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"Bootstrap" Sales in the Supreme Court

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NOTES

"Bootstrap" Sales in the Supreme Court

1. The Transaction

The tax consequences of the so-called "bootstrap" sale of a business, used in conjunction with a tax-exempt purchaser, are soon to be examined by the Supreme Court in *Commissioner of Internal Revenue v. Clay B. Brown.*[1] It is the purpose of this note to examine this type of transaction, with regard to its tax-avoiding incidents, in an attempt to analyze the competing considerations that will be presented to the Court for decision.

The term bootstrap sale refers to the sale of a business, in which the purchase price is paid out of future earnings of the business. Such a sale, where a charitable organization is the purchaser, can be used in an attempt to make use of the capital gains[2] and tax-exempt organization[3] provisions of the Internal Revenue Code to effectuate a higher purchase price and more tax savings to the seller than an outright sale to a non-exempt organization would produce.

In a sale of this kind, the owner sells the stock in his corporation to a charitable organization for a fixed price. The charity issues nonnegotiable, noninterest bearing notes to the owner for the amount of the purchase price — the charity to be liable on these notes only out of its income from the purchased business. The owner holds a mortgage on the sold assets. The charity dissolves the purchased corporation, and leases real and personal assets to a new corporation formed to run the business. This lease is for a term of five years with a rental of eighty per cent of the income from the use of the assets. The original owner is hired by the new corporation to see that the business is properly managed. The charity receives the rental income, and pays ninety per cent of it to the original owner until the notes are paid.

Various concepts of tax law necessarily make the transaction complex. A man who owns a prosperous business, and desires to sell it, is the starting point. He can sell the stock for a bargained-for price and receive capital gains treatment on the proceeds. However, he can receive a better price if, instead of requiring a firm commitment for the purchase price, he agrees that the purchaser is to be liable for the price only out of future earnings of the business. The purchaser, who thus risks little of his own capital, is willing to pay an increased price. The seller again claims that the money received is for the sale of his stock and that he is entitled to capital gains treatment. This is the basic bootstrap sale — the purchased business purchases itself through future earnings and there is no liability on the part of the purchaser other than through generated income.

Through this sale the seller would get the future earnings of the business at capital gains rates. However, these earnings are taxed as ordinary income to the purchaser before he transfers them to the seller. Consider now the added attraction of having this income escape taxation before it is funneled to the seller. It is to secure this advantage, yielding a further increase in purchase price, that a tax-exempt purchaser is used.

A simple sale of the stock in the corporation to a tax-exempt organization, with the corporation remaining in existence and paying dividends to the exempt organization, will not bring about the desired advantage. The purchased corpora-

1 37 T.C. 461 (1961), *aff'd,* 325 F.2d 313 (9th Cir. 1963), *cert. granted,* 377 U.S. 962 (1964). [Ed. Note — Immediately prior to the printing of this note, the Supreme Court, in a 6-to-3 decision, affirmed the Tax Court and Ninth Circuit. 33 U.S.L. Week 4341 (U.S. April 27, 1965). Deciding against the Commissioner, the Court, by Mr. Justice White, held the transaction was a sale within the meaning of § 1222(3) of the Internal Revenue Code, leaving to Congress the remedying of any abuses; Goldberg, J., dissenting, believed it was an artful device which ought not be permitted.]

2 Int. Rev. Code of 1954, §§ 1201-50.

3 Int. Rev. Code of 1954, § 501.

tion would then be a "feeder" corporation, and as such its profits are subject to a tax even though they are payable to an exempt organization.[4]

The purchasing organization can avoid the tax on feeder corporations by dissolving the purchased corporation and operating the business on a proprietorship basis. This, however, has unsatisfactory effects. First, the exempt organization would be in the position of risking all its assets. Second, the income of a business, operated by an exempt organization, which is not substantially related to the exempt function of the organization, is taxable to the organization as unrelated business income.[5]

These factors combine to produce the transaction outlined above. Because rents from real property, and from personal property leased with real property, are exceptions to the tax on unrelated business income, the exempt organization leases the assets of the dissolved purchased corporation to a newly created corporation (unowned by the tax-exempt organization) which agrees to pay eighty per cent[6] of its income as rental. The rental is claimed as a business expense by the new corporation, and the tax-exempt organization claims it is tax-free income to it. The tax-exempt organization then uses ninety per cent of the rental it receives to pay the purchase notes.

