charity, although Charity through its ownership of Feeder will accumulate a substantial equity via the payments on the notes, if the price does not prove too large. The payments on the notes are directly related to the fortunes of the business, and in cases where the business does better than expected it may prove possible to pay off the notes.³⁶ But where the risks of the business prove excessive, the transaction may collapse with little or no principal payment on the notes.³⁷

Usually Owner retains some control with respect to the operation of the business. The control may be limited to a contractual permission to continue management of the business or may extend to fairly extensive control of Feeder. And Owner may recapture the business if its profits do not prove sufficient to make the agreed payments.

This is a very pleasant arrangement for Owner and Charity. Charity puts in no money and takes no risk, yet it gets from the start such portion of the business' income as is left over after Owner receives his annual payments on the notes and, when the notes are eventually paid, Charity, who holds Feeder's stock, will own the business. Owner usually receives a higher price than an ordinary business purchaser would pay, has this inflated obligation repaid out of tax-free income without having fundamentally changed his economic relationship to the business, and reports the payments as capital gains rather than ordinary income. Is this then that rarest of all transactions, a deal in which everyone gains and no one has to pay the fiddler?

Charity apparently contributes nothing, not even the use of its name. Why then is Owner willing to make such a deal? Why use Charity at all? The answer clearly is not that Owner is making a gift

³⁶ *E.g.*, *Knapp Bros. Shoe Mfg. Corp. v. United States*, 142 F. Supp. 899 (Ct. Cl. 1956).

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

to Charity. The careful planning of these deals and this analysis of their actual consequences makes it quite apparent that they involve a deliberately planned *quid pro quo*. What is this *quid pro quo* that Charity contributes?

In effect Charity is selling a portion of its tax exemption. That is particularly apparent where an excessive price can be proved to the court. Of course, the income available to pay the notes is much larger if it is tax-free, and the high price was set because it was anticipated that Feeder would be held exempt by virtue of nominally paying its income over to Charity. Even where an excessive price cannot be proved, there is the very substantial advantage of more secure and more rapid payment of the notes out of tax-free income. During the whole period of the pay-off to Owner, funds which were given tax exemption so that they could be used for charitable and public purposes are going directly into Owner's pocket. And the tax advantages of having made a "sale" are granted on the assumption that there has been a substantial present change in Owner's economic relationship to the business. But Owner continues to run the business and to receive its profits much as he always did. In brief, it can only be the public who ultimately pays for the pleasant arrangement between Charity and Owner.

The "Lease" Bootstraps

The amendments to the 1939 Code contained in the Revenue Act of 1950 made it more difficult to use the "feeders" basic to the original bootstrap device. Furthermore, some charities already had subsidiary feeder corporations with substantial business assets and did not wish to expose these assets to the risks of the newly acquired business.

In order to meet these problems, Owner "sells" the business to Feeder through use of the lease type of bootstrap. Charity owns Feeder's voting stock. Since Feeder does not desire to issue notes on which it would be liable, the contract must make explicit the same lack of an independent purchase commitment that is achieved by the transfer to an assetless purchaser in the original bootstrap cases. Therefore, Feeder assumes no personal obligation to pay the price. Instead the sale contract in the lease bootstrap provides that Owner shall receive x percentage of the net profits of the business (usually as high as eighty or ninety per cent) until the price is met.

To avoid other portions of the 1950 legislation Feeder does not operate the business directly. Instead, after acquiring the business, Feeder immediately leases it for five years or less to New Company, another corporation, New Company often being directly or indirectly

controlled by the original owner. As "rental" under that lease, Feeder usually receives eighty or ninety per cent of the net profits from which Feeder pays over the stipulated percentage to Owner. The effect of this is to split off the operations of the business, which New Company handles, from its income, which Feeder retains in the form of "rent" from the lease.

These transactions, if accepted at their face value, have the same substantial advantages for their participants as the original bootstraps: retained ownership, capital gains treatment for the income from the business, an inflated price, and the security and advantage of the use of tax exemption. Their form—the short-term rental—is tailored to take advantage of certain loopholes in the 1950 Revenue Act.³⁸

The "Cemetery" Bootstraps

The simplest, and perhaps crudest, form of the bootstrap techniques considered here is that employed in the transfer of a profit cemetery to a nonprofit cemetery. Here no feeder or intermediate corporation is employed. Owners of profit cemeteries organize new nonprofit cemetery companies. Despite a lack of capital or assets, these new companies "purchase" the stock of the old profit business from Owners at prices ranging from several hundred thousand dollars to several million dollars, and often in excess of fair market value. Long term "notes" payable out of income from the cemetery operations are issued in payment to Owners. Owners retain full control over operation of the cemetery through control of the board of directors of the new corporation, or otherwise.

The new cemetery companies frequently operate a number of profit operations, such as mortuaries, the sale of crypts or flower sales. Since the provisions of the "unrelated business income tax" ³⁹ do not apply to them, they can engage in a range of such commercial activities, limited only by the outer extreme at which the courts will hold that their activities are predominantly commercial rather than nonprofit. Sometimes the old Owners also personally operate commercial activities—a mortuary, for example, or an insurance business (covering burial expenses)—in very close relationship to the cemetery. They may employ the same bookkeepers and salesmen and even engage in joint advertising. Thus the "nonprofit" cemetery often is the center of an elaborate commercial operation, diverting profits to the original owners in the ways peculiar to the bootstrap technique.

³⁸ See notes 272-81 *infra* and accompanying text.

³⁹ Discussed at notes 254-59 *infra* and accompanying text.

The "Loss" Bootstraps

The loss bootstrap differs from the earlier forms.⁴⁰ Its source of tax-free funds is net operating losses. While it uses a thinly capitalized, newly formed corporation to acquire the old (profit) business, it applies the losses to the acquired business not through a feeder, or a rental arrangement, but by affiliating the profit business with a consolidated group of loss companies who apply their losses and loss carry-overs against its profits. But the "bootstrap" features are the same as with the earlier cases. That is, the old Owners keep substantial control over the profit business and, having no independent source of payment, retain the essential risks of the business.

IV. THE ORIGINAL BOOTSTRAP DECISIONS

Technically there were only two questions before the courts in these bootstrap cases: (1) Are the original owners of the business entitled to capital gains treatment upon its "sale"? (2) Is Feeder entitled to exemption from tax under section 101(6) of the 1939 Code? These issues are interrelated. They involve a complex combination of other legal questions, the most difficult of which is central to both: should the transfer be treated as a "sale" for tax purposes?

The traditional common-law approach is to insist that there is a legal label available for every transaction. If one takes this view, then a bootstrap transfer either is a "sale" or else "no sale" has occurred and the transaction will be disregarded. This approach has several disadvantages. If you say there has been a "sale" you are confronted by the fact that Owner has retained so much of the ownership of the business—both its control and its risks—that he has in substance kept much the same economic relationship to the business that he had before the transaction. On the other hand, if you conclude that it is "not a sale," you are confronted by the fact that legal title has been transferred and that Owner will eventually yield all his interest in the business.

The transaction, indeed, is not a "sham," but neither is it the traditional sale which the formal documents and the bare passage of title might indicate. There has been a genuine transfer of the business operations to Feeder. This will ordinarily be true even where the price is inflated, for an excessive price does not necessarily show that no transaction occurred, but rather that Owner has assured himself retention of the profits of the business for a considerable period.

⁴⁰ This form of the bootstrap will be considered in detail in Part II to be published in a forthcoming issue.

Caldwell and Kolkey

The first bootstrap case to be litigated, *D.K. Caldwell v. Campbell*,⁴¹ involved an income asset (oil and gas interests) other than an active business and consequently does not follow at all points the general format sketched above. Owner sold some oil and gas interests ("carved out" oil payments) for more than \$1,000,000 to his controlled foundation, Feeder, which had total assets of \$14,000. The downpayment was \$3,400 and the balance was given in notes to be paid over a ten-year period. The issue was whether this sale to a penniless, controlled charitable foundation was entitled to capital gains treatment. The district court held that this "sale" was not a "bona fide" transaction. At the same time the court also, and inconsistently, (if the sale is to be disregarded as "sham") held Owner taxable on the market value of the notes at the time of their receipt. The majority decision in the Fifth Circuit cited the Commissioner's brief: " 'Obviously here is a case of a taxpayer trying to use, the exempt status of a charitable foundation which he controlled, the capital gains and the installment sale provisions of the revenue laws for his personal profit.' " ⁴² But the court held that this argument had no merit, approved the transaction as not a sham, and granted capital gains installment sale treatment.

The Commissioner's basic test case in the area, and the only decision he has won, is *Emanuel N. Kolkey*.⁴³ Here a reducing pill business was "sold" for \$4,000,000 to Feeder, a new corporation with assets of only \$1,000. Of this price, \$400,000 was a downpayment obtained by drawing cash from the old business and pledging its assets. The balance of the price was represented by notes to be paid over a period of years. The old Owners kept full control and management of the business. Charity received a total of only about \$43,000 from the entire transaction. The income of the business declined sharply, and after about a year Charity sold its stock in Feeder back to Owners for \$5,000. Owners then purported to turn the stock over to a nonexistent charitable trust, and later did turn it over to a trust with nominal activities, the trust being controlled by Owners. Meanwhile, Feeder paid a number of personal expenses for Owners. Within two years, two of the Owners purchased the notes held by the third for less than two cents on the dollar. Judge Pierce of the Tax Court found that the fair market value of the old business was only about \$1,100,000 and that the notes were really equity capital—treating the transfer to so thinly capitalized a

⁴¹ 218 F.2d 567 (5th Cir. 1955).

⁴² *Id.* at 570.

⁴³ 27 T.C. 37 (1956), *aff'd*, 254 F.2d 51 (7th Cir. 1958).

corporation (\$1,000 in stock, \$3,600,000 in notes) as being the equivalent of a sale for \$4,000,000 to a "penniless individual."⁴⁴ He emphasized substance over form, the lack of new capital or new management, the retention of control and risk, the absence of effort to enforce the notes on default, and the inflated price, and treated the \$400,000 down payment as a dividend to Owners, rejecting the capital gains argument. On the exemption side he emphasized Feeder's commercial activities, the fact that Owners had an equity rather than a creditor relationship to Feeder, and that Feeder's dominant purpose was to inure most of the income of the business to Owners.

Kolkey does have some elements of non-bona fides not found in the other cases. These include, in addition to the court's finding of excessive price, the doubtful nature of the particular reducing pill business involved, the sham character of the trusts set up after the original transaction collapsed, and some of the direct acts of private inurement committed after the original, and reputable, charity had exited. Nevertheless, *Kolkey* was not a "sham," at least prior to the recapture of the business, and the Tax Court opinion does not so treat it. Judge Pierce's decision represents the only judicial effort⁴⁵ to date to examine what, it is suggested, are the realities of these transactions. The Seventh Circuit affirmed in a brief opinion⁴⁶ stressing retention of ownership and income, but also questioning the arm's-length character of the transaction.⁴⁷

The Issues in the Other Cases

With the exception of *Caldwell*, the factual pattern of the original bootstrap cases is that described at the outset of this Article.⁴⁸ Indeed, the *Kolkey* transfer was copied from the plan used in *Knapp Bros.*,⁴⁹

⁴⁴ 27 T.C. at 60.

⁴⁵ Excepting Judge Pierce's dissent, joined by several other judges, in *Ohio Furnace Co.*, 25 T.C. 179 (1955) (*gov't appeal withdrawn*).

⁴⁶ 254 F.2d 51 (7th Cir. 1958).

⁴⁷ *Kolkey* also raises a more subtle issue. It held the downpayment taken out of the old business to be a dividend. This is essentially sound. However, Owner is not literally a "shareholder," nor are the periodic payments literally "dividends," particularly in the lease-type bootstraps which lack "notes" to be called "stock." The distributions are more accurately described as ordinary income under INT. REV. CODE OF 1954, § 61(a). They represent Owner's beneficial share in the profits of the business. And even if a new corporation, with no earnings and profits, is included in the transaction in such a way as not to inherit the earnings and profits of the old business, the payments are no more capital gains "distributions" under § 301(c) than they are "sales" under § 1222.

⁴⁸ See text accompanying notes 34-37 *supra*.

⁴⁹ *Knapp Bros. Shoe Mfg. Corp. v. United States*, 142 F. Supp. 899 (Ct. Cl. 1956).

*Howes' Estate*⁵⁰ and *Truschel*.⁵¹ *Ohio Furnace*⁵² added only the minor variant of a new corporation to operate the business, with its stock held by Feeder. These cases can be grouped to illustrate the principal issues which arise.

The Determination of Fair Market Value

The only bootstrap case in which a court made the finding that the purchase price was in excess of fair market value was *Kolkey*. There the business income declined sharply and Owners recaptured the notes without being paid (other than the downpayment). In *Knapp Bros.*, on the other hand, a shoe business was sold for a price that at the time of the transaction appeared by normal valuation standards to be inflated, according to the Government's expert witnesses. But there was a boom in the shoe business, and the price was paid off years ahead of the date the notes were due. The Court of Claims emphasized these events, which had occurred after the transaction, in making its finding of fair market value a central element of its holding that the *Knapp* Feeder was exempt.

In *Howes' Estate* (and *Truschel*), the income of the leather business involved declined after the transaction, some of the "bonds" being sold on the market a few years later at only 30 per cent of their face value. But the hindsight which had enabled the Court of Claims to find for the taxpayer in *Knapp* was strangely lacking in *Howes' Estate*. This was abetted by the refusal of the top experts in the leather industry to testify for the Government as to fair market value, compelling resort to industry witnesses who were less qualified, and who were quickly shaken on the stand by the court's hostile questioning.

In *Ohio Furnace*, Judge Pierce's dissent made it clear, not only that there was no factual basis for the majority's finding of fair market value, but that the Government had apparently not investigated nor presented the facts as to value, no balance sheets, earnings statements, or appraisals being offered in evidence.

The decisions in *Howes' Estate* and *Truschel*, which came after *Kolkey*, distinguish it as a "sham," emphasizing the court's finding of an excessive price. But those decisions, as well as *Ohio Furnace*, are on shaky ground where fair market value is concerned. This inference is supported by the testimony of Government expert witnesses in each

⁵⁰ *Estate of Howes*, 30 T.C. 909 (1958), *aff'd sub nom.* *Commissioner v. Johnson*, 267 F.2d 382 (1st Cir. 1959).

⁵¹ *W. H. Truschel*, 29 T.C. 433 (1957), *order amended*, 17 CCH Tax Ct. Mem. 110 (1957).

⁵² *Ohio Furnace Co.*, 25 T.C. 179 (1955) (*gov't appeal withdrawn*).

litigated bootstrap case (other than *Ohio Furnace*) based on an appraisal of the price-earnings ratio at the time of the transaction. Perhaps more significantly, it is supported by the fact that the price was not determined by normal bargaining in any bootstrap case, inasmuch as Charity, which paid nothing and took no risks, lacked bargaining power. The effort to distinguish *Kolkey* from the other bootstrap decisions on the grounds of its excessive price would appear therefore to lack an adequate factual basis.

The Retention of Risk

In every case the old business was purchased by a Feeder with no substantial assets of its own, who issued "notes" or "bonds" in face amounts many thousand times its meagre capital. The "thin capitalization" doctrine⁵³ has been applied in many cases where the ratios were far less than 100 to 1.⁵⁴ But the bootstrap decisions used the highly formal argument that Owners were not literally "stockholders" to reject application of the doctrine. They refused to treat the "notes" as "stock," even though, in fact, Owners had retained a degree of ownership higher than that normally held by stockholders, and they ignored the fact that *Kolkey* had extended the thin capitalization doctrine to similar "creditors" in a similar situation.

The Retention of Control

In each of the original bootstraps except *Ohio Furnace*, owners continued to control and manage the business much as they had always done; and in the latter, though less active, they retained substantial control.⁵⁵ Control was strengthened in each case by similar provisions providing for recapture of the business in the event of default. No court (except *Kolkey*) attached much weight to this.

Distributions to Charity and Other Exemption Issues

In *Knapp Bros.* and *Ohio Furnace*, no distributions were made to Charity during the years in question. In *Howes' Estate* and *Truschel*,

⁵³ See text accompanying notes 122-62 *infra*.

⁵⁴ Caplin, *The Caloric Count of a Thin Incorporation*, N.Y.U. 17TH INST. ON FED. TAX 771 (1959), contains a detailed briefing of the arithmetic ratios found in many cases.

⁵⁵ The former Owners in *Ohio Furnace* had the power, until payment was completed, to name $\frac{3}{4}$ of the members of the board of directors. More significantly, the company officers and the active manager were to be persons acceptable to Owners. This must be read in light of the fact that the contract originally provided for Owners to remain active managers of the business, but was modified in an apparent effort to gain the approval of the Internal Revenue Service. Two of the Owners were officers of the business, though at no compensation. The Owners also were officers of the *A Furnace Company*, a manufacturing firm which was the source of supply for the business. (The business held a franchise from *A* for the distribution of its furnaces in Ohio.)

the basic bootstrap transfer occurred in 1947. Annual distributions of about 10 per cent of the income of the business were made to Charity from 1947 to 1951, no payments being made between 1951 and the dates of decision in the two cases (1958 and 1957). Yet, the bootstrap cases (other than *Kolkey*) ignored the inurement in fact of the business income to Owners,⁵⁶ holding that Owners were receiving mere "purchase price payments" as the by-product of a "sale." The "unreasonable accumulation" ⁵⁷ which resulted from the fact that the income from the business went not to the charitable purposes whose existence supposedly justified tax exemption, but was "accumulated" in the form of Charity's increasing "equity," was similarly ignored. The court in *Ohio Furnace* stated: "We know of no case . . . denied exempt status merely because it accumulated its income for distribution in a succeeding or later year. . . ." ⁵⁸

Section 302(d) of the 1950 Revenue Act

Knapp Bros., *Howes' Estate* and *Ohio Furnace* all rely upon Section 302(d) of the Revenue Act of 1950, in upholding a charitable exemption for Feeder. Subsection (d) was added to section 302 by the Revenue Act of 1951 ⁵⁹ so as to insulate certain organizations from the provisions of Section 301(b) eliminating the exemption for charitable "feeders" which the courts had created by the so-called "destination test."

However, since section 302(d) requires all of the feeder's earnings to inure to a specified type of organization, and as Charity in *Knapp Bros.* and *Ohio Furnace* got no distributions from Feeder during the years in question, and in *Howes' Estate* (and *Truschel*) received only a small percentage of the income, and that only in some years, this holding is not easy to rationalize. This is especially so in view of the legislative history of section 302(d), which reveals a purpose to protect organizations which had received funds from a feeder and spent them in reliance on the feeder's being held exempt under the judicial "destination test." ⁶⁰ This could not have occurred in *Knapp* or *Ohio Furnace*, where nothing had been received. Nor is there anything to indicate

⁵⁶ See text accompanying notes 240-47 *infra*.

⁵⁷ See text accompanying notes 260-71 *infra*.

⁵⁸ 25 T.C. at 190.

⁵⁹ Ch. 521, § 601, 65 Stat. 562.

⁶⁰ H.R. CONF. REP. No. 3124, 81st Cong., 2d Sess. 35 (1950), states this intention. Section 601 of the 1951 Revenue Act was passed to carry it out by adding § 302(d), according to H.R. REP. No. 586, 82d Cong., 1st Sess. 35 (1951); S. REP. No. 781, 82d Cong., 1st Sess. 29 (1951).

that section 302(d) was intended to eliminate the requirement that there be no "private inurement" of exempted funds.⁶¹

Use of the "Sale" or "No Sale" Approach

All of the bootstrap cases except *Kolkey* frame the issue as "sale" or "no sale." This can give a realistic answer only in the rare situation (such as *Caldwell*) where there is so much evidence of bad faith, and so little evidence of any real transfer, that the transaction really is a "sham." In any other situation, to state the question as "sale" or "no sale" prevents analysis of the substance of the transaction, and pre-judges it along conceptual lines. Thus, the degree of tax erosion which these cases represent has a significant correlation with their emphasis upon formalistic approaches.

If the statutory standard for capital gains taxation, *i.e.*, a "sale or exchange"⁶² is to be taken seriously, then it must be read to require a commercially meaningful transfer of ownership. It is difficult to say that such a transfer has occurred if the original owners, by keeping control of the business and ability to benefit by its profits, have retained essentially the same economic relationship to it that they had before the transaction. The fact that they may eventually yield that ownership does not warrant the same tax treatment as if they had already transferred ownership. It is equally decisive for purposes of the charitable exemption statutes whether Owner is receiving "purchase price payments" as a creditor or is still so involved in the operation and success of the business that the payments are essentially a "return of profits." In the latter event there will be "private inurement" of the income of the business, a fact which the statute⁶³ declares to be fatal to tax exemption.

If the conclusion is accepted that the transaction, even though not a complete "sham," ought not be recognized as a "sale" for tax purposes, and that Owners' receipts should be treated as ordinary income, how shall Owner be given appropriate tax recognition for the cost basis of his investment? In most of the bootstrap cases there will be an eventual transfer-over of ownership when the payments are completed. Therefore, Owners would appear entitled to the recovery of their cost basis in view of the principles spelled out in decisions such as *Eisner v. Macomber*.⁶⁴ Perhaps the easiest and most acceptable method of treat-

⁶¹ Int. Rev. Code of 1939, § 101(6), ch. 1, 53 Stat. 33, as amended (now INT. REV. CODE OF 1954, § 501(c)(3)).

⁶² Int. Rev. Code of 1939, § 117(a), ch. 1, 53 Stat. 50, as amended (now INT. REV. CODE OF 1954, § 1222).

⁶³ Int. Rev. Code of 1939, § 101(6), ch. 1, 53 Stat. 33, as amended.

