PRIVATE CHARITABLE FOUNDATIONS: SOME TAX AND POLICY IMPLICATIONS

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As a part of the planning for post war federal taxation, Congress and the Treasury have been investigating the whole field of tax exempt organizations. Prominent among the organizations enjoying exemption under the Internal Revenue Code are charitable organizations created in the form of a trust, a non-profit corporation or other form by a wealthy individual or family and controlled by the creator or creators, their families or appointees. Such organizations fall within the more general terms “foundation” or “charitable foundation,” terms which, for convenience, will be used to describe these organizations.2

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2. The term “foundation” has been used to describe a large variety of organizations carrying on a number of different activities, some far from charitable in purpose. In a more restrictive sense, a “foundation” has been described as a non-profit, non-governmental organization having a principal fund of its own, established to aid or maintain activities serving the common good. HARRISON AND ANDREWS, AMERICAN FOUNDATIONS FOR SOCIAL WELFARE 11 (1946). “Within this broad definition fall community trusts, foundations in colleges, industrial foundations, associations and agencies, gifts for highly restricted purposes, unincorporated charitable trusts, and the so-called family foundations.” Note, The Use of Charitable Foundations for Avoidance of Taxes, 34 VA. L. REV. 182, 193 (1948). The present paper is restricted to a consideration of the “family foundation.”
Although the present interest in charitable foundations has centered on their tax-avoidance possibilities, they are not a new phenomenon in our society. The charitable trust has long been a part of the English and American tradition of favoring distribution of wealth by individual volition. Their social and economic implications have been the subject of debate in the past. There is no accurate knowledge today of the number of foundations in the United States, although lists of the wealthier ones run into the thousands. They represent a vast accumulation of wealth; they distribute annually large sums of money for scientific research, education, social welfare, and similar interests. The inevitable result is that foundations wield a powerful influence on our present culture.


5. Eduard Lindeman compiled a list of 533 private foundations and 40 community foundations for the decade ending in 1930. Lindeman, Wealth and Culture 10 (1936). The latest Russell Sage directory lists 505 foundations with assets of over $50,000 from a total list of over 5,000. Harrison and Andrews, op. cit. supra note 2; see also, How to Have Your Own Foundation, 36 Fortune 108 (1947). The report that the Treasury estimates more than 10,000 foundations in the United States is not authentic according to Treasury officials. Some idea of the tremendous number of charitable trusts and corporations in the United States can be gathered from a report on the subject of charitable trusts contained in Reports and Recommendations for Legislation of Former Attorney General Bushnell, 30 Mass. L.Q. 22, 24 (1945). The report states that a survey made by the Massachusetts' Attorney General's department in 1935 lists to that date in Massachusetts, 26,451 estates in which bequests had been made for charitable purposes. The use of funds was restricted in 14,428 of the bequests, whereas the use was unrestricted in 36,500. The figures do not give the number of charitable trusts having trustees independent of an established charitable institution.

6. Harrison and Andrews, op. cit. supra note 2, at 56 et seq., estimate the total assets of 505 leading foundations with assets of over $50,000 to be $1,817,817,299. The difficulty of arriving at an exact figure is illustrated by the fact that the above authors selected the 505 foundations from a list of more than 5,000. Id. at 213. Of the 505 foundations, full reports were available for only 265 and the information on 15 of these was confidential. Estimates on 69 foundations were based upon newspaper reports, capitalization of expenditures and private information. No substantial information could be obtained from 171 of the foundations. The authors therefore arbitrarily capitalized each of these at $100,000. The same authors estimate the total wealth of private foundations to be about 15 per cent of the total "philanthropic endowment" which includes all educational institutions, hospitals, libraries, museums, religious organizations, and similar institutions.

7. Harrison and Andrews, op. cit. supra note 2, at 54, 55, estimate private foundations made grants totalling $72,000,000 for 1941. This figure represents approximately 3 per cent of the total charitable giving for the year from individuals, corporations, charitable bequests, and income from endowment other than private foundations which total is estimated at $2,706,000,000. John Price Jones, The Yearbook of Philanthropy (1942-1943) estimates total foundation grants to be $46,952,000 for 1942.

8. In his study of 100 foundations and community trusts during the decade 1921-1930, Eduard C. Lindeman listed foundations as sixth in a list of major influences in American life during that decade. The full list is: (1) business; (2) the press; (3) educational institutions; (4) religious institutions; (5) governmental agencies; (6) foundations; (7) sports and amusements; (8) secret societies; (9) literature; (10) the fine arts. Lindeman, Wealth and Culture 11 (1936).
Undoubtedly the foundation creators of the early 1900s were little prompted by considerations of avoiding the minor tax burdens of that day. One provocative writer has described foundations as symptomatic of a later and disintegrating period in our economic development, and of the rise of a rudimentary social consciousness on the part of the very wealthy. Others have ascribed to donors motives of a loftier nature. Whatever the motive or impetus prior to the federal income, estate and gift taxes, since those enactments, avoidance of tax burdens has become a stimulus of increasingly greater importance. The generous charitable deductions and exemptions of the federal tax statutes have afforded points of special relaxation of pressure in an area of general tax pressure. As a result, a larger number of wealthy and moderately wealthy individuals are establishing foundations in recent years.

Of course, the creation of a charitable foundation is not the sole way of realizing the tax advantages of a charitable gift. Any charitable gift or bequest takes property out of the highest estate or income tax brackets. The sale of a business to any charitable organization may mean for the seller a quicker realization of a higher sales price. The tremendous advantage of the charitable foundation is that the creator and his family may realize charitable deductions by gifts to the foundation and still retain control of the property given away. Likewise, a business can be sold to the foundation on better terms than a private buyer can offer, and yet the seller or his family can continue to operate the business at reasonable salaries by controlling the foundation.

9. Id. at 4, 5.
10. Compare the statement of Andrew Carnegie that the millionaire should be "a trustee and agent for his poorer brethren, bringing to their service his superior wisdom, experience, and ability to administer, doing for them better than they could or would do for themselves." CARNEGIE, THE GOSPEL OF WEALTH (1900).
13. Because its income is tax exempt, the charitable organization is in a much better position to pay for the business from earnings. A striking example was given by Mr. John Gerdes, testifying for New York University before the Committee on Ways and Means. Alumni and friends of the University have formed several nonprofit corporations which have purchased commercial enterprises. The income of the corporation is payable solely to the University. One of these corporations purchased for $3,000,000 a plant in St. Louis manufacturing piston rings. The plant's profit in two years before state and local taxes was $1,800,000. See Hearings on Proposed Revisions of the Internal Revenue Code, note 1 supra, at 3539.
14. The charitable foundation also allows the creator to give more tax free income to charity than the 15 per cent limitation of § 23(o) would otherwise allow. For a summary of books and literature on the tax advantages of charitable giving, see Note, 34 VA. L. REV. 183 (1947); see also LASSEER, HOW TAX LAWS MAKE GIVING TO CHARITY EASY (1948).
This paper undertakes a survey of the present limitations placed by the Internal Revenue Code upon the creation and operation of foundations. An analysis will be made of the forms of organization required, of who may control the organization, of what may be its sources of income, and of who may be the recipients of its income. In conclusion a summary of suggested reforms will be made as a basis for further investigation and discussion of the problem.

**Statutes Involved**

Although it is not difficult to comply technically with the Code to assure a charitable deduction and exemption, still there are some unaccountable divergences in the wording of various Code sections. In a general way the sections are similar to Section 23(o), which allows citizens and residents a deduction of up to 15 per cent of their adjusted gross incomes for contributions to:

(2) a corporation, trust, or community chest, fund or foundation, created or organized in the United States or in any possession thereof or under the law of the United States or of any State or Territory or of any possession of the United States, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation; . . .

The Congressional design of promoting charitable contributions and organizations is carried forth in Sections 812(d) and 1004(a)(2)(B) allowing an unlimited charitable deduction in computing estate and gift taxes: Section 162(a) permitting trusts and estates an unlimited charitable deduction for gross income used, paid or permanently set aside for charitable purposes, and Section 101(6) granting charitable organizations exemption from income taxes. Sections 213(c), 861(a)(3), and 1004(b)(2) allow income, estate and gift tax charitable deductions to non-resident aliens.

The most pronounced lack of harmony in the Code sections exists in regard to whether the foundation must be organized in the United

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15. Section 23(o) also permits the deduction of gifts to the United States, the District of Columbia, a territory, state, or political subdivision thereof, the veterans' vocational rehabilitation fund, posts or organizations of war veterans, fraternal societies for limited uses, and special contributions to the United Nations.

16. Other income tax deductions include: Sections 120 (unlimited deductions for gifts exceeding 90 per cent of net income); 23(q), 102(d)(1)(B) (corporations); 183(c) (partnerships); 232(c) (foreign corporations); 336(a)(2) (foreign personal holding companies); 505(a)(2) (personal holding companies). Foundations are also exempt from social security tax, §§1426(b)(8), 1607(c)(8).
States or its territories. Congress, in the 1938 and 1939 Acts, amended Section 23(o) to limit the deduction to gifts to charitable corporations or trusts "created or organized in the United States." The amendment was presumably made on the theory that only domestic charitable organizations relieve the government of burdens it might otherwise have to bear. But the new section did not require that the organization dispense its funds solely within the United States. Furthermore, insofar as citizens or residents are concerned, neither the gift nor estate tax sections permitting charitable deductions restrict donations to domestically organized charities. Nor does Section 101(6) exempt only organizations created in the United States. In the case of non-resident aliens the income, estate and gift sections exempt only contributions to charitable corporations created or organized domestically, but the gift and estate tax sections make no such requirement for charitable trusts, although they do require the gifts or bequests to be used within the United States by the trustees. These are the only sections, except for the section governing corporate charitable gifts, that require the funds of the organization to be used in the United States.

**FORM AND MANNER OF ORGANIZATION**

The taxpayer is given a fairly broad scope in choosing the form which his foundation may take. The commonest forms of charitable organization, the trust and the corporation, are exempt under all the

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17. Revenue Act of 1938, §23(o) (2); Revenue Act of 1939, §224(a).
19. Sections 812(d), 1004(a)(2) (B). Section 162(a) does not make such a limitation on the charitable deductions of trusts and estates. Emily St. A. Tait, 11 T.C. No. 89 (1948). The taxpayer's appeal on another issue has been remanded pursuant to stipulation of the parties. 5 P-H 1949 Fed. Tax Serv. ¶71,107 (1949).
20. Sections 213(c), 861(a) (3), 1004(b) (2).
21. See §23(q).
22. Compare U.S. Treas. Reg. 111 §29.23(o)-1 (1944): "A contribution or gift to an organization described in Section 23(o) is deductible even though some portion of the funds of such organization is or may be used in foreign countries for charitable and educational purposes." Some support for the regulation is found in H.R. Rep. No. 1860, 75th Cong., 3d Sess. 19, 20 (1939), although the wording of the statute seems clearly to the contrary. For a general summary of the sections see Lynch, *The "Charities" Provisions of the Internal Revenue Code*, 10 Ford. L. Rev. 234 (1941). The proposed Revenue Revision Bill does much to clarify the problem by making the income, estate and gift tax sections uniform and requiring foundations to be organized domestically. Funds of the foundation must be used in this country only if they are gifts from non-resident aliens. Revenue Revision Bill of 1948, §§113, 115, 207, 254. No amendment was made to §162(a), however. The bill was introduced in the 80th Congress as H.R. 6712, and was passed by the House but was not finally enacted by Congress. The bill was introduced in the 81st Congress as H.R. 990, 95 Cong. Rec. 97 (Jan. 6, 1949) but no action has been taken on it. 5 CCH 1949 Fed. Tax Rep. ¶10,001 (1949).
pertinent code sections. Presumably any type of "association" is also exempt. The corporate form of organization seems generally preferred by practitioners over the trust form probably because it is the type of organization in which flexibility and close control are easier to attain.

