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Frank C. Fogl Jr.

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The "Bootstrap" Loophole: Can It Be Closed?

Frank C. Fogl, Jr.*

THE PURPOSE OF THIS PAPER is to review the history and background of *bootstrap* transactions and to determine: (1) Whether there is a need to close the bootstrap loophole; (2) If so, why this loophole has not been closed in the past; (3) Whether the Internal Revenue Code as it now exists contains provisions, if used, that can close this loophole; (4) If new legislation would be required to reach this end. A few key cases will be reviewed and analyzed, with major emphasis placed on the recent *Clay Brown*¹ decision, to show the attitude toward bootstrap transactions of both the Internal Revenue Service and the courts.

What exactly is a bootstrap transaction? An early definition of a bootstrap sale was: "A transaction in which a business, in effect, purchases itself."² The owner receives capital gains treatment on the "sale" for what would normally be ordinary income and yet continues to occupy the same economic position as before the transaction. A more current definition is: "A bootstrap acquisition is basically a three-party sale and lease-over agreement in which a business is purchased out of its own profits."³

The tax effect of a bootstrap sale of a business is that capital gains rates can result where the purchase price is paid out of the future earnings of the business. However, these earnings could be taxed as ordinary income to the purchaser before he transfers them to the seller. To secure the advantage of having this income escape taxation before it is funnelled to the seller, a tax-exempt purchaser is used. "Such a sale, where a charitable organization is the purchaser, can be used to attempt to make use of the capital gains and tax-exempt organization provisions of the Internal Revenue Code to effectuate a higher purchase price and more tax savings to the seller than an outright sale to a non-exempt organization would produce."⁴

Typically, under a bootstrap plan where the sale of a company's stock is made to a tax-exempt charitable organization, the corporation's assets are "leased" to a new operating company. The latter then pays a major portion of the business' profits to the foundation as rent, which the foundation in turn uses in part to pay the purchase price due the

* B.B.A., Fenn College of Cleveland State University; Account Executive, Merrill Lynch, Pierce, Fenner and Smith, Inc.; Fourth-year student at Cleveland-Marshall Law School of Baldwin-Wallace College.

¹ *Commissioner v. Brown*, 380 U. S. 563, 85 S. Ct. 1162 (1965).

² Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business—I and II*, 108 U. Pa. L. Rev. 623 and 943 (1960).

³ Note, *Bootstrap Acquisitions: The Next Battle*, 51 Iowa L. Rev. 992 (1966).

⁴ Note, *"Bootstrap" Sales in the Supreme Court*, 40 Notre Dame Law. 304 (1965).

original sellers. As a rule, the old company's management stays on to run the new concern operating under the lease.

History and Background

Bootstrap transactions have existed and have been sanctioned by the courts since the adoption of the 1939 Code. The early "sales" were made by the original owners to a "feeder" tax-exempt corporation. This very simple procedure was within the provisions of the 1939 Code. The only real questions were: (1) Was the sale eligible for capital gains treatment? (2) Is the feeder corporation entitled to tax exemption under section 101 of the 1939 Code?⁵ The amendments made in 1950, although they did not close the bootstrap loophole completely, did make this type of bootstrap transaction more difficult. Therefore, resourceful tax lawyers developed the "lease" bootstrap. It is interesting to note that when the 1950 Revenue Act was being discussed, the House Bill would have prevented many of the current abuses of exempt institutions. The Senate, however, rejected these provisions as too harsh—it felt that there could be no objection nor use of tax evasion devices when transactions would be forced to be carried out at arms length. Unfortunately, both the Commissioners and the courts chose to "focus upon whether a particular transaction would be fitted within a choice of labels—'sale' or 'no sale,' 'notes or stock,' 'assignment' or 'license,' 'sale' or 'lease'—rather than upon examining the substance of the relationships behind such concepts."⁶

Bootstrap sale cases have certain elements in common: (1) a seller—either a taxpayer or a corporation, (2) a buyer which is a tax-exempt corporation, (3) sale by the first to the second of some income-producing property, (4) the buyer does not have assets available to purchase the property, (5) the consideration payments are made by the buyer out of the income produced by the property purchased. The lease bootstrap adds the feature of the tax-exempt corporation leasing the property to a third corporation which is established solely for the purpose of operating the property purchased. As a usual matter, the same people who operated the first corporation, control and manage the established leasing corporation. The latter operates the property and pays a large proportion of the earnings to the tax-exempt buyer. The buyer in turn applies a large part of this "lease" income to the payment of the note owed to the seller. Although this would appear on its face to be an obvious tax eva-