⁶⁴ 252 U.S. 189 (1920).

ing Owners' basis is to permit it to be amortized over the combined downpayment and periodic payments. While there is no statutory authority, amortization seems more satisfactory than compelling Owner to wait for the recovery of his basis until the ultimate transfer-over is completed.⁶⁵ This combination of ordinary income treatment and recovery of basis is a recognition of the hybrid character of these transactions, and of the fact that they include a type of "sale" element.

Institutional Factors Involved

Several aspects of these cases reflect the institutional nature of the taxing process. In *Knapp Bros.*, the Justice Department based its argument primarily on the lack of a fair market value. Yet the boom in the shoe business which had started right after the transaction and had resulted in the notes being paid off years early made this a futile line of approach. The error is in part explained by inadequate correlation of the work of Internal Revenue and Justice. To this element of the *Knapp* case must be coupled the advantage to taxpayers who can afford to pay their tax in advance of being able to invoke the refund jurisdiction of the less expert, and more sympathetic, Court of Claims.

Some of the Commissioner's mis-steps in the bootstrap litigation reflect a lack of administrative coordination that may be attributable to excessive decentralization. In *Ohio Furnace*, the Commissioner failed even to inquire into the important issue of fair market value. Similarly, the Commissioner's argument in *Truschel* centered on the relatively ineffective, and somewhat formal claim that a bootstrap transaction is a "reorganization"⁶⁶ and that the downpayment is "boot." Inadequate emphasis was placed on the broad substance over form approach of *Kolkey*. And although *Kolkey* was obviously a test case for the area, *Ohio Furnace* was permitted to come to trial first, and without the extensive preparation which *Kolkey* received.

The Relationship Between the Bootstrap Decisions and Basic Tax Principles

A number of supposedly basic income tax doctrines are at issue in the charitable bootstrap cases:

⁶⁵ Although it might also be argued that Owner should be able to treat the first payments received as recovery of his basis on the authority of *Burnet v. Logan*, 283 U.S. 404 (1931), that case is both doubtful authority, and of doubtful relevance here. *Logan* was essentially based on the uncertainty of various types of engineering estimates, a premise that is no longer factually sound. It is difficult to see why Owner's basis must be recovered first in a lump sum, since he can be permitted to recover it proportionately over the income received.

⁶⁶ The reorganization approach is considered in some detail at text accompanying notes 163-65 *infra*.

(1) Exemption from taxation is reserved for organizations and funds which are devoted primarily to public purposes,⁶⁷ and is denied (a) if organizations or funds are devoted primarily or significantly to private purposes,⁶⁸ (b) if organizations are operated on a commercial basis in competition with ordinary business,⁶⁹ or (c) if funds are unreasonably accumulated without being currently used for public purposes.⁷⁰

(2) A "sale" for capital gains purposes is not satisfied by the bare transfer of legal title but requires a meaningful economic transfer,⁷¹ and such a meaningful transfer has not occurred where the former owner continues to (a) control the business,⁷² or (b) assume the risk of the business' profits and losses,⁷³ and certainly not where Owner keeps both control and risk.⁷⁴

(3) Capital gains treatment is particularly intended to apply to transfers of "investment" type assets and to prevent the bunching up in one year, at progressive rates, of income earned over a number of years.⁷⁵ Or conversely, capital gains treatment is not appropriate for the recurrent receipt of commercial or business income, particularly where the recipient is in an entrepreneurial or proprietary relationship to the income source.⁷⁶

(4) In determining the tax consequences of a transaction its mere form cannot be made to control, but the full factual nature and economic significance of what occurred, including the relationships between the parties, will be taken into account.⁷⁷

⁶⁷ See Int. Rev. Code of 1939, § 101(6), ch. 1, 53 Stat. 33, as amended; *Better Business Bureau, Inc. v. United States*, 326 U.S. 279 (1945).

⁶⁸ Int. Rev. Code of 1939, § 101(6), ch. 1, 53 Stat. 33, as amended; *Universal Oil Prods. Co. v. Campbell*, 181 F.2d 451 (7th Cir.), *cert. denied*, 340 U.S. 850 (1950).

⁶⁹ See *Better Business Bureau, Inc. v. United States*, 326 U.S. 279 (1945); *United States v. Community Servs., Inc.*, 189 F.2d 421 (4th Cir. 1951), *cert. denied*, 342 U.S. 932 (1952).

⁷⁰ Int. Rev. Code of 1939, § 3814, added by ch. 994, § 331, 64 Stat. 957 (1950) (now INT. REV. CODE OF 1954, § 504); Rev. Rul. 54-420, 1954-2 CUM. BULL. 128.

⁷¹ See *Burnet v. Harmel*, 287 U.S. 103 (1932); *Corliss v. Bowers*, 281 U.S. 376 (1930); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952).

⁷² See *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Clifford*, 309 U.S. 331 (1940).

⁷³ See *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956); *Gooding Amusement Co.*, 23 T.C. 408 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956).

⁷⁴ See *Emanuel N. Kolkey*, 27 T.C. 37 (1956), *aff'd*, 254 F.2d 51 (7th Cir. 1958).

⁷⁵ See *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958); *Burnet v. Harmel*, 287 U.S. 103 (1932).

⁷⁶ See *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956); *Bloch v. United States*, 200 F.2d 63 (2d Cir. 1952), *cert. denied*, 345 U.S. 935 (1953).

⁷⁷ See *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958); *Gregory v. Helvering*, 293 U.S. 465 (1935).

One might expect the violation of any one of these supposedly basic principles to be fatal to a taxpayer's case. Yet even when the original bootstrap deals transgressed them all the Commissioner did not prevail, except in *Kolkey*. What is the significance of this failure by a number of courts to observe what seem to be basic principles? Are the bootstrap cases unique in this respect? Are these principles given effect generally? Or are they mere tax myths, proclaimed but not practiced? In order to seek some of the answers to some of these questions, the effectiveness of these basic principles will be examined in other contexts.

V. "SALES" AND THE RETENTION OF OWNERSHIP

There is one other formal assumption concealed in an approach based on "sale" or "no sale." This is the insistence that a transaction be analyzed solely from the standpoint of the initial transfer. If this original event is classified as a "sale," then the prevailing judicial use of legal concepts requires all subsequent receipts to be treated as sale receipts, no matter what the recipient's actual relationship to the business and the nature of those receipts. And to ask "sale or no sale," also assumes that ownership is unitary, that any transfer of ownership necessarily transfers all the aspects of ownership. But where the multiple incidents of ownership are recognized and where a transfer may include some but not all of them, thinking habits which require that an entire transaction be fitted within a single label are no longer adequate.

Transactions which, like the bootstraps, seek to achieve a sufficient transfer of the business so that Owners will not be treated as owners for tax purposes, while retaining for Owners the enjoyment of the primary incidents of ownership, take their root in these conceptual approaches. To inquire whether the former owner retains the basic entrepreneurial attributes of risk and control seems both more realistic, and more decisive, than whether title has passed, words of sale were used, or the transaction otherwise fits within the label of a common-law "sale."⁷⁸

⁷⁸ See *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Clifford*, 309 U.S. 331 (1940); *Burnet v. Harmel*, 287 U.S. 103 (1932); *Corliss v. Bowers*, 281 U.S. 376 (1930); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952). See also Corbin, *The Uniform Commercial Code—Sales; Should It Be Enacted?*, 59 YALE L.J. 821, 827 (1950): The Uniform Sales Act and the Uniform Commercial Code "differ primarily in this, that the Code everywhere puts more emphasis upon the operative facts on which stated legal results depend and warns us that those legal results are not determined by such undefined concepts as 'title' or 'property in the goods.' By such emphasis and warning, the attention of both merchant and lawyer are focussed on the vitally important factors and not on the undefined and inoperative concepts."

The real nature of Owner's relationship to the business after the transaction must be explored. Is it a basic principle that retention of the risks of the business or retention of control or both will be treated as ownership for tax purposes? And are such principles effectively applied by the taxing process?

Retention of Risk

Several major lines of cases deal with the effects of retention of risk in ways that appear to be related or analogous to the bootstrap problem. These include the "economic interest" cases in the natural resources area, the cases in which an effort is made to apply economic interest principles of retention of risk to the transfer of patent rights, and the "thin capitalization" cases. Furthermore, the effort to apply "reorganization" doctrines to the bootstrap transactions rests, in part, on similar principles.

The Economic Interest Doctrine

The primary function of the "economic interest" concept⁷⁹ has been to determine who possesses such an ownership interest with respect to a wasting natural resource as to be entitled to cost or percentage depletion.⁸⁰ Since the essential rationalization for percentage depletion has been stated in terms of furnishing an "incentive" to the risk-taking entrepreneur in the natural resources field,⁸¹ the concept may be particularly relevant to the ownership implications of the retention of risk.⁸²

⁷⁹ See BREEDING & BURTON, *TAXATION OF OIL AND GAS INCOME* (1954); MILLER, *OIL AND GAS; FEDERAL INCOME TAXATION* (3d ed. 1957); Baker, *The Nature of Depletable Income*, 7 TAX L. REV. 267 (1952); Rowen, *Introduction to Oil and Gas Interests*, 34 TAXES 19 (1956); Sneed, *The Economic Interest—An Expanding Concept*, 35 TEXAS L. REV. 307 (1957).

⁸⁰ The doctrine has been developed primarily in the oil and gas cases, but is equally applicable to other types of natural resources such as coal or sulphur. Sneed, *supra* note 79, at 308. The group of Supreme Court decisions in *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958), included a sulphur case in its holding that "sales" of "carved out" production payments result in depletable ordinary income, and the strip mining cases apply economic interest concepts to coal, G.C.M. 26290, 1950-1 CUM. BULL. 42, 44.

⁸¹ Baker & Griswold, *Percentage Depletion, A Correspondence*, 1955 COMPENDIUM 877; Gonzales, *Percentage Depletion for Petroleum Production*, 1959-2 TAX REVISION COMPENDIUM 985; Lambert, *Percentage Depletion and Exploration and Development Costs*, 1959-2 TAX REVISION COMPENDIUM 1009; Lambert, *Percentage Depletion and the National Interest*, 1955 COMPENDIUM 449; Smith, *Tax Policy as Reflected in Statutory Percentage Depletion for Oil and Gas*, 1955 COMPENDIUM 484; Stanley, *The Independent Producer's Position*, 1955 COMPENDIUM 474.

⁸² This discussion is directed only at some of the more general implications of the economic interest doctrine. Its more technical aspects are considered by the materials cited in note 79 *supra*.

In natural resource law the line between a "sale" and a "lease" is often obscure, resembling the "sale or no sale" dilemma of the bootstrap. Until very recently,⁸³ the economic interest concept has served to distinguish "sale" from "lease," thereby determining both that the possessor of an economic interest is entitled to depletion, and that his income is ordinary income rather than capital gains.

The Oil and Gas Lease

The typical oil and gas lease involves a transaction in which the landowner conveys rights to explore for and develop mineral property in return for a cash downpayment, called a "bonus," and either a retained "royalty" or a "production payment" or both. A royalty is the right to receive a certain percentage of the proceeds of mineral exploitation, usually a one-eighth interest. A production payment (or "in-oil payment" as it is sometimes called) is the right to receive a specified amount out of a certain fraction of production, for example, "\$1,000,000 out of the first $\frac{5}{8}$ of oil and gas produced and saved." Unlike the royalty holder, the interest of the holder of a production payment will ordinarily terminate before the end of the particular oil and gas lease.

Burnet v. Harmel and Palmer v. Bender

In *Burnet v. Harmel*,⁸⁴ *S*, the owner of oil lands, leased them to *F* for cash bonus payments and royalties measured by production. The Supreme Court denied capital gains for the bonuses, commenting that with every oil lease ownership of the oil passes from *S* to *F* at some time, *S* being compensated by the payments. The Court pointed out that to tax *S* at ordinary income rates does not involve the hardship of "bunching" of income at progressive rates that the capital gains provisions of the 1921 Revenue Act were aimed at, for extraction of oil takes time, and payments are not usually made in just one year. The broad principle stated by *Harmel* is that even though a particular transfer is called (or held by state law to be⁸⁵) a "sale," the fact that the owner's income is dependent on production and comes to him recurrently over a period of more than one year, means that the owner has retained a sufficient "economic interest" in the oil and gas in place, so that capital gains treatment is inappropriate even for the initial cash bonus. The inference is that Owner has retained the entrepreneurial risks of the business.

⁸³ See *Crowell Land & Mineral Corp. v. Commissioner*, 242 F.2d 864 (5th Cir. 1957), and the related group of cases cited note 104 *infra*.

⁸⁴ 287 U.S. 103 (1932).

⁸⁵ Under Texas law such a mineral lease was in effect a "sale," as the Supreme Court noted.

In *Palmer v. Bender*,⁸⁶ the contracts provided that certain leased oil property be "sold" to *F*, *S* getting a cash bonus, an oil payment and a one-eighth royalty. The Commissioner denied depletion, holding the transaction a sale. But the Supreme Court stated:

"[L]essor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if . . . he has retained a right to share in the oil produced. . . ." ⁸⁷

This also recognizes—although still not very explicitly—the economic risk idea. The Court stressed that destruction of the oil before completing extraction would have caused a loss to *S*. In the traditional sale, of course, the risk is ordinarily assumed to pass to the buyer. However the case also appears to view an economic interest as almost a physical share of the mineral in place.⁸⁸ This last idea (that the economic interest is in the wasting mineral in place) and the continued emphasis of a number of oil and gas decisions on "sale" or "lease" have precipitated some confusion by their inconsistency with the emerging principle of economic risk.

In *Helvering v. Elbe Oil Land Dev. Co.*,⁸⁹ for example, *S* conveyed oil rights and equipment to *F* for \$2 million payable over five years, after which *S* was to receive one-third of the monthly net profits. Depletion was denied to *S*, the Court emphasizing explicit language of "sale" in the contract, calling the net profits royalty a mere personal promise to pay, and holding the transaction an absolute "sale." *Elbe* reflects an emphasis on "sale" language and the "sale or lease" approach to these problems. The opinion also stresses the importance of retention of a physical share of the mineral.⁹⁰ Similarly, in *Helvering v. O'Donnell*,⁹¹ where *S* sold one-third of his stock in the *X* oil company to *F* for a one-third net profits royalty, depletion was denied, in part on the reasoning that *S*, as only a shareholder of *X*, had no legal "privity" with the property. If this were sound then no one who purchased a royalty or acquired it by gift or devise would have an economic

⁸⁶ 287 U.S. 551 (1933).

⁸⁷ 287 U.S. at 557.

⁸⁸ *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364 (1925), treated an economic interest as a physical share of the mineral, and it took a good deal of judicial history to change this.

⁸⁹ 303 U.S. 372 (1938).

⁹⁰ A net profits royalty does not literally involve a physical share of the mineral. The courts had early started whittling down this idea that an economic interest was based on a physical share. *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312 (1934), grants depletion whether royalties are paid in cash or kind.

⁹¹ 303 U.S. 370 (1938).

interest. This artificial "privity" doctrine was in effect overruled by the result in *Commissioner v. Southwest Exploration Co.*⁹²

O'Donnell also held the net profits royalty to be a mere personal promise to pay—again emphasizing the supposed need for a physical share of the mineral. The weakness of the argument is revealed by inquiring as to who would be liable on this "promise" and in what amount, if there were no production. Both *Elbe Oil* and O'Donnell are in effect overruled on this issue by *Kirby Petroleum Co. v. Commissioner*⁹³ and *Burton-Sutton Oil Co. v. Commissioner*,⁹⁴ which grant depletion to a net profits royalty. *Kirby* and *Burton-Sutton* emphasize that an economic interest is not mere title to the mineral in place, but is dependency for the possibility of profit "solely upon the extraction and sale of the oil."⁹⁵

The Treatment of Production Payments

Oil and gas royalties were treated as analogous to rentals, and depletable, since they were a percentage of production extending over the entire life of the wasting asset. With an oil payment there would often be oil left in the ground after the money payment was completed, which remainder would then belong to the lessee or other transferee. That is, the original owner in the case of the oil payment eventually yields all interest in the asset (oil and gas interests) transferred. This difference between an oil payment and a royalty led the courts into conceptual difficulties over "sale" versus "lease" very similar to the bootstrap problem of "sale" or "no sale." Thus, in *Commissioner v. Fleming*,⁹⁶ where oil and gas interests were transferred in return for a cash consideration and an oil payment, the court held "that part of the income arose from a sale of a capital asset and was not subject to a depletion allowance [the cash], and that part of it arose from the operation of the oil wells and was so subject."⁹⁷ This in effect treats the transaction as a hybrid, part "sale" and part "lease," the cash receiving sale treatment and the oil payment being held an economic interest. This treatment was adopted, at least as concerns the oil

⁹² 350 U.S. 308 (1956).

⁹³ 326 U.S. 599 (1946).

⁹⁴ 328 U.S. 25 (1946). The effect of undue emphasis on precedent is perhaps illustrated by the failure of the Supreme Court expressly to state that *Elbe Oil* had been overruled, although *Kirby* and *Burton-Sutton* are directly contrary. One result may have been the persistence of the *Elbe Oil* result in decisions such as *Crowell Land & Mineral Corp. v. Commissioner*, 242 F.2d 864 (5th Cir. 1957), and the related group of cases cited note 104 *infra*.

⁹⁵ 326 U.S. at 604.

⁹⁶ 82 F.2d 324 (5th Cir. 1936).

⁹⁷ *Id.* at 327. (Emphasis added.)

payment, by the Supreme Court in *Thomas v. Perkins*,⁹⁸ involving a similar factual problem. There the court talked of the transaction as an "assignment" but held the oil payment a depletable economic interest.

The *Fleming* holding, that the cash payment was to be treated as "sales" proceeds in a transaction characterized by Owner's retaining the right to a present, recurrent receipt of commercial income from the business of oil production (the oil payment), is illustrative of the difficulties caused both for oil and gas decisions and the bootstrap area by attempting to determine results on the basis of a label such as "sale" rather than by the total relationship between the parties. However, the ordinary income treatment applied to the oil payment despite the fact that the original owner will eventually yield all ownership is significant as a solution to a legal situation that is particularly close to the bootstrap problem.

The Source of Payment

In *Anderson v. Helvering*,⁹⁹ Owner transferred mineral interests and land for cash and an oil payment to be paid out of half the oil produced and from the sale of any of the land. Depletion was denied since payment *could* come from the sale of the land, the court seeing this as the equivalent of a personal guarantee by the lessee that the payment would equal the specified sum.

It might be argued that since Owner, in a bootstrap case, receives notes in a specific amount containing an absolute promise by Feeder to pay, that under *Anderson*, an economic risk approach would not apply. If Owner *does* have a substantial independent source of payment detached from the risks of the business, the economic risk argument is not applicable. However a mere formal paper contract signed by Feeder, an entity with little or no assets, appears to have no more substance than does the fact that the contract itself is headed "Sale."

The same comment applies to the *Anderson* dictum with respect to a personal guarantee by the lessee. Ordinarily, the lessee in an oil and gas case is the individual responsible for the primary drilling or operating functions, a contracting party with resources and assets. A personal guarantee from such a person has meaning in the context of the oil and gas industry. That is far different from Feeder's personal guarantee in the bootstrap cases, where Feeder is little more than an empty shell.

⁹⁸ 301 U.S. 655 (1937).

⁹⁹ 310 U.S. 404 (1940).

Economic Interest Doctrine and the Depletion Rationale

The emphasis in depletion has tended progressively to focus on furnishing an "incentive" and reward to those who take the entrepreneurial risks necessary to develop and market natural resources. The development of the doctrine of economic interest (the prerequisite for depletion) has inclined away from merely recognizing and compensating initial capital investment. Despite the language in the decisions with respect to recovery of a wasting capital investment, the courts are more and more frankly recognizing an incentive stimulus to the true economic owners and entrepreneurs as a concurrent objective of depletion.¹⁰⁰ The Supreme Court's recent depletion decision, *Commissioner v. Southwest Exploration Co.*, contains the statement:

"The present allowance, [percentage depletion], however, bears little relationship to the capital investment, and the taxpayer is not limited to a recoupment of his original investment. The allowance continues so long as minerals are extracted, and even though no money was actually invested in the deposit."¹⁰¹

When this is read together with the emphasis in *Harmel* upon dependency on production and in *Palmer v. Bender* on ownership of a share of production, the subordination of the capital investment factor to the risk factor becomes apparent. The Supreme Court in *Southwest Exploration* has really merged these two requirements of "dependency on production" and "capital investment"—a development far beyond the early emphasis on an "investment" as a mere physical share of the mineral. In other words, wherever one has such an ownership type of economic share as to be dependent on the fortunes of mineral production, it is essentially a capital investment. Dependency on the

¹⁰⁰ The fact that mineral owners are getting not merely a "stimulus" but an extraordinary subsidy in recognition of their broad political power is not reflected in the decisions at all. There is no discernible effort by the courts to limit or narrow the depletion deduction in any way, despite widespread criticism of its effects on the equity of our tax structure, as well as on concentration of wealth and power generally. See the statement by Senator Proxmire on the floor of the Senate including detailed statistics on the effects of depletion in reducing oil and gas tax rates below that of other industries and in permitting high bracket taxpayers to pay little or no tax. 105 CONG. REC. 7892-7914 (daily ed. May 21, 1959); Gray, *Percentage Depletion Conservation and Economic Structure*, 1955 COMPENDIUM 430; Gray, *Tax Reform and the Depletion Allowance*, 1959-2 TAX REVISION COMPENDIUM 979; Harberger, *The Taxation of Mineral Industries*, 1955 COMPENDIUM 439; Lubar, *A Plan for Tax Reform*, Fortune, March 1959, pp. 92, 236, 238; Rudick, *Depletion and Exploration Costs*, 1959-2 TAX REVISION COMPENDIUM 983; *Hearings on Revenue Revision of 1950 Before the House Committee on Ways and Means*, 81st Cong., 2d Sess. 1-60, 177-219 (1950). Yet, as will be noted later in text, doctrines which cut the other way have been quickly trimmed back by judicial interpretation, e.g., "sales and lease-backs," "thin capitalization," and Int. Rev. Code of 1939, § 45, ch. 1, 53 Stat. 25; § 129, added by ch. 63, 58 Stat. 47 (1944).

