CSU
College of Law Library

Cleveland State Law Review

Volume 16
Issue 2 *Real Property Torts (Symposium)*

Article

1967

Unreasonable Accumulation of Income by Foundations

Joel H. Feld

Follow this and additional works at: https://engagedscholarship.csuohio.edu/clevstlrev

Part of the Business Organizations Law Commons, and the Taxation-Federal Commons

How does access to this work benefit you? Let us know!

Recommended Citation

Joel H. Feld, Unreasonable Accumulation of Income by Foundations, 16 Clev.-Marshall L. Rev. 362 (1967)

This Article is brought to you for free and open access by the Journals at EngagedScholarship@CSU. It has been accepted for inclusion in Cleveland State Law Review by an authorized editor of EngagedScholarship@CSU. For more information, please contact library.es@csuohio.edu.

Unreasonable Accumulation of Income by Foundations

*Joel H. Feld**

UNREASONABLE ACCUMULATION of income was and still is one of the common abuses found in some foundations. Prior to 1950 the Internal Revenue Service challenged foundation exemption by stating that unreasonable accumulations of income were evidence that the foundation was not organized for, or carrying out, a charitable purpose.[1] The courts were reluctant to follow this theory, and gave the law a liberal interpretation in favor of the foundations.[2]

It was not until 1950 that Congress enacted Section 3814 of the Internal Revenue Code of 1939.[3] The law is the same today in the Internal Revenue Code of 1954, under Section 504,[4] Denial of Exemption. A foundation may lose its exemption under Section 504 of the Internal Revenue Code

> If the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—
> (1) are unreasonable in amount or duration to carry out the . . . purpose or function constituting the basis for the "foundation's" exemptions; . . . or
> (2) are used to a substantial degree for purposes or functions other than those constituting the basis for exemptions; . . . or
> (3) are invested in such a manner as to jeopardize the carrying out of "such purpose or function." [5]

To determine what is accumulated income the basic principles of accumulated earnings and profits of a corporation must be applied to the operation of a foundation.[6] Two types of transactions which realize income and are not considered in determining accumulated income are, gains upon the sale and exchange of donated assets and gains upon the sale and exchange of property held for the production of income where the proceeds are reinvested within a reasonable time.[7]

---

* B.B.A., Ohio University; Third-year student at Cleveland-Marshall Law School of Baldwin-Wallace College.

[1] Fremont-Smith, Foundations and Government, 171-172 (1965).

[2] Mulreany, Permissible Accumulations, Proceedings of the New York University Sixth Biennial Conference on Charitable Foundations, 157 (1963).

[3] Int. Rev. Code of 1939, § 3814.

[4] Int. Rev. Code of 1954, § 504.

[5] *Ibid.* See, for a summary, Oleck, Non-Profit Corporations, Organizations & Associations, 411 (2d ed., 1965).

[6] Treas. Reg. § 1.504-1 (c).

[7] *Id.* § 1.504-1 (c) (1 & 2).

Another basis for determining what is reasonable accumulation of income is the group of revenue rulings handed down by the IRS. Thus, it was held that a charitable foundation which only made distributions to tax-exempt hospitals and research organizations, and which was supported by a sole contributor, was allowed to accumulate income for a three year period.[8] A foundation was allowed to accumulate income for a ten year period in order to restore capital used for charitable contributions.[9] A foundation may create a reserve for scientific and educational projects and deduct the total amount to be contributed in the year that it is pledged, even though it will be paid over a period of time.[10] Contributions made during the year are offset first by current income, against contributions received during the taxable year, and last against capital held at the beginning of the year.[11] These rulings are rather limited and conservative and not necessarily conclusive indications of the general policy of the IRS.[12]

A third area for determining reasonable and unreasonable accumulations of income consists of case rulings. Thus, it was held in 1954 that under a trust agreement a foundation could accumulate a percentage of trust income to be used in the future for charitable purposes, and income accumulated would be considered a deduction in the year that it was earned.[13] A year later the Tax Court ruled in favor of a foundation that purchased all the stock of a corporation, from which it received its entire income, and used this income to pay off a series of notes given to the corporation. The court held that as long as the foundation was operating for an exclusively educational purpose there was no requirement for the income to be distributed in the year in which it was realized.[14]

The case of *Samuel Friedland Foundation v. United States,*[15] was the first case to state a basic rule that could be applied generally as to unreasonable accumulation of income. That foundation planned to accumulate $500,000, over a six to eight year period, in order to build a medical research building at Brandeis University. The court formulated a basic test for the reasonable accumulation of income, as follows:

