

SOME COMMENTS ON THE REVENUE ACT OF 1950

PART II *

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When one considers that much of the work on the Revenue Act of 1950 was done between July 25, 1950, the date of the President's letter to the Chairman of the Senate Finance Committee, and the middle of September, 1950, it is apparent that the extensive changes in the law that were made represent a tremendous effort on the part of Congress. Numerous problems still need attention, of course; one that certainly needs Congressional clarification is the family partnership situation which was considered in connection with the Revenue Act of 1950 but not acted upon because of lack of time. The need for additional revenue means that new tax laws or amendments are to be expected and some of the remaining problems of revenue reform may well be considered at that time. With allowance for a few exceptions it can be said that the job on both revenue raising and reform done by the Revenue Act of 1950 was a job well done.

LOOPHOLE CLOSING PROVISIONS

Dividends Received Credits.—There is probably little, if any, room for argument that some form of amendment was required to close this loophole, but there is some question as to whether the proper method was chosen to do so. Under the prior law, the effect of the dividends received credit was that the corporation receiving the dividend had to pay tax on only 15% of the value of the dividend received whether received in cash or kind. The loophole available was that from the standpoint of the corporation declaring the dividend, any appreciation in the value of the property being distributed as a dividend in kind was not taxable as income to it by virtue of the decision in *General Utilities & Operating Co. v. Helvering*⁵⁷ so that the corporation paying such

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57. 296 U.S. 200 (1935). The Commissioner has continued to contend that the corporation distributing a dividend in kind of property appreciated in value thereby realizes gross income. In the latest case on this point, however, he did not even file a brief. *Trinity Securities Company, Inc. v. Commissioner*, 9 CCH TC MEM. DEC. 17, 958 (1950).

dividend incurred no tax, the corporation receiving the dividend paid a tax on 15% of the market value of the dividend, the basis of the property to the receiving corporation became its then market value, and on sale of the property at then market value there was no gain which could be subjected to tax. This meant that related corporations could reduce taxable profits where there were appreciations in value over cost basis with respect to property which it was desired to sell by the simple expedient of declaring a dividend in kind.⁵⁸

The amendment provides that the dividends received credit shall not exceed 85% of the adjusted basis of the distributed property in the hands of the distributing corporation.⁵⁹ It further provides that should gain be recognized to the distributing corporation as a result of the distribution, the credit would be for 85% of the adjusted basis plus any gain recognized to the distributing corporation. The Report of the House, in which the amendment originated, points out that the amendment is not intended to affect any interpretation of existing law with respect to a dividend in kind,⁶⁰ so that it is clear that the amendment cannot be used as a springboard from which to attack the principle of *General Utilities & Operating Co.*⁶¹ On the other hand, if the property to be distributed has depreciated in value, the credit is based on the value of the property.

It would seem that the Congress could have accomplished the closing of the loophole just as effectively by providing for a carryover of the basis so that any gain on sale would be taxable in the hands of the dividend receiving corporation. This would permit the continued declarations of dividends in kind made by related corporations for business purposes such as where it is desired to have property available for

58. *But cf.* Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570 (2d Cir. 1949), where a preconceived plan to sell the property distributed in a situation where the distributing corporation had obtained a commitment from a purchaser resulted in a realization of capital gain by the distributing corporation under an extension of the business purpose doctrine of Gregory v. Helvering, 293 U.S. 465 (1935) and the application of the Commissioner v. Court Holding Co., 324 U.S. 331 (1945) doctrine.

59. § 122. All references by section number only are to the Act, Pub. L. No. 814, 81st Cong., 2d Sess. (Sept. 23, 1950).

60. H.R. REP. No. 2319, 81st Cong., 2d Sess. 50 (1950), hereinafter referred as "House Report."

61. This comment gains importance in the light of the continued sniping at the rule of *General Utilities & Operating Co.*, as evidenced by Commissioner v. Transport Trading & Terminal Corp., *supra*, note 58 (preconceived plan of sale); Commissioner v. The First State Bank of Matador, 172 F.2d 224 (5th Cir. 1949) (anticipatory assignment of income); Commissioner v. First State Bank of Stratford, 168 F.2d 1004 (5th Cir. 1948), *cert. denied*, 335 U.S. 867 (anticipatory assignment of future income); Rudco Oil & Gas Co. v. United States, 82 F. Supp. 746 (Ct. Cl., 1949) (anticipatory assignment of future income); Commissioner v. Wakefield, 139 F.2d 280 (6th Cir. 1943) (assets purchased out of earnings and profits); and Binzel, Jr. v. Commissioner, 75 F.2d 989 (2d Cir. 1935) (assets purchased out of earnings and profits).

use by the receiving corporation. Likewise, it would not tax other distributions in kind where it so happens that one of the shareholders is a corporation. In addition, the current amendment would seem to have no effect where the distributing corporation does not have earnings and profits to cover the value of the property since there would be nothing to support a dividend. Thus, second thinking would seem to indicate that a carryover of cost basis would have been a more acceptable method of closing the loophole that was admittedly available to corporate taxpayers.

The amendment is effective for all taxable years ending after December 31, 1949 and, as introduced, was to apply to dividends received after December 31, 1949; this latter provision was changed in the Senate so as to apply to dividends received after the date of the Act's passage, and in Conference to dividends received after August 31, 1950.

Dealers in State and Municipal Bonds.—This amendment⁶² is designed to extend and make complete the loophole closing undertaken in the Revenue Act of 1942 with regard to the amortization of premiums paid in connection with exempt bonds.⁶³ The problem involved was brought to a head by the appearance of tax exempt securities featuring several series maturing in short periods but bearing high interest rates. Since security dealers were not required to amortize the premiums of tax exempt bonds,⁶⁴ this meant that they could acquire such bonds, receive the high rate of interest tax-free, and on sale take a loss because of the reduction in value brought about by the passage of time.

Introduced in the House⁶⁵ the new law provides that dealers must amortize the premium on all exempt bonds whose earliest maturity or call date is five years or less from date of acquisition unless the bonds are sold within 30 days of acquisition. If the dealer inventories his securities on a cost basis or does not maintain an inventory, this is accomplished by reduction of the cost basis at the time of sale.⁶⁶ In the case of dealers inventorying bonds at market price, this is accomplished by requiring that the amount of amortization for any given year be used to reduce the cost of sales for that year. As originally introduced in the House, the amendment was to apply to all taxable years beginning after December 31, 1949. The Senate, influenced by the testimony of

62. § 203.

63. Begun by the additions of §§ 125 and 113(b)(1)(H) to the Internal Revenue Code by the Revenue Act of 1942 which requires all taxpayers other than security dealers to amortize premiums on tax-exempt bonds.

64. By virtue of the provisions of § 125(d) of the Code.

65. Section 202 of the House Bill.

66. The reduction is the same as that required of all other taxpayers by § 113(b)(1)(H) of the Code.

witnesses appearing before the Finance Committee that a retroactive date would require extensive and costly reexaminations of transactions which had occurred before notice of any proposed change, changed the effective date. As enacted, the amendment requires amortization with respect to taxable years ending after June 30, 1950; however, with respect to taxable years beginning before and ending after that date, it is to apply only to obligations acquired after that date. The amendment accomplishes a worthwhile purpose and should raise no real administrative problem, but it is wondered why amortization was restricted to bonds having a maturity or call date of five years or less from date of acquisition.⁶⁷

Stock Redemption by Subsidiary Corporations.—The loophole to be plugged by this amendment was revealed by the recent case of *Commissioner v. Wanamaker*⁶⁸ in which it was decided that the purchase by a subsidiary of its parent's stock from a stockholder of the parent was not the equivalent of a taxable dividend under § 115(g) since the parent was not doing any redeeming. The loophole is closed by the addition of paragraph (2) to § 115(g)⁶⁹ providing that if a subsidiary (referred to in the amendment as acquiring corporation) buys the stock of its parent (referred to in the amendment as issuing corporation) the amount paid for the stock shall be a taxable dividend from the parent to the extent it would have been so considered under § 115(g) (1)⁷⁰ by treating the transaction as if the subsidiary had distributed the amount to the parent and the parent had redeemed the stock itself. The amendment requires control by the parent, either direct or indirect, of the subsidiary and defines control as meaning the ownership of at least 50% of the total combined voting power of all classes of stock or at least 50% of the total value of shares of all classes of stock.