¹⁰¹ 350 U.S. 308, 312 (1956). (Emphasis added.)

risks of production or ownership of an economic share of production have become but two sides of the same coin.

Current Problems

However, at least one current development in economic interest law indicates a trend away from any symmetrical¹⁰² approach grounded on economic risk. Typical of a group of recent circuit and lower court decisions which emphasize that the down payment is substantial in amount and that "sales" language is used in the instrument, and which thereupon accord capital gains treatment to the transaction, is *Crowell Land & Mineral Corp. v. Commissioner*.¹⁰³ There, all sand and gravel under the property was "sold" to an operator who had five years to remove the sand and gravel, paying the owner for it at fifteen cents a yard; then the operator was to reconvey to Owner. In other words, Owner retained a royalty of fifteen cents for each yard produced, the fact that the royalty was computed on the basis of x cents a yard not changing its essential character as a retained share of production, and the agreement to reconvey further emphasized that Owner was not ultimately giving up ownership. The Tax Court found a mineral "lease" and ordinary income. The Fifth Circuit held "sale" and capital gains.

¹⁰² It is not intended to give the impression that because there has been some symmetry in the *Supreme Court's* development of the economic interest doctrine, that oil and gas taxation itself is in anything but a state of doubt, due primarily to the flood of decisions giving special tax relief. This is particularly true of oil and gas tax decisions in the Fifth Circuit. Thus when the Treasury was drafting legislation to tax the transfer of "carved out oil payments" at ordinary income rates, the Fifth Circuit suddenly discovered that such transfers are anticipatory assignments of income, *Commissioner v. Hawm*, 231 F.2d 340 (5th Cir. 1956). But after the possibility of legislation had evaporated, the Fifth Circuit rediscovered the basic truth that a transfer of a "carved out oil payment" is a capital gains "sale," *Commissioner v. Wrather*, 241 F.2d 84 (5th Cir. 1957); *Commissioner v. P. G. Lake, Inc.*, 241 F.2d 71 (5th Cir. 1957); *Commissioner v. Weed*, 241 F.2d 69 (5th Cir. 1957); *Scofield v. O'Connor*, 241 F.2d 65 (5th Cir. 1957). (All four of these decisions were reversed by the Supreme Court, *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958)). There are many oil and gas tax doctrines that are difficult to reconcile with the supposed basic principles of oil and gas taxation and of income taxation generally. The following authorities stand for the propositions that payment of the cost of "lifting" someone else's oil is a deductible expenditure, see Special Ruling, May 15, 1956, CCH 1956 Stand. Fed. Tax Rep. ¶6608; that a de minimis amount of production suffices to guard against restoration of a bonus to income, see *Crabb v. Commissioner*, 41 B.T.A. 686 (1940), *acq.*, 1940-2 CUM. BULL. 2, *aff'd on other grounds*, 119 F.2d 772 (5th Cir. 1941); that "minimum royalties" are depletable, see *McFaddin v. Commissioner*, 2 T.C. 395 (1943), *acq.*, 1943 CUM. BULL. 16, *aff'd in part and remanded*, 148 F.2d 570 (5th Cir. 1945); that the sale of a royalty or an ordinary oil payment is entitled to capital gains, see *J. E. Thompson v. Commissioner*, 7 CCH Tax Ct. Mem. 612 (1948); and see Rev. Rul. 55-526, 1955-2 CUM. BULL. 574; I.T. 4003, 1950-1 CUM. BULL. 10; that "delay rentals" are deductible, see *United States v. Dougan*, 214 F.2d 511 (10th Cir. 1954); and that "ordinary treatment processes" include manufacturing, see *Dragon Cement Co. v. United States*, 244 F.2d 513 (1st Cir.), *cert. denied*, 355 U.S. 833 (1957). These are primarily based upon decisions at the lower court level, although the Supreme Court's failure to pass upon these doctrines has played an important role.

¹⁰³ 242 F.2d 864 (5th Cir. 1957), *reversing* 25 T.C. 223 (1955).

Crowell Land is an example of "sale-lease" formalism, as are others in the same line of decision.¹⁰⁴ Its holding resembles *Elbe Oil*, which is doubtful authority in the Supreme Court today. Economic interest controversies are frequently between taxpayers over depletion, rather than between Government and taxpayer. Whatever symmetry the economic interest doctrine has achieved is due to this and to depletion itself, whose special advantages reduce the pressure for other forms of erosion. Here in *Crowell Land*, where the issue was not taxpayer versus taxpayer¹⁰⁵ over depletion but the question of capital gains treatment for ordinary income, the "sale" concept suddenly showed up again.

The contrast between the Supreme Court's general economic interest approach and the *Crowell Land* line of cases appears to support another observation. That is that the process of judicial erosion of basic tax principles has been centered in the lower courts. Less persuaded, perhaps, by the myth that we have a system of steeply progressive taxes, the Supreme Court has been more reluctant¹⁰⁶ to focus attention on the relief of individual taxpayers rather than on the public interest in a uniform level of progressive taxation.

The Economic Interest Doctrine and the Bootstrap Cases

While the economic interest cases are persuasive authority with respect to a substantial retention of risk, they do not speak to all bootstrap issues. The economic interest doctrine does not treat income as

¹⁰⁴ *Commissioner v. Remer*, 260 F.2d 337 (8th Cir. 1958); *Barker v. Commissioner*, 250 F.2d 195 (2d Cir. 1957); *M. W. Olinger*, 27 T.C. 93 (1956); *Arthur N. Trembley*, 7 CCH Tax Ct. Mem. 972 (1948). *But see* *Albritton v. Commissioner*, 248 F.2d 49 (5th Cir. 1957); *West v. Commissioner*, 150 F.2d 723 (5th Cir. 1945), *cert. denied*, 326 U.S. 795 (1946). Note that some of those cases emphasize a subjective "purpose" of mineral production, which is essentially irrelevant to the economic interest doctrine. While these cases emphasize "sale" or "lease," they frequently involve situations that are mostly "sale," with the retained economic interest being minor. Still these are at the most hybrids like *Thomas v. Perkins*, 301 U.S. 655 (1937), and it is difficult to see why economic interest income should get capital gains treatment.

¹⁰⁵ The "strip mining" cases such as *Parsons v. Smith*, 359 U.S. 215 (1959), are mostly taxpayer versus taxpayer with the Commissioner seeking only to avoid being "whipsawed." The Supreme Court's denial of depletion to the stripper is realistic in result—the stripper being closer to an employee or independent contractor than to an entrepreneur. However, the decisions rely on some artificial criteria such as the ability to terminate the arrangement on short notice and the failure of the stripper to share in the sales proceeds. These reflect the formalistic standards listed in G.C.M. 26290, 1950-1 CUM. BULL. 42, and will probably produce further litigation.

¹⁰⁶ Decisions in a number of the legal areas to be considered below support the view that the Supreme Court has been more inclined than the lower courts to uphold the claimed basic doctrine that income shall be taxed at progressively increasing rates to the taxpayer who earned it. This is illustrated by the greater tendency of Supreme Court decisions to emphasize the substance rather than the form of the transactions at stake in various of the areas to be considered.

first being run through a corporate entity, with profits being redistributed to the equity owners, as occurs with an ordinary business. Rather, economic interest doctrine, in theory, sees production as "shared" among the various owners of the economic interest. The income thus shared is seen as belonging to and retained by the owner of the original economic interest at all times, rather than as ever passing through an artificial entity such as Feeder. In other words, if a corporate oil producer pays the landowner a one-eighth royalty, the royalty amount is completely excluded from corporate income. But dividends are paid only after the corporation has paid a tax on the income that produced them, and a dividend is not excluded from corporate income. As long as Feeder and its sub-entities are not seen as sham and as long as there really was a transfer to them, then it seems clear that the income of the business *does* pass through Feeder or its sub-corporations as the operating entities for the business and is taxable to them.

The Effort to Apply the Economic Interest Approach to Patent Cases

The Government has attempted to apply the economic interest approach outside of the oil and gas area, but with little success. This effort was made principally in the patent field.¹⁰⁷ Patents, while an income producing asset, are not, per se, an active business and differ thereby from most of the bootstrap cases; but their transfer ordinarily does involve the retention of risk. The only bootstrap cases which have not involved an active business included one patent transaction which was the subject of a revenue ruling¹⁰⁸ and one oil payment case.¹⁰⁹

Where oil and gas rights are "leased", the landowner-lessor is seen as having joined in a type of quasi-partnership or joint venture, and as having thrown his mineral rights into the "sharing pot."¹¹⁰ The lessee is viewed as contributing the know-how and the expense necessary to discover, develop and produce the mineral resource, and its related business income.

¹⁰⁷ Bailey, *The Inventor*, N.Y.U. 15TH INST. ON FED. TAX 285 (1957); DeBois, *Patents and Taxation*, 7 OKLA. L. REV. 416 (1954); Frost, *Tax Consequences of Patent Transfers*, 7 STAN. L. REV. 349 (1955); Joseph, *Tax Treatment of Sales and Licenses of Patents*, 32 TAXES 803 (1954); Pavitt, *Patents Under Code Section 1235*, 33 TAXES 265 (1955); Note, *A "Sale or Exchange" of Patent Rights for Federal Income Tax Purposes*, 23 GEO. WASH. L. REV. 457 (1955); Note, *Comparison of the Tax Treatment of Authors and Inventors*, 70 HARV. L. REV. 1419 (1957).

¹⁰⁸ This transaction involved a bootstrap-type transfer of rights to royalties from the miracle drug, sulfa, to a family controlled, thinly capitalized foundation. For a discussion see *Hearings on the Administration of the Internal Revenue Laws Before a Subcommittee of the House Committee on Ways and Means*, 83d Cong., 1st Sess. 1365-1539 (1953).

¹⁰⁹ *Caldwell v. Campbell*, 218 F.2d 567 (5th Cir. 1955).

¹¹⁰ G.C.M. 22730, 1941-1 CUM. BULL. 214.

This explains the economic interest doctrine's gradual expansion, in the oil and gas cases, into an economic risk approach. One might have expected an analogous development with patent royalties.¹¹¹ There could not be a much more typical entrepreneurial venture than an invention, whose patent the inventor transfers to a corporation to develop, taking back a share in the profits in return. The inventor shares in the business exploitation of the patent in much the same way as does an oil and gas lessor, and often much more actively: an inventor frequently participates in the development of his invention and may sometimes control the transferee company, while the landlord-lessor rarely participates in production. But despite the close parallel, the principles of retention of risk developed by the Supreme Court in the economic interest cases were not applied to patent royalties. It is now established that patent royalties will be taxed only as "capital gains."

The evolution of capital gains treatment for patent transfers—a primary product of judicial emphasis on the formalities of transfer—is typical of judicial erosion generally. The courts failed to consider either the relationship between the inventor and the commercial development of the patent, or the inventor's regular receipt of a share of the profits. A dictum in the Supreme Court case of *Waterman v. Mackenzie*¹¹² treated a transfer of patent rights as an "assignment" rather than a "license," if the documents included the transfer of the rights to "make, use and sell." Thereafter the lower courts decided cases by whether these ritual words were employed, rather than in terms of the realities.¹¹³ The Commissioner, too, initially treated patent transfers as formally as the courts, basing his arguments on the "assignment-license" dichotomy.¹¹⁴ When he finally recognized where the

¹¹¹ See Lanning, *Some Realities of Tax Reform*, 1959-1 TAX REVISION COMPENDIUM 19, which utilizes portions of the analysis herein set forth (regarding patents and regarding Int. Rev. Code of 1939, § 45, ch. 1, 53 Stat. 25) in illustration of the general problem of tax erosion.

¹¹² 138 U.S. 252 (1891).

¹¹³ *Hofferbert v. Briggs*, 178 F.2d 743 (4th Cir. 1949); *Lamar v. Granger*, 99 F. Supp. 17 (W.D. Pa. 1951); *Kronner v. United States*, 110 F. Supp. 730 (Ct. Cl. 1953); *Carl G. Dreyman*, 11 T.C. 153 (1948). In fact, the courts did not even follow their own standard consistently, where a different interpretation proved necessary in order to give capital gains treatment. Thus, in *Allen v. Werner*, 190 F.2d 840 (5th Cir. 1951), where a contract transferring patent rights said "manufacture and sell," the court held that the contract was "ambiguous" and used the parol evidence rule to read in the word "use." *Accord*, *Rollman v. Commissioner*, 244 F.2d 634 (4th Cir. 1957), where, as in *Howes' Estate*, the court cited the principle of substance over form in support of a decision which emphasized form over substance. A number of other cases grant capital gains treatment despite the failure to include the right to "use" or the right to "sell." *Lawrence v. United States*, 242 F.2d 542 (5th Cir. 1957); *A. E. Hichman*, 29 T.C. 864 (1958); *Rose Marie Reid*, 26 T.C. 622 (1956); *Monie S. Hudson*, 15 CCH Tax Ct. Mem. 284 (1957).

¹¹⁴ The Commissioner acquiesced in *Edward C. Myers*, 6 T.C. 258 (1946), *acq.*, 1958-2 CUM. BULL. 6, where the licensee got an exclusive right to "make, use and sell" in return for royalties of a percentage of the sales price.

substance of the relationship lay and used an economic interest approach to argue that the inventor was regularly receiving the profits from a patent business, it was too late; this new approach,¹¹⁵ although it prevailed in *Bloch v. United States*,¹¹⁶ the first case in which it was tried, was generally rejected by the courts.¹¹⁷

The patent decisions seem extreme, even ignoring for the moment the question of how workable the "capital gains" concept is. By almost any approach except asking "What is the proper label for the transaction?," the receipt of royalties as a result of a patent transfer represents a sharing in the profits of a basic business activity. These judicial decisions, however, soon produced the chain reaction that so often explains tax erosion. The "make, use, sell" cases lent respectability to a result that Congress might have hesitated to initiate on its own. Congress closed the book on the patent litigation, for all practical purposes, by the amendments to the Internal Revenue Code designed to make certain that patent royalties were treated as capital gain.¹¹⁸

The statutes adopt the approach of the cases. Sections 1235 of the 1954 Code and 117(q) of the 1939 Code emphasize whether "substantial rights" were transferred pursuant to the "assignment," rather than the nature and source of the income or the relationship of the transferor to the business. The reasons for such legislation must be evaluated in light of the fact that copyrights are specifically denied

¹¹⁵ Stated in Mimeo 6490, 1950-1 CUM. BULL. 9.

¹¹⁶ 200 F.2d 63 (2d Cir. 1952), *cert. denied*, 345 U.S. 935 (1953).

¹¹⁷ See the decisions cited in notes 113-14 *supra*. And see General Spring Corp., 12 CCH Tax Ct. Mem. 847 (1953), where it was particularly evident that the "transferor" had continued to participate in the business of exploiting the patent. The Internal Revenue Service won several cases after Mimeo 6490 (see note 115 *supra* and accompanying text) was issued but it had no real effect on the taxation of patent transfers. *Broderick v. Neale*, 201 F.2d 621 (10th Cir. 1953), was even based on the "assignment-license" approach. The documents read "make and sell" not "make, use and sell," and later cases distinguished it thereby. Several other cases did apply ordinary income treatment to transfers of copyrights or patents, *Commissioner v. Wodehouse*, 337 U.S. 369 (1949); *Bloch v. United States*, 200 F.2d 63 (2d Cir. 1952), *cert. denied*, 345 U.S. 935 (1953); *Misbourne Pictures Ltd. v. Johnson*, 189 F.2d 774 (2d Cir. 1951). But these were distinguished by cases such as *First Nat'l Bank v. United States*, 136 F. Supp. 818 (D.N.J. 1955), and *Kronner v. United States*, 110 F. Supp. 730 (Ct. Cl. 1953), on the doubtful argument that they applied only to the nonresident alien statutes. The court in *First Nat'l Bank*, also stated that a provision for the payment of royalties did not bar the argument that the parties intended "title to pass."

¹¹⁸ INT. REV. CODE OF 1954, § 1235. In 1955 the Commissioner issued Rev. Rul. 55-58, 1955-1 CUM. BULL. 97, interpreting the capital gains policy of § 1235 not to apply before its effective date in 1954. The Commissioner is understood to have so ruled because at the time there were a number of the original bootstrap cases pending in the courts, and his approach was in part based on the economic interest doctrine. But Congress reacted immediately by enacting § 117(q) of the 1939 Code, added by ch. 464, § 1, 70 Stat. 404 (1956), in the same language as § 1235, and made its capital gains treatment applicable to payments of patent royalties after May 31, 1950 (the effective date of Mimeo 6490), regardless of the year in which the transfer occurred.

capital gains treatment¹¹⁹ although they present precisely the same problem of retention of income from personal services as do patents. The significant distinction appears to lie in the greater influence of the patent lobby.

Some final comments. The foregoing analysis assumed the situation most favorable to those arguments of economic "stimuli" and "incentive" basic to the capital gains myth. The patent transfer was assumed to be made by the hardy individual inventor struggling on the frontiers of knowledge. One's view of the equities must be readjusted to the realization that most patents are procured by the major corporations and the giant commercial laboratories.

Furthermore, tax policy can never be viewed in isolation. It is a very special advantage to have to report only one-half of one's income from the exploitation of a patent, and to have a maximum tax rate of twenty-five per cent (capital gains treatment). This special advantage, which is primarily available and valuable to the upper bracket taxpayer¹²⁰ must be appraised in terms of the more general political and economic problem of patent monopoly and concentration of economic power.¹²¹

The Thin Capitalization Cases

"Thin capitalization" is still another way to preserve the essential advantages of ownership while avoiding the formal appearance of ownership and its related tax consequences. The technique is to set up a close corporation with very little "equity" capital and a relatively large "debt." The major tax advantages sought include (a) recovery of the investment by repayment of a "loan" without the risk that this will be held a redemption "essentially equivalent to a dividend" under section 302 of the 1954 Code, and (b) the ability of the corporation to deduct payments as interest, although they would not be deductible if viewed as dividends. But where the capital of such a company is too "thin" to afford the reasonable assurance of independent payment characteristic of a debt, so that the holder of the security must depend on the risks of the business, he is in a position similar to a shareholder.

¹¹⁹ INT. REV. CODE OF 1954, § 1231(b) (1) (C).

¹²⁰ The fact that capital gains treatment primarily benefits the upper bracket taxpayer is considered in notes 308-11, 314-17 *infra* and accompanying text as part of a brief discussion of the implications of the capital gains doctrine.

¹²¹ Among the literature which considers the general impact of the special treatment given patents is ATT'Y GEN. NAT'L COMM. ANTITRUST REP. 223-60; HAMILTON, PATENTS AND FREE ENTERPRISE (TNEC Monograph No. 31, 1941); Rich, *The Relation Between Patent Practices and the Anti-Monopoly Laws*, 24 J. PAT. OFF. SOC'Y 422 (1942).

This doctrine is relevant to two closely related ways of approaching the basic bootstrap problem:¹²² (1) Has Owner formally divorced himself from the fortunes of the business, and become a mere creditor, or is he still—in substance—so dependent on the risks and profits of the business as to retain his beneficial ownership? (2) More technically, are the notes or bonds received by Owner to be treated as really stock, making the payments equity distributions,¹²³ or are they the debt instruments they purport to be, making the payments purchase price payments?

The notes or bonds issued in a thin capitalization are in a fixed amount and, presumably, will be paid off eventually, while the owner of stock may receive a share of the profits indefinitely. This parallels the contrast between the oil payment with its fixed sum and the oil royalty with its indefinite percentage of the income. The bootstrap transfer itself more closely resembles an oil payment than any other usual legal category. The problem of how to tax an oil payment was resolved by treating the receipts as ordinary depletable income;¹²⁴ the equivalent of cost depletion would be provided in a bootstrap case if Owner were permitted to amortize his cost basis over the total payments received, which would then be taxed as ordinary income.

Judicial Approaches to the Thin Capitalization Problem

The Supreme Court has recognized the problem of thin capitalization in a widely quoted obiter dictum: "As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure."¹²⁵ But on the whole the judicial treatment¹²⁶ of

¹²² Of course, the absence of notes in the lease-type bootstraps means that there is no thin capitalization issue. But the bootstrap technique is built upon the separation of the form and the fact of ownership, and like any bootstrap the lease type must retain ownership risks. Lease bootstraps can not make use of the device of "notes" backed only by profits, because the operating entities in the lease cases are not penniless individuals; they ordinarily have assets which would be obligated if a note were signed. Resort must be had to the other major technique for making a purchase without committing substantial assets—payment out of a percentage of business income. This makes explicit what the use of notes obscured—that Owners have kept the ownership risks. Perhaps this will make the situation more clear to the courts than it apparently was in the original bootstraps.

¹²³ This ties in to the effort, considered later, to classify a bootstrap transfer as a "reorganization." See text accompanying notes 163-65 *infra*.

¹²⁴ *Thomas v. Perkins*, 301 U.S. 655 (1937).

¹²⁵ *John Kelley Co. v. Commissioner*, 326 U.S. 521, 526 (1946).

¹²⁶ The commentaries include ALI, *FEDERAL INCOME, ESTATE, & GIFT TAXATION—INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS* 56-63, 398-437 (1958) [hereinafter cited as 1958 ALI Study]; ADVISORY GROUP ON SUBCHAPTER C OF THE INTERNAL REVENUE CODE OF 1954, REVISED REPORT ON CORPORATE DISTRIBUTIONS AND ADJUSTMENTS (1958) [hereinafter cited as 1958 ADVISORY GROUP REPORT], in *Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the*

thin capitalization by the lower courts has displayed the same type of formalism seen with bootstrap and patent transfers. All too often the courts have asked "what label applies to this particular instrument, 'debt' or 'equity'?" rather than "on all the facts, what is the nature of the relationship between the taxpayer and the corporation evidenced by this document?" A mere grouping of the cases by approach is illustrative.

