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John C. Chommie

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FEDERAL INCOME TAXATION:  
TRANSACTIONS IN AID OF EDUCATION  
Part II*  
By  
JOHN C. CHOMMIE**  

The first installment of this survey was devoted to a discussion of the problems involving the character of awards in aid of education as taxable income. This portion of the paper is devoted to a discussion of the problems involving the character of a payment as a charitable (educational) contribution.

Part II  
The Payment: Is It A Charitable (Educational) Contribution?  

Section 23(o)(2) of the Code allows an individual a deduction, limited to twenty per cent of adjusted gross income, for so-called charitable contributions. A similar deduction is allowed a corporation by section 23(q)(2), limited to five per cent of net income before the deduction. The statutory language germane here allows a deduction for "contributions or gifts payment of which is made with-

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* [Editor's Note: This article is part two of a series begun in the January issue of the DICKINSON LAW REVIEW. The third and final installment, embracing a discussion of payments in aid of education as business expense, and including some reformative proposals, will appear in the June issue.]

** Professor, Dickinson School of Law; B.S.L., LL.B., St. Paul College of Law; LL.M., University of Southern California; Member of the Bar of Minnesota.


23 I.R.C. § 23(o) allows a deduction from gross income: "In the case of an individual, contributions or gifts payment of which is made within the taxable year to or for the use of: ...(2) A corporation, trust, or community chest, fund, or foundation, created or organized in the United States or in any possession thereof or under the law of the United States or of any State or Territory or of any possession of the United States, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation. For disallowance of certain charitable, etc., deductions otherwise allowable under this paragraph, see sections 3813 and 162(g)(2)." Sec. 162(a) allows a trust or estate, subject to certain limitations contained in § 162(g), an unlimited charitable deduction for contributions to organizations similarly described. Sec. 812(d) allows a similar deduction for computation of the net estate for Estate Tax purposes, and § 1004 allows a similar deduction for Gift Tax purposes. See also §§ 505(a) and 861(a). Sec. 101(6), exempting the income of such organizations from income taxation, is similar in wording to § 23(o)(2) except for the absence of the word "trust". The same general exemption is accorded such organizations under the tax levied by the Social Security Act, § 811(b)(8), 49 Stat.620,639, embodied in the Code as § 1426(b)(8).

24 The deduction is unlimited where the contribution for the taxable year, and for each of the ten preceding years, is in excess of 90% of net income for each year before the deduction. Sec.120, discussed in Wellen, "The Unlimited Deduction for Charitable Contributions," 7 Southwestern L.J. 38 (1953).

25 Sec.23(q)(2) is similar in scope to § 23(o)(2) except that in the former case the use of the contribution is limited to the United States and its possessions. It should also be noted that § 23(o)(5) allowing a deduction for a contribution to a fraternal order where such contribution is to be used for the described purposes, has no counterpart in § 23(q).
in the taxable year\textsuperscript{26} to or for the use of . . . a corporation, trust, or community chest, fund, or foundation. . . . organized and operated exclusively for. . . . educational purposes. . . . 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." Using similar terminology, section 101(6) exempts the income of educational organizations (and others so listed) from taxation.

The courts have not been too clear in defining the policies underlying the deduction and exemption provisions. Perhaps it can be said that as regards educational organizations, the deduction privilege is based on their quasi-governmental functioning. Perhaps the same policy supports their exempt status. It seems clear, however, that no such justification underlies the exemption granted the some nineteen categories of organizations also exempt under section 101. Here, the broad policy would seem to be simply that their non-profit status justifies exemption. Therefore, if the policies underlying sections 23(o)(2) and 101(6) are distinct, the distinction has not played an important part in their judicial development. Integration of the authorities would seem to be justified.

Subject Matter and Mode of Transfer

The term "contribution" is treated as being synonymous with the term "gift",\textsuperscript{27} and as such the common law concept of a transfer by gift has been followed by the courts. Required is an intent to make a present gift,\textsuperscript{28} a delivery divesting the donor of dominion,\textsuperscript{29} and, presumably, an acceptance by the donee.\textsuperscript{30} Invoked also have been such common law fictions as constructive delivery\textsuperscript{81} and relation back.\textsuperscript{82} It has also been held that if a gift is complete, a condition subsequent will affect only the value of the gift.\textsuperscript{88}

The subject matter of the gift, the Service has ruled,\textsuperscript{84} is limited to money and property; it does not include services. Allowed by the Service and the courts have been the value of such property interests as vested remainders\textsuperscript{85} (unless the

\textsuperscript{26} Accrual basis corporations are given until the fifteenth day of the third month after the close of their tax year to make the payment where such has been authorized by their board of directors within the tax year. Ibid.
\textsuperscript{28} See e.g. John M. Coulter, P 50,077 P-H T.C.Memo.Dec.
\textsuperscript{29} See e.g. Security First National Bank of Los Angeles, Ex., 28 B.T.A. 289 (1933).
\textsuperscript{30} Cf., Linwood A. Gagne, 16 T.C. 498 (1951), delivery upon condition held incomplete until acceptance by the donee.
\textsuperscript{31} See e.g. A.W.Mellon, 36 B.T.A. 977 (1937).
\textsuperscript{32} See e.g. Estate of Modie J.Spiegler, 12 T.C. 524 (1949).
\textsuperscript{33} J.T.Fargason, 21 B.T.A. 1032 (1950).
\textsuperscript{34} Reg.118, § 39.23(o)-2. Blood for a blood bank or transfusion is not property but analogous to the rendering of a personal service. Rev.Rul.162, 1953-18 I.R.B. 4. Quaere, as to the gift of a body to a medical school.
\textsuperscript{35} I.T.1776, II-2 C.B. 151 (1923); G.C.M. 3016, VII-1 C.B. 90 (1928); I.T.3707, 1945 C.B. 114.
gift is subject to a power to divest), a determinable fee, a conditional fee, a ten year-ten day term, an amount in excess of the value of a reserved annuity, and the premiums paid and the cash surrender value of insurance policies (unless the right to change the beneficiary is reserved).

Taxpayers have been denied deductions for personal expenses incurred in attending a charitable organization convention; for the value of a remainder interest that was subsequently construed as being remotely contingent; and for the value of a property interest that was restricted as to its transferability. In I.T.3918, the Service ruled that a one year grant of rental property did not represent a "payment", nor constitute a gift of property, and hence did not form the basis for a deduction for the year 1948. However, its acquiescence in Pricilla M. Sullivan, where the Tax Court allowed a deduction based on the present value of a determinable fee, may perhaps constitute a retreat from the position taken in I.T.3918.

Generally, the amount of any appreciation in value of property contributed to a charitable organization escapes taxation. However, in an effort to correct what it considers a double deduction abuse, the Service is now taking the position that a gift of an inventory item constitutes a realization of income to the donor. While this ruling's validity may be questionable, it raises problems of major importance in tax planning. If it is sustained, and its major premise approved, viz: that a transfer by gift can operate as a realization of income, it would presumably afford an opening for the Service to attempt to reach all such transfers of appreciated properties. The complex problems of realization of income and of basis of property raised by this ruling are beyond the scope of this survey. They have, how-

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86 I.T. 2403, VII-1 C.B. 92 (1928).
87 Pricilla M. Sullivan, 16 T.C. 228 (1951), acq., 1951-1 C.B. 3, rejecting the taxpayer's claim to a deduction based on the annual reasonable rental value as the building granted was used. A single transfer of a fixed term should fall within this rule.
89 Rev.Rul.194, 1953-20 I.R.B. 2, also holding that the income from the trust was not attributable to the grantor under the Clifford Regulations, § 39.22(a)-21.
90 I.T.2397, VII-1 C.B. 90 (1928).
91 See e.g. Ernst R. Behrend, 23 B.T.A. 1037 (1931); Eppa Hutton, IV, 1 T.C. 821 (1943).
92 Mortimer C. Adler, 5 B.T.A. 1065 (1927).
93 I.T.1988, III-1 C.B. 198 (1924); see Channing v. United States, n.27, supra, that there was merit in the government's argument that tuition payments for the schooling of the taxpayer's children were personal expenses expressly excluded as deductions under § 24 of the Code; but cf., Roy Upham, 16 B.T.A.950 (1929), where the taxpayer was allowed a deduction for his forgiveness of a claim to traveling expenses; Charles E. Muench, B.T.A.Memo. Op., Dkt. 88330,Nov.17,1938, cited 5 Mertens § 31.15, p.534, n.17, where a deduction was allowed the taxpayer for a contribution to a church notwithstanding the attendance of his son tuition free at the church school.
95 I.T. 2559, X-1 C.B. 122 (1931).
97 16 T.C. 228 (1951), acq.,1951-1 C.B. 3, cited supra, n.37.
99 Cf., Estate of Farrier, 15 T.C. 277 (1950), where the Tax Court distinguished I.T. 3932, ibid.

