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I UNDERSTAND THAT I AM TO SPEAK on the *Clay Brown* legislation from an "independent" point of view. I assume this means that I am supposed to say some of the critical things about this legislation that the general public might conceivably say.

This bill substitutes a technical solution of a portion of the *Clay Brown* problem for a broad approach integrated to exemption questions generally, although the recent Treasury Foundation Report documented the need for such a more basic solution. And, in my view it bypasses some of the most basic problems at issue, since it applies to only certain types of bootstrap and does not deal with a number of the objections to the bootstrap device.

In substance, a bootstrap is a unified transaction in which the owners of a closely held business purport to transfer it to an exempt organization, but continue for a number of years to run the business and to receive its profits much as always, except that the profits are now labeled as capital gains for the sellers and are exempted from tax for the charity by being labeled is short term lease "rentals." Since the profits are thus made tax exempt, the sellers also benefit from the higher price the charity can afford to pay and the more rapid and more secure repayment which this makes possible. The charity takes no risk and has no bargaining position unless one cynically concedes it is selling its exemption, since any down payment comes from the assets of the business transferred and any further payments are made from its profits, the charity not being committed to put up anything.

In this sense, the charity has no bargaining position at all, for it takes no risk and has nothing to offer. Therefore, it is difficult to see how there can be fair market value in the sense of an arms length bargain between ready buyer and willing seller, even though in each bootstrap there is an elaborate charade in which the charity *or* its learned expert purports to analyze the

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value of what it is getting, and to bargain about the price. And, of course, any excess over fair market value inures to the private benefit of the original owners, as well as suggesting a sham.

Actually, as the Supreme Court concedes, the charity is selling or leasing out the use of its exemption until such time as the price is paid, a situation whose ultimate morality did not seem to concern the courts. And, the sellers get treated as though they had transferred full ownership, even though for most of the period they keep control of the business, and the entrepreneurial risk of its profit or loss just as though they had never transferred it.

Although the hearings and this legislation stress the abuse of the charitable exemption in the sense that the bootstrap may permit exempt organizations to acquire many closely held companies, with a related removal of businesses from the tax rolls and ensuing unfair competition, much of the problem lies deeper and includes recognizing the unified nature of these transactions, not their isolated parts.

The majority holding in *Clay Brown* gave a broad blessing to a recognition of "sale" for tax purposes even when so much risk and control are retained that it can not really be said that there was a substantial transfer of ownership, and where consequently there was retention of profits, and so, private inurement.

If the Supreme Court's casual, and perhaps hastily considered words as to the unimportance of the retention of risk or control, as factors in determining if sufficient ownership transferred for there to be a "sale," are to stand, it will have a far broader impact on tax law generally than the mere revenue impact of the bootstrap—and it is this broad consequence with which the Treasury should be particularly concerned.

Thus, the question whether there is a sufficient transfer of ownership to affect tax consequences is a generic issue affecting many areas of tax law from anticipatory assignments, Clifford Trusts, stock options, patents, economic interests, sale and leasebacks to capital gains treatment of sales generally. For example, if *Clay Brown's* pronouncements on risk were to be taken seriously, much of the oft-litigated area of thin capitalization and the related cases dealing with the distinction between "debt" and "equity" would be thrown into disarray. And a corollary, but very important side effect of this majority decision is that the existence of reasonable rules for determining fair market value will be further imperiled. Furthermore, there is a whole array of bootstraps built upon using net operating losses to serve the same function as the charitable exemption in *Clay Brown,* and the legislation provides no remedy at all for this group of bootstraps.

It appears most unlikely that the Supreme Court will be able to maintain *Clay Brown's* emphasis on form over substance and its dictionary definition of "sale" as an approach to problems so basic to the operation of the revenue system. The Supreme Court is certain to retract some of its *Clay Brown* positions. But, there are likely to be a flood of confused and unfortunate lower court decisions in reliance on the *Clay Brown* language until the Supreme Court straightens out much of what it did here. Furthermore, the resolution of the capital gain issue is basic to the exemption question as well. If there has not been such a substantial transfer of ownership as to give a sale in a meaningful tax sense, then the owners are getting profits, not purchase price payments and so there is private inurement—the most basic of all violations of the exemption laws. Even if it were possible to argue that part of the payments are purchase price and part are profits, there is still private inurement from those payments that are profits.

