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Initial Impressions of the Treasury Report on Foundations

Marcus Schoenfeld*

Very recently the United States Treasury Department submitted its study of private foundations to Congress. This is the most recent development in an attempt to delineate the proper role of foundations and their donors in our society, and more particularly their proper tax treatment. Although it is much too soon to predict the effect of the Treasury Report, since Congress itself asked for the study, it is quite likely that some more restrictive legislation will result.

The general tenor of the Treasury Report is one of moderation. Although it discusses certain "problems" which have led to serious abuses among a minority of foundations, it recognizes that philanthropic activities of foundations have provided distinctive values to society which justify preferential tax treatment:

Private philanthropy plays a special and vital role in our society. Beyond providing for areas into which government cannot or should not advance (such as religion), private philanthropic organizations can be uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes, and act quickly and flexibly.

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2 The present cycle probably began with an article in this law review: Oleck, Foundations Used As Business Devices, 9 Clev.-Mar. L. Rev. 339 (1960). This article apparently led Congressman Patman to contact its author about the problems discussed; and under Dean Oleck the problem was studied at Cleveland-Marshall Law School for Congressman Patman's Subcommittee. Although Dean Oleck resigned before the study was complete, Congressman Patman continued and issued his now-famous Report (see infra, note 6), which suggested basic reforms. In late 1963, the Senate Finance Committee asked the Treasury to study the problems, and the Treasury Report is the result of this study.

3 See Treasury Report, supra note 1, at 3.

4 Note that neither the House Ways and Means Committee nor the Senate Finance Committee has held hearing or otherwise considered the matters discussed in the Treasury Report. While some legislation is likely, there will probably be some reasonably long period before it is enacted.

5 Treasury Report, supra note 1, at 5.
Therefore, rather than suggesting severe limitations on the use of the foundation form, such as a maximum life, the Treasury Report focuses on the specific problems and proposes specific solutions for each. And since the federal tax laws have largely caused the problems, the Treasury suggests that the best way to curb abuses is to reframe those tax laws, rather than to create some independent regulatory agency.

The Report is specifically limited to "private foundations." These are defined as any organization exempted from tax under section 501(c)(3), except churches, educational organizations, public safety testing organizations, and all organizations which normally receive substantial support from the general public or some government body; and also includes all non-exempt trusts which may make charitable contributions. As so limited, the Treasury discovered six major and four minor problems. Each of these will be discussed in turn. Then the shortcomings of present law will be discussed. Finally, the Treasury's proposed solutions will be discussed.

The Problems Discovered

Transactions between foundations and their donors. Except for the so-called "prohibited transactions," today foundations may lawfully engage in transactions with their donors. Psychologically this often tends to a view among donors and foundation directors that a foundation is, in a sense, the donor's alter ego. Practically, this can have profound effects on the affairs of both the donor and the foundation.

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7 Treasury Report, supra note 1, at 13.

8 Id. at 14.

9 Id. at 3.

10 Int. Rev. Code of 1954 Sec. 501(c)(3) (as amended), 26 U. S. Code Sec. 501(c)(3). Hereinafter this will be cited as I. R. C. (1954); the citation to U. S. Code will be omitted. See the author's article in the Spring 1965 volume of the Villanova Law Review for a discussion of organizations which are exempt from tax under section 501.

11 Treasury Report, supra note 1, at 3-4.

12 I. R. C. Secs. 503(c) and 681(b) (1954).

13 Treasury Report, supra note 1, at 15.

14 Id. at 15-21.
For example, the investment and distribution policies of the foundation may be determined so as to best serve the needs of the donor rather than the needs of charity. It may accumulate income and keep corpus so that funds are readily available for possible donor use, instead of disbursing the funds to further charity; or the foundation’s assets may be kept in liquid assets to facilitate possible donor use, rather than in more appropriate investments. In addition, the donor can be sure funds will be available with a minimum of formality and on favorable terms from a friendly lender. Furthermore, the donor may in effect decrease the net cost of business investments by using the foundation as a conduit.15

Delays in transmitting benefits to charity. There is often a long delay between a charitable contribution (which confers an immediate deduction upon the donor) and the actual entry of those funds into the stream of charitable endeavor. Often the contributions are added to capital, and only the income therefrom is devoted to charity. When even the income is not currently devoted to charity, clearly the justification for a charitable deduction is weak.

