Cornell Law Review

Volume 38
Issue 3 *Spring 1953*

Article 4

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INTRODUCTION

The present financial plight of American colleges and universities is not an acute non-recurring illness but the aggravation of a chronic condition of many years standing. In fact, educational institutions, particularly those supported by private funds, have for some years now been conditioned to operating on deficits. In some cases, the institutions affected have attempted to meet deficiencies by appealing to alumni and friends. Princeton University, for example, raises through its alumni more than one-half million dollars each year to meet the operating losses of the university. In other instances, private universities have been forced to modify their charters and become public institutions subject to state control in order to obtain the benefit of public funds. This source of income was an important factor in Rutgers becoming the state university of New Jersey.

In seeking to meet this very serious problem, some educational institutions have in the past lent their tax-exempt status to private business with resultant benefit to the individual business and to the institution concerned.[1] Although the occasions were few when universities were utilized by private corporations as a means of avoiding taxes, the notoriety of these few instances had by 1950 made substantial impression on the American public and consequently on Congress.[2] Serious objection was voiced by organizations and industries that suffered taxwise in the competition with businesses benefiting from the tax status of exempt institutions.

At the same time other tax-exempt entities were coming under close and critical scrutiny.[3] It was commonly felt, and with good reason, that foundations were, in fact, being financed by the Federal Government for purposes other than charitable or scientific. By placing in one a large block of non-voting stock, Henry Ford was able to retain for his family control of the motor company which bears his name. The manipu-

* Member of the District of Columbia Bar. See Contributors' Section, Masthead, p. 390, for biographical data.

1 See Note, *Criticised Uses of Federal Tax Exemption Privileges by Charitable Foundations and Educationl Institutions,* 98 U. OF PA. L. REV. 696 (1950).

2 See Note, *Open Season on Tax Loopholes—Should Section 101 be Modified,* 38 GEO. L. J. 620 (1950).

3 Eaton, *Charitable Foundations, Tax Avoidance and Business Expediency,* 35 VA. L. REV. 809, 987 (1949).

lations of the Textron Trust left a visible taint of tax avoidance and unfair competition.[4]

The Eightieth Congress's Committee on Ways and Means made a lengthy study of alleged abuses of tax exemption. Although its report was in many ways critical of exempt institutions, no revision of the tax statute was attempted. This became the task of the Eighty-first Congress—first, to compensate for a reduction in excise taxes, and then to provide a source of revenue for the anticipated expenses of the Korean conflict.

THE FEEDER CORPORATION—A TAX EXEMPT BUSINESS

> No reason is apparent to us why Congress should wish to deny exemption to a corporation organized and operated exclusively to feed a charitable purpose when it undoubtedly grants it if the corporation itself administers the charity.[5]

It should be inferred from the foregoing excerpt that the tax status of business enterprises operated by or benefiting tax-free institutions has long been legally settled. In fact the opposite is the case, and the confusion in the decisions obtains to this day. Insofar as colleges and universities are concerned, the problems have now been resolved by statute.

The law in this field stems from two decisions: *Trinidad v. Sagrada Orden*,[6] decided by the Supreme Court in 1927, and *Roche's Beach v. Comm'r*,[7] decided in 1938 by the Court of Appeals for the Second Circuit. The issue in both instances was the extent of exemption granted charitable, educational and other similar organizations by the tax statutes. The pertinent section of the Code, has existed virtually unmodified throughout the life of the Federal income tax. It reads:

> Sec. 101. *Exemptions from Tax on Corporations.*
>
> "*Except as provided in paragraph (12)(B) and in supplement U,* 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

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[4] See President Truman's Special Tax Message to Congress, January 23, 1950, N. Y. Times, Jan. 24, 1950, p. 14, col. 3; Note, 98 U. OF PA. L. REV. 696, 702 (1950), discussing criticized uses of federal tax exemption privileges by charitable foundations and educational institutions.

[5] Roche's Beach v. Comm'r, 96 F.2d 776, 779 (2d Cir. 1938).

[6] 263 U.S. 578 (1924).

[7] 96 F.2d 776 (2d Cir. 1938).

> any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation. *For loss of exemption under certain circumstances, see sections 3813 and 3814;* (Italics supplied to indicate recent amendments.)

In the *Trinidad* case, the Court was asked to decide whether a religious order in the Philippines was taxable on dividends, interest and rents from its large holdings in the islands, as well as on income from occasional sales of wine, chocolate and other articles to members of the order's own organizations or agencies. Justice Van Devanter had little difficulty in disposing of the Government's contention insofar as it regarded income from rents, dividends and interest. He noted that:

> In using . . . [its] properties to produce the income, it [the order] therefore is adhering to and advancing . . . [its] purposes and not stepping aside from them or engaging in a business pursuit.[8]

In truth, to have held otherwise would have been a recognized absurdity.

In disposing of the question as to small trade in wine, chocolate and other articles, the Court noted:

> . . . we think they [the transactions] do not amount to engaging in trade in any proper sense of the term. *It is not claimed that there is any selling to the public or in competition with others.* The articles are merely bought and supplied for use within the plaintiff's own organization and agencies,—some of them for strictly religious use and the others for uses which are purely incidental to the work which the plaintiff is carrying on. That the transactions yield some profit is in the circumstances a negligible factor. Financial gain is not the end to which they are directed.[9] (Emphasis added).

