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Federal Income Taxation: proceeds from Bootstrap Sale of a Business to Charity Given Capital Gains Treatment

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Federal Income Taxation: Proceeds From "Bootstrap Sale" of a Business to Charity Given Capital Gains Treatment

Respondent taxpayers transferred all the stock of their closely held corporation, Clay Brown & Company, to a tax-exempt organization, the Institute, in return for its note, payable over 10 years.[1] The Institute made no downpayment and assumed no liability on the note. The Institute liquidated the Corporation, sold the current assets to Fortuna Mills, Inc., a corporation newly formed by the taxpayers' lawyer,[2] and paid the taxpayers a small part of the proceeds as a downpayment. For security on its note, the Institute had given respondents a mortgage on the fixed assets, which were leased by the Institute to Fortuna in return for 80 percent of Fortuna's profits from operation of the business. The Institute retained 10 percent of its percentage of the lease receipts and passed along the remaining 90 percent to respondents to apply on the note. As part of the agreement one of the petitioners was employed as the general manager of Fortuna with substantially the same powers as he had prior to the sale. Subsequently, Fortuna suffered business reverses and shut down operations. Rather than foreclose their lien, the taxpayers accepted 90 percent of the proceeds of the Institute's sale of the fixed assets in satisfaction of its note.[3] The Commissioner attempted to tax respondents' proceeds from the transactions as ordinary income. The Ninth Circuit sustained the determination below that the transfer of stock was the sale of a capital asset within the meaning of the Internal Revenue Code,[4] and permitted taxation of the gain at capital gains rates. *Commissioner v. Brown*, 325 F.2d 313 (9th Cir. 1963), *cert. granted,* 377 U.S. 962 (1964) (No. 1041), *affirming* 37 T.C. 461 (1961).

The type of transaction attacked in *Brown* is advantageous to

1. The notes were payable in the amount of $1,300,000. Net worth of the corporation at the time of transfer was determined to be $1,050,000. All payments on the notes were to be made from future earnings of the business.

2. Fortuna was organized with $25,000 of capital stock, all of which was held by taxpayers' attorney.

3. The sale of the assets by the Institute was in pursuance of an agreement entered into by it and the taxpayers at the time the business reversals became critical.

4. "The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income." INT. REV. CODE OF 1954, § 1222(3).

both the seller and the tax-exempt[5] purchaser, if constructed within the narrow confines of the Internal Revenue Code.[6] It is a form of "bootstrap sale" of a business. The essence of a bootstrap sale is that the earnings of the business itself provide the funds with which the purchase is made.[7] Because it is possible for a charitable organization to receive tax free income from the business, it can pay a higher price or shorten the repayment period by making larger installment payments than the seller could receive in the open market. Even though the sale permits the seller to "bail out" past[8] profits and to receive his payments in installments,[9] the transaction likely qualifies for capital gains treatment. By profitably liquidating his business over a period of years, the seller can avoid the risk of not being able to find a cash purchaser when he reaches retirement. In addition, his prop-

5. Income of charitable and some other organizations is exempt from taxation. INT. REV. CODE OF 1954, § 501. Income of organizations operated for charitable, religious, scientific, or educational purposes is exempt from taxation so long as no part of the net income "inures to the benefit of any private shareholder." INT. REV. CODE OF 1954, § 501(c)(3).

6. Care must be taken to avoid Congress' attempt in 1950 to curtail such transactions. See notes 33–35 *infra* and accompanying text.

7. In this paper the term more restrictively refers to such a transaction in which the purchaser is an exempt organization. See generally Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business*, 108 U. PA. L. REV. 623 (1960); MacCracken, *Selling a Business to a Charitable Foundation*, U. So. CAL. 1954 TAX INST. 205; Moore & Dohan, *Sales, Churches and Monkeyshines*, 11 TAX L. REV. 87 (1955).

8. A significant part of the appreciated value of a business likely reflects past earnings and profits which were locked into the business. For example, in the instant case there were $448,471.63 in retained earnings at the date of sale. Had they been paid out they would have been subject to ordinary progressive taxation in the hands of the seller. By selling the business the taxpayer is able to remove ("bail out") these profits at capital gains rates as part of his gain. See generally Alexander & Landis, *Bail-Outs and the Internal Revenue Code of 1954*, 65 YALE L.J. 909 (1956); Dean, *Rules Governing Preferred Stock Bail-Outs*, N.Y.U. 14TH INST. ON FED. TAX 691 (1956).