On its face, this transaction seems to accomplish all its tax-avoidance consequences within the framework of the law. However, the overall effect of the transaction is that most of the income from the business is diverted without taxation to the original owner, who pays only a capital gains tax.

There has been a lengthy and many-faceted campaign to minimize or eliminate the use of this type of transaction. The various facets can be generally classified into two groupings: first, those directed at taxation of the business income to the exempt organization or to the newly formed management corporation; second, those directed at taxation of the money paid to the original owner at ordinary income rates.

II. Taxation of Business Income

The 1950 amendments to the Code included the taxation of feeder organizations and taxation of unrelated business income. These provisions were aimed at the operation by tax-exempt organizations of businesses in competition with taxpayers.[7] Rentals are generally excluded from unrelated business income, but rentals from "business leases" are not. A business lease is a lease of property for a term, including options to renew, of *more than five years,* where the lessor incurs indebtedness in obtaining or improving the property. A percentage of the rent from such leases is taxed; the percentage is the ratio of the indebtedness to the adjusted basis of the property.[8] These provisions, making it much more difficult for exempt organizations to engage in the purchase and operation of businesses, prompted the more complicated transaction described above. Although the business lease provision does not directly limit the purchase price or the length of time in which it can be paid, it limits the length of the lease at time of sale to five years, if tax-avoidance is to be at a maximum.[9]

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4 INT. REV. CODE OF 1954, § 502.

5 INT. REV. CODE OF 1954, §§ 511-13. If the exempt organization is a church or a convention or association of churches, it is exempted also from unrelated business income tax. See text accompanying note 18 *infra.*

6 University Hill Foundation used this figure in its purchases of businesses.

7 For legislative history, see H.R. REP. No. 2319, 81st Cong., 2d Sess. 3053, 3078-89 (1950), 1950-2 CUM. BULL. 380, 408-11; and S. REP. No 2375, 81st Cong., 2d Sess. (1950), 1950-2 CUM. BULL. 483, 502-11.

8 INT. REV. CODE OF 1954, § 514.

9 If the same tenant occupies the property for more than five years, where the original lease was for just five years, there will be a determination that the lease was one for more than five years and the statutory percentage of income will be subject to tax beginning with the sixth year. INT. REV. CODE OF 1954, § 514(b)(2)(B).

Even where the lease cannot be classified as a business lease, the Internal Revenue Service may attempt to tax the rental to the exempt organization as another kind of unrelated business income. Revenue Ruling 54-420 states this theory:

> If the foundation were otherwise exempt under Section 101(6) [501(c)(3)] of the Code, the amounts termed rents . . . received by it under the instant lease and license agreements would be considered to be income from an unrelated trade or business subject to the Supplement U tax imposed by Section 421 [511] of the Code. Section 422 [512(b)(3)] of the Code, which excepts . . . certain rents from the definition of "unrelated business net income," is not applicable to the instant case. Section 39.422-1(b) of Regulations 118 [1.512(b)-1] states that whether a particular item of income falls within the meaning of the exceptions, additions, and limitations provided in Section 422 [512(b)] of the Code shall be determined by all the facts and circumstances of each case. For example, if a payment termed "rent" by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or a joint venturer, such payment does not qualify as rent for purposes of the exception. . . . [10]

This concept of the transfer to charity not actually being "rent," and thus being taxable to the charitable organization, has not been pressed; but its complement, disallowance of the rent deduction to the newly formed corporation running the business, has been used. Section 162(a)(3) of the Code allows deductions for "rentals . . . required to be made as a condition to the continued use or possession . . . of property." In *Royal Farms Dairy Co.*,[11] the Tax Court held that payments in a similar bootstrap scheme were not rental insofar as they exceeded fair value; that is, the eighty per cent standard rate included payment for something other than property use, and to that extent was not deductible. The Court felt that this rental was all part of the package involving the sale of the business, was not negotiated for, and was therefore not required to be made for the use of the property. The amount allowed as a deduction was the reasonable rental value of the property. This doctrine has not been successfully advanced in other cases[12] in which the same foundation and the same standard package was involved, and at any rate can succeed in reaching only a portion of the income, *i.e.*, the difference between a reasonable rental and the eighty per cent figure.

