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CHARITABLE FOUNDATIONS AND THEIR BENEFITS

Melvin S. Flechner*

Sound tax planning does more than minimize taxes. It permits the saving of current income and the accumulation of capital, thereby conserving the fruits of labor for future use.

Taxpayers in the higher brackets consider control more important than ownership. This control plus the ability to accumulate more dollars can be accomplished by the use of a foundation.

A foundation is a non-profit institution established to accumulate and use funds for the purpose or purposes that the founder or founders deem worthy. Congress, after careful review of this type of organization, deemed it sufficiently valuable and important to the general welfare of the nation to merit tax exemption.

I. REASONS FOR CONGRESSIONAL APPROVAL

The reasons warranting this congressional approval stem from the worthwhile work and benefits to humanity which the foundations have done in the past.¹ In their inceptive years, foundations carried on a great deal of research in the field of medicine and other sciences. In these years they invested large sums of money

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¹ The comparative freedom from public regulations which philanthropic foundations and their founders have enjoyed is justified primarily on the grounds that foundations fill a public need which the government would otherwise be obligated to fill and that the public need is better served by private foundations than by government. H.R. Rep. No. 1860, 75th Cong., 3d Sess. (1938); 1939-1 Cum. Bull. pt. 2, 742 (i); see *In re Browning's Estate*, 165 Misc. 819, 829, 1 N.Y.S.2d 825, 833 (Surr. Ct., 1938), *aff'd*, 281 N.Y. 577, 22 N.E.2d 160 (1939): "The salvage of the American ideal will be difficult if the principles of subsidy overshadow the principle of private charity. There is reason now to approve charitable foundations as serving the public good because they restore to better balance the relationship of the individual to his government. To the extent of its resources, private charity will remove the temptation of the underprivileged to regard government as obliged to furnish support and will aid in the restoration of a sense of personal responsibility among its donees. Such private funds are not subject to bureaucratic administration. They never lose their character as true charity."

The opposing viewpoint is expressed in Wedgwood, *The Economics of Inheritance* 91 (1920): "(I)t has been obvious, at least since the days of the Tudors, that, from the fiscal point of view, taxation is a more satisfactory expedient than exhortation to private beneficence. It is also certain that it is likely to be a more efficient method of reducing inequality than the encouragement of philanthropic bequest."

to learn the cures for many of man's ailments, sicknesses, and diseases. This they were able to do because of their tax exempt status and the fact that their capital is what is known as "risk capital." They were and are the pioneers in the fields of unknowns. Today with the government and others working in these fields, charitable foundations are moving forward in order to break down the frontier barriers in the fields of the social sciences.

Foundations with their risk capital can well afford to take gambles and play the long shot; whereas industrial research organizations and universities can not.

II. BENEFITS FOR THE CREATOR OF THE FOUNDATION

By the proper use of a foundation the creator can derive both monetary and asthetic benefits. Some of the asthetic benefits include: (1) the opportunity for the creator to expound pet theories and causes in charity giving; (2) the chance to have the founder's name become a memorial of lasting significance, e.g., the Ford Foundation; and (3) giving the benefactor the tremendous satisfaction of promoting worthwhile endeavors and yet allowing him to retain virtually all but the "dividend" benefits of ownership. Such persons do not give away their property; they merely give away the income thereon.

Some of the monetary benefits are: (1) the retention of power by the creator to manage and control the investments of the fund; (2) the creation of capital gains between the founder and the foundation; (3) the availability of a source of borrowing for the creator; (4) the creation of a buffer between the creator and fund collections; (5) the opportunity for the creator to wait until the end of the year and give one large contribution once his income for the year is known; and (6) the chance to use the foundation as a vehicle to reduce estate taxes and still maintain control.

In relation to the reduction of estate taxes, the Ford Motor Company capital structure consists of voting and non-voting stock, the latter representing over ninety per cent of the equity in the company. Upon the deaths of Henry and Edsel Ford, the Ford family received the voting stock and the Ford Foundation the non-voting stock. This plan gave the family control of the company plus control of the foundation. The net effect was a great saving of the estate taxes with the Ford Company remaining a closed corporation.²

² Fortune, August, 1947, p. 108, col. 2; New York Times, April 19, 1947, p. 1, col. 4, and June 4, 1943, p. 23, col. 6.