⁵ Lange, *Bootstrap Financing: The Redemption Technique*, 18 *Tax L. Rev.* 323 (1963). For purposes of the article, the author assumed that the basis of the purchased assets equals their fair market value. With this assumption, he discusses reducing the corporation's marketable size through the redemption of the shares of selling stockholder's by the corporation. His feeling is that this does not constitute a sham or tax-motivated device.

⁶ Lanning, *op. cit. supra* n. 1 at 627.

sion maneuver, a look at some key cases will indicate that the courts have managed to cloud the obvious by attaching labels to the various transactions and showing how each one taken individually is within the provisions (if not the spirit) of the Internal Revenue Code.

One of the first important Tax Court cases was that of *Emanuel N. Kolkey*.⁷ Here a reducing pill business was "sold" for \$4,000,000 to a new corporation with assets of only \$1,000. Of the price, \$400,000 was a down-payment obtained by drawing cash from the old business. The balance of the price was represented by notes to be paid over a period of years. The old owners kept full control and management of the business. Charity received a total of only \$43,000 from the entire transaction. Two years later, two of the original owners purchased the notes held by the third for less than two cents on the dollar. Judge Pierce of the Tax Court emphasized substance over form in his decision which held that this was not an arms-length transaction but only constituted a closed circuit. The total picture was viewed and the decision was based not upon "labels" and "legal myths" but upon factual considerations—evidence that indicated the retention of control and risk by the seller, the lack of new capital or new management, the absence of effort to enforce the notes upon default and the inflated price. The courts say, "Whether these maneuvers are characterized as integrated steps of one transaction . . . or in some other fashion, one thing is clear, and that is by using several legal switches, these taxpayers connected up a closed circuit whereby the output of . . . undistributed earnings and profits must flow to the "seller" whenever the third corporation is energized."⁸

With a clear pattern set in the *Kolkey* decision, it would appear that the bootstrap loophole was closed. The Commissioner need only show that despite the legal maneuvers, the end result was a "closed circuit" intended to serve as a tax dodge. So too, the course that the courts should set was firmly established—that of viewing the entire transaction rather than each individual step. However, neither the Commissioner nor the courts chose to follow the methods that would lead to the obvious conclusion—rather, both were determined to follow the more familiar method of placing labels and analyzing each step of the transaction. If the labels fit, and all the seemingly proper steps taken, the real purpose of the sale need never be considered and the conflict could be resolved in terms of traditional thinking. The major example of this type of case was that of *Clay Brown*.⁹

Briefly, the major issue in *Brown* was whether or not there was a real sale of assets, since the third corporation formed was substantially owned by the sellers of the first corporation. Here again we find the

⁷ 27 T. C. 37 (1956), aff'd. 254 F. 2d 51 (7th Cir. 1958).

⁸ *Id.* 254 F. 2d at 54 (7th Cir. 1958).

⁹ 37 T. C. 461 (1961), aff'd. 325 F. 2d 313 (9th Cir. 1963), aff'd. 380 U. S. 563, 85 S. Ct. 1162 (1965).

“closed circuit” of *Kolkey*—if the court and the Commissioner would only look to the substance of the transaction instead of arguing over technicalities of form. The Commissioner chose to assert that the transaction was a sham sale because of the same control being carried through. The court found that the charity and corporation had bargained in good-faith, at arms-length and therefore the sale was a sale. The label “sale” was applied as soon as each step of the deal could be classified in legalistic terms such as, “bargained in good-faith” and “at arms-length.”

In affirming the Tax Court’s decision in *Brown*, the Supreme Court held that the transfer was a “sale” and that taxpayers were entitled to capital gains treatment on the proceeds which were not taxable as ordinary income on the basis that there had been no risk-shifting to the institute. Basically, the court claimed that it was a sale because: (1) The price was reasonably based on the net worth and earnings of the company; (2) There was no evidence that if the price was excessive, that resulted from the lack of risk-shifting.