As introduced in the House,⁷¹ the provision also covered corporations in a horizontal or collateral relationship as well as parent-sub-sidiary corporations, *i. e.*, where the issuing corporation does not control the acquiring corporation but both corporations are controlled directly or indirectly by the same interests. The Senate Finance Committee eliminated this provision because it felt that in that case it was not clear

67. There seems to be nothing to prevent the issuance of 6 to 10 year bonds at high premiums and providing high interest rates which would mean that the present amendment will tend to alleviate the effect of, but not close the loophole.

68. 178 F.2d 10 (3d Cir. 1949). The Solicitor-General has determined not to petition for certiorari: (P-H 1950 FED. TAX SERV. ¶71,037) indicating that he is content with the statutory plugging of the loophole and will not attack prior stock redemption by subsidiaries.

69. Added by § 208.

70. § 115(g) of the Code as it read prior to amendment.

71. Section 207 of the House Bill.

that the effect was the same as a redemption of stock by the issuing corporation.⁷² Thus, redemptions by corporations controlled by the same interests but not in a parent-subsidiary relationship would still seem to be tax-free.

What this amendment does to the already troubled waters of the earnings and profits concept for tax purposes is difficult to say. The statute only provides that the amount paid by the subsidiary is treated as if it had been distributed by the parent in the redemption of its stock. The most logical conclusion to be gathered from this is that the subsidiary's earnings and profits are reduced by the amount of the distribution and that the parent's are first increased by the receipt of the distribution and then reduced by the amount of the "dividend" so as to remain the same as before. However, this would leave the subsidiary with the parent's stock as an asset with a supposed cost basis equal to value which could be sold, if done so at cost price, without affecting its earnings and profits. In order to round out the earnings and profits treatment it would seem to be necessary to reverse the treatment on a subsequent sale by the subsidiary and treat the sale price as one paid by the parent to the subsidiary in the form of an "as if" dividend so as to reduce the parent's and increase the subsidiary's earnings and profits. Of course, the most direct treatment would be to consider the subsidiary's earnings and profits as remaining the same and the parent's earnings and profits as reduced by the amount treated as having been distributed as a dividend by it even though the parent in fact did not distribute any property. Since we will be operating in a world of make-believe the fact that no property was distributed might not be considered an insurmountable handicap. It will be interesting to see what the Treasury does with the concept of earnings and profits in this situation. It might be noted also that although the amendment treats the transaction as if the subsidiary had made a distribution to the parent, it is clearly an "as if" treatment and there would seem to be no grounds on which it could be contended that the subsidiary had in fact made a dividend payment to its parent so as to subject the parent to tax on the dividend. Although many interesting problems of interpretation are involved, the mere fact that the loophole has been plugged by legislative action would seem to preclude any but an academic interest in the problem in future years.

The House amendment was to apply to taxable years ending after December 31, 1949, but only with respect to amounts received after that date. As finally enacted, the amendment applies to taxable years

⁷² SEN. REP. No. 2375, 81st Cong., 2d Sess. 43 (1950) hereinafter referred to as "Senate Report."

ending after August 31, 1950, but only to amounts received after that date.

Capital Gains on Copyrights, Etc.—It would probably be most appropriate to consider this amendment as being in the nature of a change in tax treatment rather than a loophole closing provision. It arises out of the situation which taxed a professional writer or artist at ordinary income rates on the sales of his creations regardless of whether he sold them outright for a lump sum or received royalties for their use while an amateur, on the other hand, was taxed on a capital gains basis if he sold his creation outright but on an income basis if he received royalties for its use. The difference in treatment arose from the fact that the professional holds his works “primarily for sale to customers in the ordinary course of his trade or business” so that they could not be treated as capital assets. The change in tax treatment is to make the amateur as well as the professional taxable at ordinary income rates on the sale of his creation. This is brought about by defining capital assets in § 117(a)(1) of the Code⁷³ as not including “a copyright; a literary, musical, or artistic composition; or similar property” which is held by the artist who created it or by a taxpayer whose basis is determined in whole or in part by reference to the basis of such property in the hands of the artist who created it. Where the work has been created through the collaboration of several authors or artists, the interest of each in the work is also excluded from the category of capital assets. Section 117(j)(1) of the Code also has had its definition of “property used in the trade or business” amended by a like exclusion.

The one problem of interpretation that immediately strikes home is what is meant by “similar property”. The only hint given is in the House and Senate Reports,⁷⁴ both of which give the same examples, which in themselves are not too helpful since they would seem to be representative of two extreme situations. The one considered to fall within the meaning of similar property is a radio program which has been created by the personal efforts of the taxpayer. On the other hand, the interest of a sole proprietor in a photographic studio is not considered similar property within the intention of this amendment, even though the value of the business may be largely attributable to his personal efforts. It is evident that the Treasury has a wide interpretive latitude. Since the word “similar” is fundamentally broad in scope, it is believed the result will be a broad interpretation and that only time and the pattern of litigated cases will permit the forming of a clear

73. As amended by § 210.

74. House Report at 92 and Senate Report at 84.

picture of similar property for this purpose. Although an unfortunate result, the problem does not lend itself easily to any other treatment and it is to be hoped that the Treasury's position, when taken, will be as clearly defined as possible so that taxpayers will be aware of the problems confronting them. The House Bill⁷⁵ also included inventions; patents and designs within the scope of this amendment. These were eliminated by the Senate on the ground that the desirability of fostering the work of amateur inventors outweighs the small amount of revenue that would otherwise be obtained.

Another interesting item in connection with the passage of this amendment dealing with the definition of capital assets and of property used in the trade or business is that the Senate had included cattle used for breeding or dairy purposes in the definition of property used in trade or business so as to entitle sellers of such livestock to capital gains treatment under the provisions of § 117(j) of the Code.⁷⁶ This provision was eliminated in conference for it was deemed unwise to deal with the problem of cattle alone to the exclusion of other types of livestock and with the observation that the matter was deserving of further study, but that it was "the hope of the conferees that, pending such study and further legislation, the Treasury will follow the decision of the Eighth Circuit Court in the *Albright*⁷⁷ case".⁷⁸ It will be interesting to see whether the Treasury will heed this warning or invite the further legislation otherwise suggested. In any event it can be taken only as a hopeful sign by taxpayers who are concerned with the problem.

The amendment applies with respect to taxable years beginning after September 23, 1950. Its application in the situation where an artist has sold his work and is receiving payments on an installment basis under § 44 of the Code is to tax all payments received after September 23, 1950 as ordinary income even though the original sale resulted in a capital gain.⁷⁹ Both Committee Reports point out that the advantages of § 107 of the Code are available to the artist if he worked

75. Section 209 of the House Bill.

76. Summary of H.R. 8920, "The Revenue Act of 1950" as Agreed to by the Conferees, page 16, prepared by the Staff of the Joint Committee on Internal Revenue Taxation.

77. *Albright v. U.S.*, 173 F.2d 339 (8th Cir. 1949) in which capital gains treatment was accorded the sale of livestock used in a dairy herd and a breeding herd, respectively.

78. Conference Report, Amendment No. 82, page 7. H.R. REP. No. 3124, 81st Cong., 2d Sess. (1950), hereinafter referred to as "Conference Report."

79. This was made clear in the House Report at page 93 and Senate Report at page 85, where it is stated that the rule will be that applied by the court in *Snell v. Commissioner*, 97 F.2d 891 (5th Cir. 1938). In that case the taxpayer made an installment sale in 1923 which under the law then in force was taxed at a capital gains rate. The law was changed in 1924 so as to make the profit from the sale ordinary income rather than capital gain. Taxpayer was required to report the profit in subsequent installments as ordinary income rather than capital gains.

on the creation for 36 months or more and if he received 80% or more of the entire income in one year. It might also be noted that there would seem to be no bar to an artist transferring his creation to a corporation in return for stock and then selling the stock in order to obtain a capital gain, although it must be kept in mind to keep the corporation outside the new category of a collapsible corporation.⁸⁰

Short-Sales of Stock and Commodities.—There was closed by the addition of subsection (1) to § 117 of the Code⁸¹ a glaring loophole which had been in existence and had been taken advantage of by taxpayers for many years. The loophole was in the field of stock and commodity dealing and was made possible because a short-sale was not considered complete until delivery of property owned by the seller and gain or loss from the completion of the short-sale was considered long-term or short-term depending on the holding period of the property which was delivered to complete the sale. This meant that one could convert short-term capital gains into long-term capital gains or into a combination of long-term capital gains and short-term capital losses by use of the short-sale. For example, you buy 100 shares at \$1,000 on January 1; they increase in value to \$1,500 by April 1; to insure your profit you make a short-sale at that price on April 1; there is a further rise in value to \$1,800 by July 10; in order to close out the transaction you buy 100 shares to close out the short-sale and sell the 100 shares originally purchased January 1; and the net result achieved is that you have a long-term capital gain of \$800 of which only \$400 is taken into account and a short-term capital loss of \$300 so that although you have made \$500 you are taxed only on \$100. The Bureau ruled against use of this device as far as commodities were concerned in a ruling issued March 8, 1948,⁸² but the ruling was unsupported by court decisions and whether the ruling would have been or will be upheld is doubtful in view of the continued ability of stock traders to do the very same thing in the sale of securities.