(1) Some cases asked: is the instrument a "stock" or a "bond"?¹²⁷ Tax planners soon created hybrid instruments not falling in either category, posing the standard conceptual dilemma illustrated by bootstrap "sales."

(2) Then the cases emphasized the ratio between the face amount of the "debt" instrument and the fair market value of the "equity" assets.¹²⁸ Even if a ratio test were workable,¹²⁹ the decisions reveal no range of ratios that bears any factual relationship to the problem. Ratios of many thousands to one have been accepted in some of the bootstrap cases.¹³⁰ Other cases have been approved where there was

Internal Revenue Code Before the House Committee on Ways and Means, 86th Cong., 1st Sess. 473 (1959); ADVISORY GROUP ON SUBCHAPTER C OF THE INTERNAL REVENUE CODE OF 1954, REPORT ON CORPORATE DISTRIBUTIONS AND ADJUSTMENTS (1957) [hereinafter cited as 1957 ADVISORY GROUP REPORT], in *Hearings on a General Revision of the Internal Revenue Code Before the House Committee on Ways and Means*, 85th Cong., 2d Sess. 2491 (1958); Bittker, *Thin Capitalization: Some Current Questions*, 34 TAXES 830 (1956); Hellerstein, *Tax Court Approach to Thin Capitalization Defended*, 10 J. TAXATION 88 (1959); Manly, *Election Under Subchapter S Can Eliminate Thin-Incorporation Problem*, 9 J. TAXATION 322 (1958); Schlesinger, "Thin" Incorporations: Income Tax Advantages and Pitfalls, 61 HARV. L. REV. 50 (1947); Semmel, *Tax Consequences of Inadequate Capitalization*, 48 COLUM. L. REV. 202 (1948); Comment, *Mills Group Stands on Thin Incorporation, Gifts of 306 Stock, Despite Bar's Protests*, 10 J. TAXATION 139 (1959); Comment, *The Thin Incorporation Problem: Are the Courts Fighting the Tar Baby?*, 5 U.C.L.A.L. REV. 275 (1958); Note, *Thin Capitalization and Tax Avoidance*, 55 COLUM. L. REV. 1054 (1955). This is a sharply abbreviated list.

¹²⁷ *United States v. Title Guar. & Trust Co.*, 133 F.2d 990 (6th Cir. 1943); *Commissioner v. Meridian & Thirteenth Realty Co.*, 132 F.2d 182 (7th Cir. 1942); *John Kelley Co.*, 1 T.C. 457 (1943), *rev'd*, 146 F.2d 466 (7th Cir. 1944), *rev'd*, 326 U.S. 521 (1946). See Schlesinger, *supra* note 126; Semmel, *supra* note 126.

¹²⁸ This presents a number of problems as to exactly how "debt" and "equity" are to be measured in order to determine this ratio. See Bittker, *supra* note 126. Observe also the controversy between the majority and the dissenting opinions in *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), as to exactly what the ratio was in that particular case.

¹²⁹ See the analysis of the pros and cons of any ratio test in the 1958 ALI STUDY 400-29. On the other hand, the 1958 ALI STUDY concluded (at 435-37) that the arguments favored adoption of some type of a ratio test, perhaps one in the range of $3\frac{1}{2}$, 4 or 5 to 1.

¹³⁰ *Knapp Bros. Shoe Mfg. Corp. v. United States*, 142 F. Supp. 899 (Ct. Cl. 1956); *Estate of Howes*, 30 T.C. 909 (1958), *aff'd sub nom. Commissioner v. Johnson*, 267 F.2d 382 (1st Cir. 1959); *W. H. Truschel*, 29 T.C. 433 (1957), *order amended*, 17 CCH Tax Ct. Mem. 110 (1958); *Ohio Furnace Co.*, 25 T.C. 179 (1955) (*gov't appeal withdrawn*). Only in the *Kolkey* case was any emphasis laid upon a high ratio of thin capitalization, and the thin capitalization in *Kolkey* was not as great as in most of the other bootstrap cases.

no equity capital at all.¹³¹ On the other hand, courts have at times found an "equity" relationship where the ratio was as low as 8 to 1,¹³² 6 to 1,¹³³ or even 1 to 1.¹³⁴

(3) Some courts emphasize "intention" as a criterion.¹³⁵ But a shareholder's mere intention to be a "creditor" does not make him one,¹³⁶ although the shareholder's operative acts may be revealing as to the relationship. Thus a debt without capital to stand behind it is not debt whether or not the shareholder intends to levy on the corporation if necessary. However, the fact that the shareholder does not levy where the corporation is in default indicates an ownership relationship. A creditor would ordinarily foreclose. But to "examine the instrument" to determine "intention" is to seek a common-law form of the will-o'-the-wisp.¹³⁷

(4) Some cases frankly give free rein to tax "planning" as long as it conforms to the most perfunctory type of formality. The Fifth Circuit in *Rowan v. Commissioner*,¹³⁸ and in *Sun Properties, Inc. v. Commissioner*,¹³⁹ rejected the thin capitalization doctrine entirely, talking vaguely of "intention," and emphasizing the right to "minimize" taxes. In *Sun Properties*, a sole shareholder invested \$400 in the stock of his own corporation and then "sold" a warehouse to the corporation for an alleged \$125,000, which was held to be a debt, although no note or other security instrument was issued to indicate that any transaction had even occurred. This embodies many of the basic objections to the bootstrap device (though the transaction did not, in addition, exploit charitable exemptions or operating losses as do the bootstraps here con-

¹³¹ M. Greenhouse, 13 CCH Tax Ct. Mem. 849 (1954); R. L. Osborne, 13 CCH Tax Ct. Mem. 428 (1954).

¹³² J. A. Maurer, Inc., 30 T.C. 1273 (1958); Shaker Lee Theater, 14 CCH Tax Ct. Mem. 452 (1955).

¹³³ E. A. Matthessen v. Commissioner, 194 F.2d 659 (2d Cir. 1952).

¹³⁴ Gooding Amusement Co., 23 T.C. 408 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957).

¹³⁵ Sarkes Tarzian, Inc. v. United States, 240 F.2d 467 (7th Cir. 1957); Miller's Estate v. Commissioner, 239 F.2d 729 (9th Cir. 1956); Wilshire & Western Sandwiches, Inc. v. Commissioner, 175 F.2d 718 (9th Cir. 1949); Toledo Blade Co., 11 T.C. 1079 (1948), *aff'd*, 180 F.2d 357 (6th Cir. 1950); Bakhaus & Burke, Inc., 14 CCH Tax Ct. Mem. 919 (1955); J. B. Reilly, 14 CCH Tax Ct. Mem. 22 (1955).

¹³⁶ For similar reasons, the abortive effort of the Supreme Court in *Palmer v. Commissioner*, 302 U.S. 63 (1937), to determine by what was "intended" whether or not a particular corporate distribution was a dividend, fell by the wayside. It has not been followed on this point by other decisions and it is clear that determinations as to what is a dividend do not rest on intention.

¹³⁷ E.g., First Mortgage Corp. v. Commissioner, 135 F.2d 121 (3d Cir. 1943); Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942).

¹³⁸ 219 F.2d 51 (5th Cir. 1955).

¹³⁹ 220 F.2d 171 (5th Cir. 1955).

sidered).¹⁴⁰ Like most emphasis on mere form, the decision resulted in extensive tax "relief." Similarly, in *Kraft Foods Co. v. Commissioner*,¹⁴¹ the Second Circuit held that the instrument looked like a debt instrument, that the court could not disregard the intent and acts of the parties and that any "legitimate" corporate-shareholder arrangements must be respected. And in *Miller's Estate v. Commissioner*,¹⁴² the Ninth Circuit stated that it knew of no rule that let the Commissioner dictate how much equity financing a corporation should have.

Such court of appeals holdings reversed Tax Court decisions which had made a significant effort to apply the doctrine of substance over form in analyzing the thin capitalization problem.¹⁴³ The Tax Court, in *Kraft Foods* (and in *Gooding Amusement*, the only decision in this vein affirmed by a court of appeals)¹⁴⁴ emphasized the absence of a business purpose and the presence of tax avoidance purpose, the disproportionate debt-equity ratio and the lack of the parties' intention ever to enforce payment. The failure to enforce default provisions, is a sign of ownership emphasized in *Kolkey*, although by-passed in *Howes' Estate* and *Truschel*. It is not unusual where shareholders of a closely held company hold its debt.¹⁴⁵ And in *Miller's Estate*,¹⁴⁶ the Tax Court held that if "debt" was issued for assets vital to the business,¹⁴⁷ it revealed an intention that the assets should remain indefinitely "at

¹⁴⁰ This Article has emphasized a complex form of bootstrap transactions which include among their variables the use of tax-free funds such as is provided by a tax exemption or a loss carry-over. *Sun Properties* and *Rowan* illustrate some of the objections to even the simplest form of bootstrap sales-to-onself in the sense of a sale financed only by the earnings of the very asset transferred. Whatever the difficulties of analysis presented by a transaction where stock is sold to be paid for only out of dividends, etc., (however, see Grayck, *Taxing Income That Is Applied Against the Purchase Price*, 12 TAX L. REV. 381 (1957)) such situations do not involve the combination of variables presented by the bootstrap transaction. If the more complex bootstrap devices were rejected by the courts, then there would be grounds for questioning these simpler, commercially more usual, forms of the device.

¹⁴¹ 232 F.2d 118 (2d Cir. 1956), reversing 21 T.C. 513 (1954).

¹⁴² 239 F.2d 729 (9th Cir. 1956).

¹⁴³ *Miller's Estate v. Commissioner*, 239 F.2d 729 (9th Cir. 1956); *Gooding Amusement Co.*, 23 T.C. 408 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957); *Kraft Foods Co.*, 21 T.C. 513 (1954), *rev'd*, 232 F.2d 118 (2d Cir. 1956); Benjamin D. Gilbert, 15 CCH Tax Ct. Mem. 688 (1956), *rev'd and remanded*, 248 F.2d 399 (2d Cir. 1957), *decision on remand*, 17 CCH Tax Ct. Mem. 29 (1958), *aff'd*, 262 F.2d 512 (2d Cir. 1959). See Hellerstein, *supra* note 126.

¹⁴⁴ *Gooding Amusement Co.*, *supra* note 143.

¹⁴⁵ The thin capitalization doctrine is virtually never applied to publicly held companies, Caplin, *The Caloric Count of a Thin Corporation*, N.Y.U. 17TH INST. ON FED. TAX 771 (1959). Thus, under the Tax Court approach, the "thin capitalization" doctrine would be almost academic as very few notes or bonds of close corporations would be held to be debt instruments in their shareholders' hands.

¹⁴⁶ *Estate of Herbert B. Miller*, 24 T.C. 923 (1955), *rev'd*, 239 F.2d 729 (9th Cir. 1956).

¹⁴⁷ Bittker, *supra* note 126, suggests that the emphasis in *Miller's Estate* on whether the notes were issued for permanent assets seems unsound.

the risk of the business"¹⁴⁸ as part of its permanent capital and that the debt, accordingly, should be treated as stock.

(5) An alternative general approach is to view any debt in the hands of a shareholder of a close corporation as the equivalent of stock. The trend of the Tax Court cases discussed above may amount to this.¹⁴⁹ Indeed, it is difficult to discover a real justification for distinguishing between debt and equity for shareholders of a closed corporation.¹⁵⁰ The shareholders control all close corporate distributions. They do not care what label is put on a tax transaction, but are concerned only with its practical tax consequences. Thus the transactions of the close corporation are often manipulated for tax advantage, as many of the areas analyzed reveal. The artificial corporate entity has economic reality largely in the case of publicly held companies. It seems improbable that any realistic solution of the thin capitalization problem will be reached without first drawing some distinction between the public and the closely held corporations.

However, the Senate Finance Committee rejected the 1954 effort to distinguish between public and close companies for a number of tax purposes.¹⁵¹ Such an effort is even less likely to be successful now, particularly in the thin capitalization area, in view of such developments as subchapter S of the 1954 Code.¹⁵² If shareholders elect under subchapter S not to be taxed as a corporation, that will automatically eliminate for them most of the tax differences between debt and equity.¹⁵³

¹⁴⁸ There is some disagreement or misunderstanding over the term "risks of the business." It has been suggested that it is a useless standard since any creditor risks not being repaid if the business fails, and looks to its assets for his security. But in this context, the reference is to the entrepreneurial risk that the business will or will not make a profit, not the creditor's risk that the business will fail and be unable to meet its debts. At its most evident, the difference is between an agreement by General Motors to pay \$1,000 at 3% in six months, or to pay 1% of its profits for the next six months.

¹⁴⁹ Caplin, *supra* note 145, at 806-07, contends that the Tax Court position is inconsistent and contradictory.

¹⁵⁰ See also 1958 ALI STUDY which raises serious doubts as to whether the shareholder-creditor distinction is real for debt versus equity purposes. 1958 ALI STUDY 58-59, 409; see *id.* 398-437, for a detailed discussion of the legislative proposals of the ALI Staff and of the Subchapter C Advisory Group with respect to the debt-equity problem. In addition, the ALI study contains an elaborate analysis of many of the "technical" approaches to the problems of thin incorporation. Reading between the lines of the study, it may suggest detailed criteria for distinguishing debt from equity (of a closely held company) only as a necessary alternative to more realistic solutions such as not recognizing shareholder-debt or enacting detailed administrative regulations similar to those promulgated pursuant to *Helvering v. Clifford*, 309 U.S. 331 (1940).

¹⁵¹ S. REP. NO. 1622, 83d Cong., 2d Sess. 42 (1954).

¹⁵² INT. REV. CODE OF 1954, §§ 1371-76.

¹⁵³ See Manly, *supra* note 126; Meyer, *Subchapter S Corporations*, 36 TAXES 919 (1958); Corporate Organization and Distributions, 10 J. TAXATION 130 (1959);

The Thin Capitalization Doctrine and the Bootstrap Cases

All but one of the original bootstrap decisions avoided application of the thin capitalization cases on the argument that Owners were not literally shareholders of Feeder.¹⁵⁴ Only in *Kolkey* did the Tax Court extend the doctrine to cover debt obligations in the hands of such former owners.¹⁵⁵

Yet, so formal a distinction as whether a shareholder in form or a shareholder in substance held the instruments should not have dissuaded the court from applying the thin capitalization doctrine to the bootstrap cases. The Tax Court had made a vigorous scrutiny of the economic realities in other thin capitalization cases. The additional elements of retention of control, exploitation of a charitable exemption, and the *Kolkey* precedent, should have strengthened its position.

Formalism in the Thin Capitalization Decisions

As in the patent area, emphasis has been placed on the label. Decisions have turned on formal phrases such as "license" or "assignment," "stock" or "bond," "debt" or "equity," instead of stressing the character of the entire relationship. In both areas the Commissioner and a few courts made an attempt to apply the principle that if a taxpayer wants the tax advantages of a shift of ownership, he can not retain important items of ownership such as the entrepreneurial risk—a principle set forth by the Supreme Court not only in the natural resources field, but in the *John Kelley* case.¹⁵⁶ But the effort proved abortive with patents and is likely to meet with little more success in thin capitalization. The most apparent explanation for these developments lies in the patterns of judicial formalism.¹⁵⁷ To this must be added the related

Note, *Optional Taxation of Closed Corporations Under the Technical Amendments Act of 1958*, 72 HARV. L. REV. 710 (1959). However see Moore & Sorlien, *Adventure in Subchapter S and Section 1244*, 14 TAX L. REV. 453, 472-73 (1959), which points out that subchapter S's complexities do not make it an easy solution to the thin capitalization difficulty.

¹⁵⁴ They refused to recognize either that the retained risk left Owners still owners, or that the notes or bonds should be treated as stock.

¹⁵⁵ *Kolkey* extended the doctrine to thinly capitalized "debt" obligations where the holders of the obligations did retain significant control with respect to the corporation but did not do so as shareholders. These factors seem sufficient to overcome the resort to *LeTulle v. Scofield*, 308 U.S. 415 (1940), and its statement that the mere owner of "bonds" (or "notes") can not have a "proprietary" interest. *LeTulle* was a loosely worded effort to find that a particular transaction was not, in substance, a reorganization. The bootstraps present a different problem and a different combination of circumstances. In *Truschel and Howes' Estate*, the "bonds" even had voting rights. For those cases to rely on *LeTulle* was almost as inappropriate as *Howes' Estate's* invoking the doctrine of substance over form.

¹⁵⁶ *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946).

¹⁵⁷ Hellerstein, *supra* note 126, characterizes the thin capitalization decisions as illustrative of the current trend toward formalism.

judicial inclination to feel sympathy for the individual taxpayer, forgetting the effect that many individual grants of tax "relief" must have upon the equity of the entire taxing system.

Nor do the legislative proposals of the American Law Institute¹⁵⁸ and of the Subchapter C Advisory Group¹⁵⁹ promise a solution. Both list fixed criteria for distinguishing between debt and equity, reminiscent of the old standards as to stock or bond. In addition, the Advisory Group recommends that the ratio not exceed 5 to 1, and the ALI would now make it 3½, 4 or 5 to 1, although in its 1954 draft of the Code, the ALI rejected any ratio requirement.¹⁶⁰ These standards might be adequate for a public corporation (for whom they are probably unnecessary), but, as the ALI discussion itself indicates, the problems are considerably more difficult in the case of the one-man corporation (and other closed corporations).¹⁶¹ The proposed detailed standards would make it even easier to avoid application of the thin capitalization doctrine.¹⁶²

The Reorganization Approach to the Bootstrap Cases

A corollary of the thin capitalization argument is to treat the notes or bonds as "stock" and the transaction as a "reorganization," with Owners receiving "stock" in Feeder in place of their stock in the old business. But even if the "reorganization" concept is viewed as realistic rather than as just one more route to tax reduction, it does not accurately describe a bootstrap transfer.

Assume that a reorganization is a transaction representing a formal rather than an economic change in a business entity, and that it requires an essential continuity of ownership and the absence of any such event as will invoke the income tax doctrine of "realization." A bootstrap still does not fit any more neatly within the "reorganization" label than the "sale" label, and for similar reasons. Initially a bootstrap transfer has continuity of ownership, and the business undergoes little more than a formal change of ownership. But eventually there will be a true change of ownership and a full economic transfer-over of the business. Furthermore, the objectives of the bootstrap technique—its efforts to continue getting the income of the business at capital gains rates and to manipulate the tax exemption—are not consonant with the

¹⁵⁸ See note 150 *supra*.

¹⁵⁹ See authorities cited note 126 *supra*.

¹⁶⁰ See 1958 ALI STUDY 398-99, 436.

¹⁶¹ *Id.* at 401-02.

¹⁶² The tax section of the Chicago Bar Association has described the detailed criteria set forth by the Subchapter C Advisory Group as a "blueprint for avoidance." The tax section suggests it might be better to have no more amendments to subchapter C in view of its present "unworkable level of complexity," see Comment, 10 J. TAXATION 139, 140 (1959). And see 1958 ALI STUDY 398.

proclaimed purposes of the reorganization privilege. To call a bootstrap a reorganization, concedes a "business purpose" which a bootstrap lacks.

The unsuitability of the reorganization label is revealed in other ways, too. If the transaction is a reorganization, then the downpayment is "boot." And a court that would be content with a reorganization description of a bootstrap transfer might also conclude that the "boot" was "capital gain boot" rather than "dividend boot."¹⁶³ The inappropriateness of such a treatment has been suggested by analysis of the retention of risk and will be further emphasized below.¹⁶⁴

Furthermore, a reorganization approach, from a practical perspective, compels the proof of a long series of steps, some relatively unrealistic. First you must prove that the notes are "stock," that the downpayment is "boot" and that the boot is "dividend boot." Then you would have to demonstrate that any payments on the "notes" are "redemptions equivalent to a dividend." You would also have to show that any earnings and profits of the old business were transferred intact to the new entity. Any break in this chain would be fatal. Certainly it makes more sense to approach the transaction in terms of its realities than to run so elaborate a gauntlet. Indeed one factor that handicapped the Commissioner in handling the original bootstraps was a continued emphasis on a reorganization approach. And, of course, the reorganization approach, like the thin capitalization doctrine, offers no solution for the lease-type bootstrap, which lacks notes to be characterized as stock.¹⁶⁵

Retention of Control

The General Doctrine

The principle that retention of control is a sign of ownership is another doctrine which has been boldly proclaimed, but weakly enforced. The classic authority on the effect of retained control is *Helvering v. Clifford*.¹⁶⁶ There a traditional common-law trust for the benefit of settlor's wife was refused tax recognition. This determination was based on the broad control kept by the settlor, the short term of the trust and its intra-family nature. The Court emphasized that the arrangement must be considered as a whole and held that in substance settlor had retained so many of the incidents of ownership that the trust income was taxable to him.¹⁶⁷

¹⁶³ INT. REV. CODE OF 1954, § 356.

¹⁶⁴ See text accompanying notes 297-317 *infra*.

¹⁶⁵ See note 122 *supra*.

¹⁶⁶ 309 U.S. 331 (1940).

¹⁶⁷ Int. Rev. Code of 1939, § 22(a), ch. 1, 53 Stat. 9 (now INT. REV. CODE OF 1954, § 61(a)).