What happened to *Kolkey*? Were the guidelines set down therein forgotten? No, they were not. You need only to look into the Supreme Court dissent in *Brown* to find them. This opinion felt that the transaction should not be allowed to convert ordinary income into capital gains because: (1) The business continued under a new name only, with no essential change in the control of its operations; (2) There had been no significant shift of economic risk or control of business. Although this would appear to be the better reasoning, it did not prevail since the majority felt that the charity had bargained in good-faith, at arms-length. Instead of the left hand passing income to the right, which would have resulted in taxation at corporation rates, charity—in good-faith and at arms-length—took it from the left and placed in the right. Result? Capital gains.

Apparently, some feeling remained with the Tax Court that its decision in *Kolkey* might not be fully agreed with, for it went to great lengths to once again explain it in the case of *Royal Farms Dairy Co.*¹⁰ In this case, stockholders sold all the stock to a foundation at the suggestion of the foundation, at a price of \$2,680,000, of which \$2,360,000 was to be paid by the issuance of notes. Eighty per cent of the earnings of the new corporation were to be paid to the foundation, ninety per cent of which were to be paid in turn upon the purchase price. The dairy involved would have sold for less in a cash sale. In the decision resolving this case, the court points out the difference between the *Kolkey* and *Brown* cases. In giving the matter further consideration, the court felt that *Brown* did not follow *Kolkey* because the price did not exceed the fair market value and the former owners never regained full

¹⁰ 40 T. C. 172 (1963).

control of the corporation. It is true that the price in *Kolkey* did exceed the fair market value by four times, and the former owners did regain control of the corporation one year after the "sale." However, the heart of the decision was based on the "closed circuit" formed for the purpose of evading taxes. In *Royal Farms Dairy Co.*, the court now could strain to apply *Brown* by defining this type of transfer as a sale because it involved a real change of status from owners of the business to a holder of security interest and contemplated ultimate relinquishment of even the security interest within a reasonable time. It is apparent that the *Clay Brown* decision has opened a Pandora's Box, so additional study should be given to this case as it passed from court to court and ultimate decision.

Commissioner v. Brown

In December 1961, the Tax Court handed down its decision in *Brown*.¹¹ This was the beginning of a journey for the case through the courts which ended in the Supreme Court. In this case, the stockholders in a lumber and sawmill corporation sold their stock to a charity, in consideration for a non-interest bearing note in the amount of \$1,300,000. The agreement of sale was reached after the owners had approached the charity through investment counselors. Immediately upon acquisition of the stock, the charity liquidated the corporation and leased the assets under a five year lease to a new operating company which was formed by attorneys for the sellers. Under the terms of the lease, the new company was required to pay to the charity an amount each year equal to eighty per cent of the net profits resulting from the use and occupancy of the leased property. The charity was in turn to pay to the selling shareholders ninety per cent of the funds received by it from the lessee operating company.

In pursuing his attack against the sellers' right to receive capital gains treatment, the Commissioner contended in the Tax Court that there was no sale. Furthermore, even if in fact the sellers had sold their stock in accordance with the numerous documents which purported to reflect the sale, the sellers still retained such an economic interest in and control over the property sold that the transaction should not be treated as resulting in long-term capital gain for federal income tax purposes. In substance, the Government's position was that the transaction was an agreement whereby the sellers would siphon off the profits from the corporation business at capital gains rates and then terminate it by having the charity turn back the properties to the shareholders. The court held that the facts did not support the Commissioner's contention, stating: ". . . Petitioners by the transaction here involved parted with their

¹¹ *Supra* n. 9.

equitable ownership of the assets when they transferred their stock to the institute and became the creditors of the institute with mortgages and a management contract as security for the payment of the purchase price of the stock. This change of interest constitutes a change of economic benefits thus distinguishing this case from the cases relied on by respondent.”¹² The court added, that so long as a sale to an exempt organization of stock in a corporation engaged in a commercial business is legal, and where it is in substance as well as in form of sale, it is not to be ignored for tax purposes solely because the exempt organization is willing to pay a somewhat higher price than someone else might pay.