It is useful to distinguish between “operating” private foundations (which actively engage in or operate charitable activities) and “non-operating” private foundations (which fulfill their purpose by dispensing funds to operating charities).16 Non-operating private foundations which either accumulate income or invest in non-income producing property are the primary source of this delay.17 Although the Code prohibits unreasonable accumulations,18 in fact there is often a considerable delay

15 For example, instead of contributing capital directly to his business (corporate or otherwise), the donor contributes it to his foundation and causes it to lend the funds to his business. Since this effects an increase in business capital with before-tax dollars (because of the contributions deduction for the donor under I. R. C. Sec. 170 (1954)), the out of pocket cost of a given dollar investment is reduced. The leverage increases as the donor’s bracket increases. While the foundation must eventually be repaid by the business, the short-run advantages of before-tax investment greatly outweigh this long-run factor.

16 Congress has recently recognized this distinction in the Revenue Act of 1964, P. L. 88-272, 88th Cong., 2nd Sess. Sec. 209(e) (1964), which added Sec. 170(g)(2)(B) to the Code. While this section applies to the “unlimited” deduction, the Treasury adopts the same standard of “operating” and “non-operating” in discussing the problem of delays in transmitting benefits to charity. Treasury Report, supra note 1, at 23 n. 3.


18 I. R. C. Secs. 504 and 681(c) (1954).
between the original contribution and the actual use of the con-
tribution for charitable purposes. 19

**Active involvement in business enterprises by foundations.** Many foundations have substantial investments in operating businesses. 20 For these, assets which in theory are devoted to charity, are in fact devoted to business. Such submersion of the basic *raison d'être* of foundations—social experimentation and improvement—rob the form of much of its promise. The direc-
tors are often too concerned with business affairs to devote proper time and efforts to charity. Since investment in business may be made with pre-tax dollars, and since some income may be received tax-free, 21 the foundation-controlled business has a great competitive advantage over non-exempt business. In addition, the business operation often accentuates the previously mentioned problems of self-dealing and delay of distribution, at the expense of charity. Finally, in those situations where the business is controlled by a foundation, there is little or no pres-
sure to pay dividends; not only does this delay charitable bene-
fits, but also by permitting profits to be "plowed back" it further increases the advantage of tax-exemption in raising or increasing capital.

**Use of foundations to control closely-held property or corpo-
rations.** Each of the aforementioned problems is further intensi-
fied whenever a foundation is used to maintain control of closely-
held property. 22 For example, if the voting stock of a closely-
held corporation is donated to a foundation controlled by the same group, effective control of the corporation is maintained, income tax and gift tax deductions are available, and the stock transferred is removed from the donor's estate (reducing the estate tax). The remaining stock may be transferred to the next generation at minimal estate or gift tax, since much of the equity is in the foundation. But such minimal transfer in effect carries control with it. The leverage effect increases as the proportion of foundation stock ownership increases. In such instances, the foundation is really just a device for minimizing taxes while de

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20 Id. at 30-36. See also, Patman Report No. 1, *supra* note 6, at 8 (1962).
facto control is unaffected. Since the unity of interest is maintained, it is not surprising that self-dealing exists; since the business continues the foundation is necessarily involved in business; and because of the control of dividend policy charity is delayed.

It should be noted that this device is one of the most frequent abuses of the foundation form. Schemes such as this are advertised as a “have your cake and eat it gimmick” with control and tax-savings as the dominant motive, and charity as an afterthought.23

Financial transactions unrelated to charitable functions. While foundations of necessity must engage in various financial transactions, e.g., investing their funds, the Treasury notes three types of transactions which are not essential to the charitable ends of foundations and which can produce unfortunate results.24

For example, a foundation may borrow funds for many non-charitable purposes, such as general investment. By amortizing the purchase price with tax-free proceeds, it can acquire property with little, if any, expenditure of its funds. This is often called “bootstrapping” and can result in some transfer of the benefit of tax exemption to the seller, since the foundation can afford to pay a higher price than a non-exempt purchaser. And this effect is heavily accentuated when the seller controls the foundation and arranges a sale-and-leaseback with the foundation.