The words "for the use of" have been interpreted as meaning "in trust for". Therefore, a gift to a trust not qualifying under section 23(o)(2) because it operated as an ordinary business, was none the less deductible because all the property will eventually go to qualifying corporations.\footnote{Sec.3797(a)(3). For a discussion of the meaning of the terms "corporation or community chest, fund, or foundation", and as embracing trusts, see 6 Mertens § 34.16.} However, it is explicit in the Code from the use of the term "organized" and the characterizing of the entities, that the beneficiary operate as a separate entity whose income is used for the required purposes.\footnote{See e.g. Commissioner v. Berkeley Hall School, Inc., 84 F.2d 539 (C.C.A.9th 1936) (oral trust). See, however, reg.118, § 23(o)-1 (h) for substantiation requirements authorized by the Code.} This requirement is satisfied by actual functioning as an entity as in case of a committee whose function was to award an annual literary prize.\footnote{See e.g. Commissioner v. Berkeley Hall School, Inc., 84 F.2d 539 (C.C.A.9th 1936) (oral trust). See, however, reg.118, § 23(o)-1 (h) for substantiation requirements authorized by the Code.} It should also be noted that in the definition section of the Code, the term "corporation" includes "associations, jointstock companies and insurance companies."\footnote{Genevieve Tucker, 2 B.T.A. 796 (1925).}

**Burden of Proof**

The taxpayer has the burden of proof to establish that the payment he has made satisfies the statutory requirements. While formal documentation is not required,\footnote{I.T. 2334, VI-1 C.B. 82 (1927).} a general failure of proof has often been decisive.\footnote{I.T. 2334, VI-1 C.B. 82 (1927).}

The importance of a well prepared case is illustrated by Milton Smith, Jr., Ex.\footnote{Francis Cooley Hall, 2 B.T.A. 931 (1925); Earl King, 9 B.T.A. 503 (1927); Henry Wilson, 16 B.T.A. 1280 (1929); Alfred T. Davison, 21 B.T.A. 251 (1930), affm'd., Davison v. Commissioner, 60 F.2d 50 (C.C.A.2d 1932).} In this case, the taxpayer contributed to several local chapters of the Chi Psi college fraternity. His proof consisted of the functioning of a college fraternity house in relation to the maintenance of educational standards of its members. The Board of Tax Appeals held this was sufficient to distinguish four previous contrary decisions that had failed for want of sufficient proof,\footnote{Francis Cooley Hall, 2 B.T.A. 931 (1925); Earl King, 9 B.T.A. 503 (1927); Henry Wilson, 16 B.T.A. 1280 (1929); Alfred T. Davison, 21 B.T.A. 251 (1930), affm'd., Davison v. Commissioner, 60 F.2d 50 (C.C.A.2d 1932).} and to shift the burden to the Commissioner who offered no evidence in rebuttal. Similarly, the Board of Tax Appeals had early denied a deduction for a gift to the Daughters of the American Revolution\footnote{28 B.T.A. 422 (1933), non-acq., XII-2 C.B. 25 (1933).} and later upon sufficient evidence as to the functioning of the organization the Service ruled that such a gift was deductible.\footnote{28 B.T.A. 422 (1933), non-acq., XII-2 C.B. 25 (1933).}
The courts ordinarily will not take judicial notice of the status of any organization.61 This, however, does not make the taxpayer’s burden of proof task as formidable as it may appear.62 As an exception to a rule of strict construction generally applied where a taxpayer claims the benefit of an exemption from taxation, the Supreme Court early established a rule of liberal construction where charitable organizations in general are concerned.63 This is well illustrated by the meaning that has been attributed to the term “exclusively”. To exclude would ordinarily mean “to shut out” or perhaps, “solely.” However, the judicial approach has been to give it a meaning more akin to “substantially.”64

In conjunction with the term “organized”, as discussed below, the Board early took the position that evidence extrinsic to the charter and by-laws was inadmissible to show that an organization was in fact organized exclusively for educational purposes.65 However, it has now apparently abandoned this strict view of the term “organized exclusively” and allows, in accord with the majority of the lower courts, extrinsic evidence to show the real purpose for which an organization is formed.66

The result of this liberality has materially lightened the taxpayer’s burden in establishing that an organization is in fact organized and operated as an educational organization within the meaning of the Code. What Is Education?67

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61 See e.g. Henry Wilson, 16 B.T.A. 1280 (1929); see, Sophia G. Coxe, 5 B.T.A. 261 (1926), where the court commented that it could not take judicial notice of the nature of the organization from the prominent people associated with it; contra: Porter v. Commissioner, 60 F.2d 673 (C.C.A.2d 1932), aff’d. on other issues, 288 U.S. 436, 53 S. Ct. 451 (1933), where Judge Learned Hand took judicial notice that Princeton University is “organized and operated exclusively for... educational purposes”, but refused such recognition to a hospital.

62 Reg.118, § 39.101(6)-1(a) states the three basic tests for an organization claiming exempt status: “(1) It must be organized and operated exclusively for one or more of the specified purposes; (2) Its net income must not inure in whole or in part to the benefit of private shareholders or individuals; and (3) It must not by any substantial part of its activities attempt to influence legislation by propaganda or otherwise.” This paraphrasing of the Code has often been adopted by the courts.

63 See e.g. Trinidad v. Sagrada, infra, n.111; Lederer v. Stockton, infra, n.163; Helvering v. Bliss, 295 U.S. 144, 55 S.Ct. 17 (1934). The lower courts, as a rule, have not been remiss in application of this broad principle which is more akin to a definite judicial policy. See cases collected 6 Mertens, sec. 34.02, p.4, n.11. In a relatively recent case, the Supreme Court in commenting on this rule of liberal construction seemed to retreat to some extent form extreme liberality when speaking through Mr. Justice Murphy it said: “Even the most liberal of constructions does not mean that statutory words and phrases are to be given unusual or tortured meanings.” Better Business Bureau v. United States, 326 U.S.279,283, 66 S.Ct. 112,114 (1945).

64 See e.g. George E. Turnure, infra, n.87; James Irvine, infra, n. 87.


66 E.g. Mary du Pont Faulkner, 42 B.T.A. 1019 (1940), cited infra., n.97; 6 Mertens § 34.17. The lower courts seem to have disregarded a Supreme Court dictum that “the parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted.” Helvering v. Coleman-Gilbert Associates, 296 U.S. 369,374, 56 S.Ct. 285,287 (1935).

67 Sec. 23(o)(1) and § 23(q)(1) allow deductions for gifts to governmental units where made for a public purpose. As such, gifts to political units for educational purposes fall within these sections. 5 Mertens, § 34.11. However, even prior to the 1921 Revenue Act, first providing for such deductions for individuals, there was evidence that such gifts that otherwise qualified were allowable as charitable deductions. S. 1052, 1 C.B. 146 (1919); but cf., O.D. 126, 1 C.B. 151 (1919).
A popular dictionary describes the term "education" as embracing "all that we assimilate from the beginning to the end of our lives in the development of the powers and faculties bestowed upon us at birth. It includes not only systematic schooling, but also that enlightenment and sense which an individual obtains through experience." The Code, of course, contemplates a much more restricted concept. Not only is the meaning restricted by the entity requirement, discussed above, but it is only expressly limited by the propaganda and personal strictures, and implicitly by the social and commercial limitations which are discussed below. It also seems clear that Congress intended something more restrictive than the use of the term as embraced within the broader term "charitable." The definition of an educational organization adopted by the Treasury affords some limited aid as a point of departure:

"An educational organization within the meaning of the Internal Revenue Code is one designed primarily for the improvement or development of the capabilities of the individual, but, under exceptional circumstances, may include an association whose sole purpose is the instruction of the public, or an association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community, even though an association of either class has incidental amusement features." Perhaps this regulation is saying that ordinarily the Code requirement will be satisfied with regard to the educational institution whose primary purpose is the development of the "capabilities of the individual," and that the taxpayer will be put to his proof in such instances as where a gift is made to an organization whose purpose is primarily the dissemination of information to the public at large.

The meaning of the term "educational purpose" defies analysis in so far as many of the decisions have simply held the activities of the organization in question to have embraced two or more of the excepted purposes. For example, in George E. Turnure, an early Board of Tax Appeals decision, the taxpayer had contributed to the Lenox Brotherhood. The donee was an unincorporated membership organization similar to a Y.M.C.A. Its stated object was to "draw in closer relationship members of the community and promote their intellectual, moral and physical welfare." The Commissioner was evidently contending that it was simply

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69 See 3 Scott, Trusts, § 370 et seq., "Advancement of Education as Constituting a Charitable Purpose" (1939). In I.T. 1827, II-2 C.B. 154 (1923), it was ruled that the term "charitable" is used in the Code in a restrictive sense precluding a classification of an organization as charitable where it is otherwise classified as exempt.
70 Reg. 118, § 39.101(6)-1(c), cited with approval in Better Business Bureau v. United States, 326 U.S. 279, 66 S.Ct. 112 (1945), a Social Security Act case, where it was stated: "In this instance, in order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption." Ibid., 326 U.S. at 283, 66 S.Ct. at 114.
71 9 B.T.A. 871 (1927); accord: Robert W. de Forest, 19 B.T.A. 595, (1930); O.D. 389, 2 C.B. 148 (1920), holding The Community Service, Inc. a charitable and educational corporation without discussion of its purpose and functioning.
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a social organization. The Board held that "the social activities...were aimed at
the accomplishment of its purpose as stated in its charter" which was "charitable
and educational within the broad meaning of those terms."

The county and state fair cases have presented a similar, but perhaps more
acute problem. In James A. Connelly,72 the Tax Court held that a contribution to
a county fair association was deductible. The association's purposes were said to
be "broadly scientific and educational". The Court of Claims had previously held
such an organization as being operated "exclusively for educational purposes."73
The position of the Commissioner is not altogether clear. In the Connelly case, he
contended that the fair association was a social welfare organization within section
101(8) of the Code. In the regulations he classifies county fair "and like associ-
ations" as embraced within section 101(1) which exempts from taxation the in-
come of labor, agricultural, and horticultural organizations.74 In G.C.M. 19836,75
a corporation organized to conduct and operate, or to participate in operating public
fairs for the development of the resources of a state, was held exempt as a busi-
ness league under section 101(7) of the Code. It was denied the status of a sec-
tion 101(6) organization on grounds that education was merely the means by which
its main purpose was accomplished.

What does seem clear, however, is that by his non-acquiescence in the Connelly
case, the Commissioner will force the taxpayer to continue to litigate a claim for
a deduction for a contribution to such an organization.

The term "literary",76 as well as the term "religious"77 has likewise been
coupled with the term "educational" in allowing a taxpayer a deduction.