The bequest or gift to the charitable foundation must come indisputably from the decedent or donor to be deductible. This does not mean, of course, that a testator cannot provide for the bequest and direct his executors to organize a qualifying charitable corporation. But there are definite advantages in the inter-vivos creation of the charitable organization. The donor will have a definite ruling concerning the exempt status of the organization, thereby assuring the deductibility of the later bequest. There is the obvious advantage

23. Section 101(6) specifically exempts only "corporations and any community chest, fund or foundation." But the phrase has been interpreted to include private charitable trusts. Third Union Trust Co. v. Commissioner, 56 F.2d 767 (6th Cir. 1932); accord, G.C.M. 15778, XIV-2 Cum. Bull. 118 (1935). Section 162(a) permits trusts and estates an unlimited charitable deduction in any event for gifts made pursuant to the deed or will.

24. Section 3797(a)(3) defines the term "corporation" as including the term "association." See also U.S. Treas. Reg. 105, §§81.44, 81.54 which refer to "corporations and associations"; Bok v. McCaughn, 42 F.2d 616 (3d Cir. 1930).


26. Estate Tax: Dimock v. Corwin, 99 F.2d 799 (2d Cir. 1938), aff'd sub nom. Jacobs v. United States, 306 U.S. 363 (1939); Mississippi Valley Trust Co. v. Commissioner, 72 F.2d 197 (8th Cir.), cert. denied, 293 U.S. 604 (1934); First Trust Co. of St. Paul v. Reynolds, 137 F.2d 518 (8th Cir. 1943); Commissioner v. First National Bank of Atlanta, 102 F.2d 129 (5th Cir. 1939). Gift Tax: Martha F. Mason, 46 B.T.A. 682 (1942). The decedent or donor cannot bequeath or give a sum to a private individual and leave the making of the gift to the individual's discretion. Mississippi Valley Trust Co. v. Commissioner, supra; Burdick v. Commissioner, 117 F.2d 972 (2d Cir. 1941). Under the estate tax, however, the fact that another person has the power to divert a charitable bequest made in the will to private purposes will not destroy the charitable deduction if the holder of the power to divert makes a timely disclaimer. Sections 812(d) and 861(a)(3) as amended by §408(a), (b), Revenue Act of 1942. A private bequest is also deductible under this amendment if the legatee promptly disclaims the bequest and it falls into a bequest to charity. See Commissioner v. McCauley, 150 F.2d 847 (2d Cir. 1945). The gift tax does not contain such provisions. See Martha F. Mason, supra.

27. Commissioner v. Citizens Southern National Bank, 147 F.2d 977 (5th Cir. 1945); Potter v. Bowers, 89 F.2d 687 (2d Cir. 1937); William T. Bruckner, 20 B.T.A. 419 (1930); Compare Fremont C. Peck, 34 B.T.A. 402 (1936), appeal dismissed without opinion, 2d Cir. Nov. 18, 1937, P-H Fed. Tax Citation 1557 (1943), where the ultimate existence of the organization was in doubt. Presumably the charitable trust would be created in the decedent's will. In the Potter and Bruckner cases, supra, the estate or trust holding the assets of a charitable corporation until it could begin operating was held entitled to a deduction under §162(a) for income earned and set aside for the corporation.

28. U.S. Treas. Reg. 111, Sec. 29.101-2 (1943) requires every organization claiming an exemption under Section 101 to establish its right to an exempt status by filing a prescribed form and other data with the appropriate collector. The documents are forwarded to the commissioner for final determination. Cf. E.T. 3, XII-2 Cum. Bull. 279 (1933) disallowing an estate tax deduction because of the form of corporation provided for in the will.
of shifting income producing property to the foundation and thus minimizing the donor's income tax liability, as well as providing a convenient and controllable source for deductible gifts under Section 23(o). The Clifford-Horst doctrine discussed under the next heading and the estate tax marital deduction are factors which limit the advantage of the inter-vivos creation of a foundation.  

Under the marital deduction provisions charitable bequests are not deductible in determining the "adjusted gross estate."  

Therefore the taxpayer's gross estate will be allowed a larger marital deduction if he waits until death to make his charitable contributions, or if his inter-vivos gift will be includible in his gross estate.

MEMBERSHIP AND MANAGEMENT

At the present time neither the statutes, regulations, cases, nor administrative rulings place any direct restrictions on the membership and management of the charitable organization. The Treasury has ruled that exemption of an educational institution should not be denied on the sole ground that it was controlled by one family.

The charitable organization is obviously entitled to pay salaries as a part of administrative expense since the code sections prohibit only "net earnings" from inuring to private individuals. The cases have upheld the payment of reasonable salaries to the creator of the foundation and his family for services rendered to the family controlled organization. The "reasonableness" of salaries is, of course, a question of fact. The exemption has been denied where the payment of salaries was in reality a guise for distributing net income to private individuals.

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29. Helvering v. Clifford, 309 U.S. 331 (1940); Helvering v. Horst, 311 U.S. 112 (1940). The estate tax marital deduction is found in § 812(e).
30. See §§ 812(e)(1)(H); 812(e)(2)(A).
31. For example, if the taxpayer owns property valued at $1,000,000 and makes an inter vivos gift of $500,000, his estate will be allowed a marital deduction of only $250,000. If he provides for the $500,000 charitable gift in his will, his estate will be entitled to a marital deduction of $500,000 (presupposing no § 812(b) deductions). Inter vivos gifts made in contemplation of death or through a controlled trust may throw the gift or trust corpus into the gross estate and thereby enlarge the marital deduction.
32. I.T. 3220, 1938-2 Cum. Bull. 164, modifying I.T. 2933, XIV-2 Cum. Bull. 117 (1935). There was no showing that the salaries were unreasonable, that a reserve account was retained from which sums might later be paid as salaries, or that family control of a business rather than an educational purpose was the primary purpose of the organization. The ruling stated that any group in control might effectively distribute income to themselves, whether they are members of a family or not.
individuals, most of whom were members of the family controlling the corporation.\textsuperscript{35}

If the creator or his family are to be trustees or officers of the foundation, the organization must withstand such limitations as the \textit{Clifford-Horst} doctrine establishes.\textsuperscript{36} Although the limits of the doctrine are uncertain, retention of sufficient control over the organization's principal fund or income by the creator or members of his family may mean that the income of the organization will be taxed to the creator, or perhaps to family members. Thus far litigation and regulations concerning the doctrine have centered about controlled trusts rather than closely held corporations. It is easier to predict, therefore, the taxable status of a charitable trust under the doctrine, than that of a charitable corporation.

There have not been a great number of controlled charitable trust cases. None have been decided since the adoption of the Clifford Regulations.\textsuperscript{37} In the first decision on the problem, the Second Circuit held the grantor not taxable for the income of a five year trust,\textsuperscript{38} where the trustees were entirely independent and the grantor retained no control over trust property. Subsequent decisions involving controlled trusts and charitable beneficiaries have varied as the whole developing case law interpreting the Clifford doctrine has varied. The Second Circuit was more doubtful of its decision for the grantor in \textit{Commissioner v. Chamberlin}.\textsuperscript{39} There the trust was for four years and the grantor and another were trustees with broad administrative powers. The court emphasized that the trust was not an inter-family distribution of income as in \textit{Clifford} and \textit{Horst}.\textsuperscript{40} But where the trust

\textsuperscript{35} Northern Illinois College of Optometry, P-H 1943 TC Mem. Dec. Serv. ¶ 43,396 (1943). In this case during the tax years in question approximately 65 per cent of the gross income of an otherwise qualified educational institution was paid out in salaries and well over one-half of the total salaries went to members of the controlling family group. See \textit{Restatement, Trusts}, § 376(b) (1935) and compare Scholarship Endowment Foundation v. Nicholas, 25 F. Supp. 511 (Colo. 1938), \textit{affirmed}, 106 F.2d 552 (10th Cir. 1939), \textit{cert. denied}, 308 U.S. 623 (1939).

\textsuperscript{36} Helvering v. Clifford, 309 U.S. 331 (1940); Helvering v. Horst, 311 U.S. 112 (1940).

\textsuperscript{37} U.S. Treas. Reg. 111, § 29.22(a)-21 (1945).

\textsuperscript{38} Helvering v. Achelis, 112 F.2d 929 (2d Cir. 1940).

\textsuperscript{39} 121 F.2d 765 (2d Cir. 1941).

\textsuperscript{40} The court declined to tax the transferor on the broad definition of receipt of benefits established in Helvering v. Horst, where Justice Stone stated that the grantor's "right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or gift to his favorite son." 311 U.S. 112, 117 (1940). The \textit{Chamberlin} opinion could not interpret \textit{Horst} to mean that "every settlor of a trust is taxable upon whatever part of its income is applied to purposes the furtherance of which gives him some satisfaction." 121 F.2d 765, 766 (2d Cir. 1941). For similar judicial comment on \textit{Horst}, see Kohnstamm v. Pedrick, 153 F.2d 506 (2d Cir. 1945); see also Helvering v. Stuart, 317 U.S. 154 (1942); Miller, \textit{Gifts of Income and Property: What the Horst Case Decides}, 5 Tax L. Rev. 1 (1949).
was merely for a one year period and the grantor could substitute other securities for those in the trust corpus, the court did not doubt that the grantor was taxable under the *Clifford* or *Horst* cases.\(^4\) The Sixth Circuit applied similar reasoning to invalidate a five year charitable trust with broad powers reserved by the grantor.\(^4\)

In *Helvering v. Bok*,\(^4\) however, the Third Circuit failed to tax the grantor on trust income where the term was for three years and all administrative powers and control of distributing income was lodged in three independent trustees, two of whom were the grantor's sons. A nine year trust was also upheld by the Eighth Circuit (one judge dissenting) wherein the grantor's husband was trustee, and the grantor reserved power to alter the trust to carry out more fully its charitable purpose, to approve investments by the trustee, and to appoint a new trustee who could be the grantor.\(^4\)

The Clifford regulations have extended case law in the matter of some retained powers.\(^4\) But they have also made it clear that other powers are not important in determining the grantor's liability or are only important to a limited extent. Under the regulation if the grantor has a reversionary interest, the trust term must extend in any event for at least a ten year period.\(^4\) The regulations permit the grantor, however, to reserve the power to determine the beneficial enjoyment of corpus or income "if such corpus or income ... is irrevocably payable for the purposes and in the manner specified in § 23 (o)."\(^47\) The grantor may also escape income taxation and yet reserve,

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\(^4\) Commissioner v. Lamont, 127 F.2d 875 (2d Cir. 1942). The trust was not exclusively a charitable trust because the trustee had power to distribute income among charitable institutions and distant relatives. The court emphasized that in fact the trustee complied with the grantor's wishes in exercising this power. Compare U.S. Treas. Reg. 111, §29.22(a)-21(d). The court also had doubts as to the present validity of its *Achelis* and *Chamberlin* decisions in view of the *Horst* case and Harrison v. Schaffner, 312 U.S. 579 (1941).


\(^4\) 132 F.2d 365 (3d Cir. 1942), aff'd 46 B.T.A. 678. The trustees had sole discretion to distribute income among charitable beneficiaries including private individuals.

\(^4\) United States v. Pierce, 137 F.2d 428 (8th Cir. 1943).

\(^4\) The Clifford Regulations are accepted for the purposes of this article as a correct interpretation of § 22(a). The Third Circuit has recently approved and retroactively applied portions of the Regulation, Kay v. Commissioner, — F.2d — (3d Cir., Jan. 10, 1950). For a debate over their validity as administrative interpretations, see Pavenstedt, *The Treasury Legislates: The Distortion of the Clifford Rule*, 2 TAX L. REV. 7 (1946); Eisenstein, *The Clifford Regulations and the Heavenly City of Legislative Intention*, 2 TAX L. REV. 327 (1947); Pavenstedt, *A Reply to Mr. Eisenstein*, id. 476; Pavenstedt, *Supplemental Reply to Mr. Eisenstein*, id. 569; Eisenstein, *A Postscript*, id. 578.