Many cases follow *Clifford* in principle by emphasizing retained control as the essence of an arrangement.¹⁶⁸ The Supreme Court stated in *Commissioner v. Sunnen*:¹⁶⁹

"The crucial question remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as recipient of the income for tax purposes. As was said in *Corliss v. Bowers*, 281 U.S. 376, 378, 'taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid.' "

And the Court emphasized: "There is absent any indication that the transfer of the contract effected any substantial change in the taxpayer's economic status." ¹⁷⁰

The discrepancy between these proclaimed principles and the actual operation of the taxing process is a further source of substantial "erosion" of our progressive income tax system. The judicial history of the 1939 Code's section 45¹⁷¹ illustrates once again the basic role played in these developments by formal ways of judicial thought.

The Judicial Acceptance of Section 45

The bootstrap cases raise the question of how much recognition is to be given a transfer when the old owners retain control and other aspects of ownership. Section 45¹⁷² poses a comparable issue. If income, deductions or credits are shifted or if an entire business is split among entities under a common control or ownership, to whom are the items to be attributed for tax purposes—the formal transferee or the transferor?

The language of section 45 is broad and flexible. It gives the Commissioner a wide discretion to allocate items among entities under

¹⁶⁸ *Higgins v. Smith*, 308 U.S. 473 (1940); *Griffiths v. Commissioner*, 308 U.S. 355 (1939); *Corliss v. Bowers*, 281 U.S. 376 (1930); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952); *W. H. Armston Co. v. Commissioner*, 188 F.2d 531 (5th Cir. 1951); *Asiatic Petroleum Co. v. Commissioner*, 79 F.2d 234 (2d Cir.), *cert. denied*, 296 U.S. 645 (1935); *Estate of J. G. Dodson*, 1 T.C. 416 (1943); *Paul Plunkett Co.*, 42 B.T.A. 464 (1940).

¹⁶⁹ 333 U.S. 591, 604-05 (1948).

¹⁷⁰ *Id.* at 607-09.

¹⁷¹ Ch. 1, § 53 Stat. 25 (now INT. REV. CODE OF 1954, § 482). For convenience, "section 45" will be taken to refer to either. See Lanning, *Some Realities of Tax Reform*, in 1959-1 TAX REVISION COMPENDIUM 19, for a discussion of the general impact on erosion of the income tax of the failure to give operative effect to progressive income tax principles in areas such as the 1939 Code's § 45.

¹⁷² Section 45 reads: "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses."

common ownership or control so as to reflect economic realities.¹⁷³ Such a statute¹⁷⁴ would seem to leave little opening for the judicial conceptualism found in areas such as patent transfers. But history has demonstrated otherwise. The cases under section 45 have frequently put more emphasis on the formal validity of transactions among controlled entities or between the entities and their owners than on the underlying relationships.

Application of section 45 is denied if the transaction has a "business purpose."¹⁷⁵ Corporations *A* and *B*, both solely owned by *X*, may have a business purpose for shifting certain items between themselves. The policy problem is whether tax recognition is warranted for a transaction with so little net economic effect. The fact that a tax advantage can be achieved without more than a formal transfer also poses the issue as to how far one should question the business purpose claimed. But *Miles-Conley Co.*¹⁷⁶ holds that it is not even necessary for there to be a "business purpose" if the business operations are conducted by independent, separate entities, or if the transaction is not "sham."

This argument that because the transferee is a "real," independent entity the transfer, also, must be "real" is frequently made. But it obscures the problem. If it were sufficient that the transferee were a real entity, most of the items covered by section 45 could be shifted at will. In *General Indus. Corp.*,¹⁷⁷ for example, corporations *A* and *B* were both owned by a husband and wife. *A* sold securities which had cost it \$100,000 to *B* at their fair market value of \$25,000. The Commissioner's powers under section 45 were held not to extend to disallow-

¹⁷³ H.R. REP. NO. 2, 70th Cong., 1st Sess. 16-17 (1928), and S. REP. NO. 960, 70th Cong., 1st Sess. 24-25 (1928), state the purpose of the section (§ 45): "the Commissioner may, in the case of two or more trades or businesses owned or controlled by the same interests, apportion, allocate or distribute the income or deductions between or among them, as may be necessary in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability."

¹⁷⁴ Among the articles dealing with § 45 are Baird, *Commissioner's Power to Reallocate Income*, U. SO. CAL. 1948 TAX INST. 399; Buschmann, *The Court Holding Company Situation and Section 45*, 29 TAXES 363 (1951); Ekman, *Warning Signals Under Sections 45 and 129*, N.Y.U. 12TH INST. ON FED. TAX 693 (1954); Holzman, *Arm's-Length Transactions and Section 45*, 25 TAXES 389 (1947); McCaffrey, *Dividing a Business*, 30 TAXES 855 (1952); Mintz, *Recent Developments in Allowance of Loss on Sales Between Controlled Companies*, N.Y.U. 8TH INST. ON FED. TAX 29 (1950); Sherman, *A Case History of Section 45*, 29 TAXES 13 (1951); Swartz, *Transactions Between Related Corporations*, 26 TAXES 941 (1948).

¹⁷⁵ *Commissioner v. Chelsea Prods., Inc.*, 197 F.2d 620 (3d Cir. 1952); *T.V.D. Co.*, 27 T.C. 879 (1957); *Palm Beach Aero Corp.*, 17 T.C. 1169 (1952); *Buffalo Meter Co.*, 10 T.C. 83 (1948); *Standard Fruit Produce*, 8 CCH Tax Ct. Mem. 733 (1949); *Brost Motors, Inc.*, 7 CCH Tax Ct. Mem. 806 (1948); *John Wachtel Corp.*, 4 CCH Tax Ct. Mem. 768 (1945); but see *O'Neill v. Commissioner*, 170 F.2d 596 (2d Cir. 1948); *Alpha Tank & Sheet Metal Mfg. Co. v. United States*, 116 F. Supp. 721 (Ct. Cl. 1953); *Louis Adler Realty Co.*, 6 T.C. 778 (1946).

¹⁷⁶ 10 T.C. 754 (1948), *aff'd*, 173 F.2d 958 (4th Cir. 1949).

¹⁷⁷ 35 B.T.A. 615 (1937), *acq.*, 1937-1 CUM. BULL. 10.

ing the loss, although this would seem to be a classic case for invoking the section. Even though the controlled corporations, *A* and *B* were "real" in the sense of not being a transparent legal sham, it was unrealistic to see the economic group (husband, wife and the two corporations) as having realized a \$75,000 loss at this point, when control and ownership of the securities had been retained.

This poses the issue of the basic judicial approach. Is it sufficient to satisfy section 45 if the transaction is formally permissible—if there is a real entity, a business purpose to the transaction, or if it is not sham or non-bona fide? If so, the limitations on the shifting of income and other tax items whose manipulation is covered by section 45 will be confined to the more transparent cases of semi-fraud, where the taxpayer's error may lie in lacking tax counsel to provide a formal gloss. Or will the entire relationship between the parties—the economic realities—be decisive? That is, is the principle that income shall be taxed to the person who earned it¹⁷⁸ to be taken seriously?

A number of decisions under section 45 accept the form of the transaction unless the Commissioner can prove sham.¹⁷⁹ This argument was used to justify approval of most of the bootstrap transactions.¹⁸⁰ The presence of sham, or fraud, or even innuendoes of non-bona fides, makes it easier to pierce the form of a transaction. But the form of the transaction may not describe what is actually occurring, even though sham elements are not present or can not be proved.

The stock option cases illustrate that. The issuance of most stock options to executives or shareholders is anything but a sham transaction. But to call a stock option "property," and so a capital asset, or "proprietary" rather than "compensatory" falls far short of describing its real substance.¹⁸¹ And there have been many Supreme Court cases in which a substance over form analysis was applied, although the actual transaction was binding on the parties and was not in any literal sense a sham.¹⁸²

¹⁷⁸ See *Lucas v. Earl*, 281 U.S. 111 (1930).

¹⁷⁹ *John L. Denning & Co. v. Commissioner*, 180 F.2d 288 (10th Cir. 1950); *Polak's Frutal Works, Inc.*, 21 T.C. 953 (1954), *acq.*, 1955-1 CUM. BULL. 6; *Seminole Rock & Sand Co.*, 19 T.C. 259 (1952), *acq.*, 1953-1 CUM. BULL. 6; *Buffalo Meter Co.*, 10 T.C. 83 (1948); *Koppers Co.*, 2 T.C. 152 (1943), *acq.*, 1948-1 CUM. BULL. 1. *General Indus. Corp.*, 35 B.T.A. 615 (1937), *acq.*, 1937-1 CUM. BULL. 10. See *Swartz*, *supra* note 174, at 941; but see *Crown Cork Int'l Corp.*, 4 T.C. 19 (1944), *aff'd*, 149 F.2d 968 (3d Cir. 1945); see note 195 *infra*.

¹⁸⁰ See authorities cited note 130 *supra*.

¹⁸¹ *Commissioner v. LoBue*, 351 U.S. 243 (1956); *Commissioner v. Smith*, 324 U.S. 177 (1945). See note 20 *supra*. This is discussed in Lanning, *Some Realities of Tax Reform*, *supra* note 171.

¹⁸² *E.g.*, *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957); *Commissioner v. Phipps*, 336 U.S. 410 (1949); *Bazley v. Commissioner*, 331 U.S. 737 (1947); *Commissioner v. Tower*, 327 U.S. 280 (1946); *Burnet v. Harmel*, 287 U.S. 103 (1932).

As a practical matter, a "sham" requirement usually amounts to a decision that form shall prevail. This is due in part to the difficulty of persuading the courts to be so inquiring as to find non-bona fides. For example, in *Caldwell v. Campbell*, the Fifth Circuit sharply criticized the Commissioner for presuming to suggest that the taxpayer was using the exempt status of his controlled charitable foundation and the capital gains and installment sales provisions for his personal profit. The court held that the transaction was in good faith despite the district court's finding to the contrary, and concluded that it did not matter how much the taxpayer minimized his taxes, "if only it is clear that the transaction was real and not a sham, that is if it was what it purported to be, a real and effective transfer of title from the taxpayer to another."¹⁸³

A similar philosophy is behind the "reality" major argument, an argument which would reject use of section 45 on the ground that the particular corporation was a "real corporate entity."¹⁸⁴ *Estate of J. I. Byrne*,¹⁸⁵ carries this entity argument to a *reductio ad absurdum* by stating that it would decline to ignore the entity of an individual. A corporation (or individual) can be a real entity and yet be utilized to receive another corporation's income. If a corporate entity is so unreal that it can be completely disregarded, or if there is a complete sham, the courts would probably refuse to recognize the transaction even if section 45 or the general substance-over-form doctrine were not available. Section 45 and substance over form are both aimed at those situations where sham can not be demonstrated, but where the form of the transaction is quite different than the fact.

Among the other judicial doctrines for limiting section 45 wherever there is at least formal validity to the transaction are (1) that the terms are those that parties at "arm's length" would have arrived at,¹⁸⁶ (2) that the corporation has a "business activity,"¹⁸⁷ and (3)

¹⁸³ 218 F.2d 567, 573.

¹⁸⁴ In *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949), the Commissioner's effort to apply principles similar to § 45 on broad substance over form grounds was rejected by the Supreme Court on arguments stressing the validity of the corporate entity, that the transaction was not "sham," etc. See also *Miles-Conley Co. v. Commissioner*, 10 T.C. 754 (1948), *aff'd*, 173 F.2d 958 (4th Cir. 1948); *General Indus. Corp.*, 35 B.T.A. 615 (1937), *acq.*, 1937-1 CUM. BULL. 10; *but see* *National Investors Corp. v. Hoey*, 144 F.2d 466 (2d Cir. 1944); *Gordon Can Co.*, 29 B.T.A. 272 (1933); *J. P. Wagner*, 17 CCH Tax Ct. Mem. 569 (1958).

¹⁸⁵ 16 T.C. 1234 (1951).

¹⁸⁶ *Seminole Rock & Sand Co.*, 19 T.C. 259 (1952), *acq.*, 1953-1 CUM. BULL. 6; *Koppers Co.*, 2 T.C. 152 (1943), *acq.*, 1943 CUM. BULL. 14; *Welworth Realty Co.*, 40 B.T.A. 97 (1939), *acq.*, 1939-2 CUM. BULL. 39 (based on the finding of a fair rental price); *Fair Price Stations, Inc.*, 5 CCH Tax Ct. Mem. 401 (1946). See *Baird*, *supra* note 174, at 406.

¹⁸⁷ *National Investors Corp. v. Hoey*, 52 F. Supp. 556 (S.D.N.Y. 1943), *rev'd and remanded*, 144 F.2d 466 (2d Cir. 1944).

that it is permissible for taxpayers to "minimize" their taxes.¹⁸⁸ We have already seen that this last argument is usually but another way to emphasize form.

Some of the arguments used to deny the application of section 45 seem to go even further and to be based on little more than verbalisms. It has been held that the statutory language does not extend to actually "denying" a deduction;¹⁸⁹ that the Commissioner can not allocate income if that would be the "creation" of income;¹⁹⁰ that the apportionment or allocation of income, deductions or credits is permissible, but not the "combining" or "consolidating" of income;¹⁹¹ that the necessary statutory "control" is lacking where a husband and wife have the necessary percentage of ownership for control, but it is divided between them¹⁹² and that "gross" profits but not "net" profits can be allocated.¹⁹³

Despite such decisions, section 45 did not meet the complete frustration accorded provisions such as section 129 of the 1939 Code.¹⁹⁴ The Commissioner was upheld on a number of occasions in the application of section 45.¹⁹⁵ But the treatment of that section, on the whole, presents a problem which it is easy to oversimplify. It arises on two levels. The first is the difficulty of assuring that there is no artificial shifting of income or other tax items among controlled entities—briefly, that income is taxed to the person who earned it. It is on this level that the many decisions which stress formalities rather than the claimed objectives of the statute have been criticized.

¹⁸⁸ This is an argument that frequently accompanies the requirement of a showing of "sham." See cases cited note 179 *supra*.

¹⁸⁹ *General Indus. Corp.*, 35 B.T.A. 615 (1937), *acq.*, 1937-1 CUM. BULL. 10. See Mintz, *supra* note 174. But the case of *Hearst Corp.*, 14 T.C. 575 (1950), *acq.*, 1950-2 CUM. BULL. 2, did permit the "disallowance" of an item under § 45—mostly to the taxpayer's advantage.

¹⁹⁰ *Tennessee-Arkansas Gravel Co.*, B.T.A. Memo. Dec. 10, 073-D, June 30, 1938, *rev'd and remanded*, 112 F.2d 508 (6th Cir. 1940).

¹⁹¹ *Chelsea Prods. v. Commissioner*, 197 F.2d 620 (3d Cir. 1952); *Palm Beach Aero Corp.*, 17 T.C. 1169 (1952); *Estate of J. I. Byrne*, 16 T.C. 1234 (1951); *Cedar Valley Distillery, Inc.*, 16 T.C. 870 (1951), *acq.*, 1951-2 CUM. BULL. 2; *Seminole Flavor Co.*, 4 T.C. 1215 (1945), *acq.*, 1945 CUM. BULL. 6. See McCaffrey, *supra* note 174, at 862.

¹⁹² *A. G. Nelson Paper Co.*, 3 CCH Tax Ct. Mem. 914 (1944).

¹⁹³ *T.V.D. Co.*, 20 T.C. 879 (1957).

¹⁹⁴ Added by ch. 63, § 128(a), 58 Stat. 47 (1944) (now INT. REV. CODE OF 1954, § 269). See discussion of this section in Part II.

¹⁹⁵ *Peacock v. Commissioner*, 256 F.2d 160 (5th Cir. 1958); *Dillard-Waltermire, Inc. v. Campbell*, 255 F.2d 433 (5th Cir. 1958); *Grenada Indus., Inc. v. Commissioner*, 202 F.2d 873 (5th Cir.), *cert. denied*, 346 U.S. 819 (1953); *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir.), *cert. denied*, 344 U.S. 874 (1952); *Advance Mach. Exch., Inc. v. Commissioner*, 196 F.2d 1006 (2d Cir.), *cert. denied*, 344 U.S. 835 (1952); *Hugh Smith, Inc. v. Commissioner*, 173 F.2d 224 (6th Cir.), *cert. denied*, 337 U.S. 918 (1949); *National Sec. Corp. v. Commissioner*, 137 F.2d 600 (3d Cir. 1943); *Birmingham Ice & Cold Storage Co. v. Davis*, 112 F.2d 453 (5th Cir. 1940); *Asiatic Petroleum Co. v. Commissioner*, 79 F.2d 234 (2d Cir.), *cert. denied*, 296 U.S. 645 (1935); *Pennsylvania Indem. Co. v. Commissioner*, 77 F.2d 92 (2d Cir.),

But there is a more fundamental difficulty which suggests that the basic principle behind section 45 (and such related sections as sections 15(c) and 129 of the 1939 Code) is not itself fully consistent with this same general principle that income should be taxed—and at progressively increasing rates—to the person who earned it. The difficulty lies in the assumption behind all of these statutes that a closely held corporate entity has substantial economic reality. The public corporation usually is an independent economic unit. But the close company is the mere alter ego of its owners. To apply section 45 because the transaction is “at arm’s length” or has a “business purpose” may disregard the close corporate entity and amount to compulsory consolidation, but it is more realistic than to give a loss deduction where there is no essential transfer of ownership.

Given this analysis, it is seen that the uncertainty of the section 45 decisions reflects their effort to define the acceptable degree of reality for transactions that are ultimately unreal. The definitive answer to the problems of section 45 (and many of the other corporate tax provisions) may be to limit the advantages of the corporate form to the publicly held company. But the statutory trend is hardly in that direction.

Sales and Leasebacks

“Sales and leasebacks” present similar questions of retention of control. A sale and leaseback often involves the sale of land and buildings or fixed assets used in the trade or business of the owner to a buyer who simultaneously leases the property back to owner.¹⁹⁶ The length of the lease, which often has renewal options, frequently exceeds the usual life of the asset conveyed. The leases are often “net leases,” Owner assuming various of the duties and burdens of ownership such as operation, maintenance, insurance and taxes. There is a formal transfer of such indicia of ownership as legal title. However, Owner

cert. denied, 296 U.S. 588 (1935); *Gordon Can Co.*, 29 B.T.A. 272 (1933). A number of these cases either derive from an earlier period where more emphasis was placed on substance-over-form principles, or involve fact situations extreme enough so that a “sham” analysis is truly relevant.

¹⁹⁶ Among the many articles are Cary, *Corporate Financing Through the Sale and Lease-back of Property: Business, Tax, and Policy Considerations*, 62 HARV. L. REV. 1 (1948); Cary, *Current Problems in Sale, or Gift and Leaseback Transactions*, 29 TAXES 662 (1951); Cary, *Tax Aspects of Sale and Lease-Back of Corporate Property*, N.Y.U. 7TH INST. ON FED. TAX 599 (1949); Casey, *How To Determine Best Form for Real Estate Syndicate To Preserve Tax Advantages*, 7 J. TAXATION 328 (1957); Friedman & Silbert, *The Form of the Entity and Its Capital Structure in Real Estate Acquisitions*, N.Y.U. 16TH INST. ON FED. TAX 609 (1958); Lessers, *Does a Leaseback Save You Money?*, 32 TAXES 279 (1954); Spandorf, *Real Estate Syndicates: How To Organize, Operate and Sell Them for Tax Advantage*, 6 J. TAXATION 44 (1957); Note, *Taxation of Sale and Lease-back Transactions*, 60 YALE L.J. 879 (1951); 65 HARV. L. REV. 1250 (1952).

retains enough of the substantial aspects of ownership, such as possession and control, so that the issue is posed whether there has been a transfer of ownership sufficient to warrant tax recognition.

Sales and leasebacks may be (1) transactions with a "related party" such as a relative or a controlled legal entity, or (2) "commercial" transactions with an independent third party.¹⁹⁷ The related-party sales and leasebacks involve questions of retention of ownership, and substance over form, similar to those of the bootstraps. It is these leasebacks that will principally be considered.¹⁹⁸

*White v. Fitzpatrick*¹⁹⁹ is a typical "related" sale and leaseback. There the sole owner of a manufacturing corporation sold to and leased back from his wife both the patents and the land used for manufacturing, filing a gift tax return. The Commissioner disallowed both rental and royalty deductions. The court of appeals upheld this ruling, stating that although the wife had legal title, husband had retained as much control as if there had been no transfer, and pointing out that husband could not have run the business without the patents or the land.

One might expect that—consistent with the tax principles stated by *Clifford*,²⁰⁰ *Higgins*,²⁰¹ *Griffiths*,²⁰² and other cases²⁰³—the original owner in a leaseback transaction would be seen as having retained so much control and as having changed his economic position so little, that he would still be treated as the owner for tax purposes. There *was* a period when this view prevailed and the decisions analyzed leasebacks in terms of the economic realities.²⁰⁴ Such decisions emphasized that the transferor retained actual control of the property involved, and held that the rents or royalties under the lease were not deductible.²⁰⁵

¹⁹⁷ Most of the commentaries cited note 196 *supra* deal with such "commercial" sales and leasebacks. These commercial sales and leasebacks include *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939); *Jordon Marsh Co. v. Commissioner*, 269 F.2d 453 (2d Cir. 1959); *May Dep't Stores Co.*, 16 T.C. 547 (1951), *acq.*, 1951-2 CUM. BULL. 3; *Century Elec. Co.*, 15 T.C. 581 (1950), *aff'd*, 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952); *Standard Envelope Mfg. Co.*, 15 T.C. 41 (1950), *acq.*, 1950-2 CUM. BULL. 4.

¹⁹⁸ But even the "commercial" sales and leasebacks are not without relevance. They should probably be tested primarily by whether the leaseback covers the useful life of the asset—i.e., has anything of economic significance been transferred?

¹⁹⁹ 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952).

²⁰⁰ *Helvering v. Clifford*, 309 U.S. 331 (1940).

²⁰¹ *Higgins v. Smith*, 308 U.S. 473 (1940).

²⁰² *Griffiths v. Commissioner*, 308 U.S. 355 (1939).