While the capital gains issue, as a portion of the entire bootstrap problem, is not an easy matter to handle by legislation, it can not be as easily dismissed as did the Treasury spokesman, at the hearings, in stating that the capital gains side of the *Clay Brown* device had so many elements of the ordinary commercial transaction as to require "care" in any legislative solution, and so would not be dealt with. Care and abandon are not the same. This bill is the place for that care to be applied, even though the problem is admittedly difficult to fit within the usual legal labels. That is, too much ownership has been retained by the so-called sellers for this truly to be a "sale." But it is hard to call it "not a sale," for formal title passes, and eventually, if the transaction does not collapse for lack of the independent financing usually found with a sale, the original owners will in fact yield all of their ownership. However, since the question is not really which legal label applies, despite the decision's emphasis on the verbal meaning of "sale," but whether this is the sort of transaction, which on all its facts, properly fits within the capital gains—and the exemption—framework, appropriate legislation can be drafted once the problem is perceived.

Indeed, the Treasury has previously offered a partial solution to the capital gains issue in its 1963 proposal that periodic payments dependent on the income of the business be denied capital gains treatment. The initial congressional rejection of this approach does not mean it could not succeed if it were ever enthusiastically pursued by the Treasury. And the Treasury has suggested, at least by analogy, still another approach to this problem. Thus, the 1965 Treasury Report on Private Foundations urges that where a donor has retained control of gift property, he should not get a present tax deduction for a charitable contribution until the gift is completely transferred. Similarly, should a seller get capital gains treatment until ownership is fully transferred?

The Treasury Report also suggests that general language such as "unreasonable accumulation" or "substantial degree" etc., as used in the 1950 legislation against somewhat similar abuse, was not given full effect by the courts. The usual check and balance against a judicial tendency to read anything the court chooses into general language, is to put sound, but adequate discretion in the Commissioner. (Later on I shall suggest possible legislation to do this.) But, the Treasury failed to seek either a full correction for the bootstrap, or even an integrated approach, apparently concluding that the best way to keep Congress from rejecting an effective approach and substituting a weak solution, is to offer the weak solution first.

So the proposal to tax "unrelated debt financed income" represents little more than a limited tightening of current legislation taxing unrelated business leases, and it backs away from the total problem. Indeed, it is a sharp retreat from the position taken by the Treasury's Foundation Report of only a year ago, which urged a prohibition on borrowing by private Foundations for investment purposes. This proposal alone—incomplete as it is—would have been a broader, a more inclusive and a sterner deterrent to bootstrapping than the present legislation. Joined with the other recommendations in the Treasury Report aimed against private benefit from charity or the use of exempt organizations for business or other unrelated functions, and the Report's emphasis that current charitable exemption requires current charitable spending, much of the fun and profit would have been taken out of bootstrapping. Certainly these solutions would have avoided the doubtful complexities of a tax on "unrelated debt financed income" with its percentage allocations, and its optimistic hope that such an indirect sanction can solve a different world of problems. But there is another and more fundamental objection to the very assumption that one can meet the *Clay Brown* problem by taxing "unrelated debt financed income." The bill thereby sanctions a charity's participation in the bootstrap gimmick, but removes much—although not all—of the profit. But for a charity to participate in a bootstrap is a deliberate granting to private parties of the right to use and exploit its exemption in return for the paltry pennies—relatively—which the charity receives in return. If the major reason for granting the extra-ordinary privilege of tax exemption is to serve the lofty public goals stated in the Code such as education, religion, research, charity, then there is a serious question whether any exempt organization, which in return for a few crumbs of profit makes its exemption available for private benefit, should retain that privilege. And how appropriate is a legislative solution which takes away some, but not all of the profit? Even if the Treasury were correct that this *would* deter most bootstraps, it is a doubtful treatment from a public standpoint. Thus, is it in the public interest to build up the permanent endowment of a University which aggressively seeks out and develops these schemes, thereby giving a competitive business an unfair exemption, and channeling most of the fruits of that exemption to private hands in the form of a higher price for the business, more rapidly and more securely paid from tax exempt profits? Does taxing some, but not all of the profit, really answer this question? Or, should any charity which so diverts its exemption to private benefit lose that exemption for a period of one or more years, or have its contributions lose deductibility for a similar period? Put that proposal into the legislation and you would at least open up the morality of the entire situation for debate.