The Service has ruled on a wide variety of organizations holding them to be
educational in purpose and function without revealing possible competing con-
cepts. Held educational in this category have been military training organizations,78

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72 6 T.C. 744 (1946), non-acq., 1951-1 C.B. 2; accord: State National Bank of Texarkana, pp
(D.C.W.D. Okla. 1942); Roy Upham, 16 B.T.A. 950 (1929), holding the Homeopathic Medical
Society a "scientific and educational" organization.
73 Southeastern Fair Ass'n. v. United States, 52 F.Supp. 219 (Ct.Cl. 1943).
75 1938-2 C.B. 163.
76 Edith A. Wolf, 40 B.T.A. 1232 (1939).
77 Potter v. United States, 79 F.Supp. 297 (D.C.N.D.Ill. 1946) (The I Am Reading Room of
Chicago); I.T.3487, 1941-2 C.B.123 (The U.S.O.).
78 G.C.M. 11705, XII-1 C.B. 57 (1933) The Military Training Camp Ass'n.); G.C.M.443, V-2
C.B. 66 (1926) (National Rifle Ass'n.); but cf., G.C.M.24100, 1944 C.B. 192, revoking G.C.M.
443, ibid, but allowing exemption as a § 101(8) social welfare organization.
musical concert organizations\textsuperscript{79} (unless the primary purpose is social),\textsuperscript{80} research organizations,\textsuperscript{81} and historical and memorial organizations.\textsuperscript{82}

\textbf{What Is a Social Organization?}

In the broad sense social and recreational activities play an important part in the “improvement or development of the capabilities of the individual”. However, the Treasury and the courts have long assumed that social and recreational organizations are outside the scope of the policies implicit in section 23(o)(2) and section 101(6) of the \textit{Code}. This position seems supported by the fact that social clubs are exempt from taxation under section 101(9) of the \textit{Code} and thus by necessary implication can not be characterized as educational organizations.\textsuperscript{83}

Drawing a line, however, between an educational organization and a social organization has often proved to be a difficult task. The Service has ruled that because a social club conducts classes in dancing, boxing, and athletics it is not transformed into an educational organization,\textsuperscript{84} nor because it conducts musicales as part of its social activities.\textsuperscript{85} It has also ruled that an alumni association is not educational notwithstanding that it was organized primarily to promote the interests of a college and turned over its excess income to the college.\textsuperscript{86} Where, however, social functions have served only as a means to the accomplishment of the statutory purposes, the courts have held the latter to be controlling.\textsuperscript{87}

Up to 1933, the Commissioner had been successful in his contention that the college fraternity is primarily a social organization.\textsuperscript{88} This position is perhaps in accord with the popular conception of the functioning of such an organization. The day-to-day activities of living and eating together would seem to constitute

\textsuperscript{79} S. 1176, I.C.B. 147 (1919); I.T.1475, I-2 C.B.184 (1922).
\textsuperscript{80} I.T.2937, XIV-2 C.B. 123 (1935); cf., Samuel W. Weis, 30 B.T.A. 478 (1934), where the Board held that a contribution to guarantee an opera was not deductible.
\textsuperscript{81} G.C.M. 22120, 1940-2 C.B. 98; accord: I.T.1224, I-1 C.B. 256 (1922); I.T.2654, XI-2 C.B. 39 (1932). In Rose D. Forbes, 7 B.T.A. 209 (1927), the Board allowed a deduction for a contribution to the American School Citizenship League whose primary function seemed to consist in the preparation of books used in school citizenship courses.
\textsuperscript{82} A.R.R. 301, 3 C.B. 188 (1920), reversing S.1246, 2 C.B. 149 (1920); I.T.1579, II-1 C.B. 155 (1923) (Woodrow Wilson Foundation); I.T.1954, III-1 C.B. 198 (1924) (Harding Memorial Ass’n.); I.T.2334, VI-1 C.B. 82 (1927) (National Society of Daughters of American Revolution.). In I.T.2134, IV-1 C.B. 214 (1925), a corporation under State control whose purpose was the development of a wild life sanctuary was held educational. In James Irvine, 46 B.T.A. 246 (1942), the Board allowed a deduction for a contribution to the Society of California Pioneers.
\textsuperscript{83} See 6 Mertens § 34.30 for discussion of § 101(9). See I.T.1827, supra n.69, for ruling on the mutual exclusiveness of § 101 organizations.
\textsuperscript{84} A.R.R. 379, 4 C.B. 203 (1921).
\textsuperscript{85} I.T.2937, XIV-2 C.B. 123 (1935).
\textsuperscript{86} G.C.M.22116, 1940-2 C.B. 100, ruling the organization exempt under § 101(9) but not under § 101(6).
\textsuperscript{87} George E. Turnure, 9 B.T.A. 871 (1927); James Irvine, 46 B.T.A. 246 (1942); Bohemian Gymnastic Ass’n Sokol v. Higgins, 147 F.2d 774 (C.C.A.2d 1945), where Judge A. Hand stated: “the methodical instruction given by Bohemian in physical and cultural development...are far different from the mere pursuit of social activity for its own sake and may properly be regarded as ‘educational.’” Ibid., 147 F.2d at 776. But cf., Herbert E. Fales, 9 B.T.A. 828 (1927), where a veterans’ memorial club was held social.
\textsuperscript{88} Cases cited supra n.58; accord: G.C.M.5932, VIII-1 C.B. 172 (1929).
the core of their existence. This was the view taken by the Second Circuit in Davison v. Commissioner. However, in Milton Smith, Jr. Ex., the taxpayer was successful in convincing the full Board of Tax Appeals that several local chapters of Chi Psi were “organized and operated exclusively for” educational purposes. The charter articles were perhaps sufficient to satisfy the term “organized.” To carry his burden of proof on the functioning of the various chapters the taxpayer introduced oral testimony that the local chapters: maintained constant supervision over the studies of their members; required minimum standards of scholarship of initiation; provided library and study facilities; assisted underclassmen with their studies; and, held meetings and forums for literary and scientific purposes. This was sufficient, said the Board, to overcome the presumption of correctness of the deficiency assessment and to shift the burden to the Commissioner who offered no evidence in rebuttal.

The non-acquiescence of the Commissioner is understandable. An educational institution is often surrounded by a variety of fringe organizations educational in character. It is difficult, however, to conceive of the orthodox social fraternity, notwithstanding a high degree of diligence in guiding the scholarship of its members, of being either in fact organized or operated as an educational organization within the meaning of the Code.

What Is a Propaganda Organization?

Prior to 1934, the revenue acts did not contain an express stricture against propaganda organizations. The 1934 Revenue Act, however, established the present Code standard by denying educational (or other statutory purpose in section 23(o)(2)) status to what is broadly termed “propaganda organizations.” The Code thus allows a deduction for a contribution to an otherwise qualifying educational organization provided that “no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation.”

The term “propaganda” does not seem to have any special meaning. Generally, it is perhaps thought of as “any organized movement for spreading a given opinion or doctrine.” The legislative history of the 1934 Revenue Act does not indicate that it was used in any special sense, and therefore as the language of the Code indicates, it must be limited by the term “or otherwise attempting to influence legislation”. As such, the statutory provision was simply declaratory of the broad judicially developed rule, viz: that legislative and political activities are not embraced within the term “educational” as used in the Code.

In the period under the early revenue acts, however, the Treasury, and perhaps the Board of Tax Appeals, seemed to take a more restricted view of what was educational in this context. An early ruling denying educational status to an association promoting the passage of labor legislation stated that it was Congress' in-

89 60 F.2d 50 (C.C.A.2d 1932).
tent "to foster education in its true and broadest sense, thereby advancing the interests of all, over the objection of none." The same ruling approved a denial of educational status to the National Dry Foundation on grounds that they were "distributors of partisan propaganda." Similarly, in an early Board case, deductions were denied for contributions to an anti-saloon league, anti-cigarette league, and a temperance foundation on grounds they were formed to disseminate controversial or partisan propaganda.

These views that put the stress upon the controversial or partisan nature of the matter disseminated can hardly be said to present a precise workable rule. The test that seems to have currency and which constitutes a rejection of these early views is aptly illustrated by *Weyl v. Commissioner.* The taxpayer made a contribution to the League for Industrial Democracy. The Board had denied the deduction largely on grounds of the partisan nature of its doctrine and its advocacy of drastic political and economic change contrary to established political and economic doctrine. The Second Circuit, however, reversed. Judge Manton succinctly stated: "The organization has no legislative program hovering over its activities."

The Board of Tax Appeals, as discussed above, at one time would apparently consider only the formal charter or articles of incorporation to determine whether the Code term "organized" was satisfied, e.g. whether the organization had a legislative activity purpose. However, in reversing the Board and allowing a deduction for a contribution to the Massachusetts Birth Control League, the First Circuit rejected this restricted view and held an informal abandonment of legislative purposes sufficient. This was subsequently accepted by the Board of Tax Appeals in a gift tax case. However, the importance of formal charter amendment should not be overlooked. In *Henriette T. Noyes,* the Board of Tax Appeals denied a deduction for a contribution to the National League of Women Voters and to the Minnesota League in 1930 largely on grounds that the certificate of incorporation of the national organization contained the words "to support need-
ed legislation.” In Luther Ely Smith, a similar contribution to the St. Louis League of Women Voters was allowed, the Tax Court pointing out that in 1938 the legislative activity purpose had been deleted from the constitution and by-laws.

The test developed by the courts will usually result in each case turning on the degree of legislative activity in which the donee organization was engaged during the year of the contribution; degree of activity because the Code uses the term "substantial", and because the term “exclusively” has been interpreted liberally and not as precluding incidental non-statutory functions. Under this degree of legislative activity test, a wide variety of organizations have lost what would otherwise be an educational status because of their active support of legislative measures and candidates. On the other hand, incidental legislative appearances, or, in one case, the sponsoring of three bills in a State legislature have not prevented recognition of statutory status. It should also be pointed out that educational status is not lost merely because member organizations have a legislative purpose. Also, where separate entities in fact exist, presumably the activities of a parent and a subsidiary would not be visited upon each other.