On the other hand, the foundation may make loans which have no relation to charity. Even if limited by a reasonable rate of return,25 great private benefits may accrue, much as in self-dealing.26

Finally, foundations have engaged in active trading of securities, even to the point of speculation. Aside from the obvious impropriety of such use of moneys supposedly devoted to charity, the directors' time and effort which should be spent on furthering charity is spent instead on playing the market.

Self-perpetuating foundation management. The final major problem discovered by the Treasury is the problem of perpetual life of foundations and the self-perpetuating parochial nature of

23 See for example May 7, 1960, Business Week at 153.
24 Treasury Report, supra note 1, at 45-54.
25 See I. R. C. Secs. 503(c) (1) and 681(b) (2) (A) (1954).
26 See supra at note 14.
foundation management. Many of the values of private foundations arise from the freshness of their approach. These tend to diminish over time as its patterns become set and management tends to ossify. Even if the donor retires or dies, control of the foundation usually stays within his family or some other small homogeneous group. The problem is especially serious where the foundation has not been active in either operating or financing charity, since a superfluous device is kept perpetually alive.

**Minor problems.** Income, estate and gift tax deductions have often been claimed for donations of unproductive property to private foundations. Since the justification for the deduction is the benefit bestowed on charity, if no benefit is obtained from unproductive property it seems unreasonable to permit a present deduction.

Many of the Code provisions which call for ordinary income treatment of certain transactions—e.g., "preferred stock bailouts" or "collapsible corporations"—can be avoided by judicious use of foundations. Since a contribution to charity is not a realizable event for the donor, the remedial sections are not triggered. Regardless of the merits of foundations, the Treasury feels they should not be used as devices to avoid well-defined tax policies.

The Treasury also notes that the interaction of the estate tax provisions for the marital deduction, for charitable deductions, and for includability of property transferred subject to the donor's control, is such as to give unintended benefits.

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27 Treasury Report, *supra* note 1, at 54-56.
31 Cf. treatment of recaptured depreciation under I. R. C. Secs. 1245 and 1250 (1954) where I. R. C. Sec. 170(e) (1954) treats charitable contributions as quasi-realizations, and reduces the amount of the deduction by the amount that would have been realized as ordinary income if the property had been sold.
32 Treasury Report, *supra* note 1, at 60-63.
33 I. R. C. Sec. 2056 (1954).
34 I. R. C. Sec. 2055 (1954).
That is, property which has been transferred to a foundation which the donor controls is, in effect, "brought back" into his gross estate long enough to increase the maximum potential marital deduction and is then deducted in computing the taxable estate. And similar "double" benefits exist with respect to estate tax treatment of life insurance, transfers with retained life estates, and transfers in contemplation of death.

Finally, effective administration requires accurate information. At present the sole penalty for failure to file the required information return is quite severe. This very severity "makes it inappropriate in most such cases."

Prior Attempts at Reform

None of the major problems discussed above is really new. Congress considered them in 1950 and parts of the Revenue Act of 1950 resulted. The present Treasury Report is designed to determine whether the legislation has curbed the abuses or whether further remedies are necessary.

In general, the Treasury finds that the existing restrictive legislation is not truly effective. It provides somewhat flexible standards which courts have liberally interpreted and which are administratively difficult to enforce. The Treasury therefore suggests that more stringent standards be applied.

For example, the problem of self-dealing was treated by adoption of rules regarding certain "prohibited transactions." But each is phrased in terms of reasonableness or adequateness or substantiality (e.g., "... lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest ... "). This standard is unrealistic because of the conflicting interests of the donor; in fact, there cannot in fact be an arm's length transaction between a donor and his founda-

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36 Treasury Report, supra note 1, at 63-64.
37 Ibid.
38 The general penalty for failure to file any required return is a fine of not more than $10,000, or imprisonment of not more than one year, or both.
39 Treasury Report, supra note 1, at 64.
41 Treasury Report, supra note 1, at 3.
42 Now in I. R. C. Secs. 503(c) and 681(b) (1954).
43 I. R. C. Sec. 503(c) (1) (1954).
It draws the analogy of dealings between a trustee and a trust, where the impossibility of insuring fair dealing has resulted, in general, in an absolute prohibition of such transactions. In addition, the present rules are administratively unworkable; it is virtually impossible to ascertain the facts necessary to determine reasonableness.