> Does the charitable organization have a concrete program for the accumulation of income which will be devoted to a charitable pur-

---

8 Rev. Rul. 54-137, 1954-1 Cum. Bull. 289.

9 Rev. Rul. 54-227, 1954-1 Cum. Bull. 291.

10 Rev. Rul. 55-674, 1955-2 Cum. Bull. 264.

11 Rev. Rul. 58-535, 1958-2 Cum. Bull. 270.

12 Mulreany, *op. cit. supra,* n. 2, at 161.

13 Authur Jordan Foundation v. Commissioner, 210 F. 2d 885 (6th Cir. 1954).

14 Ohio Furnace Co. Inc. v. Commissioner, 25 T. C. 179 (1955).

15 144 F. Supp. 74 (D. C. N. J. 1956).

pose and, in the light of existing circumstances, is the program a reasonable one? . . . The factors to be considered seem to be:

(a) Purpose of accumulating a dollar goal, . . .

(b) Funds available at the starting point to be devoted to accumulations, . . .

(c) Likelihood of funds becoming available from contributions to be added to accumulation to reach dollar goal, . . .

(d) Extent of time required to reach dollar goal. . . .[16]

The court held that the proposed plan came within these general rules. Even though this is not the majority rule, it has been applied by the courts.[17] The court upheld a ten-year accumulation of income by a foundation created solely for the purpose of providing retirement benefits, so as to increase these benefits from $15 to $60 monthly.[18] It was held reasonable for a foundation to accumulate $1.4 million over a fourteen-year period for the construction of a civic auditorium.[19]

The case of *A. Shiffman v. Commissioners*,[20] is an example of the liberal interpretation, by the courts, as to unreasonable accumulation of income. This foundation, with a net worth of approximately $1,000, purchased industrial real property for $1,150,000. The foundation received $154,000 in advance rentals and borrowed $1,000,000 to complete this purchase. During the next five years the income was used to pay off the indebtedness. The court held that this was not a speculative investment, nor such an unreasonable accumulation of income as to warrant a denial of exemption. The reasoning of the court was that after the indebtedness was paid, the entire net income would be available for charitable purposes. In a similar case, a foundation had an equity of $60,000 and purchased real property subject to an industrial first mortgage of $120,000 and a second mortgage of $50,000 in favor of the donors. The income was used to make payments on the mortgage and premiums for life insurance on the life of the founder. The court held that this was not unreasonable accumulation of income that would jeopardize the carrying out of its charitable purpose.[21] The court was right when they said that these investments were not speculative. There is nothing speculative about buying land and paying it off with tax-free income in a fraction of the time it would take a corporation or individual burdened by a high tax rate. It is hard, if not impossible, to reconcile these decisions with those in the *Friedland* case and the *Hulman* case, where accumulations were used for a planned program with a charitable purpose.

---

[16] *Id.* at 92-93.

[17] Fremont-Smith, *op. cit. supra*, n. 1, at 176.

[18] Truscott v. U. S., 58-1 U. S. T. C. par. 9515 (D. C. E. D. Pa. 1958).

[19] Hulman Foundation v. U. S., 217 F. Supp. 423 (D. C. Ind. 1962).

[20] 32 T. C. 1073 (1959).

[21] Tell Foundation v. Wood, 58-1 U. S. T. C. par. 9111 (D. C. Ariz. 1959).

In *Erie Endowment v. United States,*[22] the court upheld exemption of a foundation created by an inter vivos trust. The trust agreement specified that a percentage of income was to be accumulated each year, until the amount of $10 million was reached. They applied the tests laid down in the *Friedland* case and held that the foundation did not have a specific purpose for which the money would be used, other than contributions to already organized charities. A similar decision was handed down where a foundation accumulated over $600,000, using only a small portion of their income for student loans.[23]

In the case of *Akron Clinic Foundation v. United States,*[24] the court formulated a new theory. The income of the foundation was used to reduce their original debt, and the government contended that this was an unreasonable accumulation of income. The court held that there was no actual accumulation of debt-free capital and that once the debt was paid all income would be available for charitable purposes.

The only case to date where the sole issue was unreasonable accumulation of income was *Danforth Foundation v. United States.*[25] For about twenty-five years this foundation had been accumulating a percentage of income each year and by 1950, when Section 3814 was enacted,[26] (now Section 504 of the Internal Revenue Code of 1954) the accumulation had reached a substantial amount. Prior to 1950 the foundation contracted for the services of a full-time director to develop charitable programs, but negotiations were not completed until 1951. The court did not dispute the fact that the foundation was organized and operated for a charitable purpose, but had to deny exemption for lack of a concrete program for which accumulations could be justified. Even though the new director was in the process of planning new charitable programs, the court was looking at the years in question—not at what would happen in the future.