There were six dissents in the *Brown* case at the Tax Court level, with Judge Pierce speaking for the dissenters. It is of interest to note that Judge Pierce decided the *Kolkey* case, which was the only major case of this type decided in favor of the Commissioner's contention that a sham sale had occurred. In the *Brown* dissent, great stress was placed on “the trueness of the situation in the light of realities.”¹³ The majority, as noted above, claimed to have considered the substance as well as the form of the transaction in reaching its conclusion. However, the facts did not appear to support the conclusion reached—at least not in the mind of the Commissioner.

In the appellate court,¹⁴ the government dropped its “sham” contention and restricted itself to the argument that there was not a “sale” because certain normal aspects of a sale of a business were missing. The alleged missing aspects, according to the government, were: (1) shift of business risk (2) shift of benefit of income (3) shift of operational control (4) permanent shift of ownership of assets and (5) release of sellers from business indebtedness. The circuit court said that the Tax Court's opinion had answered the government as to all five supposedly missing aspects.

The government carried the case to the Supreme Court where, in an opinion written by Justice White, the Ninth Circuit's holding was affirmed and capital gains treatment was assured to the seller. The majority opinion seemed to place great stress upon the Tax Courts' finding that the sale price was reasonable. With this finding of fact, the sellers were entitled to capital gains treatment of the realization upon the increased value of a capital asset. The court then used the reasonable price discussion to move into the risk-shifting area.

After pointing out that the Commissioner had abandoned his “sham

¹² *Id.* at 484.

¹³ O'Neill, *Sales of Businesses to Charities—The Brown Case and Its Aftermath*, 43 *Taxes*, 507, 511 (1965). Methods of selling prospering businesses to charities in order to achieve deductibility of the rental payments by the operating company and the application of the sale label to afford to the sellers capital gains treatment are thoroughly discussed.

¹⁴ Upon the Government's appeal in *Brown*, the Ninth Circuit Court of Appeals affirmed the tax court's holding. 325 F. 2d 313 (1963).

sale" argument in the Court of Appeals, the opinion discusses at length the position of the government that no "sale" had taken place for tax purposes. This argument was based principally on the theory that since there was no risk-shifting, there could be no sale.¹⁵ The court disposed of the Commissioner's argument by saying that to require a sale for tax purposes to have a financially responsible buyer who undertakes to pay the price from sources other than earnings or to require such a buyer to make a substantial down payment seems to conflict with commercial practice and the general understanding of what constitutes a sale. In short, the court rejects entirely the Commissioner's suggestion that there is no risk-shifting, hence no "sale" where the price is payable only from the income produced by the business sold.¹⁶

Analysis of the Brown Case

Brown has become a part of tax legislation history. The issues there involved have been settled. We have seen that this case has already been cited as authority for other bootstrap transactions and has appeared in Tax Court opinions. But what the real effect of this case is and will be is still a matter of dispute.¹⁷ A summation of the case would appear to be conclusive as to the legality of bootstrap sales. The Government argued before the Supreme Court that no true sale of the old company's stock had taken place; rather, the foundation had been used as a conduit in an attempt to convert future regular income into capital gains, taxable at lower rates. The Supreme Court disagreed, ruling that a legitimate transaction had occurred.

What is the effect of this decision? A search of various articles and comments relating to *Brown*, indicates that the answer to this question depends upon the writer's point of view. A simple factual analysis reads: "The Supreme Court opinion in *Brown* makes it clear that capital gains treatment results in essence from the transfer of ownership interests, rather than being dependent in any way upon the source or method of determination of payment."¹⁸ Justice Goldberg, in his dissent in *Brown*, states that the majority opinion by approving the bootstrap transaction therein concerned, "legitimizes considerable tax evasion," by permitting the unwarranted conversion of ordinary income into capital gain.¹⁹

¹⁵ Note, *Bootstrap Transfer of Business to Charitable Organizations*, 79 Harv. L. Rev. 206 (1965). The writer looks at Clay Brown as a setback for any general doctrine of business purpose. See generally, Rice, *Judicial Techniques in Combating Tax Avoidance*, 51 Mich. L. Rev. 1021 (1953).

¹⁶ Note, *Taxation—Seller's proceeds of "Bootstrap Sale" to Tax-Exempt Organization Held Taxable at Capital Gains Rates*, 34 Fordham L. Rev. 308 (1965).