Similarly, the problem of delay in benefits reaching charity was attacked by banning unreasonable accumulations. Again, the problem of defining "reasonable," the liberality of the courts, and basic administrative problems are used to prove the inadequacy of the present law.

Foundation involvement in business was treated in 1950 by adding the provisions concerning "feeder" organizations and unrelated business income. But these provide specific exceptions which are used and often abused. And these provisions do not even touch the subtle evils of business involvement mentioned previously.

The problem of unrelated financial transactions was covered generally by the Revenue Act of 1950. Thus, foundation borrowing often is for the so-called "bootstrapping" sale-leaseback transaction. Section 514 was specifically designed to cover these, but often proves ineffective because of its exceptions; and of course, it applies only to rental property. Foundation lending which meets the objective tests of adequate security and reasonable interest usually cannot be attacked, even if in fact private benefit exists, because of problems of proof. And speculation by foundations, which is limited by section 504(a) (3), is not really curbed because of the general looseness of that section.

44 Treasury Report, supra note 1, at 17-18. Whimsically, the Report says, "Indeed, the 'arms' involved may both belong to the same person who is both donor and trustee." Id. at 18.
45 Id. at 18.
46 Id. at 20.
47 I. R. C. Secs. 504(a) and 681(c) (1954).
51 Probably the most significant exception is that under I. R. C. Sec. 514 (1954) pertaining to business leases.
52 Supra at note 12.
53 See quote at n. 43 supra.
54 Treasury Report, supra note 1, at 51.
55 Id. at 53.
Neither the self-perpetuation of foundation management nor the use of foundations to control closely held property or corporations was specifically covered by the Revenue Act of 1950, although of course, many specific problems would fit within one or more of the above-discussed categories.

In short, the Revenue Act of 1950 has not solved the problems because it is too loose and difficult to administer.

The Treasury's Proposed Changes

In general, the Treasury suggests that the possible benefits accruing to charity because of the relatively loose "reasonable" standards imposed by the Revenue Act of 1950 are not worth the cost. The proposals adopt absolute prohibitions of those transactions and situations which do not measurably aid charity.

As mentioned before, the Treasury proposals are specifically aimed at the particular problems. These will be discussed in the same order as the problems were stated.

Transactions between foundations and their donors. The donor (and certain other connected parties) would be prohibited from entering into certain transactions with the foundation. These transactions would be similar to those presently "prohibited" except that the ban would be absolute; no exception would be made for "reasonable" or "arm's length" transactions.

This proscription seems well warranted. Even if at "arm's length," the ability to control both sides leaves too much room for maneuvering. If, for example, a donor may borrow funds he has just donated to his foundation, he has really not parted with his property. He has the use thereof, and has bought a contributions deduction at the cost of (deductible) interest. While he must repay the loan, he does control the situation, and his short run advantage may well offset his long-term detriment.

The Treasury position is in agreement with general trust law, which bans all transactions between the fiduciary and his trust. This recognizes the unreality of determining reasonableness in the self-dealing context; when one is representing his

56 Treasury Report, supra note 1, at 21-23.
57 Under I. R. C. Secs. 503(c) and 681(b) (1954).
own interest and also a fiduciary interest, it is unrealistic to assume he will do justice to the fiduciary interest.58

And, as the Treasury says, possibly with irony, "... a party who engages in transactions with the foundation on a truly arm's-length basis could, by definition, engage in the same transaction, on the same terms, with strangers." 59

**Delays in transmitting benefits to charity.** The Treasury proposes the simplest of solutions to the problem of delayed benefits: require current distribution of income.60 To avoid hasty decisions and to permit investigation of possible expenditures, "current" would be defined to mean not only the year during which the income is earned, but also the following year.

Recognizing that certain projects require a sum greater than one year's income, two exceptions are proposed. First, the foundation will be permitted to treat as properly expended all funds set aside for a definite, specifically stated, charitable purpose. The actual expenditure must be made within five years (or some other specific period), unless an extension is granted for good cause. Second, if a foundation has invaded corpus for actual charitable benefit, it would be permitted to recoup the amount of this invasion by accumulating income for some specified period (five years is suggested) thereafter. Either averaging device, or both, could apply to a given year.