9. Income received on the installment basis from a sale is reported under INT. REV. CODE OF 1954, § 453(a). This section requires determination of the percentage of the total sales price which represents taxable gain over the basis of the item sold. As each installment is received, an amount equal to this percentage times the installment is taxable to its recipient at the rates then applicable.

The Code does not indicate whether or not the capital gains provisions and § 453 may be applied concurrently. However, since the decision rendered in Carl G. Dreymann, 11 T.C. 153, 163 (1948), the Commissioner has not asserted that when a taxpayer reports on the installment basis he should be deprived of the benefit of capital gains treatment.

erty is readied for estate tax and probate purposes.[10] In *Brown*, the principal seller remained active in the management of the concern, which, in his mind, probably reduced the risk of incompetent management ruining the business before the installment payments were completed. The charity risks nothing, receives some net income over the installment payment period, and in the end owns the assets and reaps most of the income of a profitable business.

The Commissioner has sought to reduce the profitability of these transactions by taxing the seller's proceeds as ordinary income.[11] One approach has been the assertion that the bootstrap sale was a sham and the proceeds constituted dividend payments to the sellers[12] or some other form of ordinary income.[13] Success depends on showing an intent to bail out the retained earnings and profits at capital gains rates and then to permit the business to revert to the seller.[14] In *Brown*, however, a bona fide transfer admittedly was intended.[15]

Alternatively, the Commissioner has admitted that the bootstrap was a bona fide transaction but has asserted that it failed to meet the more stringent requirements necessary for recognition

10. See MacCracken, *supra* note 7, at 212.

11. See Caldwell v. Campbell, 218 F.2d 567 (5th Cir. 1955); Union Bank v. United States, 285 F.2d 126 (Ct. Cl. 1961); Estate of Ernest G. Howes, 30 T.C. 909 (1958), *aff'd sub nom.* Commissioner v. Johnson, 267 F.2d 382 (1st Cir. 1959); W. H. Truschel, 29 T.C. 433 (1957); Emanuel N. Kolkey, 27 T.C. 37 (1956), *aff'd*, 254 F.2d 51 (7th Cir. 1958); Rev. Rul. 54-420, 1954-2 Cum. Bull. 128.

12. See Estate of Ernest G. Howes, *supra* note 11, at 920.

13. See Caldwell v. Campbell, 218 F.2d 567, 569 (5th Cir. 1955), in which the Commissioner argued that the transaction was an assignment of income and therefore taxable to the transferor as ordinary income. See also the instant case, 37 T.C. at 483, in which the Commissioner did not equate the proceeds with any particular form of income.

14. See *id.* at 484; Estate of Ernest G. Howes, 30 T.C. 909, 920 (1958), *aff'd sub nom.* Commissioner v. Johnson, 267 F.2d 382 (1st Cir. 1959).

15. The Commissioner did not appeal from the Tax Court's determination of the existence of a bona fide transaction. In so holding the Tax Court relied on the following facts: (a) It was the Institute which approached the petitioners concerning the sale (the court felt that normally the seller would institute negotiations if an elaborate plan for only temporary transfer of assets was contemplated); (b) the Institute took steps to ascertain the real worth of petitioners' business (taken by the court to indicate an intention on the part of the Institute to enter into a profitable transaction); (c) Fortuna was organized with more than nominal capital contribution by petitioners' attorney (taken to indicate he must have intended to receive a reasonable return on his investment which could only have been accomplished by a real and lasting transfer). See 37 T.C. at 486.

as a sale under the capital gains provisions.[16] The Code affords no definition of "sale . . . of a capital asset."[17] However, the courts have not found transfer of legal title determinative. Bona fide sales have been denied tax recognition where the seller has retained an interest, indefinite in duration, in the future earnings of the transferred property.[18]

The most basic, or at least the most cited test used by courts in determining whether a particular transaction should be afforded tax recognition is the "business purpose" doctrine put forth by the court in *Gregory v. Helvering*.[19] In *Gregory* the Court refused taxpayer the tax advantages of a reorganization because the purported reorganization was performed as a means of tax avoidance and did not accomplish the business purpose for which it was enacted. "[T]he principle laid down in the *Gregory* case is not limited to corporate reorganizations, but rather applies to the federal taxing statutes generally."[20] The *Gregory* doctrine applies where the question is whether the characterization urged by the taxpayer accords with "substantial economic reality."[21]