\(^4\) U.S. Treas. Reg. 111, §29.22(a)-21(c), and see note 48 infra.

\(^47\) Id. §29.22(a)-21(d) (2). Cf. Commissioner v. Lamont, supra note 41; Helvering v. Bok, supra note 43. This provision is a limitation on the broad definition of charitable beneficiaries in §162(a). Presumably if trust beneficiaries are other than
in a fiduciary capacity, the power to vote stock held by the trust, to
direct investments, and to substitute property of an equivalent value
for trust property.\footnote{48} Certain other administrative powers may not be
retained by the grantor in any capacity no matter what the duration of
the trust.\footnote{49} The regulations define these powers as "administrative
control . . . exerçisable primarily for the benefit of the grantor.
. . ." The condemned powers include those giving the grantor or
anyone without a substantial adverse interest, or both, authority to
purchase or sell trust corpus for less than an adequate consideration,
or to borrow trust property without adequate security or interest.

Thus the major limitations under the Clifford regulations are the
minimum ten year period for the trust which will revert to the grantor,
and the proscription against the retention by the grantor, or another
without an adverse interest, of certain administrative controls in any
capacity and their retention of others in a non-fiduciary capacity.

If the Clifford-Horst doctrine is applicable to controlled charitable
trusts holding securities no reason is apparent why the doctrine is not
applicable to creator-controlled charitable corporations the sole func-
tion of which is to hold title to securities. Holding companies of this
type fit easily within the language in \textit{Higgins v. Smith},\footnote{50} stating reasons
for disregarding the solely-owned corporate entity.\footnote{51} In that case the
taxpayer was denied the right to deduct a loss arising from his sale of
securities to his wholly-owned corporation. The Second Circuit used
the rationale of \textit{Higgins v. Smith} to attribute the income of the solely
owned corporation to Smith, who admitted tax avoidance to be the
primary, if not the only, reason for maintaining the corporation.\footnote{52}
If the creator has sole and complete control of the holding company's
management and dissolution, it would seem that he would have a
difficult time escaping tax liability for the corporate income.

\footnote{48} Under the Clifford Regulations § 29.22(a)-21(c)(1), (2) the grantor may re-
tain these powers without fear of taxation, even if he has a reversionary interest.
The trust term, however, must be for at least a ten year period if the charitable
beneficiaries are within the § 23(o) definition. Otherwise the term must be for a
minimum of fifteen years. But whatever the duration of the trust term, § 29.22(a)-
21(e)(4) requires the grantor to hold these powers in a "fiduciary capacity."


\footnote{50} 308 U.S. 473 (1940). See also Griffiths v. Commissioner, 308 U.S. 355 (1939).

\footnote{51} Reed, J., said in part: "Title, we shall assume, passed to Innisfail [corpora-
tion] but the taxpayer retained the control. Through the corporate forms he might
manipulate as he chose the exercise of shareholder's rights in the various corporations,
issuers of the securities, and command the disposition of the securities themselves.
There is not enough of substance in such a sale finally to determine a loss." 308 U.S.
473, 476 (1940). "It is the command of income and its benefits which marks the real
owner of property." \textit{Id.} at 478 (1940).

\footnote{52} Commissioner v. Smith, 136 F.2d 556 (2d Cir. 1943).
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There is some authority for the position that the sole stockholder would be better insulated from taxation if the charitable corporation is created to operate a business rather than merely to hold title to securities. Thus far the courts have not passed squarely on the effect of the Clifford-Horst doctrine on solely owned corporations operating a business, although a recent Supreme Court case may be a step towards application of the doctrine.63 There have been a great number of cases in other contexts, however, considering business activity and the inviolability of the separate entity of solely owned corporations. Analysis of the Supreme Court cases indicates that if the corporation was created purely as a tax avoidance medium and performed no business activities, the Commissioner may recognize or disregard the entity, whichever produces more revenue.64 If the corporation carries on business activities, however, after incorporation, the Supreme Court has said that the sole stockholder may not disregard the corporate entity for his tax advantage.55 When such business activity is present, the Second Circuit has construed the Supreme Court decisions to mean that the Commissioner may not disregard the corporate entity.65

Will the court's emphasis on business activity prevent the application of the Clifford-Horst doctrine to charitable corporations? A blanket rule prohibiting the application of the doctrine would be unjustified. If the predominant use of the corporation by the sole stock-


55. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943); National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949). Even though the court in these cases and in those of the previous footnote speaks of an added requirement: that the corporation must be created for a business, as opposed to a tax avoidance purpose, it is doubtful if the creator's "purpose" must be a business one. The cases are all explainable on the ground that the corporation did not engage in business activity; that it had no "significant business effect." See Schlesinger, "Thin" Incorporations: Income Tax Advantages and Pitfalls, 61 HARV. L. REV. 50, 63 (1947). A purpose to reduce taxes does not invalidate a taxpayer's transaction or plan, although it may make the transaction or plan suspect.

Lower courts have held that a sole stockholder may disregard the corporate entity where the corporation merely holds title to property and was not created for tax avoidance purposes. See United States v. Brager Building & Land Corp., 124 F.2d 349 (4th Cir. 1941); Henry T. Roberts, P-H 1948 TC MEM. DEC. § 48,165.

holder is to assign income while controlling the property producing the income, it would appear that the corporate entity should be disregarded. As a result, of course, the sole stockholder would be taxable for the corporate income as earned. If business purpose or activity necessitates holding the corporate entity inviolate the creator may be taxed on an alternative theory. That is, because of his dominant position the creator controls corporate income and any distribution of income by the corporation, even though irrevocably payable to a charity, should be taxed to him. Under this theory the corporation would apparently be subject to the corporate income tax and the sole stockholder would be taxable upon distribution of corporate income.

Whether the creator is taxed under the first or second of the above theories, or whether the corporation operates a business or merely holds title to property, the vexing problem of how much control the sole shareholder must retain remains to be determined. The Clifford Regulations may be of some help in anticipating the Treasury's probable position on what controls amount to "ownership" of the corporation. No matter what other powers the creator and dominant shareholder may have, he may be taxable if the corporation's charter establishes a corporate existence of short duration. If no minimum time limit is declared, then a charter provision that the assets must go to charity upon dissolution would be a persuasive factor against taxing the dominant shareholder. By analogy to the Clifford Regulations, the fact that the creator may control the beneficial disposition of corporate income would not alone create tax liability for him.

57. See the family partnership cases, Commissioner v. Tower, 327 U.S. 280 (1946); Lusthaus v. Commissioner, 327 U.S. 293 (1946); Commissioner v. Culbertson, 69 Sup. Ct. 1210 (1949). The assignment of income rationale has been applied to hold the husband taxable on the income of sole proprietorships where title to the business was given to the wife but the husband had exclusive power to manage the business. Robert E. Werner v. Commissioner, 7 T.C. 39 (1946); R. W. Semmler, P-H 1948 TC Memo. Dec. ¶ 48,031, aff'd per cur., 173 F.2d 218 (6th Cir. 1949). Contra: Henson v. Comm., 174 F. 2d 846 (5th Cir. 1949), reversing 10 T.C. 491 (1948). Cf. Armstrong, Shall We Have a Clifford Doctrine for Corporations? 26 Taxes 830 (1948); Johnson, Taxing Dividends of Family Corporations—A Dissent, 2 Tax L. Rev. 506 (1947); Mannheimer, Income Tax Status of Gifts of Family Corporation Stock, 25 Taxes 604 (1947). The argument has been made that the corporate entity cannot be ignored under the Clifford-Horst doctrine because Congress has attempted to safeguard the revenue by enacting statutes to protect against the abuse of the corporate device. See e.g., Int. Rev. Code §§ 102, 115(g), 45, 24(b) (1) (B), 24(b) (1) (C), 24(c), 500, 331. Because Congress has attempted in certain sections to prevent tax avoidance through control of corporations would not seem to mean that the corporate entity is immune from attack. A similar, and perhaps more forceful, argument was made and rejected in regard to trusts in Helvering v. Clifford, 309 U.S. 331 (1940), and see Anderson v. Abbott, 321 U.S. 349 (1944).


59. Johnson, supra note 57.

60. See U.S. Treas. Reg. 111, § 29.22(a)-21(c) (1947).

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trative powers condemned in the regulations.\textsuperscript{62} And it may be more
difficult for him to prove he holds the powers in a "fiduciary
capacity." \textsuperscript{63}

Where the charitable corporation operates a business there are
added considerations of sufficient control. If the creator and sole
shareholder actively manages the business and has the exclusive right
to control corporate assets, the analogy to the Tower case \textsuperscript{63a} would
seem complete and the creator therefore taxable (assuming that the
entity were disregarded). On the other hand, if the charitable institu-
tion which is declared in the charter to be the recipient of all income
distributed by the charitable corporation also holds all or a majority
of the stock and actively votes that stock, perhaps the "control" by
the charitable institution would be sufficient to save the creator from
any tax liability.\textsuperscript{64} Or perhaps if a majority of voting power is given
to members of the creator's family, and they actually participate in
formulating corporate policies, the creator would not be taxed on the
theory that he is assigning income while controlling the property.
Control by the creator's family is not \textit{per se} considered control by the
creator,\textsuperscript{65} nor would the family members be taxable on corporate in-
come under present law.\textsuperscript{66}

A vigorous application of the Clifford-Horst doctrine to charitable
trusts and corporations would have some beneficial effect towards
eliminating family control of foundations. But once the short term
limitation is hurdled, the creator and his family have a pretty clear
field. The regulations prohibit only the more obvious administrative
controls. The grantor may still vote the stock and control invest-
ments in a "fiduciary capacity." He is presumed to be acting in such
capacity if he is a trustee, and even if he is not a trustee, it would
appear difficult to prove that he was not acting for the best interests
of the beneficiaries in voting or investing securities. Apparently mem-
bers of the grantor's family would be without a substantial adverse
interest, and, therefore, there would be no greater advantage in lodging
control in them during the grantor's lifetime. But after his death,
family control may be made much broader without fear of taxing

\begin{itemize}
\item \textsuperscript{62} See U.S. Treas. Reg. 111, § 29.22(a)-21(e) (1947).
\item \textsuperscript{63} The assets of a charitable corporation have been called "trust funds in its
\item \textsuperscript{63a} Commissioner v. Tower, 327 U.S. 280 (1946).
\item \textsuperscript{64} See Commissioner v. Culbertson, 69 Sup. Ct. 1210 (1949).
\item \textsuperscript{65} \textit{Ibid.} But cf. U.S. Treas. Regs. 111, § 29.22(a)-21(c) (2), (d) (3) and (4)
(1949).
\item \textsuperscript{66} See \textit{infra} notes 67 and 68.
\end{itemize}
foundation income to members having control. The regulations provide that a person other than the grantor will be taxable on trust income only if he has power to revest corpus or income in himself, or if he relinquishes those powers but retains powers which would make the grantor taxable on trust income. The cases have gone no further than the regulations, if as far.

If the charitable corporation operates a business, the creator may be taxable unless he is willing to relinquish actual control or management to members of his family, to the charitable institution, or to others. At best, however, the assignment of income rationale is a limited doctrine. Pushed to its utmost, it will probably never substantially limit family control of foundations.

**Sources of Income**

A charitable organization may derive funds for its operation from gifts, bequests, dues, tuition, the ownership of income producing property, or the operation of a business enterprise. The increasing use of the last of these sources by educational institutions has been a problem of growing concern to Congress and the Treasury. And the fact that an individual may also control a charitable organization makes the prospect of selling his business to a controlled foundation increasingly appealing to individual taxpayers.