Legislation, of course, can be influenced in more subtle ways than by bombarding congressmen with correspondence or by committee hearing appearances. The courts, as a whole, however, do not seem to have been influenced by other than such direct objective techniques. Undoubtedly, an objective legislative activity test affords a convenient judicial rule. From the standpoint of policy, however, it affords opportunity for some decided abuses. For example, Time Magazine reports that a two month investigation of Facts Forum was conducted, by Providence

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99 3 T.C. 696 (1944). In Charles W. Dahlinger, 20 B.T.A. 176 (1930), affm’d. on other grounds, 51 F.2d 662 (C.C.A.3rd 1931), c.d. 284 U.S. 673, 52 S.Ct. 128 (1931), the Court allowed a deduction for a contribution to the Pennsylvania League of Women Voters made in 1923; there was no indication the charter contained a legislative activity purpose.

100 Herbert E. Fales, 9 B.T.A. 828 (1927) (International Reform Bureau); Joseph M. Price, 12 B.T.A. 1186 (1928) (City Club of New York); Slee v. Commissioner, 42 F.2d 184 (C.C.A.2d 1930) (American Birth Control League); John H. Watson, Jr., 27 B.T.A. 463 (1932) (Citizens League of Cleveland); James J. Forstall, 29 B.T.A. 428 (1933) (League of Nations Ass'n, Inc.); Vanderbilt et al. v. Commissioner, 93 F.2d 360 (C.C.A. 1st 1937) (National Woman's Party); Luther Ely Smith, 3 T.C. 696 (1944) (Missouri Institute for Administration of Justice); Roberts Dairy Co. v. Commissioner, 195 F.2d 948 (C.A.8th 1952) (National Tax Equality Association); cf., Old Colony Trust Co. v. Welch, 25 F.Supp. 45 (D.C.Mass. 1938), denying a deduction for the Freethinkers of America, Inc. on grounds that its principal activity was the conducting of litigation in support of its purpose; but cf., G.C.M. 3830, VII-1 C.B. 114 (1928), ruling that an organization promoting the welfare of the American Indian was charitable and educational notwithstanding active legislative activities on grounds that any Indian welfare organization must so function because of the restricted Indians status as a government ward.

It should be noted in connection with the Forstall case, ibid., that the League of Nation Ass’n’s successor organization, The American Association for United Nations, is listed as approved for deductions. 2 P-H Tax Ser. pp 12,729 (1953).

101 Luther Ely Smith, 3 T.C. 696 (1944) (St. Louis League of Women Voters).


103 Cochran v. Commissioner, 78 F.2d 176 (C.C.A.4th 1935), cited supra n.94, World League Against Alcoholism composed of eleven organizations from different nations many of whom had active legislative programs including that of the Anti-Saloon League of the United States.

104 See Faulkner v. Commissioner, 112 F.2d 987 (C.C.A.1st 1940).
Journal-Bulletin reporter Ben H. Bogdikian. Facts Forum is represented as being primarily a TV-Radio disseminating organization, claiming educational status under the Code, with 125,000 "participants". Time Magazine reports that reporter Bogdikian concluded an eight-part newspaper series: "'(The) net effect (of Facts Forum) is to disseminate fear, suspicion and divisive propaganda... The results of this, if carried into the entire field of mass communications, could be to increase the pressures dividing segments of American society, to increase group hatreds and implant suspicions which did not exist before.'"105

The purpose at this time is simply to question the wisdom of such a rule as the legislative activity test for propaganda organizations. The possible impolicy implications are discussed in the final part of this article.

What Is a Business Organization?

Judicial experience with the competing concepts of "education" and "business" has been extensive. During the past decade, attention has centered around the commercial activities of what are admittedly educational institutions. However, occasionally, the courts have been faced with the problem as regards the fundamental purpose of the organization itself. This is illustrated by the better business bureau cases under the Social Security Act whose provisions were intended to exempt from taxation the same organizations exempt from income taxation under section 101(6).

In Jones v. Better Business Bureau of Oklahoma City,106 the Tenth Circuit felt that the dominant purpose of the organization was its campaign of fraud prevention which it felt was educational in character and that therefore the organization was exempt. A contrary result was reached by the Court of Appeals for the District of Columbia because of such an organization's admitted service to its commercial members.107 The Supreme Court, in Better Business Bureau v. United States,108 resolved the conflict in favor of the latter holding. Mr. Justice Murphy, speaking for the Court, said:

"The commercial hue permeating petitioner's organization is reflected in its corporate title and in the charter provisions dedicating petitioner to the promotion of the 'mutual welfare, protection and im-

105 63 Time No. 2, p.50:3, 52:1 (January 11, 1954). Reg. 118. § 39.101(6)-1(a)(3), supra n.62, seems to adopt the legislative activity test, but § 39.23(o)-1(f) provides: "Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses, are not deductible from gross income." This does not seem to require legislative activity on the part of a donee before a deduction will be denied. Sec.39.101(6)-1(c) might be interpreted either way: "An organization formed, or availed of, to disseminate controversial or partisan propaganda is not an educational organization within the meaning of the Code. However, the publication of books or the giving of lectures advocating a cause of a controversial nature shall not of itself be sufficient to deny an organization the exemption, if carrying on propaganda, or otherwise attempting to influence legislation forms no substantial part of its activities, its principal purpose and substantially all of its activities being clearly of a nonpartisan, noncontroversial, and educational nature."

106 123 F.2d 767 (C.C.A.10th 1941).
108 326 U.S. 279, 66 S.Ct. 112 (1945), cited supra n.16 and n.70.
provement of business methods among merchants' and others. . . . Petitioner's activities are largely animated by this commercial purpose. Unethical business practices and fraudulent merchandising schemes are investigated, exposed and destroyed. Such efforts to cleanse the business system . . . are highly commendable. . . . But they are directed fundamentally to ends other than that of education." 109

In short, educational means will not control an otherwise commercial purpose.

This type of conflict has been relatively rare, however, and justifies limiting this survey to a consideration of the problems of the commercial activities of educational organizations.

Ordinarily the risks inherent in competitive commercial activities will preclude the use of educational institutional funds in such ventures. However, some types of commercial activity have been traditional such as investment in securities and rent-producing land. It is clear, however, that a popular conception of permissible commercial activities would not embrace unlimited trading and manufacturing activities. The issue here is thus whether commercial activity itself in any way limits the term "educational" as used in the Code. The answer to this question up to the Revenue Act of 1950 is to be found only in the judicial decisions. The Code in this respect is silent. 110

An educational organization can engage in commercial activities either directly or indirectly through ownership of a corporation or other separate tax entity.

**Direct Commercial Activities.** The pioneering judicial decision in the area of permissible commercial activity is the 1924 Supreme Court decision rendered in the *Sagrada* case. 111 In this case, the taxpayer was a Philippian religious order. Its investment income approximated 92% of its total income and about half of the remaining income was derived from sales of wine, chocolate and other articles. These sales were made, apparently, to subordinate agencies and members of the order, and were not made in competition with other business. The Court held that the taxpayer was organized and operated exclusively for religious and educational purposes. Its explanation of the taxpayer’s income was: (1) the investment income was a traditional source of income of charitable organizations; (2) the income from the sales was incidental to its exempt functions and did not amount to trade or business in any proper sense because no sales were made to the public or in competition with others; and (3) such sales could not be regarded as being made pursuant to "a distinct or external venture." In its search for congressional intent it said of the exemption clause:

109 326 U.S. at 283-84, 66 S.Ct. at 114.
110 This is perhaps subject to inferences permissible from § 101(14) exempting from taxation: "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." See dissenting opinion of Judge Learned Hand in Roche's Beach, Inc. v. Commissioner, infra. n.116.
111 Trinidad v. Sagrada Orden de Predicadores De La Provincia Del Santissimo Rosario De Filipinas, 263 U.S. 578, 44 S.Ct. 204 (1924).
"Two matters apparent on the face of the clause go far towards settling its meaning. First, it recognizes that a corporation may be organized and operated exclusively for religious, charitable, scientific or educational purposes, and yet have a net income. Next, it says nothing about the source of the income, but makes the destination the ultimate test of exemption."¹¹²

The *Sagrada* holding permits unlimited commercial investment functions, and incidental non-competitive trading activities without loss of charitable-educational status. Does it permit substantial direct trading activities? Logically, it would seem, this is debatable. Judicially, the answer has been that it does. Starting with an early Board of Tax Appeals decision,¹¹³ the lower courts have repeatedly allowed almost unlimited direct commercial trading and servicing activities without loss of statutory status.¹¹⁴ The rationale has been almost invariably the "destination the ultimate test" language in the *Sagrada* case with some of the cases turning on the incidental character of the commercial activity.¹¹⁵

**Feeder Organizations.** Extensive commercial activity is hardly desirable from the standpoint of risk for most educational organizations. The purchase or organization of a separate corporation to "feed" the parent educational organization would thus avoid the risks inherent in competition. In fact, no cases involving educational institutions seem to have involved any other type of substantial commercial activity other than these so-called "feeder organizations." The usual practice has been the purchase of a going concern and amending its character to indicate the feeding of all earnings to the exempt organization.

From the standpoint of the educational organization, an investment in securities has been made. This results in focusing attention on the separate commercial entity. Does the *Sagrada* "destination the ultimate test" language also justify the conclusion that the source is immaterial here? Is such a commercial concern itself "organized and operated exclusively for... educational purposes"? Logic aside, the majority of the courts of appeal that have considered the issue, have held that such an "external venture" of the parent charity was likewise exempt from taxation under section 101(6) of the *Code*. This would, of course, ordinarily

¹¹² Ibid., 263 U.S. at 581, 44 S.Ct. at 205.
¹³ Sand Springs Home, 6 B.T.A. 198 (1927), acq., VI-1 C.B. 5 (1927); accord: Unity School of Christianity, 4 B.T.A. 61 (1926).
¹¹⁴ See 6 Mertens § 34.19. The cases up to 1950 are also collected and discussed in C.F. Muller Co., 14 T.C. 922 (1950), infra., n. 121.
¹¹⁵ See e.g. the fair cases cited supra n.72 and n.73, where income from concessions and amusement facilities was held incidental to the educational purposes.
qualify it for a deduction under sections 23(o)(2) and 23(q)(2). The leading case is *Roche's Beach, Inc. v. Commissioner*, a decision of the Second Circuit.