The Commissioner has successfully attacked only one bootstrap sale. It is not clear whether the court in *Kolkey v. Commissioner*[22] found the transaction a sham or held that the transfer, although otherwise legitimate, was not a sale for capital gains purposes. Although the *Brown* court read *Kolkey* as limited to holding the transaction a sham, the facts were consistent with

16. *Compare* the instant case, 325 F.2d 313 (9th Cir. 1963), *and* Union Bank v. United States, 285 F.2d 126 (Ct. Cl. 1961), *with* Commissioner v. Johnson, 267 F.2d 382 (1st Cir. 1959), *and* W. H. Truschel, 29 T.C. 433 (1957). In the latter two cases the Commissioner argued that the transaction should be considered a statutory reorganization and the proceeds should be taxed as dividends, while in the former two cases the Commissioner did not attempt to classify the proceeds, but merely asserted that they were not eligible for capital gains treatment.

17. See note 4 *supra*.

18. In the cases dealing with the sale of natural resources, the courts have denied capital gains treatment to the proceeds received by the seller where the amount to be received is made dependent upon the future extractions made by the purchaser. See Palmer v. Bender, 287 U.S. 551 (1933); Brunet v. Harmel, 287 U.S. 103 (1932); Laudenslager v. Commissioner, 305 F.2d 686 (3d Cir. 1962); 4 MERTENS, FEDERAL INCOME TAXATION § 24.54 (1960).

The loss resulting from a sale of securities by a taxpayer to a corporation in which he held all the stock was denied tax recognition in one case on the grounds that taxpayer had the same control over the securities before the transfer as after. Higgins v. Smith, 308 U.S. 473 (1940).

19. 293 U.S. 465 (1935).

20. Weller v. Commissioner, 270 F.2d 294, 297 (3d Cir. 1959).

21. Gilbert v. Commissioner, 248 F.2d 399, 406 (2d Cir. 1957).

22. 254 F.2d 51 (7th Cir. 1958), *affirming* 27 T.C. 37 (1956).

either conclusion.[23] The sale price so exceeded the fair market value of the business that the earnings could not reasonably be expected to meet the installment payments. The corporation formed to run the business on behalf of the charitable purchaser was unrealistically capitalized at the equity to debt ratio of 1 to 3,600, and the original sellers obtained ownership of its stock within a year. In addition, the court emphasized the retention by the sellers of control and economic risk and the absence of new capital and management in refusing to allow a sale for capital gains purposes. The court sustained characterization of the notes and payments received by the putative sellers as equity capital in the purchasing corporation and dividends respectively.

It has been said that a sale will be recognized for tax purposes only when an examination of the economic realities reveals that a meaningful transfer has occurred.[24] In the instant case the Commissioner asserted that there was no such meaningful economic transfer because "certain normal aspects of the sale of a business were missing."[25] He suggested that precedent required "(1) shift of business risk; (2) shift of benefit of income; [and] (3) shift of operational control . . ." to qualify as a sale under the statute.[26]

In *Brown* most characteristics of a normal sale were present in some degree.[27] The extent of the sellers' control over the business was greatly decreased. Although one seller retained management powers comparable with those he had formerly possessed, the sellers no longer held control through stock ownership. Twenty percent of the income was shifted to Fortuna and eight percent to the Institute over the installment period.[28] By agreeing to a fixed and reasonable selling price,[29] the sellers were foreclosed from sharing in any increased future profitability. Although

23. 37 T.C. at 487; *accord*, Union Bank v. United States, 285 F.2d 126 (Ct. Cl. 1961); Estate of Ernest G. Howes, 30 T.C. 909, 925 (1958), *aff'd sub nom.* Commissioner v. Johnson, 267 F.2d 382 (1st Cir. 1959). It has been suggested that the *Kolkey* court went beyond the sham rationale and inquired into the economic realities involved. See Lanning, *supra* note 7, at 641.

24. Lanning, *supra* note 7, at 647; see Moore & Dohan, *supra* note 7, at 91.

25. 325 F.2d at 315.

26. *Ibid.*

27. The instant court found present all the elements of a meaningful economic transfer which the Commissioner had asserted were lacking. 325 F.2d at 315.

28. 325 F.2d at 315.

29. The Tax Court in the instant case did not state that the price was a reflection of fair market value but merely held that it was within a "reasonable range." 37 T.C. at 486. The court found the business outlook to be good and that past earnings had averaged $300,000 per annum. The actual purchase price of the stock was $1,175,000 (the $1,300,000 figure included $125,000 in

the sellers retained some risk because the purchaser was not liable on the notes, their interest was secured by a mortgage. Nevertheless, some elements characterizing a sale were absent — for instance, an element of investment and/or assumption of personal liability by the purchaser. Therefore, in reviewing the instant case the Supreme Court might rely on the absence of these factors to reverse the decision below.

The Internal Revenue Code offers another line of attack to prevent a charity from passing along the benefits of its tax exempt status to sellers of businesses.[30] The charitable exemption is conditioned upon the charity's revenue not inuring to private use.[31] Arguably, the Commissioner could subject all of the charity's income to taxation, because the revenue from the business inures to the private seller's benefit.[32] A less harsh alternative would be to apply the unrelated business income provisions[33] and tax the charity at ordinary rates on its receipt of the earnings of the business. These provisions were added to the Code in 1950 for the purpose of equalizing competition between charities and taxable entities in purchasing businesses.[34] Congress preserved the charitable exemption for "passive" income deriving from unrelated businesses.[35] Thus, in the instant case the charity leased the assets to Fortuna for a percentage of the profits, thereby receiving income from the business in the form of rent, which is exempted from the unrelated business income tax. In view of the purpose of the 1950 legislation and the terms of the lease, it would seem appropriate to characterize the charity's receipts from the operation of the business as taxable income despite the form of the transaction.[36]

Judicial reluctance to accept the Commissioner's position in attacks on the seller of the business may be due to its inherent

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notes which were transferred to the purchaser) — less than four times average annual earnings.

30. See Lanning, *supra* note 7, at 682–89.

31. INT. REV. CODE OF 1954, § 501(c)(3).

32. See Lanning, *supra* note 7, at 682–84, 686–87.

33. INT. REV. CODE OF 1954, §§ 511–14.

34. See H.R. REP. No. 2319, 81st Cong., 2d Sess. 36 (1950), in 1950–2 CUM. BULL. 380, 408–11; Note, 60 YALE L.J. 879, 887 (1951); Comment, 60 YALE L.J. 851 (1951).

35. Congress expressly excluded the following from "unrelated income": interest, royalties, annuities, and rents (except business leases). INT. REV. CODE OF 1954, § 512(b); see Comment, 60 YALE L.J. 851, 855 (1951). Rents from a business lease qualify for exemption if made for five years or less. INT. REV. CODE OF 1954, § 514(b).

36. See Lanning, *supra* note 7, at 687–89.

unfairness. Taxation of the entire proceeds as ordinary income deprives the seller of his basis in the stock or assets of the business. A partial legislative solution would be to permit capital gains treatment of the excess of fair market value of the business[37] over the seller's basis, and to tax the excess of the price received over fair market value as ordinary income to the seller.[38] Bootstrap sales to charities would not thereby be prohibited, but exempt organizations and other purchasers of businesses would be placed on a more equal competitive basis. The charity would still be able to pay a better price because of its exempt status, but the increased price would not be worth as much to the seller because of the imposition of tax at ordinary rates on the excess received. The seller would not be deprived of capital gains treatment on the portion of the price received not depending on the charity's tax status, and the Commissioner's loss of revenue would be reduced.

Copyright Law: Broadcast of Phonograph Records Held a "Public Performance for Profit" in Violation of Section 1(e) Even Though Made in Connection With Sale of the Records

The defendant owned and operated a Merchandise Mart containing a music department[1] in Middleton, Pennsylvania, for which it handled all advertising. Both advertising announcements and phonograph records were broadcast from defendant's offices within the Mart, and on stipulated dates defendant broadcast phonograph recordings of plaintiffs' copyrighted musical compositions over its loudspeaker system throughout the premises and parking lot of the Mart. Plaintiffs sued for damages alleging a violation of their exclusive right to perform their copyrighted works publicly for profit as provided in Section 1(e) of the Copy-

37. If the sale in the instant case had not occurred and one of the petitioners were to die, a determination of a fair market value of the business would have to be made for estate tax purposes. For guidelines to be used in the determination of the fair market value of a closely held corporation, see Rev. Rul. 59-60, 1959-1 CUM. BULL. 237.

38. The existing statute does not appear to permit this result. Therefore, it is suggested as possible legislation.

1. The music department was leased from defendant by Mid-City Trading Company.