All of the above attempts to tax the rental income are attacks developed to prevent tax-exempt organizations from misusing their exemption. The most effective way to stop any abuses is the most straightforward — revocation of the tax-exempt status, so that all income to it is taxable.

It is clear that an organization may have unrelated business income and still retain its tax exemption.[13] But its unrelated business activities must not be so extensive that it cannot meet the operational test under Section 501(c)(3) of the Code, enunciated by Section 1.501(c)(3)-1(c)(1) of the Regulations:

> An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

This ultimate weapon of revocation of tax-exempt status was used against the University Hill Foundation,[14] which engaged heavily[15] in bootstrap purchases,

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10 1954-2 CUM. BULL. 128, 130.
11 40 T.C. 172 (1963).
12 Anderson Dairy, Inc., 39 T.C. 1027 (1963); Isis Windows, Inc., 32 P-H Tax Ct. Mem. 950 (1963).
13 INT. REV. CODE OF 1954, § 501(b).
14 University Hill Foundation, formerly Loyola Foundation, was granted tax-exempt status on November 19, 1946, which status was revoked on April 4, 1956, retroactive to year ended April 30, 1952. See Ralph M. Singer, 32 P-H Tax Ct. Mem. 860, 861 (1963).
15 In Oscar C. Stahl, 32 P-H Tax Ct. Mem. 1129 (1963), the Tax Court stated, at 1141, that the foundation had been involved in fifteen or twenty similar transactions.

on the ground that it was being operated primarily for business purposes and not for exempt purposes. This action was in accordance with the statement of the Service's position in Revenue Ruling 54-420 concerning the status of the foundation there involved.[16]

Two other grounds might be used to revoke an exempt status in these situations. Under Section 504(a)(1), exemption may be denied if income is accumulated unreasonably. Revenue Ruling 54-420 again states the position of the Service:

> Where an organization . . . uses income to retire indebtedness incurred in the acquisition of income producing property or business, thereby increasing its equity, it is accumulating income. . . . The question as to whether the income accumulated is unreasonable . . . is not one susceptible of resolution by a general statement, but is dependent upon the particular facts and circumstances in each case.[17]

The legal hobgoblin of "reasonableness" raised by this position should not be in question here. The unreasonable accumulation test would seem to be directed at organizations which use income or donations for purchasing property instead of for distribution for the exempt purpose. The activity of the organizations under discussion here is clearly not of that nature, despite the similarity that the Service emphasizes. Here, the organization is not using income to purchase property — from its point of view, it is accepting a donation of property (it risks nothing) with the proviso that it cannot have the income from that property for some time. If it refuses to use the income to retire the indebtedness, there can be no transaction, and hence no income.

The other basis for revoking exempt status is that Section 501(c)(3) is not met, in that "part of the net earnings . . . inures to the benefit of any private . . . individual." This basis is subject to the same argument as that above, that is, the seller is merely reserving some of the income to himself for a time, and if this is not agreed to, there will be no income later for the exempt organization.

The foregoing discussion of taxation of the exempt organization centered on a Section 501(c)(3) organization. When that type of organization is a church, several important consequences follow.

A church is specifically exempted from the tax on unrelated business income.[18] This means that a church could dissolve the purchased corporation and operate it itself and incur no tax. However, a church would not normally wish to risk its assets on such a venture, but would lease the assets according to the normal scheme. Because of its freedom from tax on unrelated business income, it is free from the business lease provisions of the Code, and is thus not limited to five-year leases.

The exemption from unrelated business income tax brings with it another benefit — the Service cannot claim that the rental payments are not really rent; whether they are rent or not, they are not taxable.

All the Service's weapons are not parried by the church's special status, as it would still be possible for the church to lose its exempt status. When Congress decided to tax unrelated business income, it exempted churches, but did not, however, exempt them from the requirements of Section 501(c)(3). Thus a church does not have a *carte blanche* to engage in unrelated businesses. But because of the church's special status, it seems unlikely that it would lose its exempt status for not being operated exclusively for religious purposes under most imaginable circumstances.[19]

Where a church is involved, the Service is, then, effectively reduced to one weapon: taxation of the proceeds paid to the original owner as ordinary income.