In the *Roche's Beach* case, the taxpayer operated a commercial bathing beach and all its net income was committed to an admitted charity under the terms of a testamentary trust. The Board of Tax Appeals had denied exemption on the grounds that the purposes for which a corporation is organized must be found in its charter. This had been the view of the Commissioner because the Income Tax Unit had previously ruled that feeder corporations to section 101(6) institutions were exempt. The Second Circuit reversed the Board. It refused to follow the narrow view adopted by the Board as to proof of corporate purpose, and allowed evidence of the testamentary trust to show what it considered to be the true corporate purpose. In adopting the "destination of income test" and finding the taxpayer exempt under section 101(6), it refused to find a congressional policy limiting feeder organization exemption to property holding corporations as provided in section 101(14). It was on the basis of this latter conclusion that Judge Learned Hand dissented.

From 1924 to 1942 the Commissioner accepted the principle of the *Roche's Beach* case. In 1942 he repudiated it with *G.C.M. 23063*. In 1950, before the enactment of the 1950 *Revenue Act*, but at a time when the publicity on the so-called abuses of feeder organizations and lease-backs had reached its peak, the Tax Court followed suit in *C. F. Mueller Co.*

In the *Mueller* case, New York University, for the benefit of its law school, purchased the outstanding stock of a going concern, a manufacturer of macaroni and related products. The purchase was financed by borrowing more than 100%
of the purchase price from the Prudential Insurance Company.\textsuperscript{122} The taxpayer was chartered under Delaware law and then merged with the old company. Both the charter and the merger agreement showed as a purpose the feeding of all profits to the University. The manufacturing operations during 1948 and 1949 were profitable; some $175,000 was distributed to the University and $600,000 was paid on its loan. The Tax Court, in a review by the full Court, Judge Opper alone dissenting, held that the taxpayer was not exempt from taxation under section 101(6). The opinion by Judge Murdock distinguished the Sagrada holding in a review of the authorities up to that time, and declined to follow the reasoning and the rule in the \textit{Roche's Beach} case. The opinion also noted the unfair competition argument with approval. The taxpayer appealed and the Tax Court was reversed by the Third Circuit on the authority of the \textit{Roche's Beach} case.\textsuperscript{123} However, there was more than just a feeling in the appellate opinion that by this time, after years of "interpretative gloss", it was a matter for Congress and not the courts.

Despite the reversal, but fortified by a recent opinion from the Fourth Circuit,\textsuperscript{124} the Tax Court adheres to its position.\textsuperscript{125}

\textit{The Revenue Act of 1950.} A discussion of the changes wrought by the Revenue Acts of 1950 and 1951 is beyond the scope of this survey in this area of commercial activity by educational organizations. They have been ably presented elsewhere.\textsuperscript{126} Generally, however, it can be said that two major policies underlie the changes concerning the commercial activities of educational organizations: (1) a desire to eliminate what was considered by Congress a type of unfair competition

\textsuperscript{122} A variation on such financing is the sale (or gift) by a commercial concern to a charity (or a family member) and its lease-back. This leaves the charity's funds in the investment category. Not objectionable per se, but where the purchase price is borrowed for such a purpose, it was considered sufficiently abusive of the exemption (the rental income) privilege as to merit special treatment in the Revenue Act of 1950, where such income is now considered as unrelated and taxable. Even so, such transactions still afford substantial business and tax advantages to both parties. For a discussion prior to the 1950 Revenue Act, see Cary, "Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax and Policy Considerations," 62 Harv. L. Rev. 1 (1948).

\textsuperscript{123} For a recent discussion, see Cary, "Current Problems in Sale or Gift and Lease-Back Transactions," 29 Taxes 662 (1951).

\textsuperscript{124} C.F. Mueller Co. v. Commissioner, 190 F.2d 120 (C.A.3rd 1951).


\textsuperscript{126} E.g., Joseph B. Eastman Corporation, 16 T.C. 1502 (1951); Donor Realty Corporation, 17 T.C. 899 (1951), John Danz, et al., 18 T.C. 454 (1952), acq. 1952-2 C.B. 1 (feeder trust). The problem of retroactivity is not considered in the text. However, the Donor case indicates that the Eastman case was disposed of by stipulation pursuant to § 601 of the Revenue Act of 1951. Anticipating the text, the 1950 Revenue Act expressly denies exempt status to feeder organizations. To obviate hardship § 601 of the 1951 Act expressly exempts feeder organizations prior to January 1, 1951 when the parent is an educational institution (and certain others).

in permitting the tax exempt organization to compete against taxpaying commercial organizations; and (2) a desire to prevent a supposed loss of revenue from such non-taxpaying commercial activity. There seemed to be little or no evidence of abuse of the deduction privilege.

The techniques used in effectuating these policies, while extremely complicated, were not drastic. While there was an express rejection of the feeder exemption (an overuling of the Roche's Beach principle), the educational status of the parent for either direct or indirect commercial activity was not affected. The heart of the changes are contained in Supplement U of the Code which levies a tax at corporate rates (individual rates in case of a trust) on unrelated income from business which is regularly carried on. This includes leave-back income where the money has been borrowed to make the purchase.

For our purposes here the last paragraph of section 101 of the Code as amended by the 1950 and 1951 Acts is pertinent:

"Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purposes of any law which refers to organizations exempt from income taxes."

The reference in the parenthetical clause is to the express elimination of feeder organizations from section 101 status, with one exception similar to section 101(14) organizations.

While there is no comparable provision in sections 23(o)(2) and 23(q)(2), the Revenue Act of 1950 contained correlating provisions for the years prior to January 1, 1951. The inference from these provisions and the underlying policies seems clear: direct commercial activities, even if substantial, do not effect deductibility if the organization otherwise qualifies under sections 23(o)(2) and 23(q)(2). To this extent the deduction privilege has been strengthened. As regards contributions to commercial feeder organizations, it would seem, a deduction would not be allowed unless it was made "for the use of" the parent educational organization.

What Is a Private Purpose?

Implicit in the idea of a charitable or educational gift in general is a flow of benefits to the public at large. This is partly expressed in the Code stricture that denies a deduction for a contribution to an organization where any part of its net earnings inure "to the benefit of any private shareholder or individual." Perhaps the entity requirement, discussed above, is also partly expressive of this idea. In any event, it seems clear that this public welfare requirement is broader than, and embraces, the inurement clause in the statute. The courts, however, do not seem to have been too clear in defining "public welfare" for tax purposes. At least

127 See § 302(a) and § 302(c), Revenue Act of 1950.
considerable uncertainty seems to exist in some areas. Perhaps some of the difficulty stems from its nature as essentially a question of fact.\(^1\)

**Indefiniteness of Beneficiaries.** The test for public welfare had often been stated to consist in the indefiniteness of the beneficiaries. Therefore, where gifts are made to, or for the benefit of, individuals, it can not be said that they are made for the benefit of the public at large. For example, in *Cap Andrew Tilles*,\(^2\) the taxpayer contributed to a fund, to which there were other contributors, to provide a musical education for a girl with a promising voice. The Board of Tax Appeals held that it was outside congressional intent to allow as a charitable deduction, a gift made for the benefit of only one person.

Similarly, deductions for contributions to professional and business membership organizations have been denied under section 23(o)(2) primarily because their purpose is to benefit their own members as a definite class rather than the public generally.\(^3\) Two of these cases illustrate the relationship between the private purpose idea and the meaning attributed to the term "private shareholder or individual."\(^4\) In *George O. May*,\(^5\) the taxpayer contributed to the American Institute of Accountants whose charter, in part, recited that its purpose was "to unite the accountancy profession"; "to safeguard the interests of public accountants"; and, "to encourage cordial intercourse among accountants". The Board of Tax Appeals held that these recitals were incompatible with what is now section 23(o)(2). A few years later, in *Journal of Accountancy, Inc.*,\(^6\) the taxpayer was

\(^{128}\) E.g., Potter v. United States, 79 F.Supp. 297 (D.C.N.D.Ill. 1946), cited supra n.77, where the taxpayer was organized under the general business corporation statutes, and was allowed to show non-profit or exempt purposes and functions. It seems that sometimes the Commissioner has put the taxpayer to his proof, perhaps on suspicion that he is simply a proprietary concern masquerading as an educational institution. Sophia G. Coxe, 5 B.T.A.261 (1926) (Mining and Mechanical Institute of the Anthracite Coal Region, Inc.); Armin A. Schlesinger, 11 B.T.A. 601 (1928) (Lake School for Girls), in both cases the taxpayer being successful in establishing the donee as educational.

\(^{129}\) 38 B.T.A. 545 (1938), affmd 'without discussion of this issue, 113 F.2d 907 (C.C.A.8th 1940); accord: Fred Dohrman, Jr., 18 B.T.A. 66 (1929), perhaps turning on the entity requirement in that the gifts were made to individuals through the medium of an employee (a social worker) of the donor; S. E. Thomason, 2 T.C. 441 (1943), the taxpayer paying the boarding school expenses of an individual ward of a charitable organization. See 5 Mertens § 31.13—Personal Gifts to Individual Objects of Charity Are Not Deductible.

\(^{130}\) 5 Mertens § 31.24 for cases and rulings. But cf., United States v. Proprietors of Social Law Library, 102 F.2d 481 (C.C.A.1st 1939), where a Boston law library was given educational status for purposes of the 1934 Capital Stock Tax although the use of the library was restricted to "subscribers" (mostly lawyers), with law students being expressly excluded. The court's rationale being that the public receives a direct and indirect benefit from the better administration of the law through knowledge thus acquired, and that the law student exclusion was a reasonable regulation to the utility of the library, intimating that they were a disturbing influence. For the ultimate in membership benefits in a communist society see: Hutterische Bruder Gemeinde, 1 B.T.A. 1208 (1925); Hofer v. United States, 64 Ct.Cl.672, 6 A.F.T.R. 7379 (1928).

\(^{131}\) Reg.118, § 39.101-1(d) defines "private shareholder or individual" as referring "to persons having a personal and private interest in the activities of the organization."