To complement this distribution requirement, which could be avoided by investment in non-income producing property, the Treasury suggests an income equivalent determination. Thus, using a rate to be set by Regulations,61 a certain percentage of the investment assets (i.e., those not actively devoted to charity) would be deemed to be an "income equivalent." The amount required to be devoted to actual charity would then be the higher of the actual income or this "income equivalent." 62 A reason-

58 No exception is made for the so-called "bargain sale" where the donor sells appreciated property to the foundation for the amount of his basis, making a gift of the appreciation only. These would no longer be allowed. Treasury Report, supra note 1, at 22.

59 Treasury Report, supra note 1, at 23.

60 Id. at 26-30.

61 The rate would vary as the market varied. A rate of 3 to 3½ percent would be a reasonable income equivalent rate at present. Id. at 28-29.

62 If there is a specific earmarking of funds, the "income equivalent" could be set aside much the same as in the proposal with respect to actual income accumulation. Id. at 29.
able period would be allowed to existing foundations to adjust their investments, before "income equivalence" would apply to them.\textsuperscript{63}

If charity delayed is charity denied, the Treasury proposals have merit. Mandatory current expenditures for active charity meets the general problem of delay simply and in an easily administered way. Reasonable flexibility is provided by the two averaging exceptions. The major criticism can be levelled at the "income equivalent" proposal. Any attempt to base taxation on fictional income is harsh. How could one differentiate the foundation with an unlucky (or incompetent) investment adviser? Must it be doubly penalized: once by the poor investment and then by a required corpus distribution? Possibly a rebuttable presumption would be better than the assumption that less than three percent is abnormal, especially since the investment adviser did not have the benefit of hindsight. With this modification, "income equivalence" is desirable to assure inappropriate delay in funds reaching the level of operating charity.

\textit{Active involvement in business enterprises by foundations.} Again the Treasury meets the problem by outlawing it.\textsuperscript{64} More specifically, no private foundation would be permitted to own twenty percent of the voting power, or twenty percent of the equity, of any corporation\textsuperscript{65} conducting an unrelated business.\textsuperscript{66} Passive income (such as interest earned, mineral royalty payments, and "clearly passive" rents) would be deemed not to have arisen from a business for this purpose.\textsuperscript{67} Present foundations would be permitted a reasonable time to reach the permissible maximum, which would be extended for good cause; and some reasonable time for divestiture would be provided if some foundation acquired more than the permissible holdings in the future.\textsuperscript{68}

\textsuperscript{63} Id. at 29.
\textsuperscript{64} Id. at 36-37.
\textsuperscript{65} Similar treatment would apply to non-corporate businesses in which the foundation owns a 20\% interest. Id. at 36.
\textsuperscript{66} The test of whether a business is or is not substantially related to the foundation's exempt purpose would be quite similar to the present test under I. R. C. Sec. 513 (1954). Id. at 37.
\textsuperscript{67} Id. at 36-37.
\textsuperscript{68} Id. at 37. The Treasury would waive divestiture as to pre-existing foundations which could not divest themselves of this degree of control under state law. Ibid.
Although twenty percent is an arbitrary figure, it is probably as good a proportion as any to prevent the dominance of business over charity. While a twenty percent interest may in fact produce working control, when coupled with the other proposals this proposal would do much to remove many non-charitable motivations from foundation management.

Use of foundations to control closely-held property or corporations. Here two alternative proposals are made, either of which would postpone the donor's contributions deduction in certain circumstances. Since the transfer of an interest in closely-held property (or of stock of a close corporation) to a foundation lacks finality in fact, the donor would be denied an income, gift, or estate tax deduction until one of three events occurs: the foundation disposes of the assets, or the foundation devotes the property to active charity, or the donor's control over the property or corporation ends.

Control, for this purpose, will be presumed to consist of a twenty percent interest in the property; but this could be rebutted by a showing that such interest in fact did not constitute control. Attribution of ownership rules would apply, so that the foundation's interest would be attributed the donor so long as the latter owned any interest in the property at all.