The *Patman Report*[26] is a study of 534 foundations for the period from 1951 through 1961. Its purpose was to determine whether legislation is needed in the area of tax-exempt foundations and charitable trusts. It revealed that almost $7 billion in such entities went untaxed in these years. This figure represents the funds of a sample of only 534 out of the estimated total of 45,124 known tax-exempt foundations

---

[22] 202 F. Supp. 580 (W. D. Pa. 1961), affd., 316 F. 2d 151 (3d Cir. 1963).

[23] Stevens Bros. Foundation, Inc. v. Commissioner, 324 F. 2d 633 (8th Cir. 1963), cert. denied 376 U. S. 969, 84 S. Ct. 1135 (1964).

[24] 226 F. Supp. 515 (N. D. Ohio 1964).

[25] 222 F. Supp. 761 (E. D. Mo. 1963), affd., 347 F. 2d 673 (8th Cir. 1965), cert. denied, 382 U. S. 955, affd., 347 F. 2d 673.

[26] Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy, Chairman's Report to the Select Committee on Small Business, House of Representatives, 87th Cong., 2d Sess. V (December 31, 1962). The second and third installments of this report will be identified as such and all three will be referred to as the "Patman Report." A fourth report was published on Dec. 21, 1966.

extant in 1960. In the *Treasury Report* that followed, the number of foundations was estimated at 15,000 in 1962, increasing at a rate of 100 per month.[27] It was discovered that the group of foundations under study had accumulated income of $271,615,733 at the end of 1959 and $906,136,256 at the end of 1960.[28] One reason for this large increase in accumulations is the lack of audits on the part of the IRS. In the second installment of the Patman Report,[29] 433 out of the 546 sample foundations under study were said to have had no field audit from 1952 through 1962. The total value of assets of the 546 foundations was $10,321,245,379 and the asset value of the 433 which had no field audits was $8,670,-528,830. Also, the ten largest foundations in the study, including the Ford Foundation, Rockefeller Foundation, Carnegie Corporation of New York, and The Duke Endowment, went without a field audit. This lack of audits, which gives rise to lack of control by the IRS over foundations, leaves the door wide open for the accumulation of income.

These are some of the reasons why the Patman Report urges an immediate moratorium on the granting of exemptions to foundations and other non-profit organizations. One recommendation is to consider all capital gain income and contributions to the foundation as income and not capital, so it will be included in determining accumulation of income. This would avoid the transferring of funds from one foundation to another, controlled by the same person, as capital which is not considered in determining accumulation of income.[30] However, this is considered a charitable contribution by the foundation transferring the funds.

The United States Treasury Department submitted its report on foundations to Congress in February, 1965.[31] The Treasury Report distinguished an operating foundation from a non-operating foundation. An operating foundation is a

> privately supported organization which has substantially more than half of its assets directly devoted to active charitable activities. Such an organization must also expend substantially all of its income for charitable purposes on a current basis.[32]

A non-operating foundation contributes to operating foundations, or, in many cases, their income is accumulated and no charitable benefit is gained. The point is brought out that in both cases a deduction may be taken by the contributor, but in the case of a non-operating founda-

---

27 Treasury Department Report on Private Foundations, Comm. Print., Comm. on Finance, U. S. Senate 89th Cong., 1st Sess. 55 (Feb. 2, 1965). Hereinafter this will be referred to as the "Treasury Report."

28 Patman Report, 1st install., *op. cit. supra* n. 26, at 4.

29 *Id.* 2d install., *op. cit. supra* n. 26, at 13, 14.

30 *Id.* 1st install., *op. cit. supra* n. 26, at 134.

31 *Op. cit. supra* n. 27, at 23.

32 *Id.* at 23.

tion the charitable benefit to the public is delayed and, in many cases, never received.[33] The suggestions made in order to combat these inequities in the law apply primarily to non-operating foundations, more commonly known as donor-controlled foundations, whereby one person, a corporation, or a single or few families are responsible for all contributions made to the same foundation. One solution is that all non-operating foundations distribute their entire income, excluding long term capital gains and contributions made to the foundations, in the year following the year when the income was received. The purposes for which the income would be expended would be:

> (1) contributions to publicly supported charitable organizations, (2) contributions to privately supported operating organizations, (3) direct expenditures for charitable programs, and (4) purchases of assets which the foundation uses as part of its program of charitable activities.[34]

Two exceptions to this rule are that non-operating foundations would be allowed to accumulate income for a five-year period for a definite charitable purpose, and amounts expended in excess of income, for a charitable purpose, could be accumulated to recoup the capital expenditure.[35] Another solution suggested by the Treasury Department is called "income equivalent." [36] By this method a foundation would be required to distribute a percentage of its total assets, excluding those used directly for charitable programs, in one of the methods described above.[37] The reason for this is to stop non-operating foundations from investing in low-income-producing investments. This would force foundations to seek the maximum income yield on their investments. The Treasury Department has suggested a 3 to 3½ per cent range. If a foundation's income does not reach this percentage, it then would have to dip into capital to make up the difference. The catch is that if ordinary income exceeds the income equivalent percentage, then ordinary income must be distributed. Many foundations and individuals have objected to the Treasury's proposals. One letter received by the Treasury Department questioned the definition of an operating foundation and particularly the words "substantially more than half" and "substantially all." [38] These words seem to be very general and could easily confuse the administrators and directors of a foundation. Another letter objecting to the income equivalent rule, stated that the Lilly Endowment receives only 2 per cent on the market value of its stock holdings. On the other hand, it has expended almost twice the amount of

[33] *Id.* at 23, 24.
[34] *Id.* at 34, 35.
[35] *Id.* at 35.
[36] *Id.* at 36.
[37] *Id.* at 36, 37.
[38] *Id.* at 206.

donations it has received since its founding.[39] There is no question as to the benefits extended by this organization, but there is a question of whether it will be able to continue if the Treasury Department proposals are enacted into law. The Duke Endowment has a similar problem. The stock of the Duke Power Company is selling at forty dollars per share and giving a dividend of one dollar per share, which is less than 2½% of market value.[40]

The wording of Section 504 of the Internal Revenue Code is very vague and misleading. There is no way for a foundation to determine what is unreasonable accumulation of income. When a foundation's director plans charitable programs he must worry whether or not the IRS will deny exemption for accumulating income. Court decisions are of little use unless his problem is directly on point, with a case already decided. A uniform rule regarding accumulation of income has not been handed down by the courts. In the *Friedland* case[41] the court handed down a sound test to determine reasonable accumulation, which should be followed in all cases.

There is one major difference between the Patman Report and the Treasury Report, having to do with capital gain income and contributions. The Patman Report revealed that there was $1,477,272,841 received in capital gain and $2,304,282,109 received in contributions for only 534 out of the estimated 45,124 foundations.[42] The Treasury Report excluded these sources as income under their first proposal. If these dollars were used for charitable programs instead of being accumulated, the government would be relieved of a great financial burden. As a result the tax rate on corporations and individuals could be lowered.

As this note goes to press, the New York *Times* reports a case in the United States Tax Court wherein the Happiness Exchange Foundation and its allegedly controlling parent, the American Chai Trust, both allegedly controlled by one family, were charged with planning to evade taxes and using funds for personal purposes. Chai remains tax exempt, but Happiness was billed for $981,863.34, its exemption having been revoked in 1963. Unreasonable accumulations were not the primary complaints, but gathering of contributions was the source of the funds of Happiness, which is one aspect of accumulations. The case will be tried in the fall.[43]

The proposals set forth in the Patman Report and Treasury Report would have little or no effect on truly charitable foundations. Since they are always engaged in a definite charitable program, accumula-

---

39 *Id.* at 361.

40 *Id.* at 506.

41 *Supra* n. 15.

42 Patman Report, 1st install., *op. cit. supra* n. 26, at 4.

43 N. Y. Times, p. 29 (Mar. 7, 1967).

tions, if needed, could easily be justified. The proposals would affect the foundation organized solely to avoid income tax, retain interest in a family business, or pass on an estate from one member of a family to another without the burden of death taxes. It is one thing to propose a new law, and another thing to have it passed. The first Patman Report came out in December of 1962 and the Treasury Report in February of 1965, during which time the law was not changed. It is now March of 1967 (as this is written) and still there is no change.[44] It would seem that Congress is very slow in changing a law that would relieve the Federal Government of a great financial burden. Then again, it could be that foundations are so powerful that even the Congress of the United States hesitates to confront the problem. In either case, legislation is desperately needed in this area.

---

[44] But, Newsweek Magazine, in the issue of Mar. 13, 1967 (p. 74), reports that the House Ways & Means Committee will hold hearings on needed legislation. Ironically, this appears on the page titled "Business Trends" (subtitled, "Foundations on the Grill").