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16 1954-2 CUM. BULL. 128, 130.
17 *Ibid.*
18 INT. REV. CODE OF 1954, § 511(a)(2)(A).
19 No case of a church losing exempt status for engaging in non-exempt activities was found.

III. Taxation of Proceeds to Original Owner as Ordinary Income

The problem of abuse of tax privileges by exempt organizations may be sufficiently serious to warrant further remedial legislation. That general problem, however, can be considered apart from the bootstrap transaction. The fundamental and unique problem in the bootstrap area is the receipt of what appears to be income from a business at capital gains rates by the original owner, as emphasized by the tax-escaping qualities of that income in the hands of the exempt organization. Is the bootstrap transaction merely an elaborate masquerade which attempts to disguise retention by the original owner of the business income or is it a real "sale" of the business within the meaning of the capital gains provisions?[20]

The position of the Commissioner is, of course, that there is no "sale" of a capital asset. This position was stated in Revenue Ruling 54-420,[21] and is being argued in the *Brown* case. In *Brown*, the Ninth Circuit stated the Commissioner's position:

> [T]he Tax Court erred in holding that there was a sale within the meaning . . . of the Internal Revenue Code because . . . certain normal aspects of the sale of a business were missing. These are (1) shift of business risk; (2) shift of benefit of income; (3) shift of operational control; (4) permanent shift of ownership of assets and (5) release of sellers from business indebtedness.[22]

Absent tax considerations, the bootstrap transaction would undoubtedly be a sale within the meaning of the term in property law. All that is retained by the seller is a security interest in the assets. However, as stated by the Supreme Court, "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed. . . ."[23] Nonetheless, the fact of the transaction cannot be ignored: the exempt organization is not under the control of the seller and does not enter the transaction in order to help the seller save taxes. It seeks a benefit for itself, namely, the eventual ownership of a profitable business. It is willing to pay a high purchase price because so few of its own assets are at stake. As stated in *Union Bank v. United States*, "the fact that a purchaser of an asset pays more for it than it is worth does not, of itself, convert the sale into something other than a sale, for tax purposes."[24]

If a bootstrap transfer were made between the original owner and an unrelated taxpayer, other than a potentially exempt organization, the transferee would pay tax on the income of the business, and, eventually, he would own the business free and clear. Would the Commissioner attempt to tax the transferor on the income of the business also? This question raises the critical point: is the Commissioner's attack premised on a "no sale" basis or does it really depend on what may be considered the exempt organization's abuse of its privilege?

The import of this last question is obvious. If the abuse of the exempt privilege is the root of the problem, then the remedy should lie in correction of this abuse, rather than in creation of a no-sale classification for a transaction that would be characterized as a sale, absent the exemption abuse. That is, determination of "sale" or "non-sale" should be made apart from considerations of peculiar characteristics of the purchaser which are unrelated to the seller.

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20 INT. REV. CODE OF 1954, §§ 1201-50.

21 1954-2 CUM. BULL. 128, 130. The concluding paragraph of the Ruling, concerned with the tax treatment of the foundation, states:

> Transactions of the type involved in this case also present a serious question as to the essential nature of the agreement entered into by the foundation. It is the position of the Service that in cases of this general nature, the amounts received from the foundation in fulfillment of the terms of the agreement will not be recognized as proceeds from a sale requiring capital gains treatment.

22 325 F.2d 313, 315 (9th Cir. 1963).

23 Corliss v. Bowers, 281 U.S. 376, 378 (1930).

24 152 Ct. Cl. 426, 430, 285 F.2d 126, 128 (1961).

There are five Tax Court decisions on capital gains treatment to sellers in bootstrap transactions (involving University Hill Foundation as purchaser) in process of appeal to the Ninth Circuit.[25] In each of these, the Tax Court held that there was a sale for purposes of capital gains. Important in reaching this characterization were these factors: the Foundation was not the creation of, or in any way connected with, the seller; the Foundation made a thorough pre-sale investigation of the business; the business was found to be not speculative and it was thus highly probable that the Foundation could soon liquidate its purchase obligation; the seller investigated the Foundation; there was real and protracted negotiation as to price and terms of the sale; and, finally, the purchase price was not grossly excessive.[26]