Until recently the practice of the Bureau has been to grant exemption to organizations operating a business. But within the last few months the Commissioner has asserted a deficiency against a non-profit

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69. See Hearings on Proposed Revisions of the Internal Revenue Code, Part 5, Tax Exempt Organizations other than Cooperatives, Committee on Ways and Means, 80th Cong., 1st Sess. 1947-8). The Treasury has recommended that income of charitable corporations and educational institutions derived from operating a business be subject to the corporate income tax. Statement by Secretary Snyder before the Committee on Ways and Means, House of Representatives, February 3, 1950, CCH STAND. FED. TAX REP., No. 9, Part 1 (February 8, 1950). Statement by Mr. Randolph Paul, tax adviser to the Secretary of the Treasury, 1 Hearings on the Revenue Revision Act of 1942, Committee on Ways and Means, 77th Cong., 2d Sess. 89 (1942). See also BLODGETT, TAXATION OF BUSINESSES CONDUCTED BY CHARITABLE ORGANIZATIONS, N.Y.U. FOURTH ANNUAL INSTITUTE ON FEDERAL TAXATION 418 (1946). Note 34 VA. L. REV. 183 (1947). For a discussion of the “lease-back” transactions wherein a tax exempt or tax favored organization purchases business property from a business concern and thereupon leases the property back to the concern, see Cary, Corporate Financing through the Sale and Lease-Back of Property: Business Tax, and Policy Considerations, 62 HARV. L. REV. 1 (1948).
71. BLODGETT, op. cit. supra, note 51.
corporation operating a business for the benefit of a university. The corporation has filed a petition for a redetermination of the deficiency in the Tax Court. The ultimate decision of the case may mean that charitable organizations defined as exempt under 101(6) will be deprived of this source of revenue.

The problem has never been squarely presented to the Supreme Court, although an early decision bears on the problem and is often cited. In that case a religious order incorporated under statutes of the Philippine Islands obtained approximately 92 per cent of its income from rentals of real property, ownership of corporate securities, and interest on loans. Somewhat more than half of the remainder of its income was derived from occasional sales of wine, chocolate and other articles "purchased and supplied for use in its churches, missions, parsonages, schools and other subordinate agencies." The order claimed exemption from income taxation under Section II(G)(a) of the 1913 Act, which corresponds substantially to Section 101(6) of the present code.

The government argued that the order was not "operated exclusively" for exempt purposes because of its commercial activities. In answering this contention, Mr. Justice VanDevanter, speaking for the court, gave the statute an extremely broad interpretation. Said he: "Two matters apparent on the face of the statute go far towards settling its meaning. First it recognizes that a corporation may be organized and operated exclusively for religious, charitable, scientific or educational purposes, and yet have a net income. Next, it says nothing about the source of the income, but makes the destination the ultimate


73. Trinidad v. Sagrada Orden de Predicadores, etc., 263 U.S. 578 (1924); affining 42 Phil. 397 (1921).

74. All of the income, estate and gift tax sections dealing with charitable exemptions and deductions define exempt organizations as "... organized and operated exclusively for religious [or] charitable ... purposes ... no part of the net earnings of which inure to the benefit of any private stockholder or individual. ..." Section 812(d) does not require trusts to be "organized and operated exclusively" for exempt purposes, but does require the trustee to use the bequest "exclusively for charitable ... purposes." In Eagan v. Commissioner, 43 F.2d 881 (5th Cir. 1930), a charitable bequest was made to a board of trustees composed of employees of a corporation. The court stated that the bequest was made to the trustees, not to the corporation, therefore questions concerning organization and operations were not issues to consider in determining if the bequest was deductible under §812(d). See also § 861(a) and PAUL, FEDERAL ESTATE AND GIFT TAXATION, § 12.18 (Supp. 1946). Sections 23(o), 106(6), 1004(a)(2)(B) and 1004(b)(2), (3) do not contain this apparent exception in regard to trusts. But cf. § 162(a). Thus the question of the organization and operation of a business operated by trustees might not be a ground for denying a deduction under the estate tax, but might still be the basis for denying an exempt status under the income or gift tax sections. See Edward Orton, Jr., Ceramic Foundation, 9 T.C. 533 (1947), aff'd, 173 F.2d 483 (6th Cir. 1949). Section 207, Revenue Revision Bill, H.R. Rep. 990, note 22, supra, would amend §812(d) and eliminate this apparent discrepancy in favor of trusts.
test of exemption." 75 The last sentence has been the principal basis in subsequent lower court decisions for upholding business activities by charitable organizations. But the second sentence of the quotation is apparently sufficient to justify the holding. The fact that a charitable organization may have a "net income" would clearly mean, as the court noted, that it may own income producing property and make "such property productive." 76 It is difficult from the reports to determine the nature of the sales of wine, chocolate and other articles. Apparently the sales were made by churches, schools and other agencies to worshippers, students, and others using the facilities maintained by the order. The court stated that from the evidence these transactions did "not amount to engaging in trade in any proper sense of the term." Sales were not made to the public in general nor in competition with other businesses. Any profits, furthermore, were negligible. The decision is excellent authority for holding that a charitable organization may own income producing property and retain its exempt status. It is negligible authority, however, for interpreting the statute as exempting charitable organizations which operate ordinary commercial enterprises. The final sentence in the above quotation was not needed for the decision. The usual liberal interpretation of the word "exclusive" in the charitable deduction and exemption sections would have sufficed to prohibit the selling transactions from destroying the corporation's exempt status.77

In two early cases involving the issue of commercial activity, however, the Board determined to interpret the statute according to the Supreme Court's broad dictum. The first opinion involved a religious organization which operated, among other things, an inn, a farm and sold publications. 78 In these and other commercial endeavors sales were made to the general public although earnings from all commercial activity were only a minor source of income. In the second case the charitable corporation received all of its income from a variety of business enterprises which it owned and operated under the sole management of its founder. 79 In the first case the charitable corporation used the income for charitable work in which it was engaged. This was true of most of the income of the organization in the second case, although a part of the income was distributed to other charitable in-

75. 263 U.S. 578, 581 (1924).
77. See text at note 104 infra.
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The essence of the Board's decisions is that the Commissioner was not justified in denying exemption because of competitive, commercial activity. The corporation is entitled to exemption if all of its net income is used for exempt purposes, and "these purposes . . . are the controlling reason for the corporation's existence. . . ." 80 Although the opinions recognize the factual distinction in regard to commercial activity between the Board cases and the Supreme Court case, the distinction is treated as without consequence.

The Board's construction of the statute has been emphatically reaffirmed by the federal district courts and courts of appeals. Competitive commercial activity as a sole or substantial source of income has not of itself been a factor denying exemption to a charitable corporation.81 Of these cases, the opinion of the Second Circuit in Roche's Beach, Inc., is of particular importance for two reasons. First, it adopts the rule generally accepted by the courts, but not by the Commissioner, that the court may look to all the evidence and not merely to the charter to see if the corporation is "organized" for charitable purposes.82 Second, the decision exemplifies a judicially approved

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80. 4 B.T.A. 61, 69 (1926).
81. Roche's Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938), reversing 35 B.T.A. 1087 (1937); Bohemian Gymnastic Association Sokol v. Higgins, 147 F.2d 774 (2d Cir. 1945); Edward Orton, Jr., Ceramic Foundation, 9 T.C. 533 (1947), aff'd, 173 F.2d 483 (6th Cir. 1949); Home Oil Mill v. Willingham, 68 F. Supp. 525 (N.D. Ala. 1945), accord for another tax year, 5 CCH 1949 Fed. Tax Rep. ¶9257 (N.D. Ala. 1949), government appeal allowed, 5 CCH 1950 Fed. Tax Rep. ¶11,843; Linderman v. Driscoll, 26 F. Supp. 565 (W.D. Pa. 1939); cf. Commissioner v. Battle Creek, Inc., 126 F. 2d 405 (5th Cir. 1942). Debs Memorial Radio Fund, Inc. v. Commissioner, 148 F.2d 948 (2d Cir. 1945) involved a similar interpretation of § 101(8): "Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare. . . ." The courts have not applied such a liberal construction to § 101(9) exempting "clubs organized and operated exclusively for pleasure, recreation and other non-profitable purposes, no part of the net income of which inures to the benefit of any private shareholder." Exemption has been denied clubs engaging in a "definite pattern of commercial activities involving transactions with the general public. Jockey Club v. Helvering, 76 F.2d 569 (2d Cir. 1935); West Side Tennis Club v. Commissioner, 111 F.2d 6 (2d Cir. 1940); National Mah Jongg League, Inc. v. United States, 75 F. Supp. 769 (S.D.N.Y. 1947). Occasional, incidental transactions do not destroy exemption. Santee Club v. White, 87 F.2d 5 (1st Cir. 1936); Koon Kreeck Klub v. Thomas, 108 F.2d 616 (5th Cir. 1939); Scofield v. Corpus Christi Golf & Country Club, 127 F.2d 452 (5th Cir. 1942), Anderson Country Club, 2 T.C. 1238 (1943). See discussion of the problem in Bohemian Gymnastic Association Sokol v. Higgins, 147 F.2d 774 (2d Cir. 1945). The courts have similarly construed § 101(7) exempting "Business leagues, chambers of commerce, real estate boards, or boards of trade, not organized for profit. . . ."

6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 34.28 (1949).
82. The Board had held for the Commissioner on this point, but the Second Circuit thought the approach too narrow. The fact that the corporation was incorporated under the New York general business corporation act, and that its charter was silent as to charitable purposes was outweighed by the other evidence. Such evidence, including the will of the creator of the corporation, showed his intent to establish the corporation solely as a medium for operating a business and deriving income for a charitable foundation to which he bequeathed all the corporation's stock. For a time the Bureau accepted Roche's Beach, Inc. as a precedent. G.C.M. 20853, 1938-2 CUM. BULL. 166; G.C.M. 21610, 1939-2 CUM. BULL. 103; G.C.M. 22116, 1940-2 CUM. BULL. 100. The case was considered an exception to the Bureau's general rule that the charter is controlling on the theory that it would be a perversion of the will
method for creating a tax exempt entity to operate a business concern for a controlling charitable institution, thereby avoiding the risk of exposing the charitable institution's assets to the hazards of business failure. The operating corporation was incorporated by Roche during his lifetime with the intention that after his death the corporation would manage his beach properties for the benefit of the charitable foundation which he established in his will. He intended to, and did, control the corporation and receive its income for the few months that he lived after forming the corporation. Upon his death he left the corporation's stock to the trustees of the foundation. His intention that the corporation's income should be devoted exclusively to the charitable foundation was reiterated in his will.

A corporation so organized and operated was held to be within Section 101(6). Its exempt status was not denied by the fact that the corporation merely produced income for another organization which actually administered the charitable activities. The corporation must be "organized," however, for charitable purposes. It is not exempt merely because all of its stock is owned by a charitable organization.

if corporate income was channeled to non-charitable sources. See O.D. 60, 1 Cum. Bull. 193 (1919); O.D. 177, 1 Cum. Bull. 194 (1919); O.D. 190, 1 Cum. Bull. 194 (1919). But in G.C.M. 23063, 1942-1 Cum. Bull. 103, the Bureau decided that it would no longer follow the Roche's Beach decision and its former memoranda were modified accordingly. The following cases are in accord with Roche's Beach, Inc.: Debs Memorial Radio Fund, Inc. v. Commissioner, 148 F.2d 948 (2d Cir. 1945); Bohemian Gymnastic Association Sokol v. Higgins, 147 F.2d 774 (2d Cir. 1945); Faulkner v. Commissioner, 112 F.2d 987 (1st Cir. 1940); Anderson Country Club, 2 T.C. 1238 (1943); Journal of Accountancy, Inc., 16 B.T.A. 1260 (1929); Unity School of Christianity, 4 B.T.A. 61 (1926). Cf. Round Table Club v. Fontenot, 143 F.2d 196 (5th Cir. 1944); United States v. Proprietors of Social Law Library, 102 F.2d 481 (1st Cir. 1939); Union & New Haven Trust Co. v. Eaton, 20 F.2d 419 (D. Conn. 1927); Bear Gulch Water Co. v. Commissioner, 116 F.2d 975 (9th Cir. 1941).