²⁰³ See cases cited notes 72, 168 *supra*.

²⁰⁴ *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952); *W. H. Armston Co. v. Commissioner*, 188 F.2d 531 (5th Cir. 1951); *Ingle Coal Corp. v. Commissioner*, 174 F.2d 569 (7th Cir. 1949); *Shaffer Terminals, Inc.*, 16 T.C. 356 (1951), *aff'd per curiam*, 194 F.2d 539 (9th Cir. 1952).

²⁰⁵ *Accord*, *Johnson v. Commissioner*, 86 F.2d 710 (2d Cir. 1936); *58th St. Plaza Theatre, Inc.*, 16 T.C. 469 (1951), *aff'd*, 195 F.2d 724 (2d Cir.), *cert. denied*, 344 U.S. 820 (1952).

But even during this period there were courts which emphasized form alone—particularly the courts in *Skemp v. Commissioner*²⁰⁶ and *Brown v. Commissioner*.²⁰⁷ And starting in the 1950's a discernible swing toward formalism and tax "relief" appears.²⁰⁸ Typical is the *Felix* case,²⁰⁹ in which a taxpayer and his wife transferred vital equipment used in their coal stripping partnership to an irrevocable trust for their children and then leased the equipment back. A major reason given by the tax court for upholding the leaseback was that the trustee, a bank paid five per cent for its services, was an "independent trustee."²¹⁰ Inasmuch as the transaction is fully prearranged, it would appear unimportant whether the trustee is a nominally independent party, such as a bank.²¹¹ Yet even those decisions which refused to recognize the sale and leaseback²¹² did not expressly call *Brown* and *Skemp* wrong, but distinguished them on the basis of this formal argument about an "independent trustee."

The leaseback cases granting tax relief employ the same formal arguments we have seen in other contexts, for example, in the limitation of section 45. *Felix*, *Brown*, and *Stearns Magnetic* all refer to the bona fides²¹³ of the transaction.²¹⁴ Other arguments emphasize that the rents were reasonable in amount,²¹⁵ that the price was fair and

²⁰⁶ 168 F.2d 598 (7th Cir. 1948).

²⁰⁷ 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950).

²⁰⁸ *Stearns Magnetic Mfg. Co. v. Commissioner*, 208 F.2d 849 (7th Cir. 1954); *Albert T. Felix*, 21 T.C. 794 (1954), *nonacq.*, 1956-2 CUM. BULL. 10.

²⁰⁹ *Albert T. Felix*, *supra* note 208.

²¹⁰ *Accord*, *Brown v. Commissioner*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950); *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948); *Sall v. Smith*, 53-1 U.S. Tax Cas. ¶9123 (E.D. Pa. 1952).

²¹¹ See Rev. Rul. 54-9, 1954-1 CUM. BULL. 20.

²¹² *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952); *Ingle Coal Corp. v. Commissioner*, 174 F.2d 569 (7th Cir. 1949); *Shaffer Terminals, Inc.*, 16 T.C. 356 (1951), *aff'd per curiam*, 194 F.2d 539 (9th Cir. 1952). The judicial technique involved in *White v. Fitzpatrick's* "distinguishing" *Brown* and *Skemp* as involving "independent trustees," rather than expressly rejecting those decisions, may have contributed to the result in *Felix*. See note 94 *supra* for a commentary on a similar situation. And the refusal of the Supreme Court to grant certiorari in *Brown* despite its apparent conflict with *Ingle Coal Corp.* also contributed to the development of the doctrine.

²¹³ Note Judge Raum's dissent in *Felix*, 21 T.C. at 807, emphasizing that the leaseback deductions lack substance, irrespective of "bona fides."

²¹⁴ This is an extraordinary argument on the facts of *Stearns Magnetic Mfg. Co. v. Commissioner*, 208 F.2d 849 (7th Cir. 1954). There a corporation which was owned by a father and son distributed a dividend in kind consisting of a patent vital to the business, and then licensed it back for ten per cent of the gross sales, on a renewable one-year nonexclusive license. The shareholders did not even report the patent dividend as income, on the claim that it had only "speculative value" at the time of the distribution. The transaction not merely lacked substance, but appears to have been a real sham, and perhaps more, despite the remarkable argument of the Seventh Circuit that the corporation had a "right" to declare a dividend and did so.

²¹⁵ *Albert T. Felix*, 21 T.C. 794 (1954), *nonacq.*, 1956-2 CUM. BULL. 10.

reasonable and in accordance with arm's-length standards,²¹⁶ and that title had shifted.²¹⁷

VI. THE BOOTSTRAP USE OF CHARITIES AND CHARITABLE EXEMPTIONS

Much of the discussion to this point might seem applicable to the simpler type of bootstrap²¹⁸ where the purchase is paid for out of earnings of the asset transferred without any use of tax exemptions or other tax-free funds. In principle it is doubtful that such a transfer qualifies as a capital gains sale. But there seems little point in exploring this beyond the analysis already made of transfers of ownership, for the courts have been reluctant to recognize the bootstrap problem even when misuse of charitable exemptions or loss carryovers is combined with retention of risk and control.

Bootsstraps and the Objectives of the Exemption Provisions

The use of a charitable exemption has been a vital catalyst of the bootstrap technique. Central to this was the charitable "feeder" and its half brother, the "split-feeder."²¹⁹ The existence and uses of charitable feeders are difficult to reconcile with the claimed objectives of the exemption laws.

The basic language of section 101(6), found in every revenue act since the Corporation Excise Tax of 1909,²²⁰ lists as exempt from taxation: "corporations, and any . . . foundation, organized and operated exclusively for religious, charitable . . . or educational purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual"

And in *Better Business Bureau, Inc. v. United States*,²²¹ the Supreme Court set out what seemed to be a basic doctrine: "[T]he presence of a single noneducational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."²²² One would assume from this that for

²¹⁶ *Stearns Magnetic Mfg. Co. v. Commissioner*, 208 F.2d 849 (7th Cir. 1954).

²¹⁷ *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948).

²¹⁸ See note 1 *supra*.

²¹⁹ This last term aptly describes the "lease" technique used after the Revenue Act of 1950 to split operating income off into one entity while retaining "passive" "rental" income in another, by leasing the business to a separate entity and taking back most of its income as "rent."

²²⁰ Ch. 6, 36 Stat. 11.

²²¹ 326 U.S. 279 (1945).

²²² 326 U.S. 279, 283. *Better Business Bureau* concerned exemption from social security taxes under § 811(b)(8) of the Social Security Act, ch. 531, 49 Stat. 620, 639 (1935). However, the relevant language of that section was the same as the language of § 101(6), of the 1939 Code.

charitable exemption an organization must be organized and operated exclusively for public purposes, that its funds must be devoted exclusively to such purposes and that for any private individual to use an exemption or exempt organization to divert exempted funds to private purposes would lead to loss of exemption. However, the doctrine and the practice deviated widely enough to open the loophole that culminated in the original bootstrap cases.²²³

A major argument in support of the original bootstrap device is that Feeder is entitled to charitable exemption because Feeder's income is "destined" for Charity: But (1) does the tax-exempt operation of a competitive business violate legislative policy? (2) do the payments to Owner constitute "private inurement" rather than purchase price payments?

Business Activity by Exempt Organizations

Charitable "Parents" and "Feeders"

Functionally, there are two general forms in which organizations claiming section 101(6) exemption seek to accomplish business, commercial and other nonexempt purposes and functions: (1) the exempt organization (a "parent" organization) personally conducts various commercial activities, or (2) the basic charity uses a separate entity (a "feeder") which operates profit-making economic activities and turns over some or all of its income to the parent.²²⁴

Some decisions which permit charities to engage in competitive business may be explained by the failure to observe the differences between parents and feeders. Where a parent charity engages in

²²³ A few of the articles that deal with the various problems of tax exemption are: Tunks, *The Modern Philanthropic Foundation and Private Property* (1948) (unpublished S.J.D. thesis in Yale Law Library); Alexander, *The Use of Foundations in Business*, N.Y.U. 15TH INST. ON FED. TAX 591 (1957); Cutler, *Various Aspects of Contributions to Charities*, N.Y.U. 17TH INST. ON FED. TAX 1117 (1959); Latham, *Private Charitable Foundations: Some Tax and Policy Implications*, 98 U. PA. L. REV. 617 (1950); MacCracken, *Selling a Business to a Charitable Foundation*, U. SO. CAL. 1954 TAX INST. 205; Moore & Dohan, *Sales, Churches and Monkey-shines*, 11 TAX L. REV. 87 (1956); N.Y.U. 14TH INST. ON FED. TAX 1-148 (1956) (a series of articles dealing with charitable foundations); Note, *Criticized Uses of Federal Tax Exemption Privileges by Charitable Foundations and Educational Institutions*, 98 U. PA. L. REV. 696 (1950); Note, *Taxation of Sale and Leaseback Transactions*, 60 YALE L.J. 879 (1951); Comment, *Colleges, Charities, and the Revenue Act of 1950*, 60 YALE L.J. 851 (1951); Comment, *The Modern Philanthropic Foundation: A Critique and a Proposal*, 59 YALE L.J. 477 (1950).

²²⁴ The term "parent" is here used to describe both a basic charity which conducts some profit-making activities, and a charity which receives the funds earned by a profit-making "feeder." Whether the feeder pays operating income over direct to the parent, or leases the business from the parent and pays it the business income in the form of rent does not appear to present any basic economic differences. Therefore the term "feeder" is used to cover both situations.

commercial activities, the issue is whether these activities are minor enough, or closely enough related to the principal charitable purposes, so as to be merely "incidental" activities. The *primary* activity of a feeder, however, is commercial or profit making. Is the fact that the feeder's income is "destined" to a basic charity sufficient to justify charitable exemption?

The "Destination" Test

In the key case of *Trinidad v. Sagrado Orden*,²²⁵ a monastery made certain sales of wines and chocolates within its own organization, the profits being used for its own exempt purposes. On the facts, these activities were merely "incidental" to this parent's primary—and exempt—activities, but the Court also said in a dictum that the test of exemption is the "destination," not the source, of income. That latter doctrine, which was not completely unsound in *Trinidad* (and in such similar parent cases as *Unity School*²²⁶) has been lifted out of context and applied to substantial commercial activities by a parent,²²⁷ as well as to the whole line of feeder cases.

The leading case of *Roche's Beach, Inc. v. Commissioner*,²²⁸ used the *Trinidad* dictum to permit a going business which "fed" exempt organizations to receive section 101(6) immunity. The court would not deny deduction to a feeder if the deduction would be permissible where the exempt organization itself did the business activity.²²⁹ But it is one thing for a parent-exempt organization whose primary activity is charitable to perform profit-making activities related to its primary purpose and relatively small in volume. This, perhaps, justifies exemption on facts such as those of *Trinidad*, *Unity School*, and *Southeastern Fair Ass'n v. United States*.²³⁰ It is quite another thing for a feeder to perform such commercial activities for profit as its primary (or substantial) function, even though some, or all, of the feeder's income eventually goes to exempt purposes.²³¹

A good number of the destination test cases involve mere incidental profit activities, somewhat like *Trinidad*.²³² But even under the destina-

²²⁵ 263 U.S. 578 (1924).

²²⁶ *Unity School of Christianity*, 4 B.T.A. 61 (1926).

²²⁷ See, e.g., *Sand Springs Home*, 6 B.T.A. 198 (1927).

²²⁸ 96 F.2d 776 (2d Cir. 1938).

²²⁹ *Accord*, *Estate of Simpson*, 2 T.C. 963 (1943).

²³⁰ 52 F. Supp. 219 (Ct. Cl. 1943).

²³¹ Yet the Commissioner acquiesced in *Roche's Beach* for a number of years, not changing his position until 1942 in G.C.M. 23063, 1942-1 CUM. BULL. 103. By then the pattern of the feeder device had started to emerge.

²³² See *Commissioner v. Battle Creek, Inc.*, 126 F.2d 405 (5th Cir. 1942); *Southeastern Fair Ass'n v. United States*, 52 F. Supp. 219 (Ct. Cl. 1943); *Estate of Simpson*, 2 T.C. 963 (1943); *Unity School of Christianity*, 4 B.T.A. 61 (1926); *Salem Lutheran Home Ass'n*, 2 CCH Tax Ct. Mem. 117 (1943).

tion test the feeder must be actually feeding the parent, that is, income must be going to exempt purposes in one sense or another.²³³ It would be difficult to find that Feeder was "feeding" substantial funds to Charity in the bootstrap cases since Feeder accumulates almost all the income from the business and turns it over to Owner.

In any event, the relevance of Feeder's income being "destined" for a charity, to the proclaimed principles in the area is doubtful. Were Feeder's activities exclusively charitable? Can it be asserted that Feeder was not competing unfairly with taxed businesses? Is the revenue loss due to excluding Feeder's business from taxation acceptable? These questions are difficult to answer affirmatively on the sole grounds that Feeder turns its profits over to a charity.

Many feeder cases rely on *Trinidad* and *Roche's Beach*.²³⁴ But so slender a reed necessarily had more covert support. Many organizations both have exempt purposes and functions, and perform other activities for profit, or of a commercial nature. As section 101(6) was drafted, however, the courts had either to declare an organization which had many exempt functions not exempt at all *or* to hold it completely immune from taxation, although many of its activities may have been commercial operations for profit on a competitive basis. Understandably, when confronted with this Hobson's choice—and particularly where such cherished objectives of our culture as education, religion and charity were proclaimed to be at stake—the courts were reluctant to choose that horn of the dilemma which would have denied exemption *in toto*. But if the courts had examined the facts, and not merely applied the "destination" label, they might have inquired whether education or charity or religion were actually being served in particular feeder situations. This might have made any departure from basic principles unnecessary in a number of these cases including the bootstraps.²³⁵

²³³ See *Bear Gulch Water Co. v. Commissioner*, 116 F.2d 975 (9th Cir.), *cert. denied*, 314 U.S. 652 (1941). See also *Fort Scott Clinic & Hosp. Corp. v. Brodrick*, 99 F. Supp. 515 (D. Kan. 1951); *Kriesien v. United States*, 99 F. Supp. 873 (D. Ore. 1951); *Medical Diagnostic Ass'n*, 42 B.T.A. 610 (1940), in all of which there is a serious question as to whether funds are actually being "fed" to exempt organizations. *But see Arthur Jordan Foundation v. Commissioner*, 210 F.2d 885 (7th Cir. 1954).

²³⁴ *C. F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951); *Willingham v. Home Oil Mill*, 181 F.2d 9 (5th Cir.), *cert. denied*, 340 U.S. 852 (1950); *Commissioner v. Orton*, 173 F.2d 483 (6th Cir. 1949); *Samuel Friedland Foundation v. United States*, 144 F. Supp. 74 (D.N.J. 1956); *Sico Co. v. United States*, 102 F. Supp. 197 (Ct. Cl. 1952).

²³⁵ The problem was compounded by the failure of the Supreme Court to grant certiorari in destination test cases such as *United States v. Community Servs., Inc.* 189 F.2d 421 (4th Cir. 1951), *cert. denied*, 342 U.S. 932 (1952), even though there was a considerable split of authority as to the validity of the destination test prior to the 1950 legislation. Courts rejecting the destination test include *Better Business Bureau, Inc. v. United States*, 326 U.S. 279 (1945); *Duffy v. Birmingham*, 190 F.2d 738 (8th Cir. 1951); *Universal Oil Prods. Co. v. Campbell*, 181 F.2d 451 (7th Cir. 1950), *cert. denied*, 340 U.S. 850 (1952); *John Danz*, 18 T.C. 454 (1952), *aff'd*, 231

The "Organized" Test

The Commissioner, too, has been guilty of formalism in the application of the exemption statutes. The Commissioner has sought to apply the so-called "organized" test, which makes exemption depend on whether the wording of an organization's charter provides exclusively for charitable purposes.²³⁶ But it is ordinarily easy to amend a charter. This test will serve mostly to penalize those who lack expert tax counsel, while revealing very little about the organization's major qualifications for exemption.

Nor are the various dogma of statutory interpretation of much assistance. The cases which permit commercial activity by parents or feeders, stress the public purposes of exempt organizations as justifying a liberal interpretation of the statute.²³⁷ The cases which deny exemption emphasize that the statute must be interpreted strictly since exemptions are a matter of legislative grace.²³⁸ "Liberal" or "strict" interpretations appear to be myths in their own right, rather than tools of analysis.²³⁹

F.2d 673 (9th Cir. 1955), *cert. denied*, 352 U.S. 828 (1956); Donor Realty Corp., 17 T.C. 899 (1951); Joseph B. Eastmen Corp., 16 T.C. 1502 (1951); Peggy Lou Riker, 14 CCH Tax Ct. Mem. 903 (1955), *aff'd*, 244 F.2d 220 (9th Cir.), *cert. denied*, 355 U.S. 839 (1957); Ralph H. Eaton Foundation, 12 CCH Tax Ct. Mem. 210 (1953), *aff'd*, 219 F.2d 527 (9th Cir. 1955). Courts continuing to support the destination test include *Lichter Foundation, Inc. v. Welch*, 247 F.2d 431 (6th Cir. 1957); *C. F. Mueller Co. v. Commissioner*, *supra* note 234; *Willingham v. Home Oil Mill*, *supra* note 234; *Commissioner v. Orton*, *supra* note 234; *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938); *Sico Co. v. United States*, *supra* note 234; *Southeast Fair Ass'n v. United States*, 52 F. Supp. 219 (Ct. Cl. 1943).

²³⁶ *Sun-Herald Corp. v. Duggan*, 160 F.2d 475 (2d Cir. 1947); *Sun-Herald Corp. v. Duggan*, 73 F.2d 298 (2d Cir. 1934), *cert. denied*, 294 U.S. 719 (1935); *contra*, *Roche's Beach, Inc. v. Commissioner*, *supra* note 235; *N.P.E.F. Corp.*, 5 CCH Tax Ct. Mem. 313 (1946). See also *Commissioner v. Battle Creek, Inc.*, 126 F.2d 405 (5th Cir. 1942); *Sand Springs Home*, 6 B.T.A. 198 (1927) (charter listed many business powers). Nonetheless, in his recently adopted regulations, the Commissioner has strongly reasserted this "organized" test, despite these objections and the authorities to the contrary. *Treas. Reg. § 1.501(c)(3)–(1)* (1959).

²³⁷ See *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937); *Commissioner v. Bliss*, 293 U.S. 144 (1934). See also *Union & New Haven Trust Co. v. Eaton*, 20 F.2d 419 (D. Conn. 1927), which states that there is an exception to the strict construction rule where public policy dictates a more liberal attitude. *Accord*, *Squire v. Students Book Corp.*, 191 F.2d 1018 (9th Cir. 1951); *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938); *Home Oil Mill v. Willingham*, 68 F. Supp. 525 (N.D. Ala. 1945).

²³⁸ *White v. United States*, 305 U.S. 281 (1936); *New Colonial Ice Co. v. Commissioner*, 292 U.S. 435 (1934); *Universal Oil Prods. Co. v. Campbell*, 181 F.2d 451 (7th Cir. 1950), *cert. denied*, 340 U.S. 850 (1952); *Barnhart-Morrow Consol. v. Commissioner*, 150 F.2d 285 (9th Cir. 1945); *Johnson v. Commissioner*, 132 F.2d 38 (4th Cir. 1942); *Scholarship Endowment Foundation v. Nicholas*, 106 F.2d 552 (10th Cir. 1939), *cert. denied*, 308 U.S. 620 (1940). But see *Griswold, An Argument Against the Doctrine That Deductions Should Be Narrowly Construed as a Matter of Legislative Grace*, 56 HARV. L. REV. 1142 (1943), which suggests that if Congress did deny all deductions and thereby tax gross receipts—exercising the power which in theory underlies the strict interpretation doctrine—it would be unconstitutional as a tax on capital.

²³⁹ Contrast the district court decision in *United States v. Community Servs., Inc.*, 50-2 U.S. Tax Cas. ¶ 9506 (E.D.S.C. 1950), *rev'd*, 189 F.2d 421 (4th Cir. 1951),

The Bootstrap Technique and Private Inurement

In General

The bootstrap retention of ownership has meant that funds exempted from taxation so that they might serve a public purpose have been, in effect, diverted into the pockets of private individuals. "Private inurement" is almost unique among the doctrines related to the bootstrap problem in that most of the cases give practical effect to its claimed principles. The Government has won many of the cases involving private inurement, with the notable exception of the bootstrap cases themselves. The courts have even, on occasion denied exemption where private inurement was, at most, technical as in *Powell Foundation*²⁴⁰ which denied exemption to a charity where the charity, to whom donor had made a gift with a reservation of income, paid over to donor's wife a sum very slightly in excess of the income derived from the burdened assets. *Universal Oil Prods. Co. v. Campbell*²⁴¹ found private inurement where patent fees were paid by small oil companies to a claimed charitable feeder whose research activities benefited the major oil companies; and *Mabee Petroleum Corp. v. United States*,²⁴² treated an excessive salary paid its donor by a claimed charitable foundation as private inurement.²⁴³ Some findings of private inurement have been under sections 101(7), 101(8) or 101(9) of the 1939 Code,²⁴⁴ but those cases also require that the organization and the funds in question must be predominantly devoted to charitable purposes.²⁴⁵

cert. denied, 342 U.S. 932 (1952), which emphasized liberal construction of a statute granting tax exemption and approved the exemption, with the court of appeals decision in the same case, which stressed strict construction and denied exemption.

²⁴⁰ 21 T.C. 279 (1953).

²⁴¹ 181 F.2d 451 (7th Cir. 1950), *cert. denied*, 340 U.S. 850 (1950).

²⁴² 203 F.2d 872 (5th Cir. 1953).