Alternatively, the denial of a present deduction would occur in those situations where the donor (and related parties) not only control the property, as above, but also exercise "substantial influence" over the donee foundation. This more limited proposal would still cover the areas of conflicting interests where both the property and the foundation were dominated by the same related group.

As the Treasury notes, the more restrictive proposal is generally less desirable. Conflict of interest is not the only relevant factor. For example, a gift of stock of a controlled corporation to a non-controlled foundation is still subject to the dominion of

69 Treasury Report, supra note 1, at 41-45.
70 Under I. R. C. Secs. 170, 2522, and 2055 (1954) respectively.
71 The qualifying event would have to occur within three years of the donor's death, or the deduction would be lost. Treasury Report, supra note 1, at 42.
72 Twenty percent of the voting stock would be the test for a corporation. Ibid.
73 The attribution rules would also cover related parties. Ibid.
the donor because of his control of the corporation; charity may
have no clearly defined present benefit from the stock. More
fundamentally, it is virtually impossible to come up with a work-
able definition of “substantial influence.” A set percentage of
the foundation’s governing body is the only feasible test of such
influence. Yet it could in no way deter a determined donor with
“friends” who are not in any related group, but who in fact
would be subservient. Indeed, unless they were quite careless,
two donors could make cross-donations to each other’s founda-
tions and escape the penalty; discovering the facts would be dif-
cult (if “planned properly”), and proof of a preconceived plan
might be difficult. 74 In short, the Treasury’s primary proposal
seems quite preferable.

Financial transactions unrelated to charitable functions. All
borrowing for investment purposes would be prohibited; but
they could properly borrow to further their exempt functions. 75
Similarly, foundations would not be permitted to make loans not
in pursuance of their exempt functions, with a few specifically
spelled out minor exceptions of a non-private nature. 76 In addi-
tion, foundations would be prohibited from using income or cor-
pus for any trading or speculation. 77

Little comment need be made about these proscriptions. A
charity should be restricted to charitable activities; it should not
engage in these types of transactions.

Self-perpetuating foundation management. It is proposed
that all foundations be operated by independent managers (i.e.,
not the donor or related parties) after twenty five years of exist-
ence. 78 That is, while the donor could maintain a significant mi-
nority voice, he would have to relinquish control within that
period. 79

Not only would this proposal avoid the problems inherent in
self-perpetuation, but it would tend to protect the foundation
from abuse even within the period of donor dominance. Since
the “in group” would be certain of outside scrutiny (after twenty

75 Treasury Report, supra note 1, at 49-50.
76 Id. at 51-52.
77 Id. at 53-54.
78 Id. at 56-57.
79 Twenty five percent is the suggested maximum. Id. at 57.
five years), their behavior within that period should be of a higher caliber and of higher utility to charity.

And the fresh views produced would tend to awaken any foundation from the inertia of age.

Minor problems. As to contributions of unproductive property, the Treasury proposes denial of a charitable deduction for income, gift, and estate tax purposes, until the asset is either made productive, or disposed of, or applied to charitable purposes. This should be correlated with the proposals discussed above as solutions to the problem of the use of foundations to control closely-held property, since the problems are similar.

To solve the problem of contributions of assets containing an ordinary income component, the Treasury suggests using an approach similar to that used with respect to contributions of section 1245 (or section 1250) property to charities: reduce the charitable deduction by the amount of ordinary income which would have been realized if the property had been sold for fair market value at the time of contribution.

The "phantom" marital deduction base is avoided by a suggestion to reduce this base by the amount of any interest in property for which the donor has received an income tax deduction.

To promote the filing of information returns, in addition to the criminal sanctions presently in force, the Treasury suggests a penalty of ten dollars for each day beyond the due date up to a maximum of $5,000. In addition, the responsible officials would be subject to a similar penalty unless good cause for such failure is shown.

Conclusions

The Treasury proposals offer a direct cure for each of the evils discovered. Since the proposals would have few effects on truly charitable activities, few legitimate complaints should be heard.

80 Under I. R. C. Secs. 170, 2522, and 2055 (1954) respectively.
81 Treasury Report, supra note 1, at 59-60.
82 Id. at 60-63.
83 I. R. C. Sec. 170(e) (1954).
84 Treasury Report, supra note 1, at 64.
85 Id. at 64.