\(^{132}\) 1 B.T.A. 1220 (1925); accord: Montgomery v. United States, 65 Ct.Cl. 588, 6 A.F.T.R. 6787 (Ct.Cl. 1927), denying a deduction for a contribution to the Institute's library endowment fund, principally on grounds of the Institute's legislative activity.

\(^{133}\) 16 B.T.A. 1260 (1929).
claiming exemption from taxation on grounds that, in effect, it was but a feeder to a tax exempt business league, the Institute, who held all of its stock and received all its dividends. The Board denied the exemption on grounds that the purpose of the taxpayer could not be separated from the purpose of the Institute who held the stock as a private shareholder. It said that the Institute could not be said to hold the stock for such part of the general public as to take it out of the class of a private shareholder. The opinion intimated that had the parent been a section 101(6) organization, it could possibly be said that such stock would be then held for the general public and not for the benefit of the members of the organization.

Following this reasoning it might be said that not only would the deduction privilege be denied where the organization exists for the benefit of its members, but that exempt status under the other section 101 provisions, containing an inurement clause, would be denied where the organization engages in direct or indirect commercial activity. This seems to have been the result generally except where the commercial activity has been merely incidental to the exempt purpose.

Employees Charitable Organizations. The center of attention in the employer-employee area has been with the statutory employee pension trust. However, a few cases have involved employee charitable organizations of a type that would seem to be governed by the principles here under consideration, but without furnishing an answer to a number of important questions. For example, A corporation establishes an educational trust or foundation for the benefit of its employees. The plan provides that the trust will pay the tuition and other expenses of any employee pursuing a formal course of instruction (eg. by correspondence or in attendance at evening classes). Assume further, that such benefits as will be granted are subject to the discretion of an independent board. Can it be said that such a trust operates for the public welfare rather than the private benefit of the employer and the employees, so that the employer's contributions are deductible.

184 Professional membership organizations have generally been held exempt as business leagues under § 101(7) of the Code. 6 Mertens § 34.27-34.28b incl. Deductions for dues and fees are generally allowed as business expense. Reg.118, § 39.23(a)-5.

185 See, Bohemian Gymnastic Ass'n Sokol v. Higgins, 147 F.2d 774, 777 (C.C.A.2d 1945), comparing substantial direct commercial activities of social clubs with educational organizations. Mere stock ownership of a commercial feeder by a § 161(6) parent generally was not considered sufficient to exempt the feeder under the Sagrada doctrine. E.g. Sand Springs Railway Co., 21 B.T.A. 1291 (1931); Bear Gulch Water Co. v. Commissioner, 116 F.2d 975 (C.C.A.9th 1941), c.d., 314 U.S. 652, 62 S.Ct. 99 (1941); Kriesien v. United States, 99 F.Supp. 872 (D.C.Ore. 1951); Universal Oil Products Co. v. Commissioner, supra, n.119.

186 See 6 Mertens § 34.18; ibid., § 34.28, discussing income producing activities of § 101(7) organizations; ibid., § 34.30, discussing income producing activities of § 101(9) organizations, the cases turning on a similar inurement clause. Cf., Medical Diagnostic Ass'n., 42 B.T.A. 610 (1940). The social welfare organizations of § 101(8), infra n.147, may constitute an exception. Debs Memorial Radio Fund, Inc. v. Commissioner, 148 F.2d 948 (C.C.A.2d 1945); Scofield v. Rio Farms, Inc., 205 F.2d 68 (C.A.5th 1953). It should be noted that § 101(8) does not contain an inurement clause and is not subject to Supplement U taxation.

187 Sec. 23(p) allows a deduction for employer contributions to a pension trust qualifying under § 165 of the Code. See extended discussion in 5 Mertens §§ 25.68 to 25.77 incl.
Can it be said that such benefits inure to the employee as something implicitly bargained for to thus preclude the characterization of the contributions as gifts? Would a contribution by an individual, eg, a corporate officer, be free of any suggestion that the employee was receiving additional compensation? A distinguishable, but somewhat similar, situation was involved in the recent Eighth Circuit case of *Duffy v. Birmingham*.

In the *Duffy* case, the taxpayer was a trust established by the widow of a former corporate president. The trust was funded by the purchase of the widow's stock, for less than its value, with an interest bearing note. The interest was paid to the widow from the stock earnings. The trust instrument provided for discrentional payments for: (1) pensions to former employees; and (2) additional compensation to current employees of the corporation. The District Court had denied section 101(6) status to the trust on grounds that the diversion of income to the widow violated the inurement of net earnings clause. The Circuit Court agreed with this conclusion and in the course of its opinion also held:

"The reason underlying exemption granted by section 101(6) . . . is that the exempted taxpayer performs a public service . . . the relief of the public of a burden which otherwise belongs to it . . . .

"But a gift of income from a fund to employees of a purely business corporation as 'added compensation'. . . . is not charitable. . . . Contrary to the prohibition in the statute, the income of a fund so distributed inures to their benefit as private individuals." 140

In rejecting the taxpayer's argument that the additional compensation provision was incidental to the pension provision, the court struck an odd note. It intimated that such a pension provision was charitable. Generally, voluntary pension payments made by an employer are treated as additional compensation. It is to be noted, however, that here any such payments would be paid by a separate tax entity funded by an individual.

The *Duffy* case should be compared with an early Board of Tax Appeals decision and a recent Tax Court case. In *John B. Sibley*, 141 the taxpayer, a corporate

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138 The C. H. Masland & Sons Dickinson Scholarship awards are made under a similar plan. The company house publication indicates the establishment of "a fund whose annual income is to be used for scholarships at Dickinson College", and as "the chief purpose of the fund is to help the children of Masland men and women receive a college education, preference is given to a candidate who has one or both parents employed at C. H. Masland and Sons at the time of the award." The fund is administered by an independent committee, but "the names of applicants for the scholarship are submitted to this committee by our Personnel Department and they are the sole judges as to who shall receive the scholarships." 16 The Shuttle, Book 3, p.42 (C. H. Masland and Sons, Carlisle, Pa., Nov. 1952). The writer has been advised that "we treat all of our donations of such type as charitable "Educational" contributions under Section 23(q)", and that "it's never been questioned" (by the Service). Letter from Donald W. Rich, Jr., Director of Public Relations, dated December 21, 1953. That such benefits are provided for the employees' children should not mitigate against possible inurement to the parent as an employee.

139 190 F.2d 738 (C.A.8th 1951).

140 Ibid., 190 F.2d at 740-41.

shareholder and officer, contributed to an employees' benefit corporation whose primary purpose was to aid employees and their dependants in case of illness, distress and death. In allowing a deduction for the contribution the Board said: "No person was required to contribute. . . and no person was entitled to aid by force of any contract, agreement, or contribution. All employees. . . were eligible, but were only entitled to relief in the discretion of the board of directors of the employees' association."\(^{142}\)

This rationale was adopted by the Tax Court in its recent decision in *T. J. Moss Tie Company*.\(^{148}\) In this case, the contributions were made by the employer corporation. The purpose of the employees' trust was to give aid to needy employees in time of family sickness and disability. It was established by the employer to give form to prior practice and to thereby improve its labor relations. Some 800 employees were potential beneficiaries. In case of dissolution, any remaining assets were to be distributed to other charities. The Commissioner's contention was that the trust was a profit sharing and pension plan that failed to meet the requirements of section 23(p).\(^{144}\) The Tax Court rejected this argument on grounds that the sole object was the employees' social welfare, a recognized charitable purpose. The taxpayer's contention that the contributions were deductible as charitable contributions was sustained.

The Commissioner's appeal to the Eighth Circuit was dismissed on his own motion.

The *Sibley and Moss Tie* cases seem to establish three broad requirements for an employee organization to qualify under sections 23(o)(2) and 23(q)(2): (1) contributions cannot be required from the member-employees; (2) the charitable benefits must be established as non-contractual; and (3) the relief or benefits given must be pursuant to some discretionarial power. Perhaps the *Duffy* case can be said to establish a further requirement in that the benefits intended must be charitable in character.

In connection with the contribution from members requirement, it has been held that where the major portion of the employee charitable organization income is from dues paid by the member employees, gifts by outsiders to the organization are not deductible on grounds that the organization in such cases more nearly resembles an insurance institution.\(^{145}\)

Therefore, assuming that where the benefits granted are discretionarial the indeterminateness requirement is satisfied, the remaining question might be simply

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\(^{142}\) Ibid., 16 B.T.A. at 918.


\(^{144}\) Supra, n.137.

\(^{145}\) The C. R. Lindback Foundation, 4 T.C. 652 (1945), affm'd., per cur., 150 F.2d 986 (C.C.A. 3rd 1945); but cf., G.C.M.19028, 1937-2 C.B. 125, where minor regular contributions by employees was ruled not to destroy the otherwise charitable character of an employee welfare organization. See also 6 Mertens § 34.20, for a discussion of the effect of contributions by beneficiaries on exempt status.
whether the benefits flowing to the recipients can be said to be an incident of the employer-employee relationship. As one commentator has indicated, it does not seem likely that the Commissioner intends to sweep all such trusts into the orbit of section 23(p), and perhaps he is taking the position that the benefits flowing to the employer take a trust out of the charitable category.\textsuperscript{146} Perhaps it is also arguable that inasmuch as certain local associations of employees, where their net earnings are devoted exclusively to charitable, educational, or recreational purposes, are given exemption under section 101(8) of the Code, they can not also be characterized as section 101(6) organizations, or similarly qualify under sections 23(o)(2) or 23(q)(2).\textsuperscript{147}

In any event, with non-acquiescence in force in both the Sibley and Moss Tie cases, the tax planner is in a difficult position. Perhaps a clarifying ruling can be anticipated.

\textit{Diversion of Income}. Generally, any substantial diversion of income, directly or indirectly, from an organization to the benefit of an individual in a private capacity will be sufficient to result in a denial of educational or other charitable status. For example, where the primary purpose of a trust was to provide for the training and maintenance of a relative-descendant who might be called to the ministry, exemption was denied.\textsuperscript{148} Also, where the primary purpose of a trust was to provide for the education of some fourteen named relatives, the same result was reached.\textsuperscript{149}

A variety of techniques in diverting earnings have been employed by taxpayers—some with a surprising degree of success. Those that would seem to justify separate attention are: (1) dividends; (2) salaries; and (3) private annuities.