Unfortunately, for the future clarity of the law, the Court, in discussing the general problem involved, made use of the following language:

> In effect, the [Government's] contention puts aside as immaterial the fact that the income from the properties is devoted exclusively to religious, charitable and educational purposes, and also the fact that the limited trading, if it can be called such, is purely incidental to the pursuit of those purposes, and is in no sense a distinct or external venture.[10]

In subsequent decisions other courts have paid excessive respect to the first clause of the sentence and disregarded the second.[11]

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8 263 U.S. at 582.

9 *Ibid.*

10 *Id.* at 581.

11 See Comment, *Colleges, Charities and the Revenue Act of 1950,* 60 YALE L.J. 851, 853 (1951).

In the *Roche's Beach* case, the Court of Appeals for the Second Circuit, with Judge Learned Hand dissenting, determined that a corporation organized by a testator to operate a public bathing beach for the sole benefit of a charitable beneficiary, was an organization exempt under the provision of the statute corresponding to Section 101(6) of the Code. Great reliance was placed upon the *Trinidad* case and the intervening cases of *Sand Springs Home v. Comm'r,*[12] and *Appeal of Unity School of Christianity,*[13] which were said to hold that: "The destination of the income is more significant than its source."[14]

The Court acknowledged that the exemption was the result of Congressional largess. But it felt that the words, "organized and operated exclusively for . . . charitable . . . purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual," could reasonably be interpreted to encompass the feeder as well as the charitable corporation. The Court continued:

> No reason is apparent to us why Congress should wish to deny exemption to a corporation organized and operated exclusively to feed a charitable purpose when it undoubtedly grants it if the corporation itself administers the charity.[15]

It is arguable that the Court failed to recognize that the *Trinidad* case and the succeeding cases dealt with actual operating charities that, incident to their purpose, carried on competitive or profitable business activities. Judge Hand, in an opinion dissenting from that of the majority in the *Roche's Beach* case, adverted to the trifling extent of the "business activity" involved in the *Trinidad* case and to its relation to the activities of the order. He concluded prophetically: "But I believe that when, however actuated, an exempt parent does resort to a business subsidiary, any income so obtained becomes taxable."[16]

The Court in the *Roche's Beach* case had been able to place reliance on the opinion of the Bureau itself, which (presumably as a result of the *Trinidad* decision) held that:

> A corporation formed to dispense charity which does not actually engage in charitable undertakings itself but distributes its income to organizations organized and operated exclusively for the purposes named in subdivision (6) of Section 231 [IRC 101(6)] is exempt from taxation under said section.[17]

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12 6 B.T.A. 198 (1927).
13 4 B.T.A. 61 (1926).
14 96 F.2d at 778.
15 *Id,* at 779.
16 *Ibid.*
17 I.T. 1945, III-I CUM. BULL. 273 (1924).

Following the *Roche's Beach* case, the Commissioner seemed to accept the proposition that feeder organizations were not taxable.[18] In 1942, however, he once again changed his mind and determined to ignore that precedent.[19] The matter has been in litigation ever since with different results in the various courts applied to and no definitive resolution by the court of final appeal.

The weight of authority appears to be in favor of the proposition that:

> . . . the exemption from taxation granted by the statutes makes the destination of the income, that is, the purpose and object to which it is devoted, rather than its source, the ultimate test of its exemption.[20]

The doctrine is qualified by a requirement that the by-laws of the corporation must clearly reflect the charitable purposes to which the income is assigned and that these purposes be exclusive.[21]

It has been said that:

> . . . no one could organize a business corporation for the purpose of profit and later make it exempt under § 101(6) by the simple expedient of transferring its ownership to an exempt organization.[22]

However, such reorganization may be effected by the expedient of amending the corporation's charter.[23]

Holding an opinion contrary to the *Roche's Beach* decision are several circuit courts and the United States Tax Court. The last tribunal adheres to its decision rendered in *Mueller v. Commissioner*,[24] in which, after carefully considering the precedents and noting the distinction mentioned above, the Court determined that the Mueller Macaroni Company was taxable even though all its income was assigned to the benefit of the law school of New York University. Judge Murdock, speaking for the court, emphasized that:

> One cannot say properly that a corporation was organized and operated *exclusively* for educational purposes where, as here, one of its important

[18] 1938-39: G.C.M. 20853, 2 CUM. BULL. 166 (1938); 1939-40: G.C.M. 21610, 2 CUM. BULL. 103 (1939); 1939-40: G.C.M. 22116, 2 CUM. BULL. 100 (1940).

[19] 1941-42: G.C.M. 23063, 1 CUM. BULL. 103 (1942).

[20] Sico v. United States, 102 F. Supp. 197, 199 (Ct. Cl. 1952). See Mueller v. Comm'r, 190 F.2d 120 (3d Cir. 1951); Willingham v. Home Oil Mill, 181 F.2d 9 (5th Cir. 1950).

[21] Universal Oil Products v. Campbell, 181 F.2d 451 (7th Cir. 1950); Sun-Herald Corp. v. Duggan, 160 F.2d 475 (2d Cir. 1947); Roche's Beach Inc. v. Comm'r, 96 F.2d 776 (2d Cir. 1938); Sun-Herald Corp. v. Duggan, 73 F.2d 298 (2d Cir. 1934).

[22] Universal Oil Products v. Campbell, 181 F.2d 451, 460 (7th Cir. 1950).

[23] Willingham v. Home Oil Mill, 181 F.2d 9 (5th Cir. 1950). But see Universal Oil Products v. Campbell, 181 F.2d 451 (7th Cir. 1950). As to the time of "organization," see Sabastian Lathe Co. v. Johnson, (S.D.N.Y. November 29, 1952).

[24] 14 T.C. 922 (1950).

> purposes was to conduct a large commercial business for profit, competing with other similar corporations all subject to tax, and where the operation of that business is not merely incidental to the conduct by the same corporation of any other overshadowing exempting activity. The purpose to aid the educational institution, regardless of its relative importance, is not the exclusive purpose in the organization and operation of the petitioner.[25]

The Tax Court holds to this opinion despite reversal of *Mueller* by the Court of Appeals for the Third Circuit (after the passage of the 1950 Revenue Act).[26]

Although the Third Circuit rejected the Tax Court's reasoning, the Fourth Circuit, in a careful decision reviewing the whole history of the law, affirmed the Tax Court's determination that a corporation organized under the charitable corporation laws of South Carolina to operate a canteen, coal yard, filling station and appliance store for the convenience of the employees of a textile manufacturer was taxable on the income therefrom although all of the profits were destined to charitable organizations.[27] The Court in its decision again emphasized "and operated exclusively for charitable purposes." It is significant to note that certiorari was denied in this case even though the Solicitor General filed a memorandum stating that the Government did not oppose issuance of the writ.[28]

Legislative Remedy for a Judicial Ill

In the early part of 1950, powerful lobbies were exerting pressure on Congress to reduce or eliminate excise taxes. Since it was clear that there would be a substantial loss of tax revenue, the legislature was interested in developing new sources of income. Its attention was invited to so-called "loopholes" in the tax structure and particularly those "loopholes" involving tax-exempt organizations.

In presenting the Treasury's position in testimony before the Ways and Means Committee, Secretary Snyder recommended, in general terms, legislation to counteract what he explained to be three specific abuses of tax exemption. He noted first that:

> The law has been interpreted by some courts to attach the exemption to the destination of the income rather than its source. Some colleges and other institutions are engaging in a wide variety of business undertakings,

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25 *Id.* at 931-32.

26 Mueller v. Comm'r, 190 F.2d 120 (3d Cir. 1951). See Eastman v. Comm'r, 16 T.C. 1502 (1951) (automotive parts and service business profit inuring to Amherst College); Donor Realty Corp., 17 T.C. 899 (1951).

27 United States v. Community Services, Inc., 189 F.2d 421 (4th Cir. 1951).

28 342 U.S. 932 (1952).

> including the production of such items as automobile parts, chinaware, and food products, and the operation of theatres, oil wells and cotton gins.[29]

The result was unfair competition.

> The tax free status of these Section 101 organizations enables them to use their profits tax free to expand operations, while their competitors can expand only with the profits remaining after taxes.[30]

It was clear that the Secretary had in mind the *Mueller* case, which was at that time under consideration by the Tax Court. The Government did not propose to ignore the challenge of Judge Holmes who a few months before had written:

> Over a period of thirty-six years, with opportunity to change but without changing, the intention of Congress has been to exempt from income tax corporations organized and operated exclusively for the sole purpose of devoting their net earnings to religious, charitable, and educational purposes. If this intention is wrong from a legislative standpoint, the courts should let changes in the law come from the legislative department.[31]

Secretary Snyder continued:

> Advantage is also being taken of the exemption by the purchase of rental properties with borrowed funds. In this type of operation the non profit organization enjoys advantages over privately owned business which is measured by the amount of the tax privately owned enterprise is required to pay. This advantage permits these institutions to apply a larger portion of rental receipts to repayment of borrowed funds than is possible for a privately owned business paying income tax. The exemption should be limited to income received from ordinary investments which involves no abuse.[32]

It seems that Mr. Snyder had in mind a particular transaction entered into by Union College and Allied Stores.[33] Union put up a nominal amount of money toward the purchase of virtually all of Allied's real estate, borrowing millions from an insurance company to finance the deal. As part of the agreement, Union released the property to Allied at a rental barely sufficient to cover carrying charges and amortization. The Treasury was convinced that a taxable organization could not have entered into such a contract. The seller was entitled to a ren-

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29 *Hearings before Committee on Ways and Means on Revenue Revision of 1950,* 81st Cong., 2d Sess. 19 (1950).

30 H.R. REP. No. 2319, 81st Cong., 2d Sess. 36 (1952).

31 Willingham v. Home Oil Mill, 181 F.2d 9, 10 (5th Cir. 1950).

32 *Hearings, supra* note 29, at 19.

33 See Bloom, *A Consideration of Lease-Backs under the 1950 Revenue Act,* 31 B.U. L. REV. 482 (1951); Note, 98 U. OF PA. L. REV. 696 (1950).

tal deduction for amount not taxable to the purchasing institution, which in truth was not using its own money. The scheme had a particular appeal to sellers who could take a loss on the sale. As a fillip, the contract might grant the seller an option to repurchase.[34] In fact, the variety of advantages to the seller were infinite and the scheme was being widely hawked to unwary institutions as "the most noteworthy financial device of the present century."[35]

The third abuse to which the Secretary called the Committee's attention was the employment of tax-exempt foundations to maintain control of businesses and avoid the estate tax. Although this problem is outside the scope of the present discussion, it must be recognized that the taxation of foundations has a substantial though indirect effect on the income of colleges and universities.

Secretary Snyder summed up the Government's position as follows:

> The correction of present abuses, which shift additional burdens to the rest of the population, becomes essential for reasons of equity. This calls for a solution which will eliminate the abuse but will not interfere with the basic activities of these organizations.
>
> To meet this problem, it is recommended that the income derived by these institutions from the operation of businesses which are clearly unrelated to their primary functions be taxed at regular corporation income tax rates.[36]

Educational institutions were in the main opposed to granting tax immunity to a business merely because its profits inured to the benefit of a tax-exempt institution. As a consequence, no serious effort was made to oppose a change in the law that would give effect to Judge Hand's dissent in the *Roche's Beach* decision. The colleges' representatives noted with approval that a simple amendment to Section 101(14) could effect this purpose insofar as it regarded independent subsidiary corporations. It was suggested that an additional sentence be added to Section 101(14) to make it read as follows:

> (14) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom and turning over the entire amount thereof less expenses to an organization which itself is exempt from the tax imposed by this chapter; *provided, however, that such corporation conducting a business not related to the purpose of the organization, which is itself exempt, shall not be exempt.*[37] (Italics supplied to indicate suggested amendment.)

As regards businesses operated directly, the college representatives

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[34] See Bloom, *supra* note 33, at 489.

[35] H.R. REP. No. 2319, *supra* note 30 at 38.

[36] *Hearings, supra* note 29, at 19.

[37] See INT. REV. CODE § 101 (14).

noted the difficulty of determining which businesses were related and which were not related, and fell back on Judge Hand's statement in *Roche's Beach v. Comm'r,* which set forth the safeguards against educational institutions indulging in an excessive business activity.

> The purpose of subdivision 14 was to tax all business income, however destined, unless the company was really not in business at all. To some extent it is indeed true that that purpose can be evaded; an exempt corporation may go into business not strictly germain to its charter powers without losing its exemption. But there are several checks upon this possibility; first, the business must be small, if the corporation is to retain its classification under its appropriate subdivision; second, in many cases it will wince at exposing its funds to the hazards of business; third, its charter will often forbid such excursions.[38]

Insofar as leasebacks were concerned, the colleges noted that the abuse was that of the seller who received, in addition to the sale price, a lease having greater value than the rental payments would indicate. They urged that taxing the seller on this benefit (or treating the whole transaction as a mortgage) would be a substantial deterrent against the use of this subterfuge for obtaining tax benefits.[39]

Despite the opposition of the universities and colleges as well as other exempt institutions, the Ways and Means Committee without hesitation adopted *in toto* the Treasury recommendations for the closing of tax-exemption loopholes.[40] The wide publicity given to New York University's ownership of the Mueller Macaroni Company, to the University of Michigan's operation of the Willow Run Airport, and to the Union College-Allied Stores agreement, served to override any objection made on the basis of reason or logic. The bill as presented to the House[41] included provisions taxing business activities, whether directly or indirectly owned by exempt institutions. The Committee felt that the leaseback scheme was as much an abuse by the tax-exempt institutions as it was on the part of the vendor-taxpayer, and included a provision taxing exempt institutions on income from the leased property that was purchased or improved with borrowed money.

The House had expended considerable time in drafting and passing the full recommended revision of the revenue law. By the time the problem was turned over to the Senate, the organizations to be affected were in a position to exert pressure on that body's Finance Committee.

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38 96 F.2d at 779.

39 Note, 60 YALE L. J. 879 (1951).

40 H.R. REP. No. 2319, *supra* note 30, at 37.

41 H.R. 8920.

For a while, it seemed as if the whole matter would be postponed until the following session of Congress, since both the reduction of the excise tax and the closing of loopholes involved controversial questions of serious import in an election year.

The commencement of the Korean War resolved the issue precipitously.[42] It was clear to Congress that taxes would have to be raised immediately. The reduction of the excise tax was at once a dead letter. The closing of loopholes seemed very politic, and the Senate Finance Committee proceeded forthwith to adopt the House's recommendations with few and minor changes.

Thus, with the Revenue Act of 1950, Congress resolved many of the perplexing questions concerning the taxation of exempt organizations on their business activities. The problem of drafting such statute had been exceedingly difficult, and it is clear that with the enactment of the bill many new and complicated problems were brought before the colleges and universities.[43]

In 1951, Congress recognized that insofar as the colleges and universities are concerned, the taxation of feeder corporations for years prior to the effective date of the 1950 Act was a problem in seething ferment. As a consequence, it determined that feeder corporations of operating colleges and universities and hospitals should not be taxed for years prior to 1951.[44]

THE STATUTE

Before we consider the statute itself and the regulations which became effective August 28, 1952, with the approval of T.D. 5928 and its publication in the Federal Register, it is pertinent to make several general observations.

The section dealing with the tax-exempt status of foundations, as such, specifically provides that it shall not apply in the case of

> (2) an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. . . .[45]

In this and other ways, Congress has indicated a desire to treat operat-

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42 SEN. REP. No. 2375, 81st Cong., 2d Sess. 1 (1952).

43 See Finkelstein, *Tax Exempt Charitable Corporations: Revenue Act of 1950*, 50 MICH. L. REV. 427 (1952); Eaton, *Charities under the 1950 Revenue Act*, 90 TRUSTS & ESTATES 220 (1952).

44 Pub L. No. 183, 82d Cong., 1st Sess. § 601 (Oct. 20, 1951).

45 INT. REV. CODE § 3813(a)(2).

ing educational institutions as belonging to a specific class within the category of tax-exempt organizations.[46]

With regard to the regulations, it is interesting to note that they are in the main taken word for word from the Committee Reports, specifically the report of the Senate Finance Committee, since that body deals last with tax bills. This practice has grown in recent years and is a tribute to the workmanship of the Joint Committee Staff on Internal Revenue Taxation, which is responsible for much of the actual drafting of the bills and reports.

a. General

To effectuate Secretary Snyder's recommendations, Congress inserted in the Code a special supplement that sets forth in three sections how certain Section 101 organizations shall be taxed on their "business income".[47] This supplement was related to Section 101 by amending that section to read: *"Except as provided . . . in supplement U* the following organizations shall be exempt from taxation under this chapter—"[48] (Emphasis added.)

and inserting at the end:

> An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property. . . .[49]

b. Tax and Organizations Taxable—Section 421

In Section 421, the first of Supplement U's three sections, Congress spells out the amount of the tax and the organizations that shall be subject to it.