Thus, the Foundation Report comments that since the unrelated business income tax does not apply to rents derived from property with respect to which the lessor has no outstanding indebtedness, foundations are able to lease business assets owned free of debt to operating subsidiaries, siphon off most or all of the business profits by means of "rent" which is deductible by the subsidiary but not taxable to the parent foundation, and thereby they can accumulate large reservoirs of untaxed capital. These remarks are equally applicable to the bill's formula of taxing income only to the extent that its source is debt financed. They indicate that the Treasury itself was intimately aware of the objections to the kind of technique employed in the proposed *Clay Brown* legislation.

Furthermore, unless it really takes a sternly disapproving slap at the whole *Clay Brown* decision, the legislation is liable to be viewed as an acquiescence in some or all of the whole chain of judicial aberrations which are to be found in the Supreme Court's majority decision. Thus, that decision accepts and approves a blatant dealing in charitable exemptions, and it overlooks a transparent manipulation of the five year lease provision for tax avoidance purposes. It completely failed to appreciate or emphasize the close relationship between the capital gains and the exemption issues. The Supreme Court majority emphasized form over substance, treated this integrated tax avoidance scheme as a mere unrelated group of separate pieces, gave local law an undue and undesirable role in federal taxation, misunderstood and mis-cited some of its own decisions in the economic interest area, confused the question of whether a transaction is "sham" with problems of "substance and form," and completely overlooked the basic question of whether the major indicia of ownership had transferred, in accepting a mere verbal definition of "sale" as its standard.

The Congress understands very well how to completely overturn an unloved Supreme Court decision, as cases like *Helvering v. Bruun* and *Court Holding Co.* illustrate. It is difficult to see what the *Clay Brown* decision has to commend it, that should prevent this legislation from embodying an equally drastic reversal.

I would like to pose to you a hypothetical case as a possible test of the effectiveness of the proposed legislation. Suppose, for example, that Taxpayer constructs a deluxe hotel with adjacent garage, of the sort that the recent Yale-Vassar merger suggests for a far-out co-educational dormitory. Taxpayer receives a bona fide offer of $2-1/2 million for the hotel and garage, title to which is in his 100% owned corporation, Title Company. Since the hotel and garage cost him more than $2,000,000, Taxpayer is tempted by this offer until he is approached by Finder who tells Taxpayer that Gotham University is looking for well paying income operations and is willing to pay top dollar. Gotham University sends its top legal and financial expert to see Taxpayer. After Expert parks his car in the garage, rides around the building twice, tries the elevators and leafs through a quick profit and loss statement, Expert gravely informs Taxpayer that in his considered opinion and based on the known and unknown state of the real estate market, the buildings are worth $3 million and offers Taxpayer $3 million. "$4 million," says Taxpayer citing the two coin washing machines in the basement of the Hotel. After a few seconds, Expert agrees that $4 million is a more closely bargained approximation of the fair market value and they shake hands on the deal, Taxpayer congratulating Expert on his tough and resourceful negotiating. Taxpayer then says, "I like you fellows. I am going to have Title Company make you a gift of the garage adjacent to the hotel." Gotham University, of course, gratefully accepts. Gotham keeps the garage a few months and then sells it to provide the $1 million downpayment. The practical effect of this is that only $3 million of the $4 million dollar payment will be "debt financed" and subject to taxation under the bill. This will exempt 25% of the income from tax during the first year and more thereafter, and will give some maneuvering room for the usual bootstrap no-risk lease to an operating company. Thus, the agreement can provide for the owners to receive 90% of 55% of the "rents" from an operating lease, even if such "rents" are taxed to the charity under this bill. The practical effect is to let the owners retain 50% of the ordinary income from the business, but at a capital gains rate. This is still enough to make the deal profitable despite the tax levied by the bill.