The amendment closes the loophole by providing that in the case of a short-sale made after September 23, 1950 three rules shall be in effect. If substantially identical property was held on the date of the short-sale

80. *Infra*, page 619.

81. Added by § 211.

82. *Mim.* 6423, 1948-1 *CUM. BULL.* 44. After pointing out that the Secretary of Agriculture, in a press release on December 4, 1947, had stated "that certain futures transactions in commodities 'appear fictitious in nature and should be eliminated'", the Commissioner went on to say that "In its audit of returns of taxpayers trading in commodity contracts, the Bureau will consider that offsetting trades in the same commodity in the same market for delivery in the same contract period are closed as of the moment the offsetting trade was made, and that the gain is realized or the loss is sustained at that time since such holding accurately reflects the realities of commodity trading."

for not more than six months or if substantially identical property is acquired after the short-sale and on or before the date of its closing, then (1) any gain upon the closing of the short-sale shall be considered as a short-term capital gain notwithstanding the length of time any property used to close such short-sale has been held and (2) the holding period of such substantially identical property shall be considered to begin on the date that the short-sale was closed or on the date of the sale, gift, or other disposition of such property, whichever date occurred first. Rule (2) applies to substantially identical property in order of acquisition, but does not apply to any property in excess of the amount which was sold short. For the purposes of Rules (1) and (2) only, the acquisition of an option to sell property at a fixed price (a "put") is considered a short-sale and the exercise or failure to exercise the option (or "put") is considered as the closing of a short-sale. If substantially identical property was held on the date of the short-sale for more than six months, then (3) any loss on the closing of the short-sale shall be considered as a long-term capital loss notwithstanding the length of time the property used to close the short-sale was held. For the purposes of this addition to § 117 of the Code "property" is defined as including stocks and securities (including stocks and securities on a "when issued" basis), and commodities futures, which are capital assets in the hands of the taxpayer. It is further provided that in the case of a short-sale of property, the term "taxpayer" is to mean taxpayer or his spouse.

It is made clear by statutory provision⁸³ that these rules do not apply in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange where there is a commodity future requiring delivery in one calendar month and another commodity future requiring delivery in a different calendar month. This is accomplished by providing that such commodity futures are not to be considered as substantially identical property. Contracts in different markets may, however, be so similar as to be considered substantially identical; in such cases the historical similarity or dissimilarity in price movements in the two markets will be the governing factor. Arbitraging is also specifically exempt from the operation of the short-sales amendments by statutory provision.⁸⁴ However, only the pure arbitrage position is exempted; if the quantity involved in one market exceeds the quantity involved in the other, the short-sale rules do apply to the excess. Hedges are also outside the operation of the amendment since they do not involve capital assets,⁸⁵ giving rise to

83. § 117(1)(3)(B)(ii) of the Code.

84. § 117(1)(3)(C) of the Code.

85. G.C.M. 17322, 1936-2 CUM. BULL. 151.

ordinary income and losses when the hedge is closed out. Although the problem of what constitutes a hedge has been with us in the past,⁸⁶ it is hoped that a greater emphasis will be given to business purpose in determining whether a given transaction is a hedge or not.

The Committee Reports⁸⁷ also make it clear that generally the term "substantially identical" does not apply to securities of different corporations nor generally to preferred stocks or bonds as compared with common stocks. However, securities of a predecessor or successor corporation in a reorganization and preferred stocks or bonds having a conversion feature where the values and price changes are very similar to the common stock into which they may be converted may result in a finding that the securities are "substantially identical". Although the question of substantially identical property is a difficult one, it is not new and the various rulings and decisions of the past under the wash sales provisions of § 118 of the Code should be helpful in determining what are substantially identical stocks and securities for purposes of the short-sales amendments.

The amendments are effective with respect to taxable years beginning after September 23, 1950 and, as noted above, apply only to short-sales made after that date.

Collapsible Corporations.—The drive generated by high income tax rates to convert ordinary income into capital gain manifested itself most strikingly in the collapsible corporation device. Employed mainly in the motion picture industry and to a lesser extent in the building industry, the device was suitable to any industry which by its nature tended to concentrate on one fairly large project. The mechanics were simple, the project would be completed by the corporation, the corporation would liquidate, and the shareholders would sell the liquidated project. On liquidation, the shareholders paid a gains tax on the difference between their cost and the fair market value of the project so that the increase in value ordinarily subjected to taxation as ordinary income would be taxed only as a long-term capital gain. The device has operated without benefit of court sanction to date. This makes doubly interesting the specific provision⁸⁸ in the collapsible corporation amendment that the treatment of gains realized prior to 1950 shall be determined as if the amendment had not been enacted and without in-

86. Cf. *Makransky's Estate v. Commissioner*, 5 T.C. 397 (1945), *aff'd*, 154 F.2d 59 (3rd Cir. 1946), in which a manufacturer of men's suits in anticipation of a shortage of piece goods bought futures in wool tops. Because of a change in supply piece goods became available and he sold the wool tops futures at a loss. It was held he had not engaged in a true hedging transaction.

87. House Report at 96, Senate Report at 87.

88. § 212(b).

ferences to be drawn from its non-retroactivity or its limitations. Evidently the Treasury is desirous of closing the door without giving up hope that it may be closeable by court decision.⁸⁹

Loophole closing is accomplished by adding subsection (m) to § 117 of the Code.⁹⁰ It provides that gain from the sale or exchange (in liquidation or otherwise) of a collapsible corporation's stock will be considered as ordinary income. A collapsible corporation is defined as one formed principally for the manufacture, construction, or production of property with a view (1) to sale or exchange (in liquidation or otherwise) of stock by its shareholders, or distribution of property to its shareholders (2) before it realizes a substantial part of the net income to be derived from the property, and (3) realization by the shareholders of gain attributable to the property. For the purposes of the definition a corporation will be considered to have manufactured, constructed or produced property if it (1) did so with respect to the property to any extent, (2) holds property having a basis determined in whole or in part by reference to the cost in the hands of a person who did so, or (3) holds property having a basis determined in whole or in part by reference to the cost of property manufactured, constructed, or produced by it. A corporation formed for the purpose of holding a collapsible corporation's stock is also considered a collapsible corporation.

The method of closing the loophole, by treating the gain as gain from a non-capital asset, causes no trouble. But the determination of a "collapsible corporation" in a given case will. In the first instance such a corporation must be formed *principally* for the purpose of capital gains realization by its shareholders. This is a fact question that lends itself to litigation rather than administrative interpretation. Comparable is the principal purpose provision in § 129 of the Code dealing with acquisitions to evade or avoid income or excess profits tax which has not yet been fully interpreted through court decision.⁹¹ The salvation to the situation, as far as the future is concerned, may lie in the possible feeling that the legislation is so effective as to make any attempt in this direction completely unattractive to taxpayers. Just as "principally" will undoubtedly be a fact problem in each case so, too, will be the question of whether distribution of property has taken place before the realization by the corporation of a *substantial* part of the net income to be derived from the property. Although "substantial" lends itself to percentage determination it is doubted whether such an interpretation

89. In contrast to the decision on the question of stock redemption by subsidiary corporations, *supra* note 68.

90. § 212.