3. The fact that he received the income from the corporation for the remainder of his life was no more than mentioned by the court in detailing the facts. Such a personal life interest in the income by the founder of a charitable corporation will probably be a point of greater concern for future cases in determining whether the corporation was "organized" for charitable purposes within the statutory definition.

84. Sun-Herald Corp. v. Duggan 73 F.2d 298 (2d Cir.), cert. den., 294 U.S. 771 (1934); Sun-Herald Corp. v. Duggan, 160 F.2d 475 (2d Cir. 1947); Sand Springs Railway Co., 21 B.T.A. 1291 (1931). The corporations in these cases were also denied exemption under §101(14) as "corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount, less expenses, to an [exempt] organization. . . ." The corporations were all organized for the operation of a business, said the courts, not for the narrow activities outlined in §101(14). See also Gagne v. Hanover Water Works Co., 92 F.2d 639 (1st Cir. 1937).

Judge Learned Hand dissented in Roche's Beach, Inc. on the ground that §101(14) defined an exempt "feeder" corporation and thereby "as to all other subdivisions it meant that a subsidiary should not be exempted merely because its parent was exempt." 96 F.2d 776, 779 (2d Cir. 1938). If the sole ground for Judge Hand's dissent was that the corporation should not be granted exemption merely because it was controlled by an exempt organization, it would seem that he had overlooked the fact that the operating corporation was organized for a charitable purpose. But if, as it appears, his dissent is upon the more fundamental ground that the source of income, not its use, is a controlling test in determining an exemption, he is decidedly in the minority.
If the owner of a business is concerned about the impregnability of the cases interpreting Section 101(6), or if the cases are overruled, he may be able to fulfill his plans by selling his business to a controlled charitable trust. Section 162(a) does not require that the trust be "organized and operated exclusively" for charitable purposes. It merely provides for a deduction of any or all of the gross income which pursuant to the trust deed is "during the taxable year paid or permanently set aside for [charitable] purposes. . . ." 85

This suggestion presupposes, of course, that the trust will not be classified as an "association" within Section 3797(a)(3) and therefore treated as a corporation for purposes of the Code. 86 The cases have broadly defined the term "association" so that a charitable trust operating a business may have a difficult time getting outside the definition. The decisions have been summarized as requiring the participants to associate together in a joint enterprise for the carrying on of a business for profit in an organization substantially resembling a corporation. 87 A charitable beneficiary would undoubtedly be classified as an "associate in a joint enterprise." Such "associates" are not required by the decisions to supply capital or to have a voice in management. 88 And where the owner of a business transfers it to a charitable trust, the trust will be operating a "business" and "for profit."

There are at least two methods whereby the trust may escape identification as an association. One is to provide for a single beneficiary. The other is to draft the trust deed so as to avoid as much as possible any resemblance to the corporate form of organization.

The first technique is based on the statement in Morrissey v. Commissioner 89 that "'Association' implies associates," and on the assumption that associates must have a beneficial interest in the trust, thereby eliminating the trustee. Thus, if the trust is limited to one beneficiary there cannot be any "associates." The Ninth Circuit has

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85. See note 73 supra for a discussion of a similar interpretation of deductions for charitable trusts under § 812(d).
86. Section 3797(a): "When used in this title, where not otherwise distinctly expressed or manifestly incompatible for the intent thereof . . . (3) The term 'corporation' includes associations, joint stock companies, and insurance companies."
88. Morrissey v. Commissioner, 296 U.S. 344 (1935); Swanson v. Commissioner, 296 U.S. 362 (1935); Porter Property Trustees, Ltd., 42 B.T.A. 681 (1940), aff'd, 130 F.2d 276 (9th Cir. 1942).
89. 296 U.S. 344, 356 (1935).
cast doubt on this theory by holding, although without citing any Supreme Court cases, that a trust with one beneficiary may be an association. If business trusts are to be taxed as corporations because they are in essence operating as corporate organizations, it is not clear why a distinction should be made between single-beneficiary trusts and solely-owned corporations. Nor is it clear why an "associate" must have a so-called beneficial interest when the trust instrument may give a trustee much greater "benefits" through powers of control over corpus.

The second method by which trusts may avoid classification as corporations is based on the agreement by the courts and the regulations that an association must resemble a corporation to be taxed as one. But neither the courts nor the regulations have specified an exact formula for applying the corporate-resemblance test. In the Morrissey case the court specified five salient features of a trust which may make it analogous to a corporate organization. These have been summarized as: title vested in a single entity, centralized management, continuity, transferability of beneficial interests, and limitation of personal liability. The Supreme Court did not make it clear, however, which or how many of these corporate attributes are required.

In a recent article surveying the problem, the author concludes that two essential features of an association are continuity and centralized management. He also believes, although with less certainty,

90. Lombard Trustees v. Commissioner, 136 F.2d 22 (9th Cir. 1943). In that case a trust operating a business had but one beneficiary during part of the taxable year. The court held against the taxpayer's contention that the trust was not an association during that period. The trust was thought to be analogous to a solely-owned corporation. See also Titus v. United States, 150 F.2d 508 (10th Cir. 1945), Ittleson v. Anderson, 67 F.2d 323 (2d Cir. 1923); Hecht v. Malley, 265 U.S. 144 (1924), implies that several trustees may be associates.

92. Smith, supra note 90, at 470, 510.
93. Id. at 534.
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that transferability of beneficial interests is essential. Where the grantor or his family or associates are to continue operating the business there will be, in most cases, centralized management. Perhaps if the trust deed prohibits the transferability of beneficial interests and provides for termination of the trust upon the death of a trustee, or contains either of these provisions, the trust will not be taxable as a corporation.

DESTINATION OF FUNDS

To meet the requirements of the law of trusts a charitable trust must devote its funds exclusively to "charitable" purposes. A similar test is established by the Internal Revenue Code to determine the exemption of a charitable organization. To gain an exempt status a charitable organization must devote its funds exclusively to purposes designated by the pertinent Code sections. They require generally that the foundation be "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals. . . ." Unless the creator of the foundation has in mind a specific purpose which may not be clearly charitable, his draftsman should have no difficulty in defining the organization's purposes so as to bring it within these requirements. The charters or documents establishing many foundations merely quote the words of the statute.

It is beyond the scope of this paper to develop a detailed analysis of the terms used in the code sections. Basically these sections impart the broad definition of the term "charitable" which has been developed in connection with charitable trusts generally. The term includes the relief of poverty, the promotion of health and the advancement of religion, education, governmental purposes, and purposes beneficial

94. Mr. Smith frankly states that no case has considered this item as solely determinative of the issue. Id. at 522-525. Cf. Porter Property Trustees, Ltd., 42 B.T.A. 681 (1940), aff'd, 130 F.2d 276 (9th Cir. 1942). Earlier commentators on the Morrissey and related decisions were not impressed with the corporate-resemblance test, or, apparently, with any test other than the business purpose of the trust. Lowndes, The Tax Burden of the Supreme Court 1935 Term, 5 Ford L. Rev. 426, 441-42 (1936); Warren, The Reduction of Income Taxes Through the Use of Trusts, 34 Mich. L. Rev. 809, 838 (1936).

95. 2 Restatement, Trusts §398 (1935); Scott, Trusts For Charitable And Benevolent Purposes, 58 Harv. L. Rev. 548 (1945).

96. The phrase "encouragement of Art" is used in §812(d) only to define charitable corporations, but not charitable trusts, nor is the term found in §§23(a) and (q), 162(a), or 101(d). The phrase is undoubtedly included, nevertheless, in the broad definition of the word "charitable." Note, however, that only §§23(a), (q), 101(d), 1004(a)(2)(B), and 1004(b)(2) refer to veteran rehabilitation service and posts or organizations of veterans. These activities, especially the latter, might not be classified as "charitable" by the courts. But see 2 Restatement, Trusts §368 (1935), quoting from the Statute of Charitable Uses, 1601, 43 Eliz. c. 4.

97. See generally Chambers, Charters of Philanthropies (1948).
to the community.98 Such a broad definition of the term has led inevitably to vagueness and to an inability in the opinions to distinguish "charitable" from the terms "religious," "scientific," "literary," and "educational." 99

In spite of the courts' liberal interpretation of the sections, some limitations are observed. The activities of the foundation must be of the specific types enumerated in the statute. Organizations promoting fraternal, social, recreational, athletic or similar activities, despite their benevolent purpose, are not within the statutory requirements.100 No substantial part of the activities of the organization may be "the carrying on of propaganda or otherwise attempting to influence legislation." 101 And, although the limitation is not specifically stated in the Code sections, the courts have followed the general holding in trust cases 102 that the organization must be operated for a public, as contrasted with a private, purpose.103

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98. 2 Restatement, Trusts §§ 368-374 (1935); 3 Scott, Trusts § 348 et seq. (1939). Definitions of charitable trusts frequently quoted in tax cases are found in Jackson v. Phillips, 96 Mass. (14 Allen) 539, 556 (1867); Ould v. Washington Hospital for Foundlings, 95 U.S. 303, 311 (1877); and see 2 Perry, Trusts and Trustees § 687 (7th ed. 1929). The following tax cases provide examples of the variety of activities held to be "charitable": Estate of Carolyn E. Gray, 2 T.C. 97 (1943) (fund to provide special nursing care for hospitalized graduate nurses) (estate tax); M. D. Thatcher Estate Co., 38 B.T.A. 336 (1938) (corporation formed "for charitable, educational and civic and philanthropic uses . . .") (gift tax); George E. Turnure, 9 B.T.A. 871 (1927) (a community club whose object was "to draw into closer relations . . . members of the community and to promote their intellectual, moral, and physical welfare") (income tax); Robert W. de Forest, 19 B.T.A. 595 (1930) (corporation publishing magazines to promote philanthropy through education) (income tax).


100. 1 Paul, op. cit. supra note 97, § 12.08.

101. This phrase was added to the income, estate and gift tax sections (except § 162(a)) in 1934, but it made no substantial change in the interpretation of the code since organizations which had as a primary purpose the dissemination of propaganda or the influencing of legislation had been held not to be "charitable" before the amendment. Sleel v. Comm., 42 F.2d 184 (2d Cir. 1930); G.C.M. 19715, 1938-1 Cum. Bull. 499. See also Girard Trust Co. v. Comm., 122 F.2d 108 (3d Cir. 1940); Henriette T. Noyes, 31 B.T.A. 121 (1934); Sharpe's Estate v. Comm., 148 F.2d 179 (3d Cir. 1945). Trust law generally does not condemn a trust which is otherwise charitable "if the accomplishment of its purposes involves a change in existing law." 3 Scott, Trusts § 374.4 (1939). See criticism of this clause in the Code sections as an unwarranted restriction on legitimate activities of social welfare organizations in Devine, Pioneers or Propagandists?, 29 Survey Graphic 348 (1940).

102. Kain v. Gibbons, 101 U.S. 362, 365 (1879); 2 Restatement, Trusts § 375 (1935); 3 Scott, Trusts § 375 et seq. (1939). Note also the limitation contained in the code sections pertaining to charitable corporations which states that "no part of the net earnings of [the corporation may inure] to the benefit of any private shareholder or individual."