¹⁷ See generally, Eliasberg, "Bootstrap" Sales Still Subject to Attack Despite Supreme Court's Holding in *Brown*, 23 J. Taxation 42 (1965).

¹⁸ Dauber, Jewell, and Hall, *Supreme Court in Brown Allows Capital Gain on "Bootstrap" Sale to Charity*, 23 J. Taxation 2 (1965).

¹⁹ Barnett, *the Struggle to Curtail Abuses by Private Foundations; New Legislation Likely*, 23 J. Taxation 300, 303 (1965).

The taxpayers' counsel analyzes the underlying rationale and explains the importance of this case as not limited only to bootstrap sales involving tax-exempt institutions. His feeling is that the tax-exempt benefits claimed for the *Brown* transaction are no different than the tax benefits sought in many corporate buy-outs.²⁰ His theory is based on the fact that in every buy-out, every business is expected to pay for itself. With the use of a tax-exempt corporation as buyer-feeder, the purchase price is allowed to be repaid more quickly. "Where the purchase price is reasonable, and where the security interest retained by the seller terminates upon payment of the purchase price, there is really nothing adverse which can be said about bootstrap sales."²¹

Thus, some analyze *Brown* as merely an interesting legal development; others see it as a threat to our tax program. Those closest to it feel that this type of transaction is normal and not out of the ordinary. One writer actually looks at *Brown* as a favorable deterrent to bootstrap sales. He feels that this case "is a significant milestone in the tax law, for it provides a checkrein. . . ." He doubts that further legislation is required to prevent three-cornered bootstrap transactions except in the case of sales to churches.²² The theory is that *Brown* clearly defined what would satisfy the requirements of an acceptable bootstrap sale and that most such attempted transactions could not so qualify. The Internal Revenue Service, however, does not agree in this opinion. It contends that the Supreme Court did not rule on the specific point of whether the foundation paid more for the stock than it was worth. So instead of limiting future bootstrap challenges, it has merely pointed the Internal Revenue Service in another direction. Henceforth, the Service says, it "will continue to resist" bootstrap transactions where it finds such excessive payments have been made.²³

Despite the fact that some viewers of *Brown* feel that it only applies to a few specific fact situations, or that the decision to allow capital gains was a proper application of existing tax law, or that it has clearly defined the ground so as to make further cases on the bootstrap sales point unnecessary, it is obvious that this type transaction does take advantage of the loophole in today's tax statutes. The question that now arises is: How can this loophole be closed? What should the future course of conduct be toward bootstrap transactions?

²⁰ Kinsey, *Bootstrap and Capital Gain—a Participant's View of Commissioner v. Clay Brown*, 64 Mich. L. Rev. 581 (1965).

²¹ Kinsey, *Behind the Scenes of Clay Brown: Taxpayer's Counsel Analyzes Underlying Rationale*, 23 J. Taxation 68 (1965).

²² Hall, *the Clay Brown Case and Related Problems*, University of S. Cal. 18th Annual Institute on Federal Taxation 337 (1966).

²³ T. I. R. No. 768 Oct. 5, 1965.

Closing the Loophole

Since *Brown*, the Internal Revenue Service has announced its intention to seek judicial resolution of the problem under existing law by focusing future attacks on operating companies and exempt foundations. Continued attacks will be made on sellers involved in bootstrap sales where the purchase price is in excess of the fair market value.²⁴ What sections of the Code can be applied so as to help close the bootstrap transaction loophole? The first section that comes to mind is Sec. 514, which was specifically designed to cover bootstrapping. This section covers business lease rents and deductions. The important aspects of this section are those applying to income derived from a lease of an unrelated trade or business and to the five-year lease limitation. The exceptions, as defined by the courts, have proven to make this section ineffective.²⁵ It would seem however, that even if the exceptions are read in a manner most favorable to charitable operations, income resulting from a bootstrap transaction would still be taxable even though such foundations are normally considered tax-exempt. This exception reads:

No lease shall be considered a business lease if such lease is entered into primarily for purposes which are substantially related aside from the need of such organization for income or funds or the use it makes of the rents derived to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the bases for its exemption under Section 501.²⁶

The phrase "purposes which are substantially related" would appear to throw out most bootstrap arrangements. That this is not in fact the result is why the U. S. Treasury Report on Private Foundations includes changes in this section in its list of suggested changes.²⁷ This report will be more thoroughly analyzed in this article.