III. POSSIBLE FOUNDATION FORMS

A charitable foundation may be either a trust or a corporation. Most tax practitioners prefer the corporate form over the trust because of the feeling that most charitable organizations' objectives can be achieved through the medium of a corporation.³ The corporate form grants permanence and flexibility. Also, it is more readily amendable than the trust form; thus enabling it easily to avoid pitfalls. It eliminates any problems which exist under the Clifford-trust line of cases, those which may arise where the creator of the charitable foundation expects to retain management and control;⁴ and it escapes restrictions which state laws may impose on the creation and administration of a trust and the investment of the funds.

The membership of the corporation can be limited to a particular family,⁵ and control can be vested perpetually in the directors or officers selected by the creator. The family members can vote all the stock held by the foundation and can set all the business policies, compensation of corporate employees, dividends, etc.

IV. QUALIFICATIONS TO BECOME TAX EXEMPT

The income of a foundation will be tax-exempt provided (1) it is organized and operated exclusively for religious, charitable, scientific, literary or educational purposes; (2) no part of the net earnings of the foundation inures to the benefit of any private shareholder or individual; and (3) no part of its activities is the carrying on of propoganda.⁶

A. Foundation Must Be Organized Exclusively for Religious, Charitable, Scientific, Literary, or Educational Purposes

In its attacks against foundation tax exemptions, the internal revenue service has fired its first salvo at the phrase "organized and operated exclusively for religious, charitable, scientific, literary or educational purposes." However, the courts in their interpretation of "exclusively" have determined its meaning to be "primarily." The service would favor the denial of an exemption unless the foundation has but a sole motive.

³ Casey, How to Use Charitable Trusts and Foundations, Handbook of Tax Techniques 1011 at 1028 (Prentice-Hall 1951).

⁴ U.S. Treas. Reg. 118, § 39.22(a)-21 (1954).

⁵ I.T. 3220, 1938-2 Cum. Bull. 164 modifying I.T. 2933, XIV-2 Cum. Bull. 117 (1935).

⁶ Int. Rev. Code of 1954, § 501(c)(3).

In *Otto T. Mallery v. Commissioner*⁷ the court had the "exclusive" problem and sustained the exemption although assistance was furnished a needy relative. A leading case in which a foundation granted benefits to the sister of the donor was *Home Oil Mill v. Willingham*.⁸ There the decedent in his will created a trust for the benefit of eight charitable organizations. The trust was authorized to operate the businesses bequeathed to it, and the decedent's sister was named chairman of the trust to serve for life. She was to be paid \$15,000 a year from earnings, but if earnings were insufficient she was to be paid from corpus. The commissioner argued that the trust had a dual motive which did not fall within the meaning of "exclusively." The court in finding for the foundation stated that "the testator intended that his very considerable residuary estate, both corpus and income, should be devoted, in maximum amount, to charitable purposes." The court also felt that the testator, instead of merely paying his sister a lifetime competence, was motivated by the assurance that she would faithfully and successfully carry out his beneficent plan. Neither the family relationship nor the provision for the compensation of the sister on a fair and reasonable basis for services actually performed operated to deny an exemption certificate.

B. Net Earnings of the Foundation Shall Not Inure to the Benefit of the Individual

The statute granting exemption provides that the *net earnings* of the foundation shall not inure to the benefit of the individual. Use of the words *net earnings* permits deducting the cost of operations in arriving at this figure. Obviously compliance with the statute is had where ministerial employees are paid salaries for their services. The same is true where the

⁷ 40 B.T.A. 778 (1939). See also, In Estate of Agnes C. Robinson, 1 T.C. 19 (1942) where old family servants benefited from the foundation; a similar case was *Havemeyer v. Commissioner*, 98 F.2d 706 (2d Cir. 1938) where employees of the donor's corporation were recipients of benefits.

