Michigan Law Review

Volume 50 | Issue 6

1952

TAXATION-FEDERAL INCOME TAX-EXEMPT CORPORATIONS-STATUTORY INTERPRETATION

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TAXATION—FEDERAL INCOME TAX—EXEMPT CORPORATIONS—STATUTORY INTERPRETATION—Plaintiff corporation was organized in 1947 by physicians who had formerly maintained a clinic for the practice of medicine as a partnership. The articles of incorporation provided that there should be no capital stock and no dividends, and stated that plaintiff was organized as a non-profit corporation for the purpose of providing medical treatment and hospitalization to sick and injured persons without regard to ability to pay therefor, and of providing such other incidental charitable services as the "trustees" of the corporation should prescribe. Pursuant to its by-laws, plaintiff paid such annual salaries to its member physicians as the trustees, who were elected by the members, directed. Plaintiff never maintained a hospital, and its sole charitable service was the rendering of medical treatment at its clinic to persons unable to pay therefor, although the vast majority of plaintiff's patients paid fees to the corporation.

Over plaintiff corporation's objection that it was exempt from taxation under section 101(6) of the Internal Revenue Code, the Commissioner assessed income taxes on plaintiff's 1948 net income, which plaintiff paid. In an action to recover the tax, *held,* plaintiff is not exempt from income taxation since it was neither organized nor operated exclusively for charitable, educational, or scientific purposes, and since at least part of its net earnings inured to the benefit of private individuals. *Fort Scott Clinic and Hospital Corp. v. Brodrick,* (D.C. Kan. 1951) 99 F. Supp. 515.

Among the corporations exempted from the federal income tax by section 101 of the Internal Revenue Code are those which are organized and operated exclusively for charitable and similar purposes, no part of the net income of which inures to the benefit of any private individual.[1] Three requirements are thus imposed to fall within the exempt category and, although liberally construed,[2] their precise application has never been free from doubt.[3] The first prescribed requirement is that the corporation be "organized" exclusively for one of the statutory purposes, but the meaning of "exclusively" is interpreted as more nearly approximating "primarily" than "solely."[4] Moreover, the articles of incorporation are not controlling, since evidence of collateral contemporaneous expressions of purpose may be considered.[5] Just what objective circumstances evidence a "charitable" purpose is by no means clear, however: the mere fact that all net earnings are to be expended for charitable purposes does not insure exemption;[6] conversely, the fact that the beneficiaries of the charitable services are to pay for them at least in part, and that the proximate dispensers of the services are to receive compensation, does not defeat the privilege.[7] In addition,

[1] ". . . the following organizations shall be exempt from taxation under this chapter . . . (6) Corporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation. . . ." I.R.C., §101(6). See generally Eaton, "Charitable Foundations, Tax Avoidance and Business Expediency," 35 VA. L. REV. 809 and 987 (1949). The form of the organization is immaterial; ordinary trusts are eligible for the privilege. James Sprunt Benevolent Trust, 20 B.T.A. 19 (1930).

[2] Helvering v. Bliss, 293 U.S. 144, 55 S.Ct. 17 (1934); Cochran v. Commissioner, (4th Cir. 1935) 78 F. (2d) 176.

[3] See Wolkstein, "Section 101(6)," 28 TAXES 847 (1950).

[4] Latcham, "Private Charitable Foundations: Some Tax and Policy Implications," 98 UNIV. PA. L. REV. 617 at 639 (1950). See Edward Orton, Jr. Ceramic Foundation, 9 T.C. 533 (1947), affd., (6th Cir. 1949) 173 F. (2d) 483.

[5] Roche's Beach, Inc. v. Commissioner, (2d Cir. 1938) 96 F. (2d) 776; Wolkstein, "Section 101(6)," 28 TAXES 847 (1950).

[6] United States v. Community Service, Inc., (4th Cir. 1951) 189 F. (2d) 421; *contra,* C. F. Mueller Co. v. Commissioner, (3d Cir. 1951) 190 F. (2d) 120, revg. 14 T.C. 922 (1950).