(1) \textit{Dividends}: Payments from profits was considered in an early case, \textit{Kemper Military School v. Crutchley}.\textsuperscript{150} The court held that while the taxpayer may have been actually functioning as an educational institution, the payment of a dividend was within the express prohibition of the statute. A similar result has been reached with regard to rebates from profits by a cooperative association or-

\textsuperscript{146} Note, "Contributions to Employees Benefit Trust," 38 A.B.A.Jo. 1041 (1952). In Harvey v. Campbell (D.C.N.D.Tex. 1952), the purpose of an employees' trust was to make loans to the employees to enable them to purchase homes from the employer. Individual contributions to the trust were not allowed as deductions on grounds that what was done was pursuant to a business purpose of the employer.
\textsuperscript{147} Sec. 101(8) exempts: "Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes." The term "local" is given a restricted meaning by the regulations. Sec.39.101(8)-1 referring to the definition used in § 39.101(10)-1.
\textsuperscript{148} James Sprunt Benevolent Trust, 20 B.T.A. 19 (1930).
\textsuperscript{149} Amy Hutchinson Crellin, 46 B.T.A. 1152 (1942); accord; Pasadena Methodist Foundation, ¶ 43,451 P.H T.C. Memo. Dec.; Henry C. DuBois, 31 B.T.A. 239 (1934).
\textsuperscript{150} 274 F. 125 (D.C.W.D.Mo. 1921); accord; Journal of Accountancy, Inc., supra, n.133; T.B.R. 33, 1 C.B.199 (1919).
ganized to carry on a general mercantile business. While a mere right to dividends from earnings where the charter so permits is enough for loss of statutory status, the position with regard to liquidating dividends is not so clear. In the 

Kemper case, the court noted that the assets of the taxpayer had increased in value and would inure to the benefit of the shareholders upon dissolution. This potentiality was apparently a sufficient basis for an early Service ruling denying exempt status. It later ruled, however, that merely because the stockholders of a bona fide educational institution may share in the assets upon dissolution, including reinvested earnings, is not sufficient to result in a denial of educational status. This is apparently the view of the Tax Court. It would seem, however, that a definite plan to divert earnings in this manner could hardly be expected to meet with success.

(2) Salaries: It is clear that an educational organization can pay reasonable salaries for services rendered without violating the inurement condition. What then is a reasonable salary? It should be noted that most of the cases and rulings in this area have involved family organizations of some type. In one ruling, for example, the Service held that where the two trustees of an incorporated school were a father and his daughter with the power to control and regulate the salary of the father, this was sufficient for a denial of educational status. However, this ruling was later rescinded on the grounds that any such group in control might distribute the income to themselves whether members of a family group or not.

The test seems to be what in fact has been paid in relation to earnings, scope of operations, responsibilities, fitness, comparable salaries and other factors. Presumably, the broad criteria established under the section 23(a) cases will be followed. In one Tax Court case exemption was denied where salaries to a controlling family group were increased in ratio to increased enrollment and income, and were disproportionate to services actually rendered. The court held this was sufficient evidence that the salaries were a means of income distribution. In a recent decision the same court denied exempt status to a correspondence school where a

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151 Stanford University Book Store v. Helvering, 83 F.2d 710 (C.A.D.C. 1936); cf., Associated Student's Store, ¶ 42,132 P-H B.T.A. Memo. Dec., where without rebates the same type of an organization was still considered non-educational.
154 I.T.1906, III-1 C.B. 270 (1924) ; semble, O.D.1102, 5 C.B. 204 (1921).
158 I.T.3220, 1938-2 C.B. 164, where the want of a reserve account from which sums might be later paid was also noted.
159 Northern Illinois College of Optometry, ¶ 43,396 P-H T.C. Memo. Dec.
nominal salary agreement was supplemented by a profit-sharing agreement whereby 50% of the net profits flowed to the guiding light of the school.\(^{160}\)

The recent decision of the Fifth Circuit in *Mabee Petroleum Corporation v. United States*,\(^{161}\) involves an interesting salary case in a feeder situation. One Mabee and his wife were the sole shareholders of Corporation A, an oil and gas producer. A was split up into Corporation B and Corporation C, and A dissolved, Mabee making the appropriate exchange of stock. Both B and C were organized as business corporations with no indication in B's charter that its function in connection with its some 200 oil wells was simply to supply the Mabee Foundation, an admitted charity, with its income. Shortly after B's formation, Mabee was employed by B as its president under a fifteen year contract at a salary of $100,000 a year. Mabee held all of B's stock and had served as president of A without salary. Foundation was later organized and Mabee transferred his stock in B to it, Foundation accepting the stock as a gift "with the obligation (salary contract) attached." This salary was paid during 1948, 1949 and 1950 at the end of which time the contract was terminated. During this time, Mabee was associated with six or seven other enterprises and he testified that he divided his time among all of his business interests.

The total profits of B (some $2,500,000) during 1948 and 1949 were paid to Foundation. On these amounts the Commissioner assessed B with the tax, which was paid and suit instituted for refund. B claimed section 101(6) status as a feeder. In affirming the District Court's finding of fact that $100,000 was unreasonable, the Fifth Circuit pointed out that it was doubtful whether comparable services in an arm's length bargain with outside sources would have cost as much, and that no consideration was given to a possible change in business conditions during the fifteen year period of the contract. Judge Holmes dissented, on grounds that to a man of Mabee's economic stature, $100,000 was not unreasonable, and because "these salary payments were obligations assumed in the acquisition of the trust property."\(^{162}\) This latter principle is discussed below.

**(3) Private annuities:** The cases involving creation of otherwise exempt organizations charged with the payment of private annuities are more difficult to analyze. A good deal of the difficulty can probably be attributed to the early Supreme Court decision in *Lederer v. Stockton*.\(^{168}\)

In the *Stockton* case, the remainder income from a residuary estate was left to an exempt hospital. The Pennsylvania Supreme Court had ruled that the income could not be paid to the hospital until the death of all the annuitants. At a time when all the annuitants were dead except one who was entitled to $800 of the

\(^{160}\) Gemological Institute of America, 17 T.C. 1604 (1952).


\(^{162}\) Ibid., 203 F.2d at 877.

\(^{168}\) 260 U.S.3, 43 S. Ct. 5 (1922).
$15,000 income, the trustee transferred the residuary fund to the hospital as a loan. Under the terms of the loan, the hospital paid only enough interest to pay the administrative charges and the annuity. The trustee was charged with the tax on the total income and in an action for refund the Supreme Court affirmed the plaintiff's recovery in the lower courts. The short opinion by Mr. Chief Justice Taft simply refused "to allow the technicality of the trust, which does not prevent the Hospital from really enjoying the income" from defeating "the beneficent purpose of Congress." 164

The Stockton case seems to stand for the principle that the acquisition of trust property charged with an annuity does not defeat the statutory purpose. The language of the opinion, however, does not justify the establishment of such a broad principle. And the lower courts have not so accepted the Stockton case even though the principle broadly stated also seems to contain some merit as a matter of logic. 165

The lower courts, however, do draw a distinction between the receipt of property under which the whole corpus or income is charged with the annuity, and where the trust has only trustee duties to perform with regard to specific property received. For example, in Scholarship Endowment Foundation v. Nicholas, 166 the donor first transferred stock and bonds to the taxpayer reserving the income from them for life. Later, under a new agreement governing the tax year involved, the donor relinquished all his interest in consideration of an annuity from the taxpayer. In denying exemption, the court said:

"It may be conceded, without deciding, that under the provision contained in the original contract...the foundation merely acted as a conduit for the receipt and transmission of such income, and did not fall outside the statute for that reason. But the new contract...the entire assets of the foundation, both capital and earnings, were unconditionally charged with the obligation." 167

Similarly, in Rodger L. Putman, 168 a deduction was denied for a contribution to a trust estate carrying on scientific work because the widow of the testator was receiving substantial benefits therefrom. And recently, the Tax Court, in William L. Powell Foundation, 169 denied exemption where transferred securities, charged with payments of their income, were commingled with the other trust assets and a higher return was paid the annuitant than was earned on the taxpayer's investments.

164 Ibid., 260 U.S. at 8, 43 S. Ct. at 5.
165 A favorite argument of the taxpayer, of course, expressed by one writer as "merely a determinable price paid for the greater asset." Ross, "A Primer On Charitable Foundations and The Estate Tax," 27 Taxes 116, 122 (1949). Judge Holmes, supra n.162, would apparently accept this principle in its broadest form. The majority of the Fifth Circuit, a tribunal that could hardly be said to be unfriendly to the taxpayer, rejected it as broadly stated in the Mabee case, supra n.161, on grounds that it would afford opportunity for evasion of the Code provision.
167 Ibid., 106 F.2d at 553.
168 6 T.C. 702 (1946); accord: The Davenport Foundation, ¶ 47,341 P-H T.C. Memo. Dec., affm'd, per cur., 170 F.2d 70 (1948).
169 21 T.C. 32 (1953).
On the other hand, in Pasadena Methodist Foundation,\textsuperscript{170} it was held that mere trustee duties and the holding of remainder interests did not result in the loss of statutory status.

An incidental diversion of income as in the Stockton case, and the situation where the exempt organization acts merely as a conduit, are easy to understand as exceptions to the Code stricture against inurement of earnings to private individuals. More difficult to define, however, is what seems to be a third exception recognized by the Tax Court and upheld by the Sixth Circuit in Commissioner v. Orton.\textsuperscript{171}

In this case, a testator's will consisted of two parts. In the first part he devised a going business concern to a non-profit foundation whose trustees were to use the net profits for research. In the second part, the residuary estate, after payment of debts, was left to his wife. As this was obviously insufficient to satisfy the wife's statutory share, the income from the commercial activities of the foundation was charged with payments to the wife totaling $42,000 over a five year period.