⁸ 68 F. Supp. 525 (N.D. Ala., 1946), appeal dismissed, 181 F.2d 9 (5th Cir. 1950). In *Edward Orton, Jr. Ceramic Foundation*, 9 T.C. 533 (1947), aff'd, 173 F.2d 483 (6th Cir. 1949) the court construed the word "exclusively" to include "clear and predominant." In addition it was their feeling that if the nonstatutory motive was "incidental" to the prime purpose, the statutory exemption was not vitiated. *Debs Memorial Radio Fund v. Commissioner*, 148 F.2d 949 (2d Cir. 1945).

creator or his immediate family are paid reasonable salaries for services actually rendered.⁹

It is not the percentage of earnings paid as salaries that affects the tax exempt status of the foundation, but it is the reasonableness of the compensation for the particular services rendered.¹⁰

The internal revenue service has achieved some success in litigating those cases which would otherwise qualify but for the fact that the bequest or gift either directed or was subject to the payment of part of the foundation's net earnings to a private individual. Here the argument is made that acceptance of the gift causes the foundation to lose its exemption because part of its net earnings are for the benefit of a private individual.¹¹

However, when a foundation accepts a bequest subject to obligations to private individuals, it is assuming an obligation in order to receive a much greater financial benefit. Its obligation, being incidental to its main charitable purpose, should not destroy its right to exemption. On the other hand, where it accepts such obligations in such a degree that they overshadow the amounts of earnings remaining for charity, the obligations are no longer incidental and the exemption should be denied.

⁹ I.T. 3220, 1938-2 Cum. Bull. 164; Sand Springs Home 6 B.T.A. 198 (1927); Unity School of Christianity, 4 B.T.A. 61 (1926). Miss Harris Florida School, Inc., P-H 1940 B.T.A. Mem. Dec. 140, 275. These cases do not sanction the use of a "salary" as an indiscriminate method of siphoning off earnings to private uses. Scholarship Endowment Foundation v. Nicholas, 25 F. Supp. 511 (D. Colo. 1938) (quoting Restatement, Trusts § 376 (1935)), aff'd, 106 F.2d 552 (10th Cir. 1938), cert. denied, 308 U.S. 623 (1939). In Northern Illinois College of Optometry, P-H 1943 T.C. Mem. Dec. ¶ 43,396, the petitioner claimed it was a non-profit organization entitled to exemption. The court held that the petitioner was organized for education purposes but that the record showed that it was operated with the view of making profit. The record showed that as the revenues increased, corresponding increases were made in the "salaries" of petitioner's members, officers and directors—most of whom were of one family. In one instance a salary was increased from \$740 to \$12,000 annually.

¹⁰ Northern Illinois College of Optometry, P-H 1943 T.C. Mem. Dec. ¶ 43,396. The basis of decision was not the fact that thirty-seven to sixty-five percent of earnings were distributed as salaries but instead the reasonableness of the salaries.

¹¹ Davenport Foundation, 6 Tax Ct. Mem. 1335 (1947), aff'd, 170 F.2d 70 (9th Cir. 1948); Scholarship Endowment Foundation v. Nicholas, 25 F. Supp. 511 (D. Colo. 1938).

In *Davenport v. Commissioner*¹² the foundation was obligated to make payments of income to the donor and his brother. In addition, the trustee had unlimited discretion to provide for the donor's children if they were in want. The donor was to live rent free in a house conveyed to the foundation. Based on our present day knowledge, it is obvious that the foundation was held taxable.

In *Scholarship Endowment Foundation v. Nicholas*¹³ the donor transferred corporate stock and bonds to the foundation and obligated the foundation to an annual annuity of \$5,000 for the donor's life and upon his death to his wife. The gross income of the foundation was \$15,000 and though \$10,000 was available for charity only \$1,300 was expended. The reason for the withholding was the necessity for future payments of the annuity should current income be insufficient. The exemption was denied.