While all these factors go to the bona fides of the purported sale, the amount of the purchase price is probably the most critical factor. It is this amount that determines for how long a period the seller will be able to hold the status of a creditor and thus participate in the earnings of the business; further, a price disproportionate to the value of the business, after due consideration is given to the fact that a higher than normal price is to be expected because of the lack of risk by the purchaser, tends to show that there is no real transfer, but just an operation of the business by another for the benefit of the seller.[27] With these purchase price considerations in mind, the Court might formulate a rule of excessiveness of purchase price based on the number of years, at past and/or expected future average annual earnings, it would take for the exempt organization to pay off its indebtedness. The business lease provisions of the Code,[28] by taxing rental income where more than a five-year lease is involved, place a tax-benefit limitation on the length of the lease; this could be considered a sufficient check on the amount of the purchase price. On the other hand, the Court might find it wise to place a direct limit on the expected pay-back period which, if exceeded, would render the transaction not a sale.

Determination of the proper pay-back period would not be as difficult as might first be imagined. There is no real problem with regard to the question of what is good business practice, because the normal business purchase is not involved. The purchaser here is not laying out his own capital which he must recover in increased income. Rather, it is merely a question of how long he is willing to operate the purchased business before it becomes his at no cost to himself. Therefore, a rule of a number of years limitation in order to qualify for "sale" classification would not require any particular relationship to the normal business investment.

Such a limitation should not be exclusive of the limitations imposed by the other factors given weight by the Tax Court. The pay-back period limitation could be met, but the transaction still would have to meet the arms-length requirement imposed by the other factors.[29]

The arms-length requirement introduces an interesting element into the transaction, namely, the purposes which should be regarded as worthy of capital gains treatment. "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted,"[30] and "the right of a taxpayer by legal means to increase the amount received from a transaction over what he might have received from a different transaction is fundamental."[31] However, since the seller has retained a

25 Anderson Dairy, Inc., 39 T.C. 1027 (1963); Royal Farms Dairy Co., 40 T.C. 172 (1963); Ralph M. Singer, 32 P-H Tax Ct. Mem. 860 (1963); Isis Windows, Inc., 32 P-H Tax Ct. Mem. 950 (1963); Oscar C. Stahl, 32 P-H Tax Ct. Mem. 1129 (1963).

26 Anderson Dairy, Inc., 39 T.C. 1027 (1963), contains the most complete listing of these factors, at 1042.

27 See Emmanuel N. (Manny) Kolkey, 27 T.C. 37 (1956).

28 INT. REV. CODE OF 1954, § 514. See text accompanying notes 8 and 9 *supra*.

29 See text accompanying note 26 *supra*.

30 Gregory v. Helvering, 293 U.S. 465, 469 (1935).

31 Clay B. Brown, 37 T.C. 461, 485 (1961).

security interest in the sold assets, and can recover them upon default of payment, the Commissioner has called into question the bona fides aspects of the negotiations, where, inferentially, there is an intent to trigger a default after several years of payments. In *Brown,* the Tax Court used the fact that the Institute was the moving party in the negotiations as some evidence that there was a purpose and intent to complete the transaction as planned, with the result that the Institute would eventually have the business free and clear. This, then, could be a limitation on the above-mentioned dogmas of valid tax minimization and profit maximization. That is, there must be some other motive. For example, the initiation of the transaction by the exempt organization would show intent to derive a benefit from the transaction, rather than to disguise tax-avoidance through long-term transfers of income or eventual default.

Looking for initiation of the transaction by the exempt organization raises a different specter, however. Such initiative may be used to show a cavalier attitude on the part of the organization toward its tax privilege and might call for withdrawal of exempt status, as occurred with the University Hill Foundation.

The best way to support a bootstrap transaction is to have the seller initiate the dealings because of some factor in addition to maximization of profits. For example, in *Anderson Dairy,*[32] one of the sellers was suffering from ill health. An additional reason such as this suggests good faith and does not call the exempt organization's motives into question.

In conclusion, it seems that, in the absence of any Congressional guidance on the subject, the bootstrap transactions should be considered as legitimate sales — except in the rare cases where an obvious sham is involved.[33] Where there is good-faith bargaining, there is no compelling reason not to recognize a sale. There is no reason to attempt to work a remedy for abuse of exempt privileges by altering the concept of "sale." Except for the possibility of a pay-back period rule, which, if exceