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Taxation -- Exempt Organizations -- Income Derived from Unrelated Business

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Fortune, in the guise of an enlightened Congress, has saved the courts from the necessity of having to adopt either viewpoint as correct. In providing for a corporation income tax, Congress clearly indicated that the replacement theory should be used. Only this interpretation can explain the provisions for a substituted depreciation basis in certain situations. That is, in cases where depreciation clearly should be allowed, as in the case of a gift or donation, but no actual cost basis exists, the donee-taxpayer is allowed to use the basis of the donor, limited to the fair market value at the time of the transfer. If Congress had intended the older view of depreciation to prevail, the taxpayer would be held to a strict cost basis, and having no cost, would be denied depreciation in many instances where his right to take it is undisputed today. In the light of this conclusion, how realistic is the argument that depreciation should be denied because there is no ascertainable cost to the taxpayer?

No distinction should be made taxwise between property acquired directly and property purchased with funds acquired. In each instance the Brown Shoe Company was required to perform certain obligations concerning the property, thus plainly contemplating that the company already owned such property, or would purchase it with the funds acquired, or would receive it by the terms of the contract. Any distinction made merely goes to the form of the transaction, and not to its substance. If this distinction were permitted to effect a different treatment from a tax standpoint, the only result would be a change in the form of all subsequent transactions. Such a result would benefit neither the government nor the taxpayer.

The Court in the Brown Shoe Company case adopts a liberal attitude in allowing depreciation on the assets and their inclusion in equity invested capital. The type of transaction involved serves a useful purpose in community development, and this helpful attitude on the part of the Court should go far in preserving the value of such transactions for both the community and the industries which it seeks to attract.

HARPER JOHNSTON ELAM, III.

Taxation—Exempt Organizations—Income Derived from Unrelated Business

Under §101 of the Internal Revenue Code certain organizations have been granted exemption from the income tax. These exemptions remained substantially unchanged from the original Act of 1913, until the Revenue Act of 1950. During the interim an increasing number

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80 Int. Rev. Code §113(a) (2).

*38 Stat. 166 (1913).*

*Pub. L. No. 814, 81st Cong., 2d Sess. §301 (Sept. 23, 1950).*
of organizations engaging in competitive businesses acquired exemption through judicial expansion of §101. Due to the resulting injurious effect on competition additional legislation became desirable.

The expansion of the exemptions under §101 of the Code was started by the Supreme Court of the United States in the case of Trinidad v. Sagrada Orden de Predicadores. There it was held that a charitable organization did not lose its exemption because engaged in selling non-competitive articles, such sales being incidental to the work of the organization. The court stated that the destination rather than the source of the income was the ultimate test of exemption. This principle was later extended to exempt organizations actively engaged in competitive businesses. In Roche's Beach, Inc. v. Commissioner, a further step was taken when a corporation was held exempt, which did not itself engage in charitable activities, but which was organized for the purpose of providing income for a charitable organization.

In order to claim the exemption under the principle of Roche's Beach the "feeder" organization must have been organized and operated "exclusively" for one or more of the specific purposes enumerated in §101 of the Code. Two recent decisions have expressed conflicting views as to what constitutes organization "exclusively" for an exempt purpose. In each case the stock of a business corporation was transferred to an exempt organization and the charter amended providing, in effect, that the corporation would be operated exclusively for charitable and educational purposes. While both courts recognized the validity of Roche's Beach, the corporation in Universal Oil Products v. Campbell was held not to be exempt as it was not originally organized exclusively for educational purposes; whereas the corporation in Home Oil Mills v. Willingham was held to be exempt on the theory that there had been a legal rebirth of the corporation by the amendment to its charter, and that, therefore, it was organized exclusively for charitable purposes.

Although the Bureau announced in 1942 it would no longer follow

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10 263 U. S. 578 (1924).
11 The organization derived income from the sale of wine, chocolate, and other articles purchased and supplied for use in its churches, missions, and schools.
12 Bohemian Gymnastic Ass'n Sokal v. Higgins, 147 F. 2d 774 (2d Cir. 1945) (operated a bar and restaurant); Sand Springs Home v. Commissioner, 6 B. T. A. 198 (1927) (sold food and oil products); Appeal of Unity School of Christianity, 4 B. T. A. 61 (1926) (operated an inn and published books).
13 96 F. 2d 776 (2d Cir. 1938) (the corporation operated a beach house).
14 181 F. 2d 451 (7th Cir.), cert. denied, 71 Sup. Ct. 78 (1950) (the court also found that the corporation was not operated exclusively for educational purposes as the organizers retained the right to use its patents without payment of royalties).
15 181 F. 2d 9 (5th Cir.), cert. denied, 71 Sup. Ct. 80 (1950).
Roche's Beach,\textsuperscript{11} the courts adhered to it.\textsuperscript{12} Recently, however, in \textit{Mueller Co. v. Commissioner}\textsuperscript{13} the Tax Court refused to follow Roche's Beach, and thereby narrowed the scope of exemption granted by §101. \textit{Mueller} involved facts similar to \textit{Universal} and \textit{Home Oil Mills}. New York University Law School purchased all of the stock of a profitable business corporation and merged it with a new corporation, the charter of which stated that it was organized exclusively for educational purposes. It was further specified that all of its income should inure to the benefit of the Law School. The Court held §101(6) of the Code exempted only organizations actually and principally engaged in an activity of the kind mentioned in the Code and did not include a corporation, the principal activity of which was engaging in competitive commercial business for profit. Thus \textit{Mueller} represented the first departure from the apparently settled doctrine of Roche's Beach and was in conflict with many decisions that had cited the latter case with approval.\textsuperscript{14}

The Internal Revenue Act of 1950, however, settled for the future the uncertainty brought about by \textit{Mueller}. A paragraph added to §101 of the Internal Revenue Code states that an organization operated primarily to carry on a trade or business for profit may not claim exemption solely on the ground that all of its profits are payable to one or more organizations exempt under that section. The underlying reason for this amendment is that such a business organization is not carrying out an exempt purpose and is in direct competition with taxable organizations.\textsuperscript{15} While the amendment denies a corporation the right to claim exemption from taxation on the ground that all of its income is payable to an exempt organization, presumably a subsidiary corporation of an exempt organization may still claim exemption if its activities are related to the function for which its parent was granted exemption.