91. See *Commodores Point Terminal Corp. v. Comm'r.*, 11 T.C. 411 (1948) and *Alcorn Wholesale Co. v. Comm'r.*, 16 T.C. No. 10 (1951).

will be made by the Treasury; and understandably so if the desire is to make the entire picture completely unattractive to taxpayers. However, this is little solace to the taxpayer who happens to find himself in the predicament of being interested in knowing what "substantial" amounts to. As far as manufacturing, constructing, or producing property is concerned, the amendment is all embracing.

There are three limitations to the application of the amendment, however, which may permit use of the collapsible corporation in certain cases. Treatment of the gain as ordinary income is done (1) only if the shareholder owned or was considered as owning more than 10% in value of the corporation's outstanding stock or owned stock which was considered as owned by another shareholder who owned or was considered as owning more than 10% in value of the corporation's outstanding stock. For purposes of determining ownership the amendment prescribes the use of the tests set forth for personal holding company purposes⁹² plus the widening of the definition of family to include spouses of the shareholder's brothers, sisters, and lineal descendants. A minor, although concededly difficult, problem is involved in determining value wherever there is more than one outstanding class of stock.⁹³ Again, gain is not treated as ordinary income (2) if 70% or less of the gain is attributable to the property manufactured, constructed, or produced. In a given situation this might prove quite helpful; for instance, where the corporation was formed by the transfer to it of assets which had appreciated in value. It may be that on liquidation or sale the gain due to the appreciation in value will reduce the gain attributable to manufactured property to the magical 70% or less. This seems to be a fairly liberal provision in a loophole closing amendment. Lastly, the amendment does not apply (3) if the gain is realized more than three years after the manufacture, construction, or production is completed. The only safe course to follow with respect to the third limitation is to hold the stock or property for the required three years and a day after completion of the product. It is believed that if the stock or property is sold before the expiration of the three-year period on the installment basis, the Treasury will take the position that the gain is realized at the time of sale and that merely its receipt is postponed under § 44 of the Code⁹⁴ so as to make the profit portion of each installment taxed as ordinary income.

92. § 503 of the Code.

93. *E.g.*, U.S. Treas. Reg. 111, § 29.501-3 (1943) which provides that "In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class therein."

94. *Cf.* § 44 of the Code which provides that one selling property "on the installment plan may return as income therefrom in any taxable year that proportion

The amendment is effective with respect to taxable years ending after December 31, 1949, but applies only with respect to gains realized after that date.

Capital Gains of Non-Resident Aliens.—Prior to January 1, 1950, non-resident alien individuals not engaged in trade or business in the United States escaped tax on capital gains from sources within the United States on transactions effected while in the United States.⁹⁵ A House sponsored provision⁹⁶ effectively closes this loophole so as to make non-resident aliens taxable on net capital gains from sources within the United States while in the United States. In doing so, the rate of tax applied is 30% of the net capital gains. The rate is higher than the maximum rate on long-term capital gains but is lower than the rates frequently applied to short-term gains and is the rate imposed on other income from sources within the United States of non-resident aliens not engaged in trade or business in the United States.

The amendment divides aliens into several classes. In the case of a non-resident alien not engaged in trade or business who is in the United States for an aggregate period of less than 90 days during the taxable year the 30% tax is imposed on net gains realized while he was present in the United States. If he is present for an aggregate period of 90 days or more during the taxable year, the 30% tax applies to net gains derived from sources within the United States regardless of whether he was in the United States at the time the sales or exchanges were effected. Thus, if a less than 90 day class alien wishes to avoid the tax he may do so by selling his United States holdings while outside the United States. In both of these classifications no distinction is made between short-term and long-term transactions, the tax being imposed upon the excess of full gains over full losses. In addition, capital losses from prior years cannot be carried over.

The third classification depends on the amount of the alien's gross taxable income. If it does not exceed \$15,400, the rate of tax is 30% as noted above. If the gross taxable income, including capital gains subject to tax, exceeds \$15,400, the tax to be paid is the higher of 30% or a tax computed at regular rates including the alternative tax treatment for capital gains. For this classification long-term gains or losses

of the installment payments actually received in that year which the gross profit *realized or to be realized* when payment is completed, bears to the total contract price" (*Italics supplied*), and *Springfield Plywood Corporation v. Commissioner*, 15 T.C. No. 91 (1950).

95. This result was first permitted by §211(a) of the Revenue Act of 1936. However, the taxpayer must be prepared to prove both non-residence and the fact that he is not engaged in trade or business in the United States. *Commissioner v. Nubar*, 185 F.2d 584 (4th Cir. 1950).

96. §212 of the House Bill.

are given the benefit of § 117(b) so that only 50% will be taken into consideration. However, as before, capital losses cannot be carried over from prior years.

This amendment applies with respect to taxable years beginning after December 31, 1949. Strategically placed immediately after the amendment dealing with this loophole is the provision in the Revenue Act of 1950 that no amendment shall apply in any case where its application would be contrary to any treaty obligation of the United States.⁹⁷

Amortization of Convertible Bond Premiums.—This loophole resulted, strangely enough, from a relief provision advocated by the Treasury and contained in the Revenue Act of 1942⁹⁸ which permitted a taxpayer to amortize the premium paid for a taxable bond. The Treasury pointed out in urging the adoption of that relief provision that in the case of a premium payment each receipt of interest is partially a restoration of capital rather than being entirely income and that to tax holders on the full amount received each year would be to tax them on a return of capital.⁹⁹ The relief given was to permit amortization in the case of taxable bonds; the loophole involved was highlighted by the decision in *Commissioner v. Korell*,¹⁰⁰ in which the United States Supreme Court construed the deduction for amortization of bond premium literally. It was there decided that a taxpayer who purchased a convertible bond at a premium, the bond having a call date in the taxable year at a price below the premium, was entitled to an amortization deduction based upon the difference between the purchase price and the call price regardless of the fact that the premium had really been paid for the conversion privilege rather than for the interest rate of the bond involved.

The new amendment, one of the shortest in the Act,¹⁰¹ closes this loophole. It provides that § 125(b)(1) of the Code shall be amended by adding that "In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion feature of the bond." The closing of the loophole raises one serious administrative problem, the determination of the amount attributable to the conversion feature. The Committee Reports¹⁰² suggest that this may be accomplished simply by ascertaining the yield of comparable bonds

97. § 214.

98. § 126(b) of the Revenue Act of 1942.

99. Statement of Randolph Paul, Tax Advisor to the Secretary of the Treasury, *Hearings before the House Ways and Means Committee on Revenue Revision of 1942*, 77th Cong., 2d Sess., Vol. I, page 90.

100. 339 U.S. 619 (1950).

101. § 217.

102. House Report at 102 and Senate Report at 97.

not having conversion features and adjusting the price of the bond under examination to that yield, which adjustment can be made with the aid of standard bond tables. Remembering the problem of value based on comparable corporations in the estate tax field,¹⁰³ one can only comment—more easily said than done.

The amendment applies with respect to taxable years beginning after June 15, 1950, which is just ten days after the date of the *Korell* decision. It also applies in the case of a taxable year beginning on or before such date with respect to bonds acquired after June 15, 1950. Thus, if a taxpayer purchased convertible bonds at a premium before June 15, 1950, it was possible for him to get the benefit of an amortization deduction for the amount of the premium arising out of the conversion feature to the extent that the deduction could be taken during 1950.

Tax-Exempt Organizations and Charitable Trusts.—Aside from the space devoted to changes in rates, approximately one-third of the Revenue Act of 1950 is devoted to dealing with the tax status of tax-exempt organizations and charitable trusts. To treat the problems created by these changes with any degree of thoroughness would require the writing of a complete article or possibly even a short text on the topic rather than a part of an article; the treatment here will be to do little other than present the statutory changes made. Although the general problem has been with us for many years, it has been highlighted in recent years by attempts on the part of individuals to reduce their income and estate taxes and at the same time to provide a method for continued control of accumulated family wealth. These attempts have in turn resulted in Congressional investigation of the problem,¹⁰⁴ direct skirmishes in the courts,¹⁰⁵ and the appearance of much literature.¹⁰⁶

103. Cf. U.S. Treas. Reg. 105, § 81.10(c) (1942). Several tax services have prepared convertible bond premium tables for more extensively traded issues and such tables should prove most helpful in determining the amount of bond premium attributable to the conversion feature.