You will note that this transaction has all the characteristics of the bootstrap. Taxpayer continues to be dependent on the receipt of 50% to 72% of the profits of the hotel operation for the payment of his so-called sale price (72% if the tax provided by the bill does not apply). Although, the contribution of the garage is a fairly transparent device, it is no more so than the other bootstrap techniques which the Tax Court, the Ninth Circuit and the Supreme Court all have accepted. Gotham takes no risk and gets something for nothing (other than the use of its exemption) since payment is due only out of profits. Taxpayer in fact got a higher price than fair value even though the courts will probably hold that the "negotiations," and the greater ability of a tax-exempt organization to pay over profits faster and in larger amounts, mean that this was a fair price. Taxpayer will claim capital gains treatment though he has kept most essentials of ownership except title and although there is no "bunching" of his receipts from the transaction, which receipts are in the form of periodic payments of a percentage of rents. And the hotel continues in the competitive business of providing accommodations, although now as a dormitory, and with an ability to charge lower prices, etc. As a college dormitory it will not be competitive in some respects, and in others it will be, something like a university book store, as some—or all—of its income will be exempt. Most of the partially tax-exempt profits from the business will go to Taxpayer rather than directly to Gotham's charitable purposes, although, of course, Gotham will be accumulating an equity in the business. Thus, charitable purposes will benefit at some remote date. And to the extent that Taxpayer's proceeds may be viewed as an extraction of profits from the hotel operation, there is private inurement of a portion of the untaxed profits to him. Limiting the sellers to receiving 50% of the ordinary income from the business, but in gains form, is not a prohibitive penalty when compared with the more usual 72% obtained by the bootstrap (leaving a net 37-1/2% rather than a net 54% after capital gains tax), and particularly, as the very existence of the *Clay Brown* statute may insulate the entire transaction from even being questioned by the Commissioner. In addition, as each year goes by, a greater percentage of the equity will have been paid off, and so a larger proportion of the income will be tax exempt each year. Of course, the proposed legislation will be of limited effectiveness in the kind of case just cited because 1) it seeks to deal with the problem via a mechanical formula based on a ratio of cost to debt financing which, even so, is less effective each year as more of the debt is paid off, 2) the failure to deal with the downpayment problem, 3) the failure to deal with whether there can be fair market value if one party lacks bargaining power, and 4) because it fails to come to grips with the main bootstrap problems such as transfer of ownership, unreasonable accumulation, and private inurement and fails to treat the problem as a unified whole. And, as has been noted, the bill gives *no* relief from the net operating loss bootstrap.