In *Baker v. Commissioner*¹⁴ the private annuity to the widow amounted to \$19,200 per year during the first three years. During this period actual charitable expenditures were from four and one-half to twelve times greater than the annuity obligation. The court in holding for the foundation, stated:

Petitioner's only activity during the taxable years which was not strictly of a charitable or educational character was the payment of the allowance to the decedent's widow and the educational expenses of her nieces and nephews. We do not think that alone defeats its classification as an exempt corporation under the statute. The payment of these amounts was merely incidental to and was a means of furthering the charitable and educational purposes for which the petitioner was organized. *It was in no sense a part of its corporate activities.* The payments... were a charge not upon the petitioner's net earnings but against the entire corpus of the residuary estate.¹⁵

In *Commissioner v. Orton*¹⁶ the annuity varied from \$6,000 to \$12,000 in the first five years and thereafter was \$350 per month. Income in the same period varied from a net loss to \$23,000. The foundation expended over \$20,000 for charitable

¹² 6 Tax Ct. Mem. 1335 (1947), aff'd, 170 F.2d 70 (9th Cir. 1948).

¹³ 25 F. Supp. 511 (D. Colo. 1938).

¹⁴ 40 B.T.A. 555 (1939). See also *Gemological Institute of America*, 17 T.C. 1604 (1952). The head of the institute received a salary of \$4500 plus fifty per cent of the net from the operation of the business. An exemption certificate was denied inasmuch as the net earnings inured to the benefit of an individual. *Quaere*—What percentage of net earnings would be sanctioned?

¹⁵ *Baker v. Commissioner*, 40 B.T.A. 555, 561 (1939).

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

purposes. The fact situation in this case was similar to the *Baker* case and the court applied the same theory in granting an exemption.

In a very early case, *Lederer v. Stockton*,¹⁷ an annuity of \$800 was payable out of \$15,000 income to an annuitant, the rest of the income being actually expended for charity. The exemption was granted.

C. The Foundation Can Not Spend a Substantial Part of Its Activities Carrying On Propaganda

Very careful attention is given to the requirement that "no substantial part" of the activities may consist of "carrying on propaganda, or otherwise attempting to influence legislation." In considering this phrase, it is necessary to distinguish between two kinds of organizations which may be regarded as political. The first includes those engaged in political activity in the popular sense of the term, that is, the promotion and support of a political party and the support of candidates for office. This type of organization clearly is not tax-exempt, contributions thereto being specifically denied by the regulations.¹⁸

The second kind of organization includes (1) those organized and operated primarily for the purposes of promoting principles of government; (2) those engaged in activities pertaining to the conduct or form of government; (3) those engaged in activities to effect certain systems of administration; and (4) those engaged in legislative activities to accomplish these or other purposes. Many organizations having such purposes apply for exemption as "educational" foundations. One authority in the tax field has described the precedents as establishing the following rule:

A primary devotion is enough, totality of devotion is not required. The general or predominant purpose is to be considered. Activities which are not . . . educational in themselves, but merely the means of accomplishing the desired purposes, do not prevent the desired purposes from being deemed "exclusive" under the statute . . . A purpose, "incidental, contributory, subservient or mediate" to one of the statutory purposes, will not prevent an organization from being within the required category.¹⁹

¹⁷ 260 U.S. 3 (1922).

¹⁸ U.S. Treas. Reg. 118, § 39.23(o)-1 and § 39.23(q)-1 (1954). See also *Textile Mills Security Corporation v. Commissioner*, 314 U.S. 326 (1941) denying deductions for money expended for lobbying purposes, the promotion or defeat of legislation as trade or business expenses.

¹⁹ 1 Paul, *Federal Estate and Gift Taxation* § 12.19 (1942).

In the early days, the revenue service tried to resolve cases by distinguishing between "education" on the one hand and "propaganda" on the other.²⁰ On the basis of these judicial precedents²¹ it is now reasonably established that under the present law an organization may have as its ultimate objective the creation of a public sentiment favorable to one side of a controversial issue and still secure exempt status provided that its methods are of an educational nature, and it does not to any "substantial" degree attempt to influence legislation.

The revenue service will deny exemption to any organization where evidence demonstrates it is subversive. Any truly subversive organization will not meet the requirement of being exclusively for education as set forth above.²²

V. PROCEDURE TO BECOME TAX EXEMPT

Once a foundation is created and the initial contribution is made, the usual procedure is to apply to the internal revenue service for a ruling granting the exemption certificate so that contributions will be deductible. As a general rule the service will not rule on the status of a foundation until it has actually operated for about one year. Members of the service feel that unless they have one year of operations before them, it is difficult and unfair to pass on the qualifications of an organization. If the ruling is favorable, the certificate is retroactive to the inception of the organization and deductions may be taken for the contributions made in the first year and thereafter.²³

The service may be willing to issue a ruling before one year of operation, but this applies only to organizations receiving contributions from the populace and which serve community needs. These rulings will be tentative in nature, and a formal ruling will be issued only at the end of a year of activity. At the present time rulings are being issued by the local offices in cases in which the service will rule before one year's operations have been completed. The Washington office is now ruling on all family type foundations, but under the plan of decentralization the local offices will soon handle these cases.

²⁰ *Faulkner v. Commissioner*, 112 F.2d 987 (1st Cir. 1940); *Cochran v. Commissioner*, 78 F.2d 176 (4th Cir. 1935); *Leubushcer v. Commissioner*, 54 F.2d 998 (2d Cir. 1932); *Slee v. Commissioner*, 42 F.2d 184 (2d Cir. 1930); *James J. Forstall*, 29 B.T.A. 428 (1933).

²¹ *Ibid.*

²² *Casey*, op. cit. supra note 3, at 1028.

²³ 1954 Int. Rev. Bull. No. 15, at 8.

When filing for the exemption certificate it is necessary to file Form 1023 which includes the articles of incorporation, the charter, by laws, and a record of the first year's operation. This form is first filed with the Director of Internal Revenue in the district where the foundation is created. If the foundation is of the family type, it is referred to the Exempt Organization Branch in Washington for a ruling. At the present time one can expect a ruling within four months after Washington receives the files.

In the first year of operation, before the foundation receives its exemption, it is necessary for the foundation to file a taxable return. In most cases this return will be due before the exemption is received, and it is suggested that an extension be requested for filing the return and for paying the tax in accordance with the provisions of section 39.56-2 of Regulations 118.²⁴

Once the exemption has been granted, the organization is required to file an annual information return on Form 990 or Form 990A.

VI. LIMITATIONS ON CHARITABLE FOUNDATIONS

The Revenue Act of 1950, which was enacted to clarify the permissible transactions in this field and eliminate some of the abuses, gives implicit approval to all legitimate philanthropic organizations. The new rules and regulations are reasonable, easy to live within, and, though general and all inclusive in their wording, are attempting to remove some of the doubt in the field.²⁵

²⁴ 1954 Int. Rev. Bull. No. 372, at 15.

²⁵ 34 Va. L. Rev. 182 (1948); Latchem, *Private Charitable Foundations: Some Tax and Policy Implications*, 98 U. of Pa. L. Rev. 617 (1950). H.R. Rep. No. 2319, 81st Cong., 2d Sess. 130 (1950), the original House bill contained a provision disallowing any deduction to donor for income, estate and gift tax purposes in instances in which (1) the assets of the organization might be loaned to substantial donors of the organization or any member of their families or to a corporation controlled by them; (2) a substantial part of the assets of the organization might be used to purchase securities or other property from such persons; and (3) a substantial part of the property might be sold to such persons. In addition the bill denied deductions in the following instances: (1) Where the donor or members of his family, possessed control of the organization to which the contribution was made and (2) where the organization owned stock in a corporation in which the donor, together with members of his family, controlled fifty percent or more of the stock, counting the stock held by tax exempt organizations which the family controls. The minority members of the House Ways and Means Committee, however, felt that this stringent provision might have undesirable results and might discourage wealthy persons "from making legitimate charitable contributions." *Id.* at 156. Apparently persuaded by this reasoning the Senate Finance Committee deleted the proposal.

They are in addition to and not in limitation of the restrictions found in section 501(C)(3) of the Internal Revenue Code of 1954.

A. *Prohibited Transactions*

A foundation engaging in prohibited transactions with specified persons shall lose its exempt status.²⁶ These persons are (1) the creator of the organization; (2) a substantial contributor to the organization; (3) a member of the family of such creator or contributor (whole or half-blood brothers and sisters, spouse, ancestors, and lineal descendants); or (4) a corporation controlled by (1), (2), or (3). Control in this case means owning directly or indirectly fifty percent or more of the voting power or fifty percent or more of the value of the stock of the corporation.²⁷

The objective is to deny tax exempt status to organizations which are manipulated to the private advantage of any substantial donors of the organization. A donor who makes a gift or contribution in the year, or prior to the taxable year, in which the organization engages in a prohibited transaction will be permitted to deduct the gift or contribution provided the donor or any member of his family is not a party to such prohibited transaction.