²⁴³ *Accord*, *Scholarship Endowment Foundation v. Nicholas*, 106 F.2d 552 (10th Cir. 1939), *cert. denied*, 308 U.S. 620 (1940). *Contra*, *Home Oil Mill v. Willingham*, 68 F. Supp. 525 (N.D. Ala. 1945) (a destination case which found a salary of \$15,000 a year to donor's sister, as chairman of the trust, not unreasonable).

²⁴⁴ NOW INT. REV. CODE OF 1954, §§ 501(c)(4), (6), (7).

²⁴⁵ *Scholarship Endowment Foundation v. Nicholas*, 106 F.2d 552 (10th Cir. 1939), *cert. denied*, 308 U.S. 620 (1940) (donor or his wife were to get \$5,000 a year for life out of income); *Jockey Club v. Helvering*, 76 F.2d 597 (2d Cir. 1935) (members, in effect, benefited from profits made from transactions with non-members); *Gemological Institute*, 17 T.C. 1604 (1952), *aff'd per curiam*, 212 F.2d 205 (9th Cir. 1954) (founder and executive director received fifty per cent of net income of allegedly exempt organization); *Medical Diagnostic Ass'n*, 42 B.T.A. 610 (1940) (allegedly nonprofit laboratory served commercial convenience of its members and profited from nonmembers in a way not unlike *Universal Oil Prods.*). See also *Underwriters' Labs., Inc. v. Commissioner*, 135 F.2d 371 (7th Cir.), *cert. denied*, 320 U.S. 756 (1943); *Fort Scott Clinic & Hosp. Corp. v. Brodrick*, 99 F. Supp. 515 (D. Kan. 1951), whose charities also were set up primarily to convenience and benefit their members.

While either a parent or a feeder organization can be used for private inurement, the feeder is particularly controllable by the seller or donor, and with it a reputable exempt organization, such as a university, can be used as the basic charity.²⁴⁶ There is often economic inurement in fact, in the form of cheaper services and other commercial conveniences, even though the inurement does not take the form of actual cash dividends.²⁴⁷

The pattern of private inurement is similar in all three types of charitable bootstrap. Wherever the price exceeds fair market value, the excess will be a diversion of funds from Charity to Owners. Even where an unfair price can not be proved, these transactions still involve substantial direct and indirect private inurement. The so-called "down payment" usually is directly taken out of the earnings of the old business and involves a dividend to the original owners—as was held in *Kolkey*—while the retention of most aspects of ownership, including both control and the risks of the business, makes the subsequent payments distributions of profits and income, not purchase price payments from an independent source. In the cemetery bootstraps, in addition to these usual bootstrap forms of private inurement, the exempt cemetery itself may be the vehicle of a number of related commercial activities on the part of Owners.

"Accumulation" of Income, and Private Inurement

A practical sign of the economic exploitation of an exemption is that little or no income is being currently spent for exempt purposes.²⁴⁸ In the bootstrap cases the income received must be devoted to notes or other debt for a considerable term of years, and little or nothing is distributed to charity. The exempt entity will accumulate an eventual "equity" (unless the price turns out to be so inflated that the instru-

²⁴⁶ The fact that institutions which are supposedly pillars of respectability, such as churches and universities, are not only willing, but eager to participate in such tax avoidance devices raises some interesting questions about their, and our, morality. Perhaps our rectitude myths parallel our wealth and power myths.

²⁴⁷ *United States v. La Societe Francaise*, 152 F.2d 243 (9th Cir. 1945), *cert. denied*, 327 U.S. 793 (1946); *Northwest Municipal Ass'n v. United States*, 99 F.2d 460 (8th Cir. 1938) (both stress that private inurement need not assume the form of direct cash payments). See *Duffy v. Birmingham*, 190 F.2d 738 (8th Cir. 1951) (charitable trust which paid employee pensions viewed as set up for private commercial convenience of employer); *Puritan Church*, 10 CCH Tax Ct. Mem. 485 (1951), *aff'd per curiam*, 209 F.2d 306 (D.C. Cir. 1953), *cert. denied*, 350 U.S. 810 (1955) (created in part for personal purposes of founder); *Davenport Foundation*, 6 CCH Tax Ct. Mem. 1335 (1947), *aff'd per curiam*, 170 F.2d 70 (9th Cir. 1948) (good deal of income inured directly to donor; not all of balance went to exempt purposes); *Pasadena Methodist Foundation*, 2 CCH Tax Ct. Mem. 905 (1943) (private charity).

²⁴⁸ Rev. Rul. 54-420, 1954-2 CUM. BULL. 128 (1954).

ments are never paid off as in *Kolkey*) but this hardly serves any immediate public goals.²⁴⁹

If there is accumulation of income, it is hard to conclude that any exempt purposes are being "fed." Thus, *Bear Gulch Water Co. v. Commissioner*,²⁵⁰ held that where funds are accumulated for, but not paid over to, a parent state university the funds do not "accrue" to the parent—i.e., if you accumulate, you do not "feed."²⁵¹

Accumulation may provide a subtle form of private inurement through the economic power which the control of a substantial charity may represent—the power to purchase, to hire and fire, and to grant or withhold large contributions, as well as to effect major business deals.²⁵² These powers may be rationalized, at least, where an exempt organization is in fact currently distributing funds to charity or otherwise serving public purposes. They appear to have less warrant if funds are merely accumulating and no exempt purposes are presently being served.²⁵³ But discussion of accumulation requires an examination of the Revenue Act of 1950, which dealt specifically with "unreasonable accumulation."

The Effect of the Revenue Act of 1950

Abuses of the charitable exemption, either of the bootstrap type or in conjunction with sale and leasebacks, provided the main impetus for the Revenue Act of 1950.²⁵⁴ The act dealt with the dilemma arising from the earlier provisions which forced an organization performing some business activities to be held totally exempt or not exempt at all. It enacted sections taxing "unrelated business income"²⁵⁵ and then amended section 101 of the 1939 Code to provide that the tax on

²⁴⁹ But see *Arthur Jordan Foundation v. Commissioner*, 210 F.2d 885 (7th Cir. 1954), where the Seventh Circuit held, in effect, that it did not matter how much a feeder accumulated, nor that nothing was being currently spent for charity. *Accord*, *Ohio Furnace Co.*, 25 T.C. 179 (1955) (*gov't appeal withdrawn*).

²⁵⁰ 116 F.2d 975 (9th Cir.), *cert. denied*, 314 U.S. 652 (1941). See also cases cited note 233 *supra*.

²⁵¹ *Andrew W. Mellon*, 36 B.T.A. 977 (1937), *acq.*, 1938-1 CUM. BULL. 20, *nonacq.*, 1938-1 CUM. BULL. 49, and *William T. Bruckner*, 20 B.T.A. 419 (1930), *acq.*, X-1 CUM. BULL. 9 (1931), specifically approve of accumulation without current distributions to exempt purposes. However, these are arguably distinguishable as being "temporary accumulations" pending full operation of the charities created.

²⁵² More than one commentator has pointed out the dominant influence of the private foundation, which exercises decisive economic power without publicity or regulation—and, indeed, is generally a political untouchable. *Tunks*, *supra* note 223; *Comment*, 59 YALE L.J. 477 (1950).

²⁵³ See Note, 98 U. PA. L. REV. 696 (1950).

²⁵⁴ Ch. 994, 64 Stat. 906. See Note, 60 YALE L.J. 879 (1951); *Comment*, 60 YALE L.J. 851 (1951). And see Statement of Secretary of the Treasury Snyder, *Hearings on the General Revenue Revision of 1950 Before the House Committee on Ways and Means*, 81st Cong., 2d Sess. 19 (1950).

²⁵⁵ NOW INT. REV. CODE OF 1954, §§ 511-14.

"unrelated business income" would not result in the denial of exemption.²⁵⁶ "Unrelated business net income" was defined as gross income from any trade or business whose conduct is not substantially related to the organization's exempt activity. However, so-called "passive" income—including dividends, interest, royalties, certain rental income and capital gains—was excluded from unrelated business income. The Senate Committee stated that this type of "passive" income is "not likely to result in serious competition for taxable businesses having similar income."²⁵⁷ It is not clear why these types of "passive" income involve activity on the part of an exempt organization that is any more or less competitive with private enterprise than other types of business income.²⁵⁸

But the unrelated business income tax would have meant little if charities could have continued to use feeders with the assistance of the destination test. Section 301(b) of the 1950 Revenue Act (the so-called "feeder amendment") amended section 101 of the 1939 Code by providing that no profit organization shall be exempt merely because its profits are payable to an exempt organization.²⁵⁹ However, in this case too the statute made exceptions for certain types of "rentals."

Finally, the act contained provisions designed to meet various abuses that had been revealed²⁶⁰ in dealings between donors and their tax-exempt entities. Certain transactions between donors and foundations created by them were prohibited²⁶¹ at the penalty of loss of exemption,²⁶² and loss of exemption was also prescribed if amounts "accumulated" out of income by a section 101(6) organization are not

²⁵⁶ NOW INT. REV. CODE OF 1954, § 501(b).

²⁵⁷ S. REP. NO. 2375, 81st Cong., 2d Sess. 30-31 (1950).

²⁵⁸ One other loophole is added to these provisions by the exclusion of churches from the unrelated business income tax. Int. Rev. Code of 1939, § 421, added by ch. 120, § 8, 57 Stat. 149 (1943), as amended (now INT. REV. CODE OF 1954, § 511). This makes the lease technique unnecessary for those churches that choose to engage in transactions such as the bootstrap deals. See Moore & Dohan, *supra* note 223.

²⁵⁹ NOW INT. REV. CODE OF 1954, § 502.

²⁶⁰ *Hearings on H.R. 8920 Before the Senate Committee on Finance*, 81st Cong., 2d Sess. (1950); *Hearings on the General Revenue Revision of 1950 Before the House Committee on Ways and Means*, 81st Cong., 2d Sess. (1950).

²⁶¹ Int. Rev. Code of 1939, § 3813, added by ch. 994, § 331, 64 Stat. 957 (1950) (now INT. REV. CODE OF 1954, § 503). Generally these "prohibited transactions" are between an exempt organization and its donor or other closely related persons and involve loans, compensation, sales, etc., where the amounts involved are not reasonable or security is inadequate, etc., or where the transaction otherwise results in diverting a substantial part of the income or corpus to a creator of the organization or other closely related person.

²⁶² Representative of the administrative role in tax erosion is Rev. Rul. 59-29, 1959-1 CUM. BULL. 123. There what was clearly a loan (a bank deposit) was held not a loan for purposes of the "prohibited transaction" statute (§ 503(c)(1)), thereby eliminating some of the statutory protection, as well as giving the bank a deduction for a "contribution" of funds whose possession and control it retained (it was trustee of its employees' pension funds, which it deposited with itself). This is discussed in Lanning, *Some Realities of Tax Reform*, in 1959-1 TAX REVISION COMPENDIUM 19.

actually paid out by the end of the taxable year, if the accumulations are unreasonable, and so on.²⁶³

The House bill would have prevented many of the current abuses of exempt entities.²⁶⁴ It restricted exemption to income actually distributed to charity,²⁶⁵ providing that, with certain exceptions, a private charitable trust was to be taxed on all income not paid to beneficiaries within two and one-half months after the close of the taxable year. But the Senate eliminated these provisions on the argument that they might injure "charitable" projects,²⁶⁶ and the final law contained only such limitations on the accumulation of income as that it be not "unreasonable in amount or duration."²⁶⁷

It has been said that the addition of these qualifying phrases "removed all the sting from the House provisions."²⁶⁸ This was prophetic. With the possible exception of *Kolkey* no court decision has arrived at a holding of unreasonable accumulation.²⁶⁹

In the bootstrap cases, all of Feeder's income for a number of years will go to Owner. It is by no means certain that Charity will ever benefit from the accumulation, especially where the price is inflated. It is difficult to see how there could be a more clear cut case of unreasonable accumulation.²⁷⁰ It is true that the original bootstrap cases have often involved tax years before the effective date of the legislation expressly dealing with unreasonable accumulations. However, the bootstrap accumulations involve both the failure currently to devote exempt income to exempt purposes and the inurement of income to Owner while Charity merely accumulates future rights. If the general

²⁶³ Int. Rev. Code of 1939, § 3814, added by ch. 994, § 331, 64 Stat. 957 (1950) (now INT. REV. CODE OF 1954, § 504).

²⁶⁴ The Senate rejected the House provisions as "harsh," stating that there could be no objection where the transactions were carried out at arm's length. S. REP. NO. 2375, 81st Cong., 2d Sess. (1950). This approach is reminiscent of the judicial language ("not sham," etc.) rejecting inquiry into dealings between related parties.

²⁶⁵ H.R. REP. NO. 2319, 81st Cong., 2d Sess. 40-41, 115-23 (1950).

²⁶⁶ S. REP. NO. 2375, 81st Cong., 2d Sess. 34 (1950).

²⁶⁷ Int. Rev. Code of 1939, § 3814, added by ch. 994, § 331, 64 Stat. 957 (1950) (now INT. REV. CODE OF 1954, § 504).

²⁶⁸ Comment, 60 YALE L.J. 851, 873 (1951).

²⁶⁹ *Arthur Jordan Foundation v. Commissioner*, 210 F.2d 885 (7th Cir. 1954); *Truscott v. United States*, 58-1 U.S. Tax Cas. ¶9515 (E.D. Pa. 1958); *Samuel Friedland Foundation v. United States*, 144 F. Supp. 74 (D.N.J. 1956); *Knapp Bros. Shoe Mfg. Corp. v. United States* 142 F. Supp. 899 (Ct. Cl. 1956); *Estate of Howes*, 30 T.C. 909 (1958), *aff'd sub nom. Commissioner v. Johnson*, 267 F.2d 382 (1st Cir. 1959); *W. H. Truschel*, 29 T.C. 433 (1957), *order amended*, 17 CCH Tax Ct. Mem. 110 (1958); *Ohio Furnace Co.*, 25 T.C. 179 (1955) (*gov't appeal withdrawn*).

²⁷⁰ Rev. Rul. 54-420, 1954-2 CUM. BULL. 128, applies the "unreasonable accumulation" doctrine to an original bootstrap situation. Unfortunately, the Internal Revenue Service has never published an explanation of its position in the bootstrap cases. This would not only have been helpful to the public and the tax bar, but might have brought an improved understanding of Internal Revenue Service policy. And see Rev. Rul. 54-137, 1954-1 CUM. BULL. 289.

principle that tax exemption is granted because funds are being devoted to public purposes is to be taken seriously, then the bootstrap accumulations should not have been permissible even before the 1950 Act.²⁷¹

Lease-Type Bootstraps and the 1950 Legislation

The "feeder amendment," which denied exemption to charitable feeders,²⁷² excluded "the rental by an organization of its real property (including personal property leased with the real property)." ²⁷³ And the "Supplement U" lease provisions of former section 423 ²⁷⁴ tax as "unrelated business income," "rental" income from leases for a term of more than five years, where the lessor incurred certain indebtedness in acquiring or improving the property.

These provisions created an opening for the lease-type bootstrap: Owner takes a going business and "sells" it to Feeder who "rents" it for a term of less than five years to a subsidiary, New Company, for a large percentage of the profits of the business. The lease-type case thus represents an effort to "split off" the operation of the transferred business from its income.²⁷⁵ This will permit the claim of exemption of the business income (from the unrelated business income tax) as mere "rent." Since the legislative history of the Revenue Act of 1950,²⁷⁶ indicates that the term "rent" was used only for passive investment income, this effort to stretch the term over active business income parallels the formalistic use of the "sale" concept.

In effect this arrangement is an anticipatory assignment of income in reverse. That is, Feeder and Charity have assigned the tree (the operating business) to New Company, while keeping most of the fruit (the business income). But it is not realistic to call the lease a "sham," for the new operating company is performing real functions as a corporate entity. In other words the lease serves to permit two corporate entities, Feeder and New Company, formally to operate the business, and initially to receive the profits. To characterize Feeder's rent re-

²⁷¹ *United States v. Community Servs., Inc.*, 189 F.2d 421 (4th Cir. 1951), *cert. denied*, 342 U.S. 932 (1952), holds that the enactment of the 1950 legislation merely clarified the prior law.

²⁷² For a discussion of § 302(d) of the 1950 Act, which excepts certain organizations from the "feeder amendment," see notes 59-61 *supra* and accompanying text.

²⁷³ Revenue Act of 1950, § 301(b), 64 Stat. 953 (now INT. REV. CODE OF 1954, § 502). (Emphasis added.)

²⁷⁴ Added by ch. 994, § 301(a), 64 Stat. 950 (1950) (now INT. REV. CODE OF 1954, § 514).

²⁷⁵ Hence the term "split feeder."

²⁷⁶ S. REP. NO. 2375, 81st Cong., 2d Sess. (1950); H.R. REP. NO. 2319, 81st Cong., 2d Sess. (1950).

ceipts as "dividends" suggests that both New Company and Feeder will be initially taxed on the operating income of the business, since no basis appears for a "dividends received credit." This is perhaps harsh in view of the relationship between Owner, Feeder and New Company with respect to the profits of the business. But to treat the receipts as rent would be to accept a transparent effort to split off a business' operations from its income and thereby to shift business income into charitable hands on an exempt basis, and thence back into private pockets.

A realistic solution is to see Feeder and New Company as being, in substance, in the position of joint operators and taxable as such on their respective shares of the business income, Feeder's portion being "unrelated business income."²⁷⁷ With Feeder and the new operating company, together, seen as occupying the same position that Feeder alone occupied in the original bootstraps, the distribution of income to Owner is subject to the analysis applicable to those transactions. In one respect, in fact, there is more retained control here than in the original bootstrap cases inasmuch as Owner, in the lease-type situations, often retains some direct stock ownership in the new operating entity itself.

One recent case is quite similar to the lease-type bootstraps. In *Amon G. Carter Foundation v. United States*,²⁷⁸ the donor conveyed various oil and gas interests and related equipment to his exempt family foundation. The foundation in turn conveyed them to a new operating company which it had formed, retaining unusually high "overriding royalties" (approximately eighty per cent). This left the operations in the hands of the operating company while reserving almost all of the operating income to the foundation in the guise of passive royalty income. A proper analysis would appear to be similar to that suggested for the lease-type bootstraps, namely that the foundation and the operating company jointly retained the working interest in a relationship analogous to that of joint venturers. Therefore, the foundation was receiving active operating income from the operation of the oil and

²⁷⁷ The language of the Regulations supports this position. Treas. Reg. 118, § 39.422-1(b) (1953), and Treas. Reg. 1.512(b)-1 (1958), state: "[I]f a payment termed 'rent' by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or joint venturer, such payment is not within the exception for rent." On the other hand, the Regulations offset this to some extent by specifically providing in Treas. Reg. 118, § 39.422-1(b) (3) (ii) (1953), and Treas. Reg. 1.512(b)-1(c) (2) (1958), that the income from the operation of an office building is "rent," although in most respects the commercial and business activity involved is so extensive as to make it the type of "rent" described by the provisions just quoted. It is understood that efforts within the Internal Revenue Service to correct this situation have been unavailing.

²⁷⁸ 58-1 U.S. Tax Cas. ¶ 9342 (N.D. Tex. 1958).

gas properties and should have been subject to the unrelated business income tax.²⁷⁹

But the Justice Department brief, while analyzing the situation, added a "sham" contention concluding:²⁸⁰ "the Court [should] ignore the existence of [the operating company] insofar as the tax problem is concerned." The court seized on this in its decision and stated that the Government had merely urged sham and the piercing of the operating company's entity. The court held it was not sham and did not really examine the substance of the transaction—as frequently happens where sham is urged in a situation where substance-over-form analysis is appropriate.²⁸¹

Despite the fate of the *Carter Foundation* case—an oil and gas case decided in oil and gas country—there is some possibility that the Commissioner will prevail in the lease-type bootstraps. The use of the "rental" technique for avoiding the unrelated business income tax is so transparent a device that the courts might give some weight in this context to the many basic tax principles which a bootstrap transaction violates.

The Cemetery Bootstraps

The ordinary bootstrap problems are further complicated in the cemetery cases by the liberal interpretation of the provisions exempting certain cemeteries from taxation.²⁸² The courts have held it was sufficient for exemption, that a cemetery meet any one of three independent requirements: (1) owned and operated exclusively for the benefit of its members, (2) not operated for profit, (3) chartered as a cemetery but

²⁷⁹ Fisher, *Oil and Gas Transactions of Exempt Organizations*, in SOUTHWESTERN LEGAL FOUNDATION, 6TH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 339, 354 (1955), comments as to a "split-feeder" situation like *Carter Foundation*: "The substance of the transaction would not then be an effective disposition of the working interest, even though the subsidiary entity became subject to tax on the income of the working interest."

²⁸⁰ Brief for the Government, *Amon G. Carter Foundation v. United States*, 58-1 U.S. Tax Cas. ¶9342 (N.D. Tex. 1958).

²⁸¹ The Solicitor General declined to appeal the case, although the ability to split off a Feeder's or a Charity's "operating" income from its "passive" income and thereby avoid the unrelated business income tax would appear to be an issue of importance. It is understood that the Solicitor General's refusal to appeal was based on the difficulty of piercing the entity of the operating company—but it would be possible to recognize that entity, and still find that the charity was receiving a share of operating income, not mere passive rent.