Certain sections of the 1939 Code were carried through substantially unchanged into the 1954 Code. Can the use of these sections, together with the new additions in the 1954 Code, effectively end bootstrap transactions? (Examples of such sections are sections 502, and 511 to 514. Sections 1245 and 1250 are among those new sections suggested as being deterrents to future bootstrap sales.)²⁸ These sections place substantial tax liabilities upon the liquidation of a going business and such liabilities

²⁴ *Ibid.*

²⁵ Note, Capital Gain Treatment Afforded Proceeds of Sale in a Charitable Sale and Lease-Back, 34 Geo. Wash. L. Rev. 360 (1965). (Also notes that the courts were reluctant to close the loophole in Sec. 514 because Congress had had an opportunity to reconsider the abuse of exempt income status and had refused to alter the Code in accordance with the commissioner's suggestions.)

²⁶ Int. Rev. Code of 1954, § 514(b) (3) (A) (i).

²⁷ CCH 1965 Stand. Fed. Tax. Rep. No. 12, Pt. 1, Feb. 10, 1965.

²⁸ See generally, Hester and Eidman, Jr., Profits from Bootstrap Sale of a Corporation to a Charitable Institution are Capital Gains, 44 Texas L. Rev. 360 (1965).

would seem to discourage bootstrap transactions in most cases.²⁹ Another section which might be used to lessen the incentives of bootstrap sales is Sec. 483(d). Where the deferred payments are indefinite as to time, liability or amount—even though the parties have no intention to pay or receive interest—this provision requires discounting of each payment when received, to the date of the original sales agreement, so as to reflect interest at the rate of five per cent compounded semi-annually. In the case of a substantial time lag in payout, the attractiveness of bootstrapping to the seller will be sharply curtailed.³⁰ The imputation of interest on the payments received by the seller, if applicable to bootstrap transactions, would certainly destroy some of the primary appeal of bootstrapping. In analyzing the arguments propounded in the various articles supporting the use of one section of the Code or another to end bootstrap sales, there is applicability to some certain types of transactions, but it would appear that the use of any one section or combination of them would not completely close the loophole.³¹

Some writers suggest that this type of sale may be eliminated through a denial of the rental deduction claimed by the corporate-lessee member of the transaction.³² Since *Commissioner v. Brown* held that the Internal Revenue Service's sham sale argument would be accorded no weight in the future unless the purchase price can be shown to be unreasonably inflated, it would appear that in most cases the "sale" must be conceded. If the transaction is to be attacked, another argument must be used. Section 162 of the 1954 Code limits rental deductions to payments which are required to be made for the use or possession of property in which the lessee has no equity.

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.³³

The important phrase is "ordinary and necessary" which allows only reasonable sums for the purchaser to deduct as trade or business expenses. This approach was applied with some success in *Royal Farms Dairy Co.*,³⁴ where the rental payments were reduced, and in *Warren*

²⁹ See generally, Lewis, Bootstrap "Sales," Charities and Non-Charities, Corporate Buyouts, and Clay B. Brown, 18 Tax Executive 150 (1966).

³⁰ Note, Federal Income Taxation—Capital Gains—Payment of Purchase Price From Anticipated Earnings, 40 Tul. L. Rev. 190 (1965).

³¹ Comment, Taxation—Federal Income Taxation—The Three-Party Sale and Lease-Back, 61 Mich. L. Rev. 1140, 1157-58 (1963). Discusses various provisions of the Internal Revenue Code that might be used to close the loophole with conclusions in line with those reached in this article.

³² See generally, Note, *op. cit. supra* n. 3.

³³ Int. Rev. Code, § 162(a) (3).

³⁴ *Supra* n. 10.