104. Tax-Exempt Organizations Other than Cooperatives, Part 5, *Hearings before the House Ways and Means Committee on Proposed Revision of the Internal Revenue Code 1947-1948*, 80th Cong., 1st Sess.; Senate Interstate and Foreign Commerce Committee Investigation of Closing of Nashua, N. H. Mills and Operations of Textron, Inc., SEN. REP. No. 101, 81st Cong. 1st Sess.; *House Ways and Means Hearings on Revenue Revision of 1942*, 77th Cong. 2nd Sess., Vol. 1 at 89 and 91.

105. *Universal Oil Products Co. v. Campbell*, 181 F.2d 451 (7th Cir. 1950); *Willingham v. Home Oil Mill*, 181 F.2d 9 (5th Cir. 1950); *Commissioner v. Edward Orton, Jr. Ceramics Foundation*, 173 F.2d 483 (6th Cir. 1949); *Community Services, Inc. v. U.S.*, F. Supp. (E.D. S.C., 1950); *Cummins-Collins Foundation*, 15 T.C. No. 83 (1950); and *C.F. Mueller Co. v. Commissioner*, 14 T.C. 922 (1950).

106. One of the latest articles written on the subject prior to consideration of the Revenue Bill of 1950 by Congress was the article by Latham, *Private Charitable Foundations: Some Tax and Policy Implications*, 98 U. OF PA. L. REV. 617 (1950). Another recent and rather extensive treatment of this field was by Eaton, *Charitable Foundations, Tax Avoidance and Business Expediency*, 35 VA. L. REV. 809, 987 (1949).

The changes in the tax treatment of tax-exempt organizations and charitable trusts have been accomplished by the addition of a new Supplement U¹⁰⁷ to the Internal Revenue Code and by amendments to existing sections of the Code. The major changes are (1) to subject the business income of certain tax-exempt organizations and feeder organizations to income taxation, thus reversing by statute the long standing rule born in *Trinidad v. Sagrada Orden de Predicadores*¹⁰⁸ that the taxing statute is not concerned with "the source of the income, but makes the destination the ultimate test of exemption";¹⁰⁹ (2) to tax rents received by charitable organizations from certain types of leases of property; (3) to require arms length dealings between the creator or substantial donor of a charitable trust and the trust itself; and (4) to deny exemption in the case of unreasonable accumulations of income. All of these changes are affected further by general provisions dealing with loss of exemption, disallowance of deductions, and requirements as to making certain information available to the public.

Undoubtedly, the most significant fact to be derived from the legislation that was enacted by Congress is that private charity is still given a full complement of encouragement. The House provision,¹¹⁰ which denied deductions for charitable contributions where the contribution consisted of stock in a corporation controlled by the donor and his family and where the contributions were given to an organization which the donor and his family controlled or could control was not contained in the Act on final passage.¹¹¹ Nor was the suggestion of the Treasury made in hearings before the House Ways and Means Committee when considering the revenue revision of 1942 that the estate tax deduction for amounts bequeathed to charities be limited to a specified percentage of the decedent's estate¹¹² included as one of the changes made in the law. What has been accomplished is to take away from charitable corporations the competitive advantages they had in the business world arising from their tax-exempt status and to prevent abuses in the use of charitable trusts and foundations so as to prevent the creator and his family from being their major beneficiaries. These changes, of course, raise a great many interpretative and administrative problems. On the whole, however, the changes represent a definite stride forward in a

107. The old Supplement U referred to the abatement of tax for members of armed forces upon death which related only to the period December 7, 1941 to January 1, 1948 and thus expired by its own terms.

108. 263 U.S. 578 (1924).

109. *Id.* at 581. This dictum and its effect on later cases is discussed by Latham, *supra* note 106, at 630 *et seq.*

110. § 331 of the House Bill proposing to add § 3810(c) to the Code.

111. These provisions were eliminated by the Senate Finance Committee. Senate Report at 27.

112. *Supra* note 104, at 91.

complicated field where economic, social and even political concepts are subtly intertwined. They will undoubtedly need further revision over the future years, but at this point they should be welcomed by taxpayer and tax administrator alike as beneficial.

The single most important change is to impose tax¹¹³ on the unrelated business income of certain tax-exempt organizations and feeder organizations. The organizations which may become taxable under this change are those exempt under paragraphs (1),¹¹⁴ (6),¹¹⁵ (7),¹¹⁶ or (14)¹¹⁷ of § 101 of the Code. Churches and conventions or associations of churches are exempted from possible imposition of tax, but auxiliary religious organizations, even though organized under church auspices, and title holding corporations are subject to possible taxation. Trusts otherwise exempt under § 101(6) of the Code are also brought within the tax sphere.¹¹⁸ The many other types of organizations exempted from taxation by the fifteen paragraphs of § 101 not mentioned above including cooperatives, continue to be exempt.

The new concept of unrelated business income upon which such organizations will be taxed will raise important administrative and interpretive problems. The complexity of the subject has required the incorporation of many limitations and exceptions in the statute. The first limitation contained is that the unrelated business must be one which is regularly carried on.¹¹⁹ Even though the business is one that is regularly carried on, it must also be one which is not substantially related to the exercise or performance of the organization's educational or charitable purposes in order to cause its income to be taxed as unrelated business income.¹²⁰ Athletic activities of exempt educational institutions, farms operated by exempt agricultural colleges as part of their educational program, and care of paying patients in a non-profit

113. §§ 421 and 424(b) of the Code as added by § 301 of the Act. References to statute in this portion of the article will be mainly to sections of the Code as added or amended by the Revenue Act of 1950 because of the number of provisions covered by given sections of the Act.

114. Labor, agricultural or horticultural organizations.

115. Corporations, community chests, funds, or foundations organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, or for the prevention of cruelty to children or animals.

116. Business leagues, chambers of commerce, real-estate boards or boards of trade not organized for profit.

117. Corporations organized for the exclusive purpose of holding title to property, collecting income from the property, and turning the income over to one of the organizations set forth in the preceding three footnotes.

118. § 421(b)(2) of the Code.

119. § 422(a) of the Code. The Senate Report points out, at 106, that the giving of an occasional dance to which the public is admitted for a charge would not constitute a trade or business regularly carried on. On the other hand, if an organization operates a race track during only a few weeks of every year it will be considered as regularly carrying on an unrelated business activity since it is usual to carry on that type of business during a particular season.

120. § 422(b) of the Code.

hospital are all considered substantially related businesses or activities by the Congressional Committees.¹²¹ It should be noted that in the case of a trust, unrelated trade or business means any trade or business regularly carried on by the trust or by a partnership of which it is a member even though the trade or business is substantially related to the charitable or educational institution which the trust is required, by the terms of the instrument creating it, to support. Even though the business is unrelated and regularly carried on it is still not taxable under the statute if (1) substantially all the work in carrying it on is performed for the organization without compensation,¹²² or (2) it is carried on by an organization exempt under § 101(6) primarily for the convenience of its members, students, patients, etc.,¹²³ or (3) it consists of selling merchandise substantially all of which has been contributed to the organization.¹²⁴ Each one of the limitations and exceptions noted in this paragraph, phrased as each of them is in terms such as "regularly carried on", "substantially related", "charitable purposes", etc. raises definite administrative and interpretive problems.

Unrelated business net income means the gross income from unrelated business activities less the deductions allowable under § 23 of the Code connected with such activities including the 5% charitable deduction in the case of organizations taxed as corporations and a 15% deduction in the case of trusts taxed as individuals. The charitable deduction, it might be noted, should take into account contributions or distributions made pursuant to directions in the trust instrument as well as voluntary contributions. However, the contribution must be paid to another organization to be allowable, so that an educational institution running an unrelated business would not have a deduction for a charitable contribution to any extent if all the profits realized in the business were turned over to it.¹²⁵ Excluded from the concept of unrelated business income are all types of passive investment income traditionally recognized as a proper source of income for educational and charitable organizations and trusts. Thus, dividends, interest (including business interest on overdue open accounts receivable), annuities,

121. House Report at 109 and Senate Report at 106.

122. An example of this exception given in the House Report at 110 and the Senate Report at 108 is the running of a second-hand clothing store by an exempt orphanage in which volunteers perform all of the work without compensation.

123. The House Report at page 110 and the Senate Report at 108 give as an example a laundry operated by a college for the purpose of laundering dormitory linens and students' clothing.