Upon the death of the testator, the residuary estate was insufficient to pay the testator's debts. The foundation trustees, to preserve the foundation, entered into a three party agreement under which the debts were paid and the wife was to receive an annuity of $350 a month after payment of the $42,000. By 1940 this latter amount had been paid to the wife and she was receiving $350 monthly. In 1940, the trustees paid an income tax and on being assessed a deficiency, claimed exemption under section 101(6).

In finding the taxpayer exempt, the Sixth Circuit stressed that the payments out of income were necessary to the preservation of the foundation, and held that otherwise the Stockton case controlled. The Tax Court had rationalized that the payments to the wife were not the "real purpose for which the foundation was founded."\textsuperscript{172}

The net income of the foundation, apparently after deduction of the payments to the wife, was about $13,500 annually. On this basis, the payments could hardly be characterized as incidental. It seems that the case establishes a new departure or exception; perhaps based on the post-death settlement but this is not altogether clear.

Trading and Investment Benefits. More subtle private benefits are received sometimes as a result of trading and investment transactions entered into between


\textsuperscript{172} Edward Orton, Jr. Ceramic Foundation, 9 T.C. 533, 541 (1947). "The naked implications of the Orton case appears to be that, all a donor needs to do... is to endow his 'charitable' foundation so heavily, that his wife cannot realize her dower out of the residual estate and then both the payments under his will and any additional payments she may be able to extract will be allowable to the charity as tax immune items." Note, 30 B.U.L.Rev. 116 (1950).
a grantor-incorporator and his private educational trust, foundation or corporation. Perhaps typical of this type of situation, although the litigated cases seem to be few in numbers, are the transactions disclosed in the recent Tax Court case of The Cummins-Collins Foundation.\textsuperscript{178}

In this case, the taxpayer was a two-family charitable corporation whose activities consisted largely in making gifts to various church groups. The taxpayer claimed exemption under section 101(6). On its investment side, it had purchased, indirectly, mortgage notes from its founder, and had also made loans to a distillery in which the founder had an interest by borrowing from an insurance company and from the founder. The investments made were seemingly well secured and the loans made carried a reasonable rate of interest.

The Tax Court refused to deny exempt status simply because of any indirect benefits flowing to the founders from such transactions. It emphasized that the investments were amply secured and bore reasonable rates of interest, and that, therefore, the foundation was not a mere tool of the founders. The opinion, in a dictum, pointed out that these pre-1950 transactions did not violate the prohibited transactions provisions in the \textit{Revenue Act of 1950}. These provisions are outlined below.

\textit{The Prohibited Transactions of the 1950 \textit{Revenue Act}.} As outlined in the introductory part of the paper, our concern is limited to the educational deductions of an individual or corporation for purposes of the income tax. The \textit{Revenue Act of 1950} imposed some important restrictions on this deduction.

It was pointed out above that the measures restricting the commercial activities of educational organizations, taxing their unrelated business income and denying exempt status to commercial feeders, have no effect on the deductibility of a contribution made to, or for the use of, an educational organization. Similarly, the restrictive measures taken with regard to unreasonable accumulation of income by charitable organizations have no effect on deductibility. Here, perhaps, simplicity ends.

In general, deductions are denied for a gift made to, or for the use of, an otherwise qualified educational organization when its income or corpus is used in certain prohibited transactions. In the case of a section 162 trust, the restriction is limited to income or corpus which has been "permanently set aside or is to be used" for educational (or other charitable) purposes.\textsuperscript{174}

\textsuperscript{178} 15 T.C. 613 (1950).
\textsuperscript{174} Sec.162(g) (2) (B).
The non-deductibility sanctions, pertinent here, are to be found in section 162(g)(2)(E),\textsuperscript{176} and in section 3813(e).\textsuperscript{176} The former provision would apply to gifts made in establishing, and in gifts made to, a trust that itself could not qualify under section 23(o)(2) or section 23(q)(2), but where such gifts would ordinarily be deductible as being made "for the use of" educational purposes. The second provision, section 3813(e), applies to all corporations, trusts, foundations and other organizations otherwise qualifying under section 23(o)(2) and section 23(q)(2). However, and this is important, section 3813(a) expressly excepts five specific types of organizations from being subject to the prohibited transactions provisions. One of these expressly excepted types is "an educational organization which normally maintains a regular faculty and curriculum and

\textsuperscript{176} Sec. 162(g)(2)(E) provides: "No gift or bequest for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and the prevention of cruelty to children or animals, otherwise allowable as a deduction under section 23(o)(2), 23(q)(2), 162(a), 505(a), 812(d), 861(a)(3), 1004(a)(2)(B), or 1004(b)(2) or (3), shall be allowed as a deduction if made in trust and, in the taxable year of the trust in which the gift or bequest is made, the deduction allowed the trust under subsection (a) is limited by subparagraph (A). With respect to any taxable year of a trust in which such deduction has been so limited by reason of entering into a prohibited transaction with the purpose of diverting such corpus or income from the purposes described in subsection (a), and such transaction involved a substantial part of such income or corpus, and which taxable year is the same, or prior to the, taxable year of the trust in which such prohibited transaction occurred, such deduction shall be disallowed the donor only if such donor or (if such donor is an individual) any member of his family (as defined in section 24(b)(2)(D)) was a party to such prohibited transaction."

Subsection (a) is § 162(a) providing the unlimited charitable deduction referred to in n.23, supra. Subparagraph (A) is § 162(g)(2)(A) limiting such deduction to 15\% where the prohibited transactions of subparagraph (B) are engaged in. Such are the devious ways of the legislative draftsman.

To invoke the 15\% limitation, § 162(g)(2)(C) requires notification by the Secretary unless the diversion was purposeful and involves a substantial part of the income or corpus. This explains the last sentence, ibid.

Sec. 3813(e) provides: "No gift or bequest for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and the prevention of cruelty to children or animals), otherwise allowable as a deduction under section 23(o)(2), 23(q)(2), 162(a), 505(a)(2), 812(d), 861(a)(3), 1004(a)(2)(B), or 1004(b)(2) or (3), shall be allowed as a deduction if made to an organization which, in the taxable year of the organization in which the gift or bequest is made, is not exempt under section 101(6) by reason of the provisions of this section. With respect to any taxable year of the organization for which the organization is not exempt pursuant to the provisions of subsection (c) by reason of having engaged in a prohibited transaction with the purpose of diverting the corpus or income of such organization from its exempt purposes and such transactions involved a substantial part of such corpus or income, and which taxable year is the same, or prior to the, taxable year of the organization in which such transaction occurred, such deduction shall be disallowed the donor only if such donor or (if such donor is an individual) any member of his family (as defined in section 24(b)(2)(D)) was a party to such prohibited transaction."

For loss of exempt status, § 3813(c)(2) requires notification by the Secretary to the organization unless the diversion was purposeful and involves a substantial part of the income or corpus. This explains the last sentence, ibid.
normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."\textsuperscript{177}

In short, as one authority put it: "any organization which engages in any prohibited dealings is, for tax purposes, outlawed."\textsuperscript{178} A study of the excepted organizations and the prohibited transactions, however, indicates that this statutory outlawry is limited to what might be termed "private" organizations as distinguished from "public" organizations. This was apparently the theory or reason behind the exceptions thus created.

Section 3813(b), in defining prohibited transactions, provides:

"For the purposes of this section, the term 'prohibited transaction' means any transaction in which an organization subject to the provisions of this section—

(1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;

(2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

(3) makes any part of its services available on a preferential basis to;

(4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;

(5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

(6) engages in any other transaction which results in a substantial

\textsuperscript{177} Sec.3813(a) provides: "This section shall apply to any organization described in section 101(6) except—

(1) a religious organization (other than a trust);

(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;

(3) an organization which normally receives a substantial part of its support (exclusive of income received in 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(6)) from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public;

(4) an organization which is operated, supervised, controlled, or principally supported by a religious organization (other than a trust) which is itself not subject to the provisions of this section; and

(5) an organization the principal purposes or functions of which are the providing of medical or hospital care or medical education or medical research."

\textsuperscript{178} Eaton, "Charitable Foundations and Related Matters Under The 1950 Revenue Act," 37 Va. L.Rev. 1, 27 (1951). The other sanctions include the loss of exempt status under § 101(6), and for § 162 trusts, a limitations of its charitable deductions to 15% of net income. Sec.3813(e), supra n.176, and § 162(g)(2)(E), supra n.175 indicate the scope of the deductibility sanctions. The prohibited transactions provisions apply to dealings after July 1, 1950 and the deductibility sanctions to gifts made on or after January 1, 1951. The regulations are extensive, largely paraphrasing the committee reports.
diversion of its income or corpus to; the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in section 24(b)(2) (D)) of an individual who is the creator of such trust or who has made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 per centum or more of the total combined voting power of all classes of stock entitled to vote or 50 per centum or more of the total value of shares of all classes of stock of the corporation.”

Section 162(g)(2)(B) contains a similar definition of prohibited transactions for purposes of section 162 trusts, but limited to “income or corpus which has been permanently set aside or is to be used exclusively for charitable or other purposes described in subsection (a).”

It is not the purpose of this survey to discuss in detail the effect of these statutory provisions on the developed judicial doctrine. However, these general observations might be made: (1) as regards the tax entities covered, the statute is restricted generally to the limited group of creator and family members; (2) within the limited group covered, the statute establishes rules that go beyond the developed judicial doctrine and general provisions of the Code, e.g. the controlled corporation rules and those providing for transactions dealing with “corpus” and “income” rather than "net earnings" only; (3) these provisions do not preempt the field, i.e. the other provisions of sections 23(o)(2), 23(q)(2), 101 (6), etc. must still be complied with; (4) the provisions may establish a judicial guide for persons and transactions not expressly covered; (5) these provisions will probably be productive of considerable litigation (how much will depend upon taxpayer boldness and willingness to risk the imposition of the sanctions); and, (6) in the policy area, as new techniques of avoidance are developed, perhaps additional statutory measures can be anticipated.