The prohibited transactions²⁸ are: (1) lending any of its income or corpus without the receipt of adequate security and a reasonable rate of interest to the creator of the organization or other person mentioned above; (2) paying them unreasonable compensation; (3) offering them services on a preferential basis; (4) making a substantial purchase of securities from them for more than adequate consideration; (5) selling them any substantial part of its securities or property for less than adequate consideration; or (6) engaging in any other transaction that results in a substantial diversion of the income or corpus of the organization.²⁹

1. When Transactions Are Permissive

The transactions enumerated in the statute are all permissive whenever the specified person is dealing at arms length with the charitable foundation. If a transaction with a founda-

²⁶ Int. Rev. Code of 1954, § 501(c)(3).

²⁷ Int. Rev. Code of 1954, § 503(c).

²⁸ See note 25 *supra*.

²⁹ See note 25 *supra*.

tion improves its income or asset position, the fact that the creator receives collateral benefits, such as improving his liquidity, financing, or the realization of capital gain does not bar the transaction.

2. Construction of Ambiguous Language

As can be seen from the language used in describing the prohibited transactions, the wording is general and in such engulfing terms as "reasonable," "substantial," and "adequate consideration."

As to "reasonable" we can look to its meaning in the general line of compensation cases. "Substantial" brings with it such language as "major portion," or "the great part"; and "adequate consideration" can be considered what a free buyer in a free market would be willing to pay for the asset and a free seller would accept.

3. Penalty for Engaging in Prohibited Transactions

Any organization which engages in any prohibited dealings as set forth above is for tax purposes outlawed and its exemption certificate denied. A considerable interval may elapse, however, between the "crime" and "punishment"; for generally speaking, the penalties become effective only for taxable years subsequent to the year in which the organization is notified by the service that it has participated in a prohibited transaction. The commissioner shall notify the violator in writing by registered mail at the last known address of the organization. However, notification will not be required (1) if the organization commenced the prohibited transaction with the purpose of diverting income or corpus of the organization, or (2) if the foundation diverts corpus from its exempt purposes, such transaction involving a substantial part of the income.

4. Procedure for Regaining Exemption

An organization which has lost its exempt status may file for an exemption certification as a new organization in any taxable year following the taxable year in which notice of denial for exemption was issued, and in addition file an affidavit to the effect that it will not knowingly engage in a prohibited transaction again.³⁰

B. Restrictions on Accumulations of Income

Another new and important provision, which relates to re-

³⁰ Int. Rev. Code of 1954, § 503(d).

restrictions on accumulations, is in section 504.³¹

This new section bars excessive accumulations *out of income* when: (1) the accumulations are unreasonable in amount and duration to carry out the purpose or function constituting the basis of the organization's exempt status; (2) the income funds are used to a substantial degree for purposes or functions other than those constituting the basis of the organization's exempt status; or (3) the income funds are invested in such a manner as to jeopardize the carrying out of the purposes or function constituting the basis of the organization's exempt status. An excessive accumulation of income, thus determined, results in the loss of tax free status.

The rules and regulations apply to income and not to gifts which the foundation receives. Without the corpus with which to earn income, the foundation could not operate. It is common knowledge that foundation purposes and functions are carried on with income received from properties dedicated to the fulfillment of the foundation's pursuits.

The term "income" means gains, profits, and income determined under the principles applicable in determining the earnings and profits of a corporation. The amount accumulated out of income during the taxable or prior year shall be determined under the principles applicable in determining the accumulated earnings and profits of a corporation.