²⁸² Int. Rev. Code of 1939, §101(5), ch. 1, 53 Stat. 33, as amended (now INT. REV. CODE OF 1954, §501(c)(13)), lists as organizations exempt from taxation: "Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual."

not permitted by charter to engage in a business not incidental to burial purposes, and with no private inurement.²⁸³

To treat these three criteria as separate and independent opens an easy route to abuse. It means that if one of the first two standards is met, both private inurement and large scale business activity would be permissible. Private inurement is so basic a barrier to exemption under section 501 of the 1954 Code that it would hardly seem permissible here. A nonprofit cemetery under section 501(c)(13) surely has no greater claim to exemption, and therefore no lesser need to keep its skirts clean, than a section 501(c)(3) organization. It is understood that the Commissioner regards the absence of private inurement as a minimum essential for any section 501(c)(13) exemption.²⁸⁴ And the concept of "private inurement" has broadened beyond the point it represented when most of the cemetery cases were decided fifteen or twenty years ago. On the other hand, the Commissioner may have slightly eroded his own position by failing to repeal regulations which permit a cemetery to pay dividends of up to eight per cent a year on preferred stock if the stock is retired at par as soon as possible.²⁸⁵

Similar comments should apply to the large scale business activities which so many nonprofit cemeteries conduct. If the "members" for whose "benefit" the cemetery is exclusively operated are limited to owners of lots or burial rights,²⁸⁶ (a limitation which seems consistent with the purposes of the exemption) then these broad commercial activities are hard to justify. But "members" may mean those who effectively control and operate the cemetery business and its many related commercial operations, as decisions such as those in the *Forest Lawn* cases²⁸⁷ imply. It is difficult to see why the business of operating a mortuary in competition with other private business should be tax-exempt.

²⁸³ *West Laurel Hill Cemetery Co. v. Rothensies*, 139 F.2d 50 (3d Cir. 1943), *cert. denied*, 321 U.S. 780 (1944); *Forest Lawn Memorial Park Ass'n*, 45 B.T.A. 1091 (1941), *nonacq.*, 1942-2 CUM. BULL. 25; *The Kensico Cemetery*, 35 B.T.A. 498 (1937), *nonacq.*, 1937-1 CUM. BULL. 40, *aff'd*, 96 F.2d 594 (2d Cir. 1938); *Forest Lawn Memorial Park Ass'n*, 5 CCH Tax Ct. Mem. 738 (1946). None of these are "bootstrap" cases. No cemetery bootstrap has as yet appeared before a court, although litigation is understood to be en route.

²⁸⁴ This is implied by Rev. Rul. 58-190, 1958-1 CUM. BULL. 15, at 17, which in discussing nonprofit cemetery problems states: "an organization is not exempt from tax merely because it is organized and operated not for profit."

²⁸⁵ Treas. Reg. 1.501(c)(13)-1 (1958).

²⁸⁶ *West Laurel Hill Cemetery Co. v. Rothensies*, 139 F.2d 50 (3d Cir. 1943), *cert. denied*, 321 U.S. 780 (1944).

²⁸⁷ *Forest Lawn Memorial Park Ass'n*, 45 B.T.A. 1091 (1941), *nonacq.*, 1942-2 CUM. BULL. 25; *Forest Lawn Memorial Park Ass'n*, 5 CCH Tax Ct. Mem. 738 (1946).

Furthermore, section 170(c)(5), which was added by the 1954 Code to permit the deduction of "contributions" to nonprofit cemeteries²⁸⁸ contains a more broadly stated ban on private inurement²⁸⁹ than does section 501(c)(13), which is a verbatim reenactment of a statute which had been in force for many years.²⁹⁰ It is unlikely that Congress in simultaneously enacting both statutes in 1954 meant the greater privilege of exemption to embody the lesser restriction on private inurement. It is also possible that the increased tax advantages brought by section 170(c)(5) may lead to a closer judicial scrutiny of nonprofit cemeteries than has been practiced to this point.

One might argue that the *Forest Lawn* cases reveal an economic complex in which the manager of the cemetery benefited by its dealings with other companies which he, or persons closely related to him, controlled. It has been suggested that the criterion for private inurement be whether it is possible for the earnings to be distributed to any private individual or corporation.²⁹¹ This test might prevent direct private inurement if "earnings" were adequately defined, but does not cope with the indirect inurement that is so important a part of arrangements such as those in *Forest Lawn*.

The cemetery decisions reveal some of the same judicial formalism and reluctance to examine dealings between closely related parties that is characteristic of the bootstrap area. Thus in *Kensico Cemetery*, the vendors of land to the cemetery were to receive half the proceeds from any future sales of cemetery lots. The court approved this arrangement, emphasizing that the vendors did not get a share of the "net earnings" of the cemetery company, but only a portion of the "gross." A verbalism of this sort cannot obscure the fact that the sale of lots was a major business operation for the cemetery company. Under this arrangement the original owners would continue to share indefinitely in

²⁸⁸ INT. REV. CODE OF 1954, § 170(c)(5), provides that a "charitable contribution" is a contribution or gift to or for the use of: "A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, if such company or corporation is not operated for profit and no part of the net earnings of such company or corporation inures to the benefit of any private shareholder or individual."

²⁸⁹ S. REP. NO. 1622, 83d Cong., 2d Sess. 210 (1954), states flatly: "A corporation will not qualify under this paragraph if any part of its net earnings inure to the benefit of any private shareholder or individual, or if it is operated for profit." This amounts to saying that compliance with only one of the three criteria is insufficient.

²⁹⁰ Section 231(5) of the Revenue Act of 1921, ch. 136, 42 Stat. 253, had the same wording as Int. Rev. Code of 1939, § 101(5), ch. 1, 53 Stat. 33, as amended (now INT. REV. CODE OF 1954, § 501(c)(13)).

²⁹¹ *West Laurel Hill Cemetery Co. v. Rothensies*, 139 F.2d 50 (3d Cir. 1943), cert. denied, 321 U.S. 780 (1944), distinguished *Kensico* and the *Forest Lawn* cases on the argument that in the former the earnings could not be distributed to any individual or corporation.

income from the sale of lots. The Commissioner does not accept *Kensico* as a resolution of the problem.²⁹²

Kensico, furthermore, was based on a New York statute that permitted land to be sold to a cemetery corporation in return for up to half of the gross receipts from the sale of cemetery lots.²⁹³ Due to extensive profiteering and other abuses, this authority was revised in 1949 so as to forbid cemetery corporations to pay more than the fair and reasonable market value of land purchased, with the terms, method of payment and price to be subject to court approval.²⁹⁴ This eliminates the most important justification for *Kensico*—the existence of a state statute approving the type of open-end arrangement involved (which again illustrates the undesirability of basing federal tax law on state laws).²⁹⁵ Finally, although there was complete retention of risk in *Kensico*, it lacked the additional element of retention of control true of the cemetery bootstraps.

The public purposes for which cemeteries get tax exemption may be less lofty, or less articulate, than those necessary for a section 501(c)(3) exemption. But this can be offset by the fact that commercialism, retention of risk and control, and private inurement appear to be more overt in the cemetery bootstrap cases. In at least one case it is understood that the cemetery and the related profit enterprises of the Old Owners advertised jointly and even employed common salesmen.²⁹⁶

VII. THE CAPITAL GAINS PROBLEM AND THE BOOTSTRAP CASES

The central bootstrap issue is the tax characterization of the transfer of the business. If the transfer falls within the traditional "sale" category, that determines not only the capital gains issue, but

²⁹² There is an outstanding nonacquiescence in the *Kensico* case, 1937-1 CUM. BULL. 40.

²⁹³ N.Y. MEMBERSHIP CORP. LAWS § 87.

²⁹⁴ *Ibid.* See Walsh & Walsh, *The 1949 Revision of the Membership Corporation Law in Regard to Cemetery Corporations*, 24 ST. JOHN'S L. REV. 168, 174 (1949).

²⁹⁵ *Burnet v. Harmel*, 287 U.S. 103 (1932).

²⁹⁶ The handling of these cemetery problems may have suffered from the fact that they represent a secluded corner of the tax law which to date has been given inadequate public attention. This may be a product of a cultural proclivity to shy away from death and any of its trappings. Revenue agents and others are often reluctant to inquire too closely into the details of cemetery operation, mortuaries, burial and death. See Walsh & Walsh, *supra* note 294, for a description of some of the objectionable practices indulged in by those engaged in the business end of cemetery operations. In any event, despite the religious overtones of death and burial, there is a serious question whether cemetery operations truly serve such public purposes as to warrant their existing tax treatment. To permit contributions to a cemetery to be deductible often is to subsidize personal expenditures. The contributor is paying for the preservation or beautification of his own last resting place. Since a full consideration is paid for burial in such cemeteries, the public service is questionable.

such basic exemption issues as private inurement. A bootstrap transfer (or any transfer) must be analyzed as a complex of economic relationships through time, rather than as characterized by the legal label. So viewed, bootstrap owners appear to be receiving a steady flow of business profits, as entrepreneurs rather than as creditors. The contrary conclusions reached in the bootstrap cases must be explained in part by the character of the capital gains doctrine.

The Claimed Rationales of Capital Gains Taxation

The tax treatment of capital gains raises questions not merely as to the relationship between its principles and their application in practice, but as to the consistency of those principles with general principles of progressive income taxation.²⁹⁷ The statutes²⁹⁸ talk of the "sale and exchange" of a "capital asset," or of "property used in the trade or business," as producing "capital gain." None of the first three terms appears to have any reference to economic reality,²⁹⁹ nor does the

²⁹⁷ See SELTZER, *THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES* (1951); TAX INSTITUTE, *CAPITAL GAINS TAXATION* (1946); U.S. TREASURY DEPT., *TAX ADVISORY STAFF, FEDERAL INCOME TAX TREATMENT OF CAPITAL GAINS AND LOSSES* (1951); VICKREY, *AGENDA FOR PROGRESSIVE TAXATION* ch. 5 (1947); Blum, *A Handy Summary of the Capital Gains Arguments*, 35 *TAXES* 247 (1957); Groves, *Taxation of Capital Gains*, 1959-2 *TAX REVISION COMPENDIUM* 1193. None of these analyses find any very adequate justification for capital gains treatment. But see Clark, *The Paradox of Capital Gains: Taxable Income That Ought Not To Be Currently Taxed*, 1959-2 *TAX REVISION COMPENDIUM* 1243; Miller, *Taxation of Capital Gains*, 1959-2 *TAX REVISION COMPENDIUM* 1257; Smith, *Tax Treatment of Capital Gains*, 1959-2 *TAX REVISION COMPENDIUM* 1233; and see also Steger, *Economic Consequences of Substantial Changes in the Method of Taxing Capital Gains and Losses*, 1959-2 *TAX REVISION COMPENDIUM* 1261.

²⁹⁸ Int. Rev. Code of 1939, § 117(a), ch. 1, 53 Stat. 50, as amended, § 117(j), added by ch. 619, § 151, 56 Stat. 846 (1942), as amended (now INT. REV. CODE OF 1954, §§ 1221, 1222, 1231).

²⁹⁹ See Miller, *The "Capital Asset" Concept: A Critique of Capital Gain Taxation*, 59 *YALE L.J.* 837, 1057 (1950). If the essential meaning of "capital asset" lies in the distinction between income and the asset that produced it (Staff Comm. of the Joint Economic Committee, *The Federal Revenue System: Fact and Problems* 62 (1959)), i.e., in the difference between the fruit and the tree, then how does one explain the capital gains treatment accorded income both from the cutting or disposal of timber and from coal royalties, INT. REV. CODE OF 1954, §§ 631, 1231, from unharvested crops sold with land, § 1231 (the very "fruit" itself), or the sale of livestock "held for draft, breeding or dairy purposes," § 1231? Some of the items in § 1231 fall within the technical rubric of "property used in the trade or business," which for present purposes is primarily another label for "capital asset." The similarity of these items to the normal day-by-day profits of a business casts doubt on the supposed line between investments and business for capital gains purposes. Nor can the distinction be whether the receipt is due to "personal services or efforts," Miller, *Capital Gains of the Fruits of Personal Efforts: Before and Under the 1954 Code*, 64 *YALE L.J.* 1 (1954), in view of the capital gains treatment provided for stock options, INT. REV. CODE OF 1954, § 421, and the proceeds from distributions from employees' (pension) trusts, § 402. The court decisions appear to grant even more tax relief in this area of stock options to those who do not qualify for the statutory relief, than to those who do, *MacDonald v. Commissioner*, 230 F.2d 534 (7th Cir. 1956); *McNamara v. Commissioner*, 210 F.2d 505 (7th Cir. 1954); *Commissioner v. Stone's Estate*, 210 F.2d 33 (3d Cir. 1954). How explain, moreover, that while the sale or exchange of patents receives capital gain treatment, § 1235,

very term "capital gains" reflect any independently meaningful concept in either economics or accounting.³⁰⁰ The classic economic definition of "income" is in terms of "money value of the net accretion of one's economic power between two points in time,"³⁰¹ meaning one's consumption plus the increase in one's net worth over any period of time. But there is nothing in this approach that permits a distinction between "capital gain" and "income."

The lack of any real distinction³⁰² lies at the heart of the problem. No fully articulate rationalization for capital gains treatment has been set out by Congress. Vague legislative comments were made about the original capital gains provisions:

"The sale of farms, mineral properties and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are, under the present law, taxed as a lump sum in the year in which the profit is realized."³⁰³

This justification for special treatment would appear to rest on two grounds: (1) gains accumulated over a period of years "bunch up" in the year realized, and so are taxed at higher rates under a progressive system; (2) the development of the economy requires the "incentive" provided for "investment"-type transfers by the low capital gains rate.

The "Bunching" Rationale

It has been suggested that the bunching argument is the "one really meritorious argument in favor of special tax treatment for cap-

the transfer of copyrights is taxed as ordinary income, § 1231? Little assurance is provided by the vagueness of some of the statutory language. In the Code's § 1221, defining "capital asset," the phrase appears "*property* held by the taxpayer." (Emphasis added.) No term defined by so ambiguous a concept as "property" could be very clearcut.

See discussion at note 20 *supra* as to the application of the "property" concept to the stock option problem. The sale of an oil payment or royalty is traditionally given capital gains treatment as the sale of "property" and a fractional share of a capital asset. The Federal Revenue System, *supra* at 51. But by economic interest doctrine an oil payment or royalty represents ordinary income from a retained ownership share in the business of extracting natural resources. And the Supreme Court recently held in *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958), that the sale of a "carved-out" oil payment results in ordinary income. The "property" and "capital asset" concepts have thus produced capital gains treatment for what, in principle, is an anticipation of future income.

³⁰⁰ See note 299 *supra*. SELTZER, *op. cit. supra* note 297; Blum, *supra* note 297; Surrey, *Definitional Problems in Capital Gains Taxation*, 1959-2 TAX REVISION COMPENDIUM 1203.

³⁰¹ HAIG, *THE FEDERAL INCOME TAX* 7 (1921); SIMONS, *PERSONAL INCOME TAXATION* 51, 125 (1938).

³⁰² Miller, *supra* note 299, 59 YALE L.J. at 1078; Surrey, *supra* note 300.

³⁰³ H.R. REP. NO. 350, 67th Cong., 1st Sess. 10-11 (1921).

ital gains.”³⁰⁴ Meritorious or not, it does not seem to justify capital gains taxation. The capital gains holding period is now only six months;³⁰⁵ for patents the holding period is zero.³⁰⁶ Since a great many capital gains transactions are opened and closed within less than the annual accounting period, such transactions are hardly being protected from bunching.³⁰⁷

Furthermore, most of those who benefit by capital gains treatment are high bracket taxpayers,³⁰⁸ for whom averaging is often of little importance.³⁰⁹ It is the capital gains schedule which sharply cuts their effective rate of taxation.³¹⁰ And if it is desirable to grant relief from bunching, any type of income, not just investment types, would seem to qualify. Finally, the twenty-five per cent capital gains rate has little factual relationship to the rate that would have applied had the gain been taxed as it accrued, instead of being bunched.³¹¹

The lower courts often cite but give little practical effect to the anti-bunching rationale, as the patent and bootstrap cases illustrate. In *Carl G. Dreyman*,³¹² the Commissioner argued with no success, that capital gains treatment was not appropriate for recurrent installment receipts. The Government did not appeal although the Supreme Court, at least, takes the bunching rationale seriously by denying capital gains treatment where income is received over a period of time.³¹³

³⁰⁴ Lowndes, *The Taxation of Capital Gains and Losses Under the Federal Income Tax*, 26 TEXAS L. REV. 440, 442 (1948).

³⁰⁵ Int. Rev. Code of 1939, § 117(h), ch. 1, 53 Stat. 52, as amended (now INT. REV. CODE OF 1954, § 1223).

³⁰⁶ INT. REV. CODE OF 1954, § 1235.

³⁰⁷ The Treasury Department in 1951 urged that the holding period should be made a year in order to provide greater consistency with the bunching rationale. U.S. TREASURY DEP'T, *op. cit. supra* note 297.

³⁰⁸ GROVES, *POSTWAR TAXATION AND ECONOMIC PROGRESS* 214 (1946); PAUL, *TAXATION FOR PROSPERITY* (1947); *Hearings on Proposed Tax Revisions Before the House Committee on Ways and Means*, 75th Cong., 2d Sess. 39 (1938); The Federal Revenue System, *supra* note 299. U.S. TREASURY DEP'T, *STATISTICS OF INCOME* (1956), contains statistics which reveal that out of 45.5 million returns showing income below \$20,000, 2.15 million or 4.7% reported tax savings from capital gains totaling \$504 million, an average of about \$250 a return, while out of 700,000 returns with income over \$20,000 more than 300,000 returns, or 45.7% reported savings on capital gains totaling over \$2 billion, an average of about \$6,500 a return, and several times the total for the rest of the country.

³⁰⁹ The Federal Revenue System, *supra* note 299, at 65.

³¹⁰ Heller, *Investor's Decisions, Equity and the Capital Gains Tax*, 1955 COMPENDIUM 381, 390.

³¹¹ The Federal Revenue System, *supra* note 299, at 61.

³¹² 11 T.C. 153 (1948).

³¹³ *Corn Prods. Ref. Co. v. United States*, 350 U.S. 46, 52 (1955); *Burnet v. Harmel*, 287 U.S. 103, 106 (1930). In *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260, 265 (1958), the Court stated that § 117, whose "purpose was 'to relieve the taxpayer from . . . excessive tax burdens on the gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions' . . . has always been narrowly construed so as to protect the revenue against artful devices. . . ." When the Court commented that the capital gains "exception" had "always" been narrowly construed, it must have meant only by itself.

The "Incentives" Rationale

The other major justification offered for capital gains treatment is that it provides the necessary incentives³¹⁴ for business investment.³¹⁵ This argument is offered in support of many of the tax "loopholes" considered here. It assumes that business incentive is the only mechanism for producing a healthy and growing economy. But, depending on the state of economy, there may be other modes of public and private spending that produce more socially desirable forms of capital accumulation and a healthier and more broadly based economic structure.³¹⁶

In selecting among these alternative philosophies a primary emphasis on business "investment" appears to include a preference for a distribution of the tax burden that leaves more in the hands of the high bracket taxpayer.³¹⁷ Such special treatment of capital gains is one of the most important factors in the erosion of our democratic system of progressive taxation. It is a classic example of the type of rationalization of special interests that the formalism so frequently encountered in this study serves to mask.

VIII. SOME INTERIM CONCLUSIONS

For purposes of this Article, the component elements of the bootstrap problem have been separated and individually analyzed. But the proper analysis of a bootstrap does not turn upon any single factor such as retention of risk, use of an exemption or loss carryover, retention of control or deviation from the proclaimed patterns for capital gains treatment. Indeed, many of the individual elements are relatively innocuous: people often dispose of businesses, sometimes get an inflated price, often have a charitable purchaser, frequently have the

³¹⁴ SELTZER, *op. cit. supra* note 297; Blum, *supra* note 297; Brown, *The Locked-In Problem*, 1955 COMPENDIUM 367. This is the standard argument of almost every tax lobbyist.

³¹⁵ A minor objection is that the only statutory criterion for distinguishing "investment" from "speculation" is the six-months holding period—surely an inadequate dividing line. Furthermore, an "incentive" that gives a greater tax stimulus to casual stock market speculation than to regular business activity is open to question. See Heller, *supra* note 310, at 290-91.

³¹⁶ See Lanning, *Some Realities of Tax Reform*, in 1959-1 TAX REVISION COMPENDIUM 19. The question as to whether fiscal policy should take the form of an emphasis on business investment or on other forms of public or private spending is beyond the scope of this paper. In politics we quickly see the disadvantages to democracy of stimulating the power of a few at the top. But the parallel in fiscal policy of stimulating investment with a set of special tax privileges is not so readily dissected. It is suggested that a more democratically oriented economy will afford a sounder base for economic growth and prosperity than any system of special incentives. And see, Paul, *Erosion of the Tax Base and Rate Structure*, 11 TAX L. REV. 203, 219 (1956); Ruttenberg, *The Declining Role of Business Investment in a Growing Economy*, 1955 COMPENDIUM 217.

³¹⁷ See Heller, *supra* note 310, at 381.

present management continue for a period. Notes with little capital behind them are given and received; percentage leases are often utilized; loss corporations are frequently involved in the transfer of a business. The issue is the combined impact of all these elements, in terms of the policies of income taxation proclaimed by Congress and the Supreme Court.

The bootstrap transactions have been upheld by the courts despite the violation of a combination of at least four claimed public policies: the policy against granting tax exemption for activities and funds a significant portion of which serves private benefit rather than public purposes, the policy against permitting tax exemption for the operation of competitive businesses, the policy that capital gains treatment is to be given to significant economic transfers of investment-type assets but not to ordinary commercial or business income, and the policy that transactions are to be judged on their entire substance rather than their naked form. Not only do the original bootstrap decisions themselves disregard or bypass these basic principles but when the principles are analyzed in operation it is seen that other decisions, particularly in the lower courts, often give them no more than lip service. This situation has many disconcerting implications if one believes in the importance of a democratic system of progressive income taxation.

Possible explanations of these phenomena were noted during the course of their analysis—particularly the role of judicial formalism, and of certain institutional practices of the taxing process. Part II of this paper will be devoted to a detailed analysis of the final major type of bootstrap transfer, the unlitigated problem of the "loss bootstrap," and to general conclusions regarding the process of tax erosion as exemplified by the bootstrap transactions.