Brekke,³⁵ where the entire rental deduction was disallowed. "In view of the Government's defeat in *Brown*, it must be assumed that a vigorous effort will be made to sustain the disallowance of rental deductions, either in whole or in part, and it is highly likely that the reasonableness of the rental figure will control."³⁶ In *Brown*, the court touches on the rent question only obliquely, by commenting that "if the rents were deductible" the charity would pay off the sale price faster and this is important to a seller who wants the balance of his price quickly. No indication of the courts' attitude toward rental deductions can be gleaned from this, other than the use of the word "if." Does this indicate the doubtfulness of the deduction?³⁷ This suggested theory of attack is interesting, but, like all others, does not seem to have all the necessary ingredients to close completely the bootstrap loophole.

In an article entitled "A Charitable Armageddon," *Brown* is labeled as a tax avoidance device, pure and simple. This case is also described as ". . . the last desperate attempt to deter bootstrap sales . . ."³⁸ A review of most of the writings indicates that the Code as it now stands can do little to deter bootstrap transactions. Sections 1245 and 1250, for example, will have little effect on a business whose major assets are inventory and to which depreciation is unimportant. It can almost be said that the present Code contains provisions which may even encourage charitable bootstrapping. The only conclusions that can be reached are:

- (1) Since charitable bootstrap sales do constitute an abuse of the tax system, and
- (2) Since the Commissioner has no effective weapons with which to make an assault on such transactions—the courts having frustrated every effort, and
- (3) Since further attacks on an operating company's rental deduction, or the charitable exemption, or the rental payments or the lessor-lessee relationship would appear to have little likelihood of success, therefore,
- (4) There is a definite need for remedial legislation.

This latter conclusion has been reached by the Treasury Department and by Representative Mills (D., Ark.) Chairman of the House Ways and Means Committee. The Treasury Department Report on Private Foundations proposes two major reforms intended to curb bootstrap transactions.³⁹ First, it suggests that exempt organizations be prohibited from

³⁵ 40 T. C. 789 (1963).

³⁶ O'Neill, *op. cit. supra* n. 13 at 516.

³⁷ *Id.* at 517.

³⁸ Notes, a Charitable Armageddon: Commissioner v. Clay B. Brown, 13 U. C. L. A. L. Rev. 167 (1965). A further point was made that this last attempt was not effective because tax-exempt and non-tax-exempt purchases were not differentiated.

³⁹ *Supra* n. 28.

owning more than twenty per cent of an unrelated business. Second, it requests a prohibition on investment borrowing by charities. Also included in this report are less wide-sweeping reforms which would also limit the appeal of bootstrapping by charitable organizations.⁴⁰ Section 514 could be amended to include all leases in "business leases" by removing the five-year limitation. Section 511 could also be amended to enable the Commissioner to attribute unrelated business income to religious organizations.

The new bill introduced in Congress by Representative Mills is intended to "soften" the Supreme Court decision upholding bootstrap transactions. Under the Mills proposal, the income received by the charitable organization could be taxed to it as "unrelated business income" to the extent that the tax-exempt unit borrowed funds to finance the purchase. The tax would not apply, however, where the business is related to the educational, charitable or other purposes for which the organization initially received its tax exemption. Income from existing bootstrap transactions would be excused from the tax for five years from the date the bill was introduced.

So it would seem that the days of the bootstrap are numbered. But it must be remembered that the struggle to curtail abuses by private foundations has been a long-standing one. Once before it appeared that the tax loopholes had been less than desirable because the Congress chose not to expressly prohibit certain transactions between a donor and his controlled foundation. It chose to challenge such transaction only "where there was *inadequate* security, or *unreasonable* rates of interest, or *substantial* diversion of income or corpus, or *excessive* compensation, or *improper* sales or purchase prices,"⁴¹ and used other similar imprecise, modifying terms in the legislation passed. The result, as time has shown has actually served to open new and wider loopholes. A similar result could be forthcoming if the new legislation is also filled with imprecise terms that tax lawyers could use to good advantage.

Summary

The Internal Revenue Service has challenged a number of "bootstrap" purchase cases, but the taxpayers have generally prevailed. These transactions have been upheld by the courts despite the violation of at least four claimed public policies: (1) the policy against granting tax exemption for activities which serve private rather than public purposes; (2) the policy against permitting tax exemption for the operation of competitive businesses; (3) the policy that capital gains treatment is to be given the significant economic transfers of investment-type assets and

⁴⁰ See generally, Schoenfeld, Initial Impressions of the Treasury Report on Foundations, 14 Clev.-Mar. L. Rev. 286 (1965).