In determining the reasonableness of an accumulation out of income the following will be disregarded: (1) the accumulation of gain upon the sale or exchange of a donated asset to the extent that such gain represents the excess of the fair market value of such assets when acquired by the organization over its substituted basis in the hands of the organization; and (2) the accumulation of gain upon the sale or exchange of property held for the production of investment income, such as dividends, interest and rents, where the proceeds of such sale or exchange are within a reasonable time reinvested in property acquired and held in good faith for the production of investment income.³²

An accumulation out of income may be permitted if the purpose of the organization requires accumulation for a period of years in order to perform a specific job authorized in its charter. As to what is a reasonable accumulation we have section 102 of the 1939 Code to consider. There is no one hundred percent rule

³¹ Int. Rev. Code of 1954, § 504.

³² U.S. Treas. Reg. 118, § 39.3814-1 (1954).

of distribution, and Congress turned down an eighty-five percent rule. The feeling on the subject is that seventy-five percent and possibly as little as fifty percent of the income is permissible. Whether an accumulation is reasonable or not depends on the history of the foundation and the ability to show that the purpose of the foundation is being carried out.³³

A recent ruling interpreted accumulations under section 3814 of the 1939 Internal Revenue Code.³⁴ The organization which requested the ruling was tax-exempt under section 101(6) of the Code, receiving its chief support from gifts by its founder. In past years the foundation had distributed its entire income and in some years invaded a substantial amount of its contributed capital in order to make distributions. The organization maintained no reserves for purposes of accumulating income. From 1948 through 1953 it had a total gross income of 900x dollars of which amount 500x dollars represents gain from the sale of capital assets. During such year 1,400x dollars were distributed. The foundation was desirous of restoring its income producing corpus and proposed to accumulate each year its capital gains income and a certain minor part of its annual dividend and interest income, so as to accomplish such restoration over a ten year period or less.

The ruling stated:

In view of the circumstances here present, it is held that the accumulation each year by the instant organization of its capital gain income and part of its annual dividend and interest for the period of ten years or less . . . until past invasions of its income producing corpus have been restored *will not* be considered an unreasonable accumulation of income within the meaning of § 3814 of the Code (Italics supplied)³⁵

C. *Taxation of Unrelated Income*

In order to eliminate the competitive advantages that tax-exempt organizations enjoyed, or it was felt they enjoyed, when engaged in commercial business, the Revenue Act of 1950 taxed unrelated business income.³⁶ If the organization is a corporation, it is taxed at corporate rates; and if a trust, it is taxed at individual rates on its unrelated income. Unrelated trade or business income is described as "the conduct of which is not substantially related (aside from the need of such organization for

³³ See 1954 Int. Rev. Bull. No. 24, at 22.

³⁴ *Ibid.*

³⁵ *Id.* at 23.

³⁶ 64 Stat. 948 (1950); Int. Rev. Code of 1939, §§ 421-423.

income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose"³⁷

Excluded from unrelated trade or business income as defined above are dividends, interest annuities, gains or losses from the sale, exchange, or other disposition of property other than inventory or property held for sale to customers, and rents from real property.

In contrast to these exclusions, business lease rent is income of a lease of real property for a term of more than five years if at the end of the taxable year there is outstanding an indebtedness incurred in acquiring or improving the property.³⁸ The mortgaging of property and the use of the funds thereof for the purchase of a new piece of property, as well as purchasing real estate subject to a mortgage, is considered the type of indebtedness which would subject income to corporate rates of tax.

Section 514(b) (2) (B) contains a new rule under which a lease is treated as continuing for more than five years where the property has been occupied by the same lessor for a total period of more than five years (commencing not earlier than the date of acquisition of the property by the tax exempt organization) whether the occupancy is under one or more leases, renewals, etc. However, this provision applies only in the sixth and succeeding years.³⁹

CONCLUSION

It is felt by the writer that in this field the tax attorney can do the greatest good for the most people at one time; his client, his government, humanity and the world. With the aid of the foundations, basic research has been strengthened in this country to a point where it is expected to take a place of international preeminence much as medical science has done. No longer will we need to import from Europe our basic research and fundamental science. With the mushrooming of small family foundations striving to move in the right direction, we will accomplish the mission and purpose of the charitable foundation.

³⁷ Int. Rev. Code of 1954, § 513(a).

³⁸ Id. § 514.

³⁹ Sen. Rep. No. 1622, 83d Cong. 2d Sess. 312 (1954).