This amendment is only applicable to taxable years beginning after December 31, 1950. Cases involving a taxable year prior to this date must be decided without drawing any inference from the amendment.\textsuperscript{16}

It would seem that if income is to be taxed when earned by a subsidiary of an educational or charitable organization, it should also be taxed when earned directly by such an organization. In both cases the

\textsuperscript{11} G. C M. 23063, 1942-1 CUM. BULL. 103.
\textsuperscript{12} Orton v. Commissioner, 173 F. 2d 483 (6th Cir. 1949); Debs Memorial Radio Fund v. Commissioner, 148 F. 2d 948 (2d Cir. 1945) (The court said that it would continue to follow Roche's Beach until instructed to do otherwise by final authority.); Estate of Louise v. Simpson, 2 T. C. 963 (1943).
\textsuperscript{13} 14 T. C. —— (May 25, 1950).
\textsuperscript{14} See note 10, supra.
\textsuperscript{15} H. R. REP. No. 2319, 81st Cong., 2d Sess. 41 (1950); SEN. REP. No. 2375, 81st Cong., 2d Sess. 35 (1950).
\textsuperscript{16} Pub. L. 814, 81st Cong., 2d Sess. §303 (Sept. 23, 1950) (Apparently this provision was intended to avoid a retroactive effect.).
type of business function is the same and the income used for the same purposes. If the law were otherwise the business carried on by the subsidiary could easily be transferred to the parent and thereby escape taxation. Apparently in an attempt to close any loophole that might result from such action by an exempt corporation, the Congress amended Chapter 1, Supplement U of the Internal Revenue Code, in the Revenue Act of 1950.

Under this amendment certain organizations exempt under §101 of the Code are made subject to the income tax on income from the operation of business enterprises unrelated to the purpose for which such an organization received its exemption. Many organizations, however, now exempt under §101 of the Code are not affected by the amendment, and the application of the new tax is restricted by numerous exceptions and limitations.

The new tax applies only to the unrelated business income of labor, agricultural, and horticultural organizations exempt under §101(1) of the Code; literary, scientific, religious (other than churches or associations of churches), educational and charitable organizations exempt under §101(6); the business and trade associations exempt under §101(7); and title holding companies exempt under §101(14) if their income is payable to section 101 (1), (6), or (7) organizations.

The act defines unrelated income as income derived from a trade or business "regularly carried on" and "not substantially related" (aside from the need of income) to the purpose for which the organization was granted exemption under §101 of the Code. Sporadic activities such as the operation of a sandwich stand during the week of an annual county fair would not be considered a business regularly carried on. Athletic activities of schools would be considered substantially related to their educational functions.

The Supplement U tax is not applicable to a business in which all of the work is performed without compensation; a business carried on, by an organization exempt under §101(6), for the convenience of its members, students, patients, or employees; or a business in which all of the merchandise sold was acquired by the organization as a gift or contribution.

Although money received by an exempt organization is within the definition of unrelated business income it may not be subject to the

17 INT. REV. CODE §421.
18 INT. REV. CODE §421(b).
19 INT. REV. CODE §422.
21 INT. REV. CODE §422(b). The Senate Finance Committee illustrates the type of businesses excluded under this section as (1) an exempt orphanage running a second-hand clothing store by means of volunteer workers, (2) a university laundry operated for the convenience of the students. (3) a thrift shop operated by an exempt organization. SEN. REP. No. 2375, 81st Cong., 2d Sess. 107 (1950).
Supplement U tax if derived from dividends, interest, annuities, royalties, rents, gains from the sale of property, or research. Such income is not taxable because it is considered to be passive in nature and not to have a harmful effect on competition.

The new law does not deprive an organization of its tax exemption or require it to dispose of its unrelated business. The tax is imposed only on unrelated business income in excess of $1,000. The related income of an exempt organization will continue to be exempt as under the old law.

The new tax became effective with taxable years beginning after December 31, 1950. Organizations taxable as corporations will pay the normal rate of 25 per cent on their unrelated business income and a surtax of 20 per cent on such income over $25,000; however, these rates may be changed by current legislation proposing increases in corporation tax rates and an excess profits tax. Organizations taxable as trust will be taxed at the same rate as individuals. Also of importance is the fact that the tax is imposed on the net unrelated income in order that losses on one unrelated venture may be offset against gains on another.

ROBERT M. WILEY.

Torts—Malpractice—Liability of Physician for Acts of Substitute

The liability of a physician to a patient for malpractice is dependent upon the existence of a physician-patient relationship, or upon a relationship based on contract. Absent a special contract to the contrary, a physician-patient relationship is brought into existence upon acceptance of the patient for treatment, and such relationship may be terminated by mutual consent, dismissal of the physician by the patient, determination by the physician that his services are no longer needed, or reasonable notice to the patient in order that that patient may have an

Reference to physicians throughout this article also includes surgeons.