⁴¹ Barnett, *op. cit. supra* n. 19 at 300.

not to ordinary commercial or business income; (4) transactions are to be judged on their entire substance rather than on their naked form.⁴² Bootstrap operations have been permitted because of the application of "legal myths" to them by the court. Decisions have turned upon such points as sale or no sale, retention of risk, or retention of control. The fundamental principles of tax law—the doctrine that the retention of control is a sign of ownership—has been ignored or weakly enforced as the history of bootstrap cases shows. If the legal fiction of a "sale" between the owner of a company and a charity feeder is applied and the court accepts it, all other subsequent steps are given similar validity—even though the result often is that the original owner/seller becomes the ultimate lessee/operator.⁴³ This occurs even though in many cases the courts state that the purpose of the capital gains provisions is to relieve the taxpayer from excessive tax burdens on gains resulting from a conversion of capital investments; the courts further point out that these provisions are narrowly construed in order to protect against the use of tax evasions devices and attempts.

The courts have seemed to become bogged down in the technicalities and niceties of form involved in these intricate A, B, C transactions. The Commissioners likewise have played the game on the same ground and have attempted to refute legal myths and fictions rather than to strike to the heart of the matter—that bootstrap sales were and are tax evasion devices. There has been no similar problem involved in cases that revolved around the transfer of assets, such as leaseholds, patents and mineral rights. The major consideration there was whether the lump sum payment was a substitute for what would otherwise be received as ordinary income at a future time. An application of similar logic to bootstrap transactions might well have closed the loophole, but the courts have not been so inclined and the Commissioner has not so argued.

Apparently the Commissioner's mis-steps have permitted the bootstrap litigation to evolve as it has. *Kolkey* received great attention and was a test case that should have showed the way to block these transactions—which although not a sham, were "sales" designed for tax purposes.⁴⁴ The principle involved is that "taxation is not so much concerned with the refinements of title, as it is with actual control commanded over the property taxed. . .".⁴⁵ That bootstrap transactions violate the spirit of the Code, and that court decisions have seemingly ignored provisions of the Code that might be used to halt such sales, cannot be denied. It is also apparent that the Internal Revenue Service must have

⁴² Lanning, *op. cit. supra* n. 2 at 697.

⁴³ *Id.* at 634, generally describes the conflict between "Formalism and of Substance Over Form." Conclusion is that "Many Legal Myths Are a Rationalization For Particular Interests. . . ."

⁴⁴ *Supra* n. 7.

⁴⁵ *Corliss v. Bowers*, 281 U. S. 376, 378, 50 S. Ct. 336 (1930).

help if the loophole is to be closed and the tax advantages resulted therefrom are to be curtailed. A study of the cases indicates that the Code as it now stands cannot halt bootstrap transactions. Even when most favorably construed toward this end, only certain fact situations could be declared as invalid sales or transactions resulting in a tax charge to either the seller, the feeder charity, or the resulting operating company.⁴⁶ What is needed is forceful legislation directly aimed at bootstrapping—legislation without qualifying phrases, without special exceptions, and without wordage that merely would result in the opening of additional loopholes. The far-reaching consequences of *Brown* have apparently opened the eyes of responsible segments of our Government and have led them to the conclusion that such legislation must be passed. Until such time however, the Internal Revenue Service will be forced to continue its futile attempts to stem the tide by attempting ingenious interpretations of the existing Code. Perhaps the courts will take judicial notice of the apparent trend in the attitude toward bootstrap sales and return to the fundamental tax principle that has successfully arrested other tax evasion devices, the principle that substance, rather than form, should be considered. If the end result aimed at by any transaction, no matter how many steps it travels, is considered, rather than the steps themselves, the decisions reached must be in favor of the Commissioner. The courts have seldom demonstrated this ability when the complexity of the bootstrap was being considered. It is time for the courts to receive help in seeing past the trees, so that the entire forest can be viewed.

⁴⁶ Ginstling, *Permissible Activities of Exempt Organizations (Other Than Foundations)*, New York University Twenty-Fourth Annual Institute on Federal Taxation (1966), p. 115. Note that the holding in *Clay Brown* has touched off a wave of activity urging legislative reform.