124. This exception was introduced by the Senate Finance Committee and is for the purpose of removing the activities of thrift shops and the like from the application of the tax. Senate Report at 107.

125. House Report at 111 and Senate Report at 109.

royalties (including overriding royalties, but not royalties where the organization has a working interest and is liable for its share of development expenses), rents (not including "lease-back" rentals to be considered later or running of businesses involving rents as the prime source of gross income), and gains or losses from the sale or exchange of property other than stock in trade or property held primarily for sale to customers. Also excluded from the concept of unrelated business income is all income derived from research for federal, state, or local governments and all income derived by colleges, universities and hospitals from research or by organizations dedicated to fundamental research the results from which are freely and publicly available. Of course, any expenses attributable to gross income not includible within the unrelated business income concept are not deductible from such income. This large number of rules dealing with the determination of unrelated business net income results directly from the sudden imposition of existing normal forms of income taxation on the panorama of the tax-exempt institution; Congress is to be commended rather than condemned for the fullness of its treatment and the effort to safeguard sincere charitable endeavor.

Somewhat less complicated and less cumbersome are the newly enacted statutory rules dealing with the "lease-back" problem.¹²⁶ Of fairly recent development, the lease-back in its simplest form constituted the purchase of commercial property by a tax-exempt institution, often with borrowed moneys, and the immediate leasing back of the property to the seller at a rental designed (1) to cover operating costs or with the seller-lessee being obligated for such costs, (2) to amortize the purchase price of the property over the term of the lease so as to leave the property free and clear at the end of the term in the hands of the tax-exempt institution, and (3) to provide a small return to the tax-exempt institution over the term of the lease.¹²⁷ The leverage brought to bear in this type of situation was the feature of tax exemption and it resulted in competitive economic advantages permitting the tax-exempt institution to pay a higher purchase price or exact a lower rental or offer a combination of both. The statutory remedy is to tax the rentals received under such lease-backs as unrelated business income.

126. § 423 of the Code.

127. The many ramifications of this type of corporate financing are thoroughly treated in Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations*, 62 HARV. L. REV. 1 (1948). Life insurance companies have often engaged in this form of transaction partly because of their former quasi-exempt status; their activities in this field are the subject of an article by McPherson, *Some Economic and Legal Aspects of the Purchase and Lease of Real Estate by Life Insurance Companies*, 97 U. OF PA. L. REV. 482 (1949).

In order to be considered a taxable lease-back, or "supplement U lease", to use the terms of the Code, the lease must be for a term of more than five years or provide for renewals at the option of the lessee extending the term beyond five years and there must be a leaseback indebtedness. If real property is acquired subject to a lease, the term of the lease is considered to begin on the date of acquisition. The other *sine qua non*, leaseback indebtedness, occurs where indebtedness was incurred by the lessor in connection with the acquiring or improving of the property regardless of whether the indebtedness was incurred prior to or subsequent to such event. The acquisition of property subject to a mortgage or other lien is treated as creating an indebtedness of the lessor even though there is no assumption of the mortgage debt. However, where the property was acquired by gift, devise, or bequest prior to July 1, 1950 subject to a mortgage it is not considered to result in a leaseback indebtedness. Likewise, if property was so acquired subject to a lease requiring improvements upon the happening of stated contingencies, indebtedness incurred to make such improvements is not considered a leaseback indebtedness.¹²⁸ In the case of a § 101(14)¹²⁹ title-holding corporation all of whose stock was acquired by a § 101(1), (6) or (7) organization prior to July 1, 1950 with more than one-third of the stock having been acquired by gift or bequest, indebtedness of the type mentioned in the two preceding sentences is also not considered leaseback indebtedness.

Certain types of leases are excepted from the concept of leasebacks subject to income taxation on net rentals. A lease is not considered to result in a taxable leaseback if it is entered into for purposes which are substantially related to the exercise or performance of the educational or charitable organization's purposes.¹³⁰ There was also excepted from the definition of taxable leaseback by the Senate Finance Committee a lease of premises in a building primarily designed for occupancy and used by the organization. A further exception is provided where only part of the property is rented under leases running more than five years. In those cases a taxable leaseback is considered to have been entered into only if (1) the rents from such long-term leases represent 50% or more of the rents from the property during the taxable year or the

128. The Senate felt that it was most unlikely that there was any intent to avoid taxes where property was acquired by gift prior to July 1, 1950. Senate Report at 33.

129. It might not be amiss to point out that the § 101(14) type of title-holding corporation is expressly excluded from the concept of feeder organization by § 424(b) of the Code with the result that such corporations only become involved in taxation of unrelated business income if they incur leasehold indebtedness and are parties to taxable leaseholds.

130. As where a hospital leases a clinic to an association of doctors if the lease was made for purposes substantially related to the carrying on of hospital functions. Senate Report at 111.

space involved represents 50% or more of the total area at any time during the taxable year, or (2) the rent received from any one of the long-term leaseholders represents 10% or more of the rents received from the property during the taxable year or the space involved represents 10% or more of the total area at any time during the taxable year.

The taxation of rents from taxable leaseholds is accomplished by including them in unrelated business income. The amount included is the proportion, not exceeding 100%, of rents derived during the taxable year from taxable leaseholds which the leasehold indebtedness at year end bears to adjusted basis at year end. The important date is the year end which means that taxable income can be reduced by repaying leasehold indebtedness during the course of the year out of the taxable leasehold rentals; a sanctioned form of lifting oneself by the bootstraps. The same rules are applicable to determine the amount of the deductions which may be taken into account; allowable deductions being identified as taxes and other expenses paid or accrued during the year with respect to the property subject to the taxable leaseback, interest on leaseback indebtedness, and a depreciation or obsolescence allowance. If only a portion of the property is rented under taxable leaseholds then only the rentals from such leaseholds enter into the item of taxable unrelated business income; in such case only an appropriate proportion of the deductions is allowable. An excess of deductions over taxable rentals can be applied against other unrelated business income of the organization.

As in the case of unrelated business, one finds rather thorough Congressional treatment of the taxable leaseback problem. Although it was the sale and leaseback which gave rise to statutory correction of abuse of tax exemption, the statute properly covers leases made to others than the seller. The administrative and interpretive problems will be somewhat the same as in the case of unrelated business income, encountering as one does such phrases as "primarily", "substantially related", "charitable purpose", "reasonably foreseeable", and so on. To the extent that like terms are used in dealing with unrelated business and taxable leaseholds a precedent in one field will be useful in the other. The answers to many of the questions and the final outline of taxable activities will be determined only after lengthy and extensive application of the statutory language, but that is to be expected when a legislative body comes forth with totally new theories. It is hoped, however, that the administrative interpretation of these provisions is such that institutions will be in a position to make decisions soundly. The regulations dealing with these sections should be drawn so that the line of demarcation is made as clear as possible—consonant with

protection of the revenue—to permit taxpayers to know where they may tread fearlessly and where they will invite litigation.

The taxation of tax-exempt organizations, feeder organizations, and charitable trusts is relatively simple. The organizations are taxed at corporate normal and surtax rates on unrelated business net income exceeding a \$1,000 exemption. Trusts are taxed at individual normal and surtax rates also with a \$1,000 exemption. The exemption was put into the statute to take care of the nuisance cases and to eliminate cases where unrelated business income was incidental as well as because of the costs of collection in such cases.¹³¹ Trusts which are outside the category of exempt trusts because they have some personal rather than all charitable beneficiaries are also taxed on unrelated business income. There is, however, no special \$1,000 exemption applicable to them. In all other respects they are taxed on unrelated business income as are the exempt trusts. This means that they may deduct charitable contributions to other organizations up to 15% of the unrelated business income in determining unrelated business net income and use that net figure in conjunction with total income to determine the proportion of income going to charities which is traceable to and taxed as unrelated business income. The latter proportion is only of interest where the trust has income such as dividends and interest which is excluded from the concept of unrelated business income as well as unrelated business income.

The amendments dealing with unrelated business income are applicable only to taxable years beginning after December 31, 1950.¹³² In so providing Congress also made it a point to provide that the determination of whether an organization is exempt under § 101 of the Code for taxable years beginning before January 1, 1951 is to be made as if the specific reference to feeder organizations added to § 101 of the Code by § 301(b) of the Act had not been made law and without inferences to be drawn from the fact that that amendment is not expressly made applicable to taxable years beginning before January 1, 1951. Because of pending litigation¹³³ in this general field the Senate Finance Committee added § 302 to the Act to prescribe rules respecting possible assertion of tax liability for prior years against organizations which might be affected by the ultimate outcome of such pending litigation.