103. A foundation created primarily to aid fourteen grandnephews and grandnieces to obtain college educations, held neither a "charitable" nor "educational" trust within §§ 1004(a)(2)(B) and 101(6) of the code. Amy Hutchison Crellin, 46 B.T.A. 1152 (1942). See also Cap Andrew Tilles, 38 B.T.A. 545 (1938), aff'd, 113 F.2d 907 (8th Cir. 1940), cert. denied, 311 U.S. 703 (1940); James Sprunt Benevolent Trust, 20 B.T.A. 19 (1930); Henry C. DuBois, 31 B.T.A. 239 (1934); Estate of Carolyn E. Gray, 2 T.C. 97 (1943).
The requirement in the Code sections, that the foundation be "organized and operated exclusively for religious" and other purposes, is not, however, to be construed literally. "Exclusively" does not mean "solely" according to the cases; closer synonyms are "primarily" or "substantially." 104

To some extent a similar interpretation has been given to the qualification, common to all pertinent sections, prohibiting a charitable organization from distributing any "part of the net earnings . . . to the benefit of any private shareholder or individual." 105 This limitation has been strictly adhered to when the charitable corporation has private shareholders who are receiving dividends from net earnings, 106 or who have the right to dividends from earnings under the corporate charter. 107 The cases involving receipt of net income by non-shareholders, however, have not construed it so strictly. Several decisions have affirmed the exempt status of charitable foundations required by their creator to pay private annuities out of income.

Perhaps the most extreme example is Edward Orton, Jr. Ceramic Foundation. 108 Decedent devised a plant manufacturing "pyrometric cones" for use in the ceramics industry to a non-salaried board of trustees. Under a plan outlined in the will the business was to be operated by the trustees at a profit. Decedent, while a professor of ceramic engineering at Ohio State University, had invented the process and established a plant for manufacturing the cones. His will declared that his primary purpose in making the devise was to continue the manufacture and sale of cones "of the highest quality and most exact accuracy commercially feasible, at a reasonable price." 109 The "second and subsidiary purpose" 110 of the trust was to provide a research organization for studies in ceramic arts. If the business became

104. See Girard Trust Co. v. Comm., 122 F.2d 108 (3d Cir. 1941); Commissioner v. Citizens & Southern National Bank, 147 F.2d 977 (5th Cir. 1945); Marshall v. Commissioner, 147 F.2d 75 (2d Cir. 1945); Anderson Country Club, 2 T.C. 1238 (1943); Estate of Carolyn E. Gray, 2 T.C. 97 (1943); James Irvine, 46 B.T.A. 246 (1942); George E. Turnure, 9 B.T.A. 871 (1927); Chemists' Club v. United States, 64 Ct. Cl. 157 (1927).

105. But see discussion of § 162(a) in note 127 infra.


107. Uniform Printing & Supply Co. v. Commissioner, 33 F.2d 445 (7th Cir.), cert. denied, 280 U. S. 591 (1929); Berkeley Hall School, Inc., 31 B.T.A. 1116 (1935), aff'd, 84 F. 2d 539 (9th Cir. 1936). The remote possibility that members of non-profit corporations forbidden to pay dividends might receive the assets upon dissolution has not been held a sufficient ground for denying exemption. Goldsby King Memorial Hospital, P-H 1944 Mem. TC Dec. ¶44, 233 (1944); Washington State Apple Growers, Inc., 46 B.T.A. 64 (1942); Armin A. Schlesinger, 11 B.T.A. 601 (1928).

108. 9 T.C. 533 (1947), aff'd, 173 F.2d 483 (6th Cir. 1949).

109. 9 T.C. 533 (1947).

110. Ibid.
obsolete, the trustees were authorized to turn over the assets to Ohio State University.

The will provided that decedent's debts should be paid out of the other assets of the estate and the remainder should go to his wife. She was also to receive under the will the sum of $42,000 payable over a period of five years out of the "current earnings" of the business. The wife received none of the remaining assets, however, since they proved insufficient to pay decedent's debts. The foundation, therefore, contracted with the wife to liquidate these debts and to pay her $350 per month for life, payments to commence after the $42,000 was paid to her. The annuities to the wife were made a charge against all of the assets of the foundation. The Tax Court found that the wife required the above contract as a condition for her taking under the will.

Between 1934 and 1943 the foundation had a total net income of $135,564.59. By 1940 the wife had received $42,800 out of net income, and in that year she began receiving her monthly payments of $350. This amount was charged as a "general expense" on the foundation's books.\(^\text{111}\) The Trustees paid an income tax for the year 1940 and thereafter claimed an exempt status under Section 101(6). The Commissioner denied their claim and determined a deficiency in tax for 1940. Apparently the trustees did not argue that income paid to the wife was deductible under Sections 162(b) or (c), and that the remaining income was deductible under Section 162(a).\(^\text{112}\)

The Tax Court (five judges dissenting) held the foundation exempt under Section 101(6) despite the Commissioner's argument to the contrary based primarily on the grounds that the foundation was operating a commercially profitable business (a point discussed supra), and that part of its net income was being distributed to the wife. On the second point the court held that the predominant purpose of the foundation was to promote research in ceramics. The payments to the wife were not the "real purpose for which the foundation was founded," said the court. "They were a charge upon its entire assets and had to be paid in order to free the assets and income for use in

\(^{111}\) For the years 1934-1943, in addition to the $42,000 distributed to the wife, the foundation disbursed $37,021.51 to research fellowships and endowment, and the remaining income ($56,537.08) was applied to the decedent's debts ($21,679.65), debts of the business, and additions to plant and equipment. In addition, the wife received $14,700 in monthly payments which was charged as a general expense against gross income. The foundation also maintained a research staff at an annual expense of $16,800. The staff "continues tests and gives advice . . . without charge . . . to any person or company engaged in the [ceramics] business." 9 T.C. 533, 538 (1947).

\(^{112}\) Perhaps the trustees believed the trust would be classified as an association anyway, or perhaps they feared that payments to the wife would not be deductible under §§ 162(b) or (c). She was not strictly a trust beneficiary and she was receiving greater sums from the trust than the testator provided for. Furthermore, there was precedent for holding an organization exempt under § 101(6) even though its income was subject to private annuities. See notes 114 et seq., infra.
the scientific aims of the foundation.” 113 The opinion of the Sixth Circuit echoed the Tax Court’s reasoning. Both opinions referred to Lederer v. Stockton 114 as a basic authority.

In the Stockton case a decedent bequeathed his residuary estate to a hospital subject to certain private annuities. The state court required a private trustee to hold the estate until all of the annuitants were dead. By 1913 only one annuitant receiving a small sum was living and the trustee had “loaned” the trust property to the hospital which paid him sufficient interest to pay the annuity and administration expenses. The collector assessed a tax on the trust income for the years 1913 through 1917, which the trustee paid under duress and then sued to recover.115 The Supreme Court upheld the lower court judgments in favor of the trustee.116

Although the necessary implication of the Stockton decision is that income received by a charitable institution and charged with a private annuity is non-taxable and the receipt of such income does not destroy the institution’s exemption, the opinion does not discuss the problem.117 The court instead seemed intent on demonstrating that the income in substance belonged to the hospital rather than the private trust, which perhaps could not deduct payments of income to a charity under the 1916 Act, and if it could, the deduction would be subject to a 15 per cent limitation.118

Decisions subsequent to the Stockton case have consistently applied a liberal construction to the charitable exemption and deduction sections in private annuity cases.119 If income of the organization is

113. 9 T.C. 533, 541 (1947).
114. 260 U.S. 3 (1922). The opinions refer also to Emerit E. Baker, Inc., 40 B.T.A. 555 (1939), where the decedent created a foundation during his life to which he devised his residuary estate which included all of the stock in a manufacturing concern. The bequest was subject to annuities to his wife and for the education of relatives. From 1929 (when decedent died) to 1937 payments to charities from corpus and income were from four to twelve times the total annuities. The wife’s annuity of $19,200 slightly exceeded income for the first three years and thereafter was about one-third of income. The foundation was held exempt on the basis of Lederer v. Stockton, supra note 114. See also Commissioner v. Citizens & Southern National Bank, 147 F.2d 977 (5th Cir. 1945).
115. Only the years 1916 and 1917 were at issue before the Supreme Court. See First Trust & Savings Bank v. Smietanka, 257 U.S. 602 (1922) which held that a trust estate was not a taxable entity under the 1913 Act.
116. The trustee (Stockton) obtained a judgment in the district court and the circuit court affirmed, 266 Fed. 676 (3d Cir. 1920).
117. Section 11(a), 1916 Act, 39 Stat. 756, defining exempt charitable organizations contained the same limitation against distributing net income to private persons as that found in the present Code.
119. Compare Helvering v. Bliss, 293 U.S. 144 (1934); Estate of J. B. Whitehead, 3 T.C. 40 (1944), aff’d sub nom. Commissioner v. Citizens & Southern Na-
used "primarily" for charitable purposes and the payment of private annuities is only "incidental" to its main activities, exemption will be granted. But if the private diversion of net income becomes so large that it is apparent that the organization "was created for private as well as public purposes," exemption is denied. The question of when the private diversion of income becomes too large is a difficult one to resolve. At least it can be said that if private individuals are receiving approximately one-half of the net income, or more, the exemption is destroyed. It is worthy of note, however, that in two of the cases permitting the payment of private annuities there was the added factor of pacifying the wife who might otherwise destroy the foundation by insisting on her statutory share.

Although the cases permitting charitable organizations to pay private annuities and retain their exemption are contrary to the statute, failure to assert liability may be justified if the annuity is small and the organization could not otherwise realize the bequest. Of course it places the trustees of the organization in the position of acting as trustees for private beneficiaries with added responsibilities which they might not wish to assume. The designation of a private trustee to administer the trust during the lives of the private income beneficiaries need not make the income, estate or gift tax consequences any more onerous than are the tax liabilities under the present inter-

120. The Davenport Foundation, P-H 1947 TC MMem. Dec. § 47,341, aff'd per cur., 170 F.2d 70 (9th Cir. 1948); Scholarship Endowment Foundation v. Nicholas, 25 F. Supp. 511 (D. Colo. 1938), aff'd, 106 F.2d 552 (10th Cir. 1939), cert. denied, 308 U.S. 623 (1939); Roger L. Putnam, 6 T.C. 702 (1946). In the last case taxpayer was claiming a deduction under § 23(o) for a gift to a trust established by his uncle.

121. In Roger L. Putnam, supra note 120, the private annuitant received one-half of the trust's net income. In The Davenport Foundation, supra note 116, the private individuals were receiving slightly less than one-half of the net income. The creator of the Scholarship Endowment Foundation was entitled to an annuity amounting to substantially all of the net income.

122. This was a factor stressed in Edward Orton, Jr., Ceramics Foundation, supra note 105, and Emerit E. Baker, Inc., supra note 114. Cf. Estate of J. B. Whitehead, 3 T.C. 40 (1944), aff'd sub nom. Commissioner v. Southern National Bank, 147 F.2d 977 (5th Cir. 1945), involving private annuities and a settlement by the executors with an estranged wife. The settlement was paid out of income of the estate which otherwise would have gone to a charitable foundation. The estate claimed that it had no taxable income under § 162 because all of its income was distributed to the foundation or private annuitants. Both courts held that the settlement out of income did not make the estate taxable under the alternative theories that either the settlement was necessary to preserve the charity and was thus for a charitable purpose, or that taxation is based on what the will requires the executor to do with income, not what the executor actually does with it.

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pretation of the Code if a charitable organization manages the fund. If all trust income is annually distributable to the private and charitable beneficiaries within the limitations of Sections 162(a), (b) and (c), the trust will not be subject to income tax. In computing the estate tax charitable deduction it would have to be reduced in any event by the present value of the private annuitant’s interest. And if either the charitable or private trustee has power to invade corpus, an adequate “standard” must be set forth in order that the extent of invasion may be adequately calculable.