Even if, despite *Knapp Bros.* and similar cases, the Court were to recognize the down payment as being in substance a dividend—and I suppose Mr. Justice White's killing rejoinder would be to prove by the dictionary that a "down payment" can not be a "dividend"—the problem persists. Thus assume that Gotham actually invested $1 million of its own funds. This would mean that only 37-1/2% of the income would be actually paid out in taxes (*i.e.*, a 3/4 ratio of debt to cost, times a 50% corporate tax rate) and would still leave an adequate margin both for Gotham to pay an inflated price and for a number of these abuses to persist. Gotham's risk would be limited to 25%, but it would succeed in escalating its endowment from sources quite different from public charitable contributions and with benefits to private individuals, difficult to reconcile with the whole purpose and policy behind tax exemption. And, of course, if Gotham risks nothing, these arguments are that much stronger. Furthermore, we have been assuming that the proposed legislation might lead to at least partial taxation of income in the hypothetical bootstrap case of the hotel transfer, which I just cited. Actually, however, there is at least one other provision in the *Clay Brown* bill as drafted that might totally exempt the hotel owner. This is proposed Section 514 (d) (1) which follows existing law in exempting property all of whose use is related to performance of the charity's exempt functions. The hypothetical poses some questions as to the total wisdom of that exception. This is particularly so since, following approved bootstrap techniques, it might be relatively easy for the owner of a business to set up a Foundation owned by his accountant, his niece and his secretary, whose exempt purposes were tailored to the functions of the business to be transferred. Thus, if you have an auto repair shop you might set up such an auto safety foundation on the assumption that the doubtful syllogism of this relationship would be accepted by any court able to swallow *Clay Brown*. And the owners of Playboy might set up a Foundation for Divine Premeditation. Or, instead of a hotel, the owners might attempt the transfer of one of the country's giant research organizations. With a little tailoring—and any bootstrap attorney is expert at that—such a transaction could probably be given complete exemption under the "basic research" provisions of proposed Section 514 (d) (3). Yet even when labeled "basic research" these are often very active, very competitive businesses.

Certainly, such possibilities of avoiding or mitigating the impact of the proposed legislation suggest the need of broader and more determined approaches. As the Foundation Report states, the answer can not lie in the use of general language alone—that is too often frustrated in the courts. But if broad solutions are adopted and if the Commissioner is given genuine discretion to adopt regulations for their application, then there is some possibility of coming to grips with so difficult a form-over-substance device as the bootstrap. However, the major defect in the judicial treatment of *Clay Brown* and other bootstrap cases, as well as, implicitly, a major defect in the proposed bill, is the failure to regard the bootstrap problems, both capital gains and exemption, as a single integrated transaction, meaningful only in total. Thus, both the Government's presentation and the Supreme Court's analysis failed most singally in that they tried to fractionate the problem. Even those parts of the problem which they did recognize, were treated piecemeal, instead of as a unified whole. It is not merely the retention of risk, the retention of control, the inflated price, the private inurement, the trading on the exemption, the effort to transmit active operating income as passive rent, the unreasonable accumulation, the deliberate manipulation of the tax laws, the artificial reliance on mere passage of title, the extraction of the downpayment from the assets of the business—none of these can be viewed in detachment and rejected via the Supreme Court's erroneous argument that each such factor is not sufficient alone. A bootstrap can be viewed only in total, and for what it is in substance.

By the same token, a bootstrap is difficult to deal with by legislation—particularly if most courts are not understanding—and therefore should have been properly presented to the Supreme Court and properly disposed of. Since that was not done, the present difficulty is at least in part a matter of tax administration. The litigators and the courts have failed to perceive the substance of the bootstrap. That being so, reasonable discretion in the Commissioner to promulgate detailed regulations dealing in a unified way with the most difficult elements of the bootstrap, is the approach most likely to avoid the kind of frustration by the courts which the Treasury has cited with respect to the 1950 legislation. Accordingly, the bootstrap legislation should be drafted so as to A) deny any *capital gains* treatment to the taxpayer *until* he has met the burden of demonstrating to the Commissioner's satisfaction, as set forth in detailed regulations, that there has been a substantial transfer of ownership, *in any situation where a combination of several* of the following six bootstrap factors are present: 1) the transferor transfers property to a charity, and the charity assumes no liability for payment, 2) since the charity thus lacks a true bargaining position, the price is more than real bargaining would have produced, 3) the transferor retains the substantial risks of the business, via an arrangement for periodic payments dependent on profits or otherwise. This usually includes the ability to recapture the business in the event of default, 4) the transferor retains control of the business through a management contract, or otherwise, 5) the basic charity receives distributions that are essentially operating income of the transferred business, even though they may be labeled "rent," and 6) finally, the downpayment comes directly or indirectly from the assets of the transferred business.* B) The same legislation should also include provisions that wherever several of these bootstrap factors are present, and an exempt organization receives payments which the Commissioner, pursuant to regulation, shall determine to be essentially payments of the operating income of an unrelated business, even though labeled as "rent," etc., they shall be taxed as unrelated business income unless the taxpayer demonstrates to the Commissioner's satisfaction that the payments really are "rent" or otherwise "passive" income. C) And, the legislation should also provide