131. Senate Report at 30.

132. § 303.

133. The cases referred to by the Committee are in the Senate Report at 117 and include *Universal Oil Products Co. certiorari denied on the taxpayer's application October 16, 1950* and rehearing on the application denied November 27, 1950; *Home Oil Mill v. Willingham, certiorari denied on the Solicitor General's application October 16, 1950*; and *C. F. Mueller Co., now on appeal by the taxpayer to the Court of Appeals for the Third Circuit*; cases cited *supra* in note 105, in addition to the old case of *Roche's Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938)*.

These provisions have no application with respect to taxable years beginning after December 31, 1950 and they apply only where the attempt to deny exemption to the organization is being made or might be made on the ground that the organization was carrying on a trade or business for profit.

With respect to years prior to January 1, 1951, it is provided that no organization is to be denied exemption under paragraphs (1), (6) or (7) of § 101 of the Code on the ground that it is carrying on a trade or business for profit if the income from such trade or business would not be taxable as unrelated business income or if such trade or business is the rental of property. It is also provided that the statute of limitations against the assessment of income tax is to begin to run with the filing of an information return or, if such a return was not required to be filed, assessment is barred three years after the date such a return would have been due had it been required. These provisions do not apply to a taxable year with respect to which any assessment of tax was made or any tax paid or a notice of deficiency sent prior to September 20, 1950.¹³⁴ It is further provided that a charitable contribution otherwise allowable as a deduction under either income, estate or gift tax provisions is not to be denied for any taxable year prior to January 1, 1951 if the denial of the exemption to the organization which received the contribution is prevented by the preceding provisions for the period in which such contribution was received. The Senate had also provided¹³⁵ that no organization which had been advised that it was exempt from taxation under § 101 of the Code was to be denied exemption from income tax on the ground that it was carrying on a trade or business unless it was informed that its exemption was withdrawn in a letter prior to January 1, 1951 or a request prior to that date had been made for further information relative to its exemption status, with the further provision that in no event was exemption to be denied for any taxable year prior to the taxable year in which such letter was mailed. This provision is not contained in the final version of the Act. However, the conferees¹³⁶ suggested that undue hardship would arise if institutions such as colleges or universities are required to pay taxes on income which has already been spent to carry out educational programs and stated that they hoped that this matter might be reviewed in subsequent legislation.

The third major change, the requiring of arms length dealings between the creator or substantial donor of the trust and the trust itself,

134. Added by the Conference Committee under Amendment No. 157.

135. § 302(b) of the Senate bill.

136. Conference Report at 13.

attempts to do nothing more than to prevent abuse of a charitable trust by individuals who make themselves the real beneficiaries of such a trust through payment of excessive salaries to themselves, borrowing funds at abnormally low interest rates, and so forth. This is accomplished by limiting the charitable deduction of the trust otherwise available under § 162(a) of the Code to 15% of its net income if the trust engages in any prohibited transaction. The term "prohibited transaction" is defined¹³⁷ to include any transaction after July 1, 1950 in which any trust which would otherwise be deemed a charitable trust either (1) lends principal or income without adequate security and a reasonable rate of interest,¹³⁸ (2) pays excessive compensation, (3) makes services available on a preferential basis, (4) makes a substantial purchase of securities without adequate consideration, (5) sells a substantial part of its securities or other property without adequate consideration, or (6) engages in any other transaction which results in a substantial diversion of principal or income to either the creator of the trust, any substantial donor, a member of the family¹³⁹ of either of such individuals, or a corporation controlled by any such creator or donor through direct or indirect ownership of 50% or more of the total combined voting power or 50% or more of the total value of shares of all classes of stock of the corporation. The statute makes it clear that a prohibited transaction is involved only where principal or income which has been permanently set aside or is to be used exclusively for charitable purposes is being tampered with. The limitation as to charitable deductions applies only to years subsequent to the taxable year during which the trust is notified that it has engaged in such a prohibited transaction unless it entered into that type of transaction with the express purpose of diverting principal or income from charitable purposes and the transaction involved a substantial portion of the principal or income. In the latter case, exemption may be denied retroactively. If the charitable deduction has been limited by reason of the receipt of a notice that the trust has engaged in a prohibited transaction, it may file a claim for allowance of the privilege of unlimited deductions granted in § 162(a) of the Code under regulations to be prescribed by the Secretary of the Treasury; if the Secretary is satisfied that the trust will not knowingly again engage in such transactions, the 15% limitation on charitable deductions will be removed with respect

137. § 162(g) (2) of the Code as added by § 321 of the Act.

138. This provision will undoubtedly be interpreted in the alternate rather than conjunctive sense particularly in view of the explanation in that sense contained in the Senate Report at 37.

139. As defined in § 24(b) (2) (D) of the Code dealing with disallowance of losses from sales or exchanges of property between members of a family.

to years subsequent to the year in which such claim is filed. In the case of contributions by donors to such a trust the statute provides disallowance of the charitable deduction otherwise allowed under either income, estate, or gift taxation if the contribution is made in a year during which the charitable deduction allowed the trust is limited to 15% by virtue of its having been notified that it has engaged in a prohibited transaction. In the case of a retroactive limitation of the charitable deduction of the trust occasioned by a prohibited transaction involving a substantial part of income or principal which was entered into with the purpose of diverting income or principal from charitable purposes, the charitable deduction otherwise allowable to the donor for contributions to the trust shall also be disallowed retroactively if such donor or any member of his family was a party to the prohibited transaction.¹⁴⁰ The House bill¹⁴¹ had provided that the charitable trust instrument had to affirmatively provide that none of the prohibited transactions could be entered into, but this was regarded by the Senate Finance Committee¹⁴² as being unduly harsh and therefore the method finally adopted was one designed to require arms length dealing through statutory provisions penalizing the failure to so deal.

These amendments are applicable only with respect to taxable years beginning after December 31, 1950. They are, on the whole, rather liberal provisions in a loophole closing statute and again Congress has made quite clear that trusts or foundations administered conscientiously to achieve their charitable objectives have nothing to fear. Even if there is a straying from the straight and narrow philanthropic path the statute permits reentry into the fold pursuant to a procedure prescribed by the Secretary. In view of the liberality of these provisions generally, reentry should not be made too difficult although security should certainly be required to prevent further abuse. As before, there are the administrative and interpretive problems raised by such terms as "substantial," "adequate," and "purpose". Both this change and the accumulations change, which is discussed in the next paragraph, apply to all § 101(6) organizations except religious organizations (other than trusts) and organizations operated, controlled, or principally supported by such religious organizations; certain educational organizations; certain organizations supported by the general public or government; and certain medical organizations. In the event any § 101(6) organization other than those specifically excepted engages in a prohibited transac-

140. § 162(g)(2)(E) of the Code.

141. § 331(a) of the House Bill proposing to add § 3810(b) to the Code.

142. Senate Report at 37.

tion or abuses the accumulation privilege it loses its exemption under provisions similar to those applying to charitable trusts.¹⁴³

The fourth major change deals with the accumulation of income by charitable trusts and foundations and emerged at the Conference Committee level.¹⁴⁴ It appears at best to have been a hastily drafted change. As finally enacted, it has complete potentialities of being a vicious section in an otherwise complicated but quite acceptable tax revision. The section unfortunately has no real standards to guide either tax administrator or taxpayer. It proposes that if the amounts permanently set aside or to be used exclusively for charitable purposes

“(A) are unreasonable in amount or duration in order to carry out such purposes of the trust; or

(B) are used to a substantial degree for purposes other than those described in subsection (a) [i.e., charitable purposes]; or

(C) are invested in such a manner as to jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries,”

the charitable deduction shall be limited to the contributions or amounts paid during the year but not exceeding 15% of net income. The limitation of the charitable deduction is applicable in the year in which the privilege of accumulation is abused and continues until that situation is corrected. Any hope that the interpretation of these provisions by the Bureau will alleviate the situation would seem not too well founded since the duty of the administrator is to administer the statute given to him and not rewrite it. That is a task for Congress and it should assume it promptly. This change is applicable only with respect to taxable years beginning after December 31, 1950.

A companion provision, in a sense, to the accumulations provision is that requiring charitable organizations and trusts to file annual information returns in accordance with regulations to be prescribed by

143. There is a curious provision in § 3813(c) (1) of the Code as added by § 331 of the Act stating that the general rule with respect to the denial of exemptions to organizations engaged in prohibited transactions is that no such organization which engaged in a prohibited transaction after July 1, 1950 shall be exempt under § 101 (6). This general rule appears in the statute even though the effective date of § 3813(c) of the Code is specified by § 333 of the Act to be with respect to taxable years beginning after December 31, 1950. Since only a prohibited transaction entered into for the purpose of diverting a substantial portion of principal or corpus from charitable purposes permits a retroactive denial of exemption, it may be that the general rule in § 3813(c) (1) of the Code was inserted to permit a denial of exemption for 1951 in the case of such a purposeful diversion of funds since notice of the prohibited transaction could not under the statute be given prior to some time in 1951.

144. Amendment No. 159 noted in the Conference Report, at 14. The provision as finally enacted might be compared with the House provisions appearing in House Bill § 301 (a) proposing the addition of §§ 424 and 425 to the Code and the lack of any such provision in the Senate Bill.

the Secretary.¹⁴⁵ Charitable organizations exempt under § 101(6) of the Code which are subject to the filing requirements of § 54(f) of the Code are required to file reports showing gross income, expenses, income disbursements for charitable purposes, accumulations both for that year and aggregate accumulations, principal disbursements during the current and prior years for charitable purposes, and a balance sheet. Trusts claiming a charitable deduction under § 162(a) of the Code are required to file reports showing the amount of their charitable deduction separated between the amount paid out and the amount permanently set aside for charitable purposes, the amount paid out for charitable purposes representing amounts for which deductions under § 162(a) had been taken in prior years, the amount of deductions taken in prior years which have not been paid out, principal payments in current and prior years for charitable purposes, income and expenses of the trust, and a balance sheet. This information, together with the names and addresses of such charitable organizations and trusts is to be made public in such manner as the Secretary may prescribe. If there is a willful failure to furnish this information it is provided that the penalties prescribed in § 145(a) of the Code are to apply.¹⁴⁶ This amendment applies to taxable years beginning after December 31, 1949. Although the Senate Finance Committee¹⁴⁷ stated that it was left to administrative discretion to determine whether this new information was to be returned on a separate form or on an information return form now in use revised to include the new information, it is hoped that only one information return will be required of any reporting organization so as to avoid confusion and unnecessary duplication of effort. In some instances it may be difficult for given organizations or trusts to supply accurately all the information required, but in general the requirement of furnishing the information called for and its publicity seems worthwhile.

On the whole, the amendments in the Act dealing with tax-exempt organizations and trusts are helpful. They should take away the tax advantage of the exempt organization in the business world and the market place and they should prevent much of the abuse of the charitable exemption and deduction. On the other hand, they will not adversely affect charitable endeavor undertaken and carried out in good faith. Aside from the accumulations provision, which might be an

145. § 153 of the Code as added by § 341 of the Act.

146. § 145(a) of the Code provides that in the event of a willful failure to supply information as required by law or regulations, the person involved shall, in addition to the penalties provided by law, be guilty of a misdemeanor and, upon conviction thereof, be fined not more than \$10,000, or imprisoned for not more than one year, or both, together with the costs of prosecution.

147. Senate Report at 126.

instance of a cart before the horse situation in the sense that the provision was drafted before complete information was available, the amendments should prove to be fair and workable ones. From the information garnered as a result of these amendments it may well be that a more workable accumulations abuse section can be written.

MISCELLANEOUS PROVISIONS

United States Employees in Possessions.—The exemption contained in § 251 of the Code for income derived from the conduct of a trade or business within a possession of the United States had been interpreted by the Treasury as applying to the compensation paid by the United States to the members of its civil, military, or naval personnel for services rendered within a possession of the United States.¹⁴⁸ If such employees were citizens and were stationed elsewhere than in a possession of the United States they were not exempt from tax. The amendment¹⁴⁹ eliminates the exemption with respect to taxable years beginning after December 31, 1949.

Residents of Puerto Rico.—Residents of Puerto Rico had previously been taxed in a number of different ways. The Revenue Act of 1950¹⁵⁰ takes a comprehensive look at their tax problems. It provides that all residents, including United States citizens and alien residents, who are residents of Puerto Rico during the entire taxable year are taxable on their world-wide income excluding only that income derived from Puerto Rican sources. No deduction is permitted for amounts allocable to such excluded income. The exclusion does not, however, apply to income received by residents of Puerto Rico as employees of the United States government.¹⁵¹ In the case of United States citizens, but not in the case of resident aliens, if the Puerto Rican residence is given up after a bona fide residence in Puerto Rico for a preceding period of at least two years, any income derived from Puerto Rican sources earned during residency there prior to the change in residence may also be excluded from gross income. There are also changes made with respect to withholding of tax at the source, declaration of estimated tax, foreign tax credit, the self-employment tax,¹⁵² and the collection of taxes. In general, the amendments are applicable with respect to taxable years beginning after December 31, 1950.

148. U.S. Treas. Reg. 111, § 29.251-1(2) (1943).

149. § 220.

150. § 221.

151. See page 622, *supra*.

152. Imposed under the Social Security Act Amendments of 1950.

Life Insurance Companies.—The formula used to determine the taxable net income of life insurance companies contained in the law prior to its amendment by § 401 of the Act generally permitted those companies to enjoy tax exemption. This has been corrected by a change in the formula. The change is a complicated and technical one which affects the determination of the company's "reserve and other policy liability credit". As introduced in the House,¹⁵³ the change would have affected 1947, 1948, 1949 and 1950. The Senate Finance Committee reduced the application to 1949 and 1950 because¹⁵⁴ it believed the constitutionality of a tax imposed retroactively to 1947 and 1948 was at least debatable and because it was opposed to retroactive taxation extending over such a long period of time. As enacted, the changes apply to taxable years ending after December 31, 1948. It is made clear in the Senate Report that this amendment is merely an interim measure which will permit the further study necessary to develop a permanent solution to the taxing of life insurance companies.

Estate Tax Deduction for Support of Dependents.—This amendment,¹⁵⁵ which is effective with respect to estates of decedents dying after September 23, 1950, repeals the deduction for allowance for support of dependents. The passing of this deduction should cause no great amount of lament. It was an administrative problem inasmuch as the deduction related to amounts reasonably required and actually expended during settlement of the estate for the support of decedent's dependents to the extent such expenses were allowed by state law and discriminated in favor of estates in states which authorized liberal allowances for the support of dependents. Since it did not involve much in the way of taxes¹⁵⁶ and since the marital deduction provisions will now be effective with respect to support of the surviving spouse,¹⁵⁷ the repeal of the deduction should meet with a favorable reaction.

Excise Taxes.—As noted at the outset of this article, the excise tax reductions originally contained in the House Bill were eliminated because of the outbreak of military activity in Korea. Instead, the Congress increased some rates and added new subjects. The changes appear in the Act at §§ 601 to 610, inclusive, and in the order of their appearance, involve auction sales of jewelry and furs, retailers' excise taxes on such sales by the United States or any agency or instrumental-

153. § 401 of the House Bill.

154. Senate Report at 39.

155. § 502.

156. The Senate Report at 58 estimates the elimination of the deduction will increase revenues annually by \$3,000,000.

157. House Report at 136.

ity such as post exchanges, coin-operated gaming devices, extension of occupational taxes to federal agencies or instrumentalities, television sets, quick freeze units, transportation of persons and property to make clear that tax on such transportation is due in each case where the transportation begins and ends in the United States, allowance of stamps to be attached in foreign countries to certain tobacco products, and refunds in the case of articles sold for use of aircraft engaged in foreign trade. These various changes are effective on and after November 1, 1950.

Excess Profits Tax.—Last but by no means least (and it has already effectively proved that it was not least) is the interesting directive contained in the last section of the Act ¹⁵⁸ calling upon the House Ways and Means Committee and the Senate Finance Committee to report an excess profits tax bill with retroactive features to October 1 or July 1, 1950. Coupled with this directive was one to the Joint Committee on Internal Revenue Taxation or an authorized subcommittee to make a complete study of the problems involved in the taxation of corporate excess profits which arise out of our nation's current defense program.