[7] Treas. Reg. 111, §29.101(6)-1; Battle Creek, Inc., 1940 P-H B.T.A. Mem. Dec. ¶40,478, affd. (5th Cir. 1942) 126 F. (2d) 405.

corporations which make payments to private persons out of net earnings[8] or which engage in competitive enterprises[9] may be exempt. The second requirement is that the corporation must be "operated" for the purpose stated. Consequently, a corporation organized for an exempt purpose may lose its exemption by subsequent operations beyond that purpose.[10] However, a subsequently formed charitable purpose, though acted upon, will not operate to exempt a corporation.[11] The third requirement, that no part of the net income inure to the benefit of any private individual, has not limited the courts, contrary to what seems a clear direction of the statute, to an inquiry into whether there are dividend-like distributions of "net income" in the accounting sense. Rather, it appears well established that if the instrumentality is used for the commercial benefit of any private person, by payment of salary or otherwise, this statutory condition for exemption is not fulfilled.[12] The end result is that this portion of the definition blends into the other two. These generalizations, however, while usually set out by the courts, are of little assistance in the decision of individual cases. It is submitted that a careful reading of the decisions construing the exemption-defining terms of the statute reveals that it is generally impossible to assert that a given set of objective circumstances will result in an exempt or non-exempt status. In almost all instances in which exemption is claimed by the organization and denied by the Commissioner, the ultimate inquiry must be into the subjective motive of the promoters and managers of the corporation or foundation.[13] Such an approach inevitably leads to the result that each case must stand on its own facts. The principal case is an excellent illustration of this method of analysis. In spite of the facts that the articles provided for a clearly charitable corporation, that charitable services were in fact rendered, and that no attempt to distribute net earnings was made, the court held that none of the statutory tests were fulfilled. This holding was based on the court's belief that the organizers viewed their corporation as a useful vehicle for the profitable practice of medicine rather than as a charitable instrumentality. As a matter of policy, the subjective test, while lacking in certainty, is probably the best available if the dual objective of the exemption provisions of the Code, namely, the insuring of a favored position to all organizations legitimately

[8] Edward J. Orton, Jr. Ceramic Foundation, supra note 4. 6 MERTENS, LAW OF FEDERAL INCOME TAXATION §34.17 (1949).

[9] Roche's Beach, Inc. v. Commissioner, supra note 5; see also, cases cited in note 6 supra. See Trinidad v. Sagrada Orden, etc., 263 U.S. 578, 44 S.Ct. 204 (1924).

[10] Although the foundation was held exempt, this was the theory on which the Little Foundation v. Jones, (D.C. Okla. Dec. 10, 1951) P-H 1952 Tax Service ¶72,252, was tried.

[11] Sun-Herald Corp. v. Duggan, (2d Cir. 1947) 160 F. (2d) 475.

[12] Northern Illinois College of Optometry, 1943 P-H T.C. Mem. Dec. ¶43,396. But compare Unity School of Christianity, 4 B.T.A. 61 (1926); Home Oil Mill v. Willingham, (D.C. Ala. 1946) 68 F. Supp. 525; see Willingham v. Home Oil Mill, (5th Cir. 1950) 181 F. (2d) 9.

[13] Latcham, "Private Charitable Foundations: Some Tax and Policy Implications," 98 Univ. Pa. L. Rev. 617 (1950). See cases cited in notes 6 and 10, supra.

charitable regardless of the details of their structure or operation and the prevention of abuses of the privilege by organizations *prima facie* charitable which actually serve some more ulterior purpose of their creators, is to be achieved. Finally, it seems clear that the motive approach will remain the method employed by the courts despite the changes in the statutory treatment of charitable corporations and foundations brought about by the Revenue Acts of 1950 and 1951,[14] for the new provisions do not substantially affect the initial question whether the corporation or foundation fulfills the basic requirements for exemption of section 101(6).

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[14] The general effect of these new provisions: (1) imposition of tax on "unrelated business net income" of exempt organizations; (2) denial of exemption to otherwise exempt organizations which engage in transactions with their creators or with the latter's associates resulting in diversion of income or property of the organization to such creator or associate on a preferential basis; (3) denial of exemption to otherwise exempt organizations which unreasonably accumulate income. See I.R.C. §§421, 422, 423, 3813, 3814. The "unrelated income" aspect of these provisions alleviates the problem of "charities in business," whether they conduct such business through a subsidiary corporation or otherwise. But the prohibited transaction aspect is believed to add little to what was implied in the former law. In either event, the initial inquiry into satisfaction of the requirements of I.R.C., §101(6) remains. See Finkelstein, "Tax Exempt Charitable Corporations: Revenue Act of 1950," 50 MICH. L. REV. 427 (1952).