Thus under the Code, where the remainder and perhaps part of the present income of a trust are payable to a charitable organization, the tax consequences are the same whether a charitable organization or a private trustee administers it even though the trust may be subject to private annuities. If the courts conclude that the foundation device is being overworked by ingenious taxpayers, this factor may be one reason for their adopting a narrower construction of the Code where charitable organizations are paying private annuitants.

124. For discussions of the deductibility from trust net income of income “to be distributed currently . . . to beneficiaries” (§ 162(b)) or “income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated” (§ 162(c)), see § MERTENS, THE LAW OF FEDERAL INCOME TAXATION §§ 36.40 et seq. (1949); KENNEDY, FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES §§ 2.01 et seq. (1948).


126. There are many cases discussing the problem of an adequate standard. Three Supreme Court cases lead the way: Ithaca Trust Co. v. United States, 279 U.S. 151 (1929); Merchants National Bank of Boston v. Commissioner, 320 U.S. 256 (1943); and Henslee v. Union Planters’ National Bank & Trust Co., 69 Sup. Ct. 290 (1949). These decisions, particularly the last two, provide that the proper test is whether the extent of invasion of corpus is accurately calculable, not the test of whether the possibility of invasion is imminent or remote. The Tax Court and lower federal courts have not relinquished using the second test, probably because it is much easier to apply. See Union Planters’ National Bank v. Henslee, 166 F.2d 993 (6th Cir. 1948), rev’d, 69 S. Ct. 290 (1949); Estate of Finley Kenny, 11 T.C. 104 (1948). Compare National Bank of Commerce of San Antonio v. Scofield, 169 F.2d 145 (5th Cir. 1948); DeCastro’s Estate v. Commissioner, 155 F.2d 254 (2d Cir. 1946). The cases are elaborately discussed in PAUL, FEDERAL ESTATE AND GIFT TAXATION § 12.26 (Supp. 1946).

127. There may be an advantage in the trust form of charitable organization if the creator wishes the organization to distribute part of its income to private individuals and devote the remaining income to charitable purposes. Under the wording of § 162(a) a trust is permitted an unlimited charitable deduction for income paid pursuant to trust terms to exempt charitable organizations and for income which the trust devotes to its own charitable undertakings. Sections 162(b) and (c) also permit the trust to deduct income paid to private beneficiaries. Thus a foundation in the form of a trust need not fear taxation of its income even though part of it is payable to private beneficiaries (barring its classification as an association under § 3797(a)(3)). However, such a trust would still run the risk of failing to qualify as an exempt organization under §§ 23(a) and 1004(a)(2) and therefore gifts to the trust or the gift creating the trust would not be qualified charitable deductions under the income and gift taxes. Because of the language in which estate tax § 812(d) defines exempt trusts an estate tax charitable deduction might perhaps be allowed, but this is doubtful.
Proposed Solutions for Three Problems

A survey of the tax status of foundations discloses at least three major problems, problems which are not confined solely to foundations. The first, and easiest of solution, is that presented by the inconsistent language of the Code sections. The other problems require a reconsideration of fundamental objectives. Should legislation be enacted to forbid foundations, or charitable organizations in general, from operating commercial enterprises? What other legislation is necessary to cope with foundations as tax avoidance devices? How broad in scope should the legislation be?

Uniform Language in the "Charities" Sections.—If the Revenue Revision Bill now pending before Congress is adopted, the difficulty presented by the lack of uniform language in the various Code sections will largely be overcome. Unfortunately, the bill does not amend Section 162(a). This section should contain requirements similar to the other sections in order that charitable trusts are not given special advantages. A method of achieving this result would be to amend Section 162(a) to provide that if more than a certain percentage (for example, 15 per cent) of trust gross income is payable to charitable beneficiaries, the trust must comply with the requirements for charitable organizations contained in Section 101(6) (except that trust income may inure to private individuals).

The Operation of Commercial Enterprises.—The Treasury proposed two amendments to the Code in 1942 which would go far towards eliminating other tax advantages afforded by foundations. The first proposal was to tax the income of exempt organizations derived from the operation of a commercial enterprise. The second was to limit the estate tax charitable deduction to an undetermined percentage of the gross estate similar to the limitation in Section 23(o). The proposals are all-embracing in their scope. They do not differentiate, for example, between charitable organizations operating a business but controlled by the former owner of the business, and charitable organizations controlled by alumni, faculty, or friends of a college or university. Nor do they distinguish between bequests to a family foundation and bequests to an independently established chari-

128. See note 22 supra.
129. See note 127 supra.
130. This amendment would eliminate specifically any possible advantage which charitable trusts might obtain over charitable corporations in the operation of a business.
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A general treatment of the problem assumes that Congress intends to limit the federal tax subsidy to both family controlled charitable organizations and those with a long recognized function and independent status. The treasury proposal is still some distance, however, from the viewpoint that all tax exemptions should be abolished and direct government aid for worthy enterprises substituted. Its position was more or less that the government should share in certain activities of exempt organizations and in every charitable donation of over a certain amount.

The Treasury recommendations presented to the present Congress by Secretary Snyder are not as comprehensive insofar as private charitable foundations are concerned. Secretary Snyder proposed that business undertakings by exempt institutions "which are clearly unrelated to their primary functions be taxed at regular corporation income tax rates." Mr. Snyder's second recommendation relating to charitable organizations was directed at eliminating the use of the organization by the founder for the benefit of himself and his family. His remarks seemed particularly pointed at the Textron situation. There a special Congressional investigation showed that a textile firm had created charitable trusts for the purposes of controlling other businesses (in many cases former competitors) and as sources of investment capital in the settlor's business. Little or no trust income had ever been paid to the charitable beneficiaries. One way to eliminate these abuses of tax exemption the Secretary suggested "would be to require that such trusts or foundations pay out substantially all net income within a specified period after the close of the taxable year. A further requirement should be a prohibition against dealings between the trust and its creator or businesses under his control and against the use of the trust for the personal advantage


134. Ibid.


136. See proposed legislation discussed in note 153 infra. But unlike the bills discussed therein, the Treasury recommendation is limited to foundations which are "privately controlled and which are not supported by the general public." Supplementary Treasury Department Statement, supra note 133, at 3.
of the grantor,” or his family or associates.\textsuperscript{137} Although Mr. Snyder proposed far reaching changes to the estate and gift taxes \textsuperscript{138} the 1942 recommendation for a percentage limitation on estate and gift tax charitable deductions was not renewed.

The problem presented by charitable organizations operating commercial enterprises needs legislative treatment. The remedy should not be left to the uncertainty of judicial decisions with the consequent confusion caused by their retroactive effect and uncertainty of application to other types of investment now open to exempt organizations. Presumably the amendment would deal only with the problem of income derived from the operation of a business and would not apply to income from securities, leases or mortgages held by the institution. The Treasury’s present recommendations for legislation so indicate, although it proposes that rental income received by an exempt institution under a sale and lease-back transaction be subject to the corporate income tax. A clear line of demarcation must be drawn between these different sources of income.\textsuperscript{139}

Should the legislation distinguish between organizations controlled by the former owner of the business and those controlled by alumni or friends of an exempt institution? The answer depends upon what practice Congress is attempting to eliminate. If Congress wishes to eliminate advantages obtained by an individual in selling his business to a foundation which he thereafter controls, then an all-inclusive proposal such as the Treasury’s is too broad. But if Congress is seeking to put an end to the competitive advantages derived by a charitable corporation over its non-charitable rival, then whatever the proposal, it must have a general application.\textsuperscript{140} Insofar as competitive advantages are concerned, there would seem to be little difference between a charitable corporation controlled by the former owner of the business, the net income of which must go to a college, and a similar charitable corporation controlled by alumni. Both corporations would

\textsuperscript{137} See note 133 \textit{supra}, Statement by Secretary Snyder at 10, and Supplementary Treasury Statement at 3.


\textsuperscript{139} Congress may find it difficult to define what are “businesses which are clearly unrelated to [the] primary functions” of non-profit organizations. The Supplementary Treasury Department Statement, \textit{supra} note 133, at 2, states that a university bookstore may continue to sell books to students, an agricultural college may run a wheat farm in connection with its educational program, and a social club may sell food to its members, without affecting tax exemption status.

\textsuperscript{140} The contention that a business operated by an exempt organization has a potential competitive advantage over rival private firms seems the principal argument at present by those advocating that the income of such businesses be taxed. For a resume of various considerations see Finkelstein, \textit{Freedom From Uncertainty in Income Tax Exemptions}, 48 Mich. L. Rev. 449, 459 \textit{et seq.} (1950). See cases cited note 132 \textit{supra}. 
have the advantage of escaping federal taxes and thus being able to accumulate reserves or to cut prices when their competitors could not.  

It has been suggested that instead of taxing the income of an exempt organization operating a business, the Code be amended to provide that such part of the organization's annual income as would be taxable if it were privately owned be distributed to charity or to the exempt organization which it supports. The proposal could also be applied to rental income which an exempt organization receives under a sale and lease-back transaction. The non-profit institution is favored in this situation over private investors since a larger part of its rental income can be applied to repayment of borrowed funds. If this proposal were applied from the time when the charitable corporation acquired the business or entered into the sale and lease-back transaction, it would eliminate the advantage which the charitable organization has over competitors. Such a solution, however, might make the purchase of a business by an alumni group so much more difficult that this method of investment by a college would be discouraged. The proposal would seem to take away any tax advantage from selling to a family foundation. The original owner might as well sell to a non-charitable corporation owned by the family. He will not get the purchase price any sooner; and the family will receive the corporation's net income after the original owner has been paid. The individual taxpayer would receive only the advantage ordinarily derived from a charitable donation.

If this analysis is correct, the issue left for Congress on this part of the charities problem is whether to allow colleges and other exempt institutions this new and more promising source of investment. With the competitive advantages gone, the greatest impetus towards an over-concentration of wealth in the hands of charitable corporations would disappear. However, the rate of return on this type of investment may be extraordinarily high, especially under present economic conditions.
conditions. This factor alone might prove such an inducement for exempt institutions to purchase businesses that an over-concentration of wealth and endangering of federal revenue would result, forcing Congress to tax this source of income.  

The Percentage Limitation.—The second of the Treasury’s 1942 proposals, the percentage limitation, suggests what appears to be a simple solution to most of the other tax and social problems created by the foundation. The limitation would be fairly easy to enact as legislation and to administer. This method of governmental control of charitable bequests and devises is not new. Some states, but for a different policy reason, that of protecting the surviving family, limit the percentage of a decedent’s estate that can be left to charitable organizations. A consideration of the Treasury’s proposal requires, again, a clarification of policy. The amendment would place a limitation upon the creation of all foundations as well as a

145. Many state property tax statutes afford charitable exemption on the basis of the use of the property rather than on ownership. Under a use statute most courts require direct physical use of the exempt property by the charitable organization, thereby precluding exemption to property which the organization leases for commercial purposes, even though the income from the property is devoted to charitable activities. On the other hand, under an ownership statute the courts generally exempt all property owned by an exempt organization regardless of use. Stimson, The Exemption of Property from Taxation in the United States 18 MINN. L. REV. 411, 420-421 (1934); Comment 1 WEST. RES. L. REV. 151 (1949). Mr. Gerdes testified that the New York University alumni-owned piston ring factory in St. Louis pays local and state taxes on the ground that the University does not “directly benefit” St. Louis. Note 142 supra at 3531, 3532.