It is interesting to note that although private colleges and universities were taxable under the 1950 Act, state institutions were not. Until modified by the 1951 Act, Section 421(b)(1) merely provided for the taxation of "organizations exempt under Section 101(1), (6), (7) and

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[46] See INT. REV. CODE §§ 421(b)(1)(B), 422(a)(8)(A), also the last two sentences of §§ 422(a) and 422(b)(2). See also Pub L. No. 814, 81st Cong., 2d Sess. § 302 (Sept. 23, 1950), 64 Stat. 953, as amended by Pub. L. No. 183, 82d Cong., 1st Sess, § 601 (Oct. 20, 1951).

[47] INT. REV. CODE Supp. U §§ 421, 422, 423. For an extensive review of the 1950 act, see Comment, *Colleges, Charities and the Revenue Act of 1950,* 60 YALE L. J. 851 (1951). For a less detailed study, see Levin, *Exempt Organizations and the 1950 Act,* 29 TAXES 882 (1951).

[48] INT. REV. CODE § 101.

[49] *Ibid.* U. S. Treas. Reg. 111, § 29.101-3(b) (1952).

(14)." It was recognized at the time of the enactment of the 1950 statute that state universities and colleges were probably exempt under Section 116(d) rather than under Section 101(6). In the haste which surrounded the final enactment of the statute, it was argued that the Federal Government could not constitutionally tax a university that was owned and operated by a state. In retrospect, it is evident that the Federal Government *can* tax a state educational institution on its income from clearly unrelated business activities.[50] Congress corrected its error by adding subparagraph (B) to Section 421(b)(1), which specifically adds state colleges and universities to the list of organizations taxable.[51]

c. Unrelated Business Income—Section 422

Sections 422 and 423 spell out what is and is not unrelated business income. Section 422 is concerned with the general definition of unrelated business income and some specific limitations thereto. In Section 423, Congress set forth in detail how an exempt organization is to be taxed on its rental income from real property purchased with borrowed money.

What is an "unrelated trade or business"? The statute defines it as

> . . . any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 101 (or, in the case of an organization described in Section 421(b)(1)(B), [state college or university] to the exercise or performance of any purpose or function described in Section 101(6)) . . .[52]

Note that the *taxable* unrelated business net income is

> . . . the gross income derived by any organization from any unrelated trade or business (as defined in subsection (b)) *regularly carried on by it* less the deductions allowed by Section 23 which are directly connected with the carrying on of such trade or business. . . .[53] (Emphasis added.)

Thus,

> . . . in determining whether the income of an exempt organization from a trade or business is subject to the Supplement U tax, it is first necessary

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[50] New York v. United States, 326 U.S. 572 (1946); South Carolina v. United States, 199 U.S. 437 (1905).

[51] SEN. REP. No. 781, 82d Cong., 1st Sess., pt. 2, 57 (1951); U.S. Treas. Reg. 111, § 29.421-4(a)(2) (1952).

[52] INT. REV. CODE § 422(b).

[53] *Id.* at § 422(a).

to determine whether it is income from a trade or business which is regularly carried on, or is income from a sporadic activity.[54]

If a college gives an occasional dance or operates a sandwich stand during reunion or an annual fair, the income from such activity is not taxable.[55] But a sporadic activity may be "regularly carried on" within the meaning of the statute if it is conducted with "sufficient consistency to indicate a continuing purpose of the organization to derive some of its income from such activity."[56] The operation of a parking lot one day a week or of a race track one week a year would amount to the regular conduct of a business.[57]

The relation of the business (or lack of it) to the exercise or performance by an organization of its educational purpose is a much more perplexing question. The operation of a wheat farm by an agricultural college would ordinarily be related business.[58] But (in one of the few instances in which the regulations go beyond the committee reports) the Bureau notes that the operation must not be on a scale disproportionately large when compared with the educational program of the college.

Incidental use of a trade or business by a tax-exempt organization will not relate it to the functions of the organization. For example, students performing clerical or bookkeeping functions of a business as a part of their educational program do not necessarily relate that business to the activities of the educational institution.[59]

The Senate Report expressly states that athletic activities of schools are substantially related to their educational functions: "For example, a university would not be taxable on income derived from a basketball tournament sponsored by it, even where the teams were composed of students of other schools."[60]

Three specific exceptions are noted to the definition of unrelated trade or business.[61] The term does not include a trade or business in which substantially all the work is performed without compensation. As an example, the report and regulations cite the operation of a second-hand clothing store by an exempt orphanage in which the work is performed by volunteers. The production of a play by a volunteer

54 SEN. REP. No. 2375, *supra* note 42 at 106.
55 *Ibid.*
56 U.S. Treas. Reg. 111, § 29.422-3(a)(3) (1952).
57 SEN. REP. No. 2375, *supra* note 42 at 107.
58 *Ibid;* U.S. Treas. Reg. 111, § 29.422-3(a)(3) (1952).
59 SEN. REP., *ibid;* U.S. Treas. Reg. 111, § 29.422-3(a)(3) (1952).
60 SEN. REP., *id.* at 29.
61 INT. REV. CODE § 422(b)(1), (2) and (3).

student drama group would probably come within this exemption. In subparagraph (2), Congress excepted from the definition a business carried on by certain organizations (including colleges and universities) primarily for the convenience of its "members, students, patients, officers, or employees." The Committee had in mind the operation of a laundry by a college for the purpose of laundering dormitory linen and clothing of the students. A third exception noted is a trade or business which consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions. According to the report, this provision was enacted to remove thrift shops from the application of the Act.[62]

In Section 422(a), Congress carefully spells out some specific *exclusions* from *unrelated business income,* most of which come within the general category of investment income. Thus, there are excluded dividends, interest and annuities;[63] royalties;[64] rents from real property including personal property rented with real property;[65] gains (or losses) from the sale, exchange, or other disposition of property (other than stock in trade or other property of a kind which would properly be includible in inventory or property held primarily for sale to customers in the ordinary course of a trade or business):

> Dividends, interest, royalties, most rents, capital gains and losses and similar items are excluded from the base of the tax on unrelated income because your committee believes that they are "passive" in character and are not likely to result in serious competition for taxable businesses having similar income. Moreover, investment-producing incomes of these types have long been recognized as a proper source of revenue for educational and charitable organizations and trusts.[66]

There is further excluded from unrelated business income any income from research performed for the United States, federal agencies and instrumentalities, or for states or political subdivisions of states.[67] A similar exclusion applies to income from research performed by an organization operated primarily for the purposes of fundamental research, the results of which are freely available to the general public.[68]

Specific provisions are included setting forth the treatment to be

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62 SEN. REP. No. 2375, note 42 *supra* at 107, 108; U.S. Treas. Reg. 111, § 29.422-3 (b) (1952).

63 INT. REV. CODE § 422(a)(1).

64 *Id.* at § 422(a)(2).

65 *Id.* at § 422(a)(3).

66 *Id.* at § 422(a)(5); SEN. REP. No. 2375, *supra* note 42 at 30, 31.

67 INT. REV. CODE § 422(b)(7).

68 *Id.* at § 422(a)(8)(C).

afforded net operating losses,[69] and charitable contributions,[70] which in the case of an unrelated business must be made to beneficiaries other than the owning exempt institution.[71]

In the case of a college, university or hospital there is "excluded all income derived from research performed for any person".[72] This section was added by the Finance Committee in Executive Session with little explanation in the Report.[73] In his regulations, the Commissioner, after stating the law, attempts to fix some limits on the term "research" as used in Section 422(a). The term, he says,

> . . . does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations. For example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc.[74]

Just what these words really mean is not quite clear.[75] The individual who drafted the regulations is no longer with the Bureau and is, therefore, not available for comment. It is demonstrable that research organizations operating for profit exerted pressure on the Bureau to restrict the definition of research in order to prevent the universities and foundations from carrying on certain activities.

Subsection (iv) is one of those few places in the regulations under Supplement U where the Bureau goes beyond parrotting the law or the Finance Committee Report. Possibly it represents an attempt by the Bureau to limit the word "research" to a narrower meaning than Congress intended. It might be used to restrict the exclusion of the statute in the case of research by a college, university or hospital to research related to the purposes of the university.

Under the law and regulations a university's operation of an ordinary commercial testing laboratory would not be considered "research". With this proposition one would hardly disagree, but a real problem is posed by the phrase, "or the designing or construction of equipment, buildings, etc." There may be an activity "of a type ordinarily carried on as an incident to commercial or industrial operations" involving "the designing or construction of equipment, buildings, etc.," which is research in the ordinary meaning of that word. Should a university, for instance, assimilate a commercial laboratory that is in the business of

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69 *Id.* at § 422(a)(6).

70 *Id.* at § 422(a)(9).

71 U.S. Treas. Reg. 111, § 29.422-1(b)(6)(vi) (1952).

72 INT. REV. CODE § 422(a)(8)(A).

73 See SEN. REP. No. 2375, *supra* note 42, at 30, 109.

74 U.S. Treas. Reg. 111, § 29.422-1(b)(6)(iv) (1952).

75 See Finkelstein, *supra* note 43, at 430, and Eaton, *supra* note 43, at 222.

testing fire extinguishers and use its facilities, under a contract with a private concern, to discover a better kind of fire extinguant, it is arguable that under the law the income would be excluded from unrelated business income. Yet the regulations could be used to deny this exclusion.

The legislative history shows that Congress had in mind a rather broad meaning of the word "research". This intention follows from the inclusion of a specific provision for organizations engaged in "fundamental research". This latter provision was added by Senate-House Conferees after the bill had passed both bodies and is traceable to a paragraph in the Senate Report that reads as follows:

> A special exemption is provided under your committee's bill in the case of colleges, universities, and hospitals for income received from research done for anyone. This is not intended to imply, however, that funds received for research by other institutions necessarily represent unrelated business income. For example, a grant by a corporation to a foundation to finance scientific research would be a gift rather than trade or business income (either related or unrelated) if the results of the research were to be made freely available to the public. However, a "grant" by a corporation to be used for research by a foundation with the results of the research to be given only to the grantor would clearly not be a gift and would constitute unrelated business income.[76]

(It is patent from the above that Congress intended that the result of the research done by a college, university or hospital need not be freely available to the general public.)

As indicated above, the exemption of research by colleges, universities and hospitals was added by the Senate to the House Bill. At the same time, the Senate Committee changed the exclusion in the case of research for the United States, etc., to read "work" instead of research "because it was pointed out to the Committee that Government contracts given to universities frequently provide for development and instruction as well as research."[77] The House accepted the addition of the special provision for colleges on the condition that the exclusion with reference to contracts with the United States be changed back to "research." From this it is reasonably inferrable that "research" does not include development in the commercial sense of the word.[78]

With the foregoing reservation, it is arguable that the whole shows

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[76] SEN. REP. No. 2375, *supra* note 42 at 30.

[77] *Ibid.*

[78] Air Force Reg. 80-4 (Mar. 1, 1949), defines "applied research" as follows:

> To apply scientific personnel, facilities and knowledge to specific problems which arise from military requirements for new and improved concepts, techniques and material to a point where a definite outline of the path in development or other application is indicated.

an intent that the word "research" be broadly not narrowly defined. The House Ways and Means Committee in dealing with the problem initially stated: " 'Research' would include not only fundamental research but also applied research *such as testing and experimental construction and production.*"[79] (Emphasis added.) It is certainly clear that the exclusion in the case of a college, university or hospital should not be limited to activities which are related and which would therefore be excluded under other provisions of the Act.

Relief Provisions in the 1951 Act

In 1951 Congress inserted at the end of 422(a) and at the end of 422(b) two relief provisions for the benefit of specific educational institutions that found themselves in difficulty because of the 1950 Act. Both provisions were inserted as a result of amendment from the floor of the Senate and any explanation, therefore, is to be found in the conference committee report in the Revenue Act of 1951.[80] The regulations are pointedly silent.[81] The first provision permits a partnership of colleges and universities operating an unrelated business organization to deduct from their unrelated business income that portion which they were required by written contract, executed prior to January 1, 1950, to pay in discharge of the indebtedness that they incurred in acquiring their share of the business. The second provision added at the end of 422(b), was enacted to permit Wesleyan University to integrate its publishing business within three years.

d. Leases under Supplement U—Section 423

Section 422(a)(4) specifically provides that Supplement U lease income shall be included as unrelated business income. It will be remembered that the Supplement U lease provision has to do with lease-backs and was intended to tax exempt institutions on that portion of the rent received from leased property which is reasonably allocable to the indebtedness that the institution incurs to purchase or improve the property.[82]

Parenthetically, it should be observed that in the regulations the Commissioner reserves to himself a right to determine whether a pay-

79 H.R. REP. No. 2319, *supra* note 30 at 37.

80 See Summary of the Provisions of the Revenue Act of 1951 (H.R. 4473) as agreed to by the conferees, prepared by the staff of the Joint Committee on Internal Revenue Taxation (Oct. 1951) at pages 20 and 21.

81 U.S. Treas. Reg. 111, § 29.422-2(b) (1952); INT. REV. CODE § 422(a)(3).

82 See Bloom, *supra* note 33.

ment is actually "rent" or not. Thus, despite the general rule that rent is excepted—a rule stated twice in the statutes[83]—a payment designated as rent might be included in unrelated business income of a university if it were, in fact, a return or a share of profits in the business operating the "rented" property.[84] Thus, income derived from the operation of a hotel would not be rental income although income from the lease of a hotel would be.[85]

In defining a Supplement U lease, Congress was obviously constrained to make the terms as liberal as possible to the tax-exempt institutions. To be included a lease must run for a term in *excess* of five years. The statute is drawn to include leases that actually run for more than this period whether or not the initial agreement so provides. A lease that is substantially related to the performance by the educational institution of its charitable purposes is likewise excluded. The example given is of a hospital leasing a clinic to an association of doctors.[86] It is also provided that an organization occupying a building may lease part of the premises without considering the imposition of I.R.C. 423.[87] As a final general exception, it was provided that the section will not apply unless the rents derived from such leases represent more than fifty percent of the total rents, or the area occupied under such leases is more than fifty percent of the total area. However, if one tenant or a group of tenants pays more than ten percent of the rents or occupies more than ten percent of the total area the income from that particular lease will be taxable under Supplement U. As in the case of general rents, personal property leased with the real estate is to be lumped with it in applying Section 423.[88]

For a lease to be subject to 423, the institution must have incurred an indebtedness either before or after acquiring or improving the property for the purpose of acquiring or improving the property. If such an indebtedness exists, then a proportionate part of the rental income is included as unrelated business income, the proportion being the ratio of the indebtedness to the adjusted tax basis of the property.[89]

The committee reports and the regulations make it clear that substance not form is determinative. If acquisition (or improvement) is

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[83] See the next to last paragraph of INT. REV. CODE § 101, and § 422(a)(3).
[84] U.S. Treas. Reg. 111, § 29.422-1(b) (1952).
[85] *Id.* at § 29.422(b)(3)(ii); SEN. REP. No. 2375, *supra* note 42, at 108.
[86] SEN. REP., *id.* at 111; U.S. Treas. Reg. 111, § 29.423-1(c)(1) (1952).
[87] SEN. REP., *id.* at 33.
[88] See INT. REV. CODE § 423(a).
[89] U.S. Treas. Reg. 111, § 29.423-3 (1952).

in any way traceable to an institution's debt then that indebtedness comes under the statute:

> The rules respecting Supplement U leases cover cases where the leased property itself is not mortgaged. They are intended, for example, to reach cases such as the following: A university pledges some of its investment securities with a bank for a loan which is used to purchase a building that is leased for a long term. This would be an example of a Supplement U lease indebtedness incurred prior to the acquisition of the property. If the building itself were later mortgaged to raise funds to release the pledged securities, the lease would continue to be a Supplement U lease. Likewise, if a scientific organization mortgages its laboratory to replace working capital used in remodeling another building, otherwise free of indebtedness and leased for a long term to a grocery store chain, the lease would be a Supplement U lease inasmuch as the indebtedness, incurred subsequent to the improvement of such property, would not have been incurred but for such improvement and the incurrence of the indebtedness was reasonably forseeable at the time of such improvement, since the organization knew it must have working capital to continue current operations.[90]

It is irrelevant that the property is acquired by gift, devise or purchase if it is in fact subject to an indebtedness. To prevent undue hardship from the application of this last provision, the statute specifies that, where property was acquired by gift, devise or bequest prior to July 1, 1950, subject to a mortgage or lease requiring improvements, neither the mortgage nor the indebtedness incurred to improve the property in accordance with the terms of the lease shall be subject to Supplement U. The same relief is granted a Section 101(14) corporation acquired prior to the same date provided that at least a third of the stock of such corporation was acquired by gift or bequest.

The statute permits deducting the same proportion of taxes, interest and a reasonable allowance for depreciation or obsolence as is applied to the rents. It is to be noted that only these specific deductions are allowed. Where only a part of the property is subject to the lease, an allocation of rent and deductions is provided for.[91]

e. Consolidation

The Act provides for the consolidation of all of an organization's income from its various unrelated trade or business activities. "To do otherwise would deny to the organization the benefit now enjoyed by ordinary corporations of offsetting losses on one venture against the gains on another."[92]

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90 SEN. REP. No. 2375, *supra* note 42, at 112; U.S. Treas. Reg. 111, § 29.423-2 (1952).

91 U.S. Treas. Reg. *id.* at § 29.423-4.

92 SEN. REP. No. 2375, *supra* note 42, at 30, 115; U.S. Treas. Regs., *id.* at § 29.423-4(b).

CONCLUSION

Abuse and calumny have been heaped upon the sections of the Revenue Act of 1950 that affect the tax status of exempt institutions.[93] Insofar as the criticism relates to the complexity of the law, the objections are warranted. On the other hand, it must be acknowledged that the statute hardly represents an unreasonable imposition on the institutions involved.

In some instances educational institutions may find it very difficult to determine whether activities are exempt or come within the purview of the statute. The problem of research noted above is likely to be one of the most perplexing. In general, however, it will not be difficult for an institution to restrict its activities to those not penalized under the statute.

The punishment imposed by Section 423 with regard to Supplement U leases is probably more severe than the nature of the crime requires. In certainty, the section is unnecessarily complicated and involved. Moreover, it hardly seems fair that a university should have to include in its unrelated business income a portion of the rent received on real property given or bequeathed the university subject to a mortgage.

So far as the vendor lessee of property sold subject to a leaseback is concerned, his problem may be just beginning.[94] The Commissioner will undoubtedly contend that the transactions are in the nature of a mortgage loan particularly where an option to repurchase is involved.[95] Where the lease is for a period in excess of 30 years, the transaction will be subject to I.R.C., Section 112(b)(1) and Reg. 111, Section 29.112(b)(1).[96]

It is probable that the courts in interpreting the statute will continue to be lenient in their treatment of tax-exempt institutions, particularly colleges and universities. In this regard it is interesting to note the opinion of the Ninth Circuit in *Squire v. Students Book Corp.*[97] In determining that a corporation owned by a state college which operated a book store and restaurant on the college campus was exempt from federal taxation, Judge Healy first stated that the court would follow

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93 Eaton, *supra* note 43.

94 SEN. REP. No. 2375, *supra* note 42, at 110.

95 Helvering v. Lazarus & Co., 308 U.S. 252 (1939). See also Higgins v. Smith, 308 U.S. 473, 477 (1940); Watson v. Comm'r, 124 F.2d 437, 439 (2d Cir. 1942).

96 Century Elec. Co. v. Comm'r, 15 T.C. 581 (1950) (taxpayer was denied loss on sale of foundry to William Jewell College where the college executed a leaseback for a term of 95 years).

97 191 F.2d 1018 (9th Cir. 1951).

Roche's Beach. He then observed that Congress had declared a different rule applicable for taxable years commencing after 1950. The Judge continued,

> Resolution of the case before us does not depend wholly on the ultimate destination of the taxpayer's profits. The business enterprise in which the taxpayer is engaged obviously bears a close and intimate relationship to the functioning of the College itself. In some of the cases adhering to the general rule no similar relationship is discernible.[98]

What of the possibilities of new and more restrictive legislation? In times such as these when the nation is in desperate need of revenue, any transaction which smacks of unfair tax advantage is likely to invoke legislative sanction. It is demonstrable that legislation in the field of tax exemption has stemmed from a few specific transactions which achieved sufficient notoriety to attract the attention of Congress. Mr. Little's dealings with the Textron Foundation, New York University's ownership of Mueller Macaroni Company, and Union College's transaction with Allied Stores may be followed directly to the Revenue Act of 1950. If similar schemes are developed Congress's reaction is likely to be sharp and possibly extreme. It is not exaggerating to say that there is a fear abroad in the land that the tax laws encourage concentration of wealth and property in the hands of exempt institutions.[99]

Nonetheless, if the colleges in good faith observe the *spirit* of the 1950 Act, there is little likelihood that further revision of the laws will be required in the near future. The overwhelming majority of these institutions have in the past scrupulously avoided any questionable transactions and it is predictable that in future activity they will be even more circumspect.

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[98] *Id.* at 1020.

[99] See Finkelstein, *supra* note 43; H.R. REP. No. 2319, *supra* note 30, at 39.