* This and the following is only a loosely stated, approximate formula. To deal with a substance and form problem involving this many inter-related variables, legislation should be drafted along the lines of the *Clifford* trust provisions, although with appropriate discretion in the Commissioner. Time did not permit for inclusion in this speech.

that wherever several of these bootstrap factors are present *and* the down payment directly or indirectly, by liquidation, sale, loan or otherwise, is derived essentially from the assets of the transferred business, rather than the independent assets of the purchasing exempt organization, that the taxpayer shall have the burden of demonstrating that it should *not* be taxed as dividend or ordinary income—as appropriate—to the transferors of the business. D) Similarly, the legislation should provide that whenever several of these bootstrap factors are present, and particularly where it is thereupon held that a capital gains sale has not occurred, that payments to the alleged "sellers" of the business whether by down payment or installment payment, made during any period when the Commissioner finds that a meaningful transfer of ownership has not yet been consummated, shall be treated as a private inurement of profit to the "sellers". E) The legislation should also provide that whenever several bootstrap factors are found present, and the charity is accumulating a significant equity in the transferred assets without equivalent current spending for charity, nor justification by the taxpayer, this should be treated as an "unreasonable accumulation of income" under Section 504. F) And finally, the legislation should put a strict burden of proof on the parties to demonstrate that the price is not inflated nor above what normal arms' length bargaining would have produced, in any situation where a charity or other purchaser puts up no significant assets of its own and otherwise assumes no substantial risks.

Passage of this legislation may be difficult to obtain. But this discussion was billed as an "independent" point of view, so I believe I am permitted what is—no doubt—an idealistic approach. And, if we seek a whole solution, we may get at least part. If we seek only part, we may get none.

The Foundation Report says that the major contributions made by private foundations to the public interest, and particularly their financing of controversial and unconventional inquiry, which would have difficulty in getting support elsewhere, require the abandonment of such drastic proposals as that exemption should be terminated for private foundations or that limits should be put on the length of life of any private foundation. However, many students of Foundations have pointed out their current, and increasing, tendency to emphasize the conventional, the conformist and the uninspired in their grants. It is far more difficult nowadays to get support for anything pioneering from the private foundation. If this is so, and if the social value of the private foundation is declining, and the pattern of abuse is climbing, then it may not be unreasonable to conclude that the private foundation is not so sacrosanct that it should be relatively free to aid and abet private inurement, unreasonable accumulation and the related bootstrapping of capital gains. Put another way, the arguments are strong for a tough minded, effective crackdown on the bootstrap in concert with related legislation on exemption questions generally, without a need to provide percentage formulae or special exemptions that will leave many bootstraps almost intact.

I have spent most of my time criticizing the proposed legislation as neither wide nor deep. It does have, however, several good—although limited features. The first of these is the removal of the exemption for five year leases, a desirable, although long over-due correction. However, this should be supplemented by an approach taxing any operating income paid out as "rent" no matter what the state of any indebtedness—as I have suggested. The provisions extending the bootstrap legislation to churches and other utterly exempt organizations are also necessary. If such organizations can be tempted to participate in arrangements as dubious as a bootstrap, then it is apparent that the more susceptible among them may be induced to aid less flagrant abuses of their tax exemption. The bootstrap may be a speical situation, but it focuses attention on many general abuses, and calls for general remedies. Several of the more technical provisions such as the denial of accelerated depreciation and of the dividends received credit are also useful within the scope of the bill, as drafted.

The Treasury Foundation Report was both an imaginative and a courageous document. I hope that the Treasury will approach the integrated problems of the bootstrap and of general abuse of the charitable exemption with comparable imagination and courage.