146. The legislative history does not tell why Congress did not place a percentage limitation upon the estate tax deduction. The 1916 Act did not have any charitable deduction. It was first provided for in § 403(a)(3) of the Revenue Act of 1918 “almost by accident.” See Griswold, CASES AND MATERIALS ON FEDERAL TAXATION 285 (1946), for a review of the legislative history. The income tax charitable deduction limited to 15 per cent of net income first appeared in § 1201, War Income Tax Act of 1917. The failure to provide a limitation in the estate tax deduction is all the more strange in view of the investigation and criticism of large foundations by the United States Commission on Industrial Relations. See 1 UNITED STATES COMMISSION ON INDUSTRIAL RELATIONS, FINAL REPORT AND TESTIMONY, SEN. DOC. 415, 64th Cong., 1st Sess. 80-85, 220 (1915-16). See id. 7430 (testimony of Samuel Untermyer); 8 id. 7647 (Samuel Gompers); 8 id. 7663 (Louis D. Brandeis); 8 id. 7850 et seq. John D. Rockefeller, Jr.). Representative Jerry Voorhis proposed in 1942 that testamentary gifts to “educational and charitable trusts” be limited to twenty-five per cent of “the estate.” Hearings on the Revenue Revision Act of 1942, H.R. 77th Cong., 2d Sess. 888 (1942).

147. A corresponding amendment will have to be added to the gift tax which will not be as simple to enact. It would appear impractical to estimate a taxpayer’s total wealth at any one time in his life and limit his total deductible charitable gifts to a certain percentage of that total. Perhaps the amendment would take the form of a certain percentage of the taxpayer’s annual income as is done under § 23(o). Another possibility is a deduction in the nature of a definite amount which could be given tax free annually or in one person’s lifetime. The gift tax annual exclusion, and its specific exemption are models. Sections 1003(b); 1004(a)(1).

148. See ATKINSON, WILLS 106 et seq. (1937); 1 PAGE, WILLS 85 et seq. (1941). States that have limitations in regard to the proportion of the estate which may be devoted to charity frequently also stipulate that testamentary gifts are invalid unless the will is executed a specified time before the testator’s death. Generally only close, surviving relatives can object to invalid gifts. Atkinson lists only ten jurisdictions which restrict charitable testamentary gifts in any manner.
limitation upon a source of revenue to other private charitable institutions, universities and colleges, for example, which are now in difficult financial positions. The issue is thus renewed of whether to attack the problem by such an all-inclusive amendment or by legislation directed specifically at foundations in general, or as sources of family control of tax exempt wealth.

Statistical studies indicate that decedents do not avail themselves of the estate tax charitable deduction to any considerable extent. Charitable bequests are estimated to average six per cent of the gross estate of those leaving estates large enough to require the filing of a return under the federal estate tax.\textsuperscript{149} This would seem to demonstrate that a percentage limitation would be an easily applied remedy aimed directly at limiting large bequests to family foundations. The statistics, however, are not derived from comprehensive individual case studies listing the recipients of donations.\textsuperscript{150} They do not purport to deny the obvious fact, for example, that occasionally large donations are made to independent exempt institutions. It has been estimated that during the period from 1920 to 1940 "private benefactions" to institutions of higher education varied from sixteen to forty-three per cent of educational and general income.\textsuperscript{151} A general percentage limitation might seriously eliminate an important source of college revenue, whereas the failure to provide a percentage limitation has not been an important revenue loss to the government.\textsuperscript{152}

In addition to the general policy considerations that must be decided before the enactment of a general percentage limitation, there are separate considerations in determining appropriate legislation dealing specifically with foundations. Foundations are in many instances being used as means of personal tax avoidance, while at the same time, whether family controlled or not, they are doing a great variety of important philanthropic work. These factors raise two problems: (1) whether the Code is too liberal in permitting family control of foundations; (2) whether foundations in general are doing work of sufficient


\textsuperscript{150} The studies is the above note, except for Lindeman's, are based on the Treasury's compilations reported in the Statistics of Income. For a critique of this source see Harriss, supra note 149. Lindeman investigated samplings of probate court records in New York City for alternative years from 1927 to 1933.

\textsuperscript{151} Goldthorpe, op. cit. supra note 149 at 3 et seq.

\textsuperscript{152} See especially, Harriss, supra note 149 at 540.
public importance in improving the public welfare to justify their tax exemption.

In answer to the first problem, it is obvious that the Code provides almost no limitations against family control of foundations. The board of trustees and officers of the foundation may be staffed by the founder, his family and associates; they may receive compensation, and private individuals may receive annuities, from the foundation's income; the board may be self-perpetuating; they may accumulate income for an indeterminate number of years,¹⁶³ and the principal fund may be kept intact in perpetuity. The second of the Treasury's 1950 proposals would provide a considerable limitation on family control. The private foundation would generally be required to distribute substantially all net income within a specified period after the close of the taxable year. And the foundation would be prohibited from making loans to the founder or officers or their families; from paying unreasonable salaries; or from making substantial purchases of securities or other property from such persons. Moreover, the founder or his family would be prohibited from using the foundation to continue control of an existing business. These activities would be "prohibited" by providing that contributions to foundations permitting such practices would not be allowed as charitable deductions for income, estate, and gift tax purposes.¹⁵⁴

In regard to the second problem, the activities of foundations, no general knowledge is publicly available. The Treasury Department

¹⁵³. The common law rule restricting accumulations of income to the period determined by the rule against perpetuities is not applicable to charitable trusts. But the court will invalidate a provision for accumulation in a charitable trust if the period for accumulation is on the facts and circumstances unreasonable. Restatement, Property § 442, comment a. The section indicates that the rule is also applicable if the trustee has a discretionary power to accumulate or expend income for charitable purposes. Three bills introduced in the first session of the 81st Congress strike at this problem of accumulating income. Similar bills introduced by Senator Tobey (Sen. Rep. 1408, March 25, 1949) and by Representative Lane (H.R. Rep. 3898, March 30, 1949) would amend § 162(a) to limit its deduction to a trust which paid its beneficiaries during the taxable year 85 per cent of the trust gross income. The bills, which are aimed at the Textron situation (see notes 1 and 135 supra), also provide that trusts which invest funds in manufacturing concerns must register with the Secretary of Commerce, submit to audits and file annual reports. The bill introduced by Representative Kean (H.R. Rep. 2976, February 24, 1949) would require organizations exempt under § 101(6) to distribute 75 per cent of their yearly income, excluding capital gains added to principal, unless their plan to accumulate more than 25 per cent of their income was approved by the Commissioner, and a trust would be allowed a deduction under § 162(a) for any part of its gross income (exclusive of capital gains added to principal) which was paid for charitable purposes or permanently set aside under a plan approved by the Commissioner.

¹⁵⁴. These proposals are made in the Supplementary Treasury Department Statement, note 133 supra at 3. The Statement does not spell out specific legislation. It does state, however, that the foundation should be allowed to retain a reserve for contingencies or to meet a long term commitment to furnish funds for research or similar projects. The Clifford Regulations contain some limitations upon transactions between the grantor or his family and a charitable trust but the limitations are fairly narrow in scope. See U.S. Treas. Reg. 111, § 29.22(a)-21(e), and text at note 67 supra.
has amassed the greatest amount of information on the subject, information, of course, not open to public inspection. Since 1921 the regulations have required an organization to file a claim for an exemption, and since 1941 foundations and many other types of exempt institutions have had to file annual information returns. Staffs in the Treasury and the Joint Committee on Internal Revenue are now using these returns to prepare reports on a number of exempt institutions, including foundations. The reports will undoubtedly be made public. They should supply a considerable amount of information on foundation activity. The returns are not of sufficient breadth, however, to provide the basis for a complete picture.

Charitable foundations file their returns on Form 990. Among other items it calls for a fairly detailed statement of the foundation's sources of income (including business activity) and its disposition of income. Expenses and compensation paid must be listed, as well as contributions and the names of donees. If the organization's gross income exceeds $25,000, balance sheets for the beginning and ending of the year must be attached. When the organization holds more than ten per cent of any class of stock in a corporation, the name of the corporation and a description of the stock must be given.

As a minimum of adequate reporting, the form should be amended to include the following information: The names, relationship, and business association with the founder of all trustees, officers, and members of any committee controlling the investment of assets and distribution of income. The compensation of such individuals should be separately listed. The foundation's assets and all major changes during the year should be described. The returns should be kept by the Bureau in files subject to public inspection.

Most of the above changes in Form 990 could be made without amending Section 54(f), but the Code would have to be amended to provide for public inspection of returns. At present, although a charitable trust claiming a total or partial charitable deduction under Section 162(a) must file a fiduciary's return, the trust does not have to file under Section 54(f) since this applies only to organizations.

156. Returns were first required by regulation for the years 1941 and 1942 from all exempt organizations except religious organizations. See U.S. Treas. Reg. 103, § 19.101, as amended by T.D. 5152 (1942). From 1943 and subsequent years returns have been required by statute. Section 54(f), added by § 117, Revenue Act of 1943. Congress enlarged the number of institutions excepted from the requirement of filing annual returns.
157. See note 1 supra.
158. The suggested amendments must also apply to Form 1023, the form upon which a charitable organization files its original claim for exemption under U.S. Treas. Reg. 111, § 29.101-2.
159. The bill introduced by Representative Kean, note 153 supra, also provides for public inspection by adding a subsection (d) to § 55.
exempt under Section 101. To achieve uniform reporting, a trust which distributes more than a certain percentage of its gross income (for example, 15 per cent) to charitable purposes should also be required to file a return under Section 54(f). Whatever other legislation is finally adopted, a comprehensive system of public reporting is a requisite. Congress and federal agencies in various fields would benefit from more complete information. Such knowledge would also be of benefit to the foundations themselves and to various units of local and state government in order that a better coordinated program of philanthropic activity may be carried on.  

Private attempts to survey the field have been far from complete. Most of the foundations do not publish annual reports, and among this group are some of the largest. Many of the foundations refuse to answer any questionnaires sent by private investigators, even if they are from fellow foundations. From the information gathered, however, the surveys agree that the most substantial fields of foundation interest are education, medicine, and social welfare. In these three fields, foundations have made their most significant contributions in medicine and higher education. Their activities in the social welfare field have been typified as largely palliative in character, a charge often levelled at foundation activities in general. Probably this difficulty can never be adequately dealt with until those who control foundations cease to be drawn largely from the most conservative strata in our society.  

Certainly the Code needs strengthening against family control of foundations. Such use of the charitable deductions and exemptions is contrary to the fundamental policy of our federal tax system. The re-

160. State attorneys general charged with the duty of enforcing charitable trusts and corporations would be greatly aided. See Reports and Recommendations for Legislation of Former Attorney General Bushnell; Charitable Trusts, 30 Mass L.Q. 22 (1945).

161. Recent general surveys are: Harrison and Andrews, American Foundations for Social Welfare (1946); Raymond Rich Associates, American Foundations and Their Fields (1942); Jones, The Yearbook of Philanthropy, 1942-43; Lindeman, Wealth and Culture (1936). Lindeman's is the only independent critical study. The others, while giving valuable information, are written by foundation administrators or those closely connected with foundations.

162. Id. Harrison and Andrews at 5; Lindeman at 6.

163. Id. Harrison and Andrews at 79; Lindeman at 19; Raymond Rich Associates at 36.

164. Lindeman, op. cit. supra note 5, at 29. See also Flexner, Private Fortunes and the Public Future, 156 Atlantic Monthly 215 (1935).


167. Lindeman, supra note 5, at 32, et seq., gives a summary of the background, occupations, and affiliations of the trustees of the 100 foundations and community trusts that he studied.
recent Treasury proposals in this direction should be carefully considered. They have the merit of attacking problems which the present evidence demonstrates should be corrected. A percentage limitation on charitable donations to foundations in general would also tend to discourage independent foundations as distinguished from other exempt institutions, a policy which is certainly not justified on the present evidence. Both of these solutions necessitate some difficult problems of defining prohibited activities of the specific type of foundation that is to be non-exempt. These difficult questions of definition would not be present in a general percentage limitation, but such legislation might seriously encroach upon the financing of some exempt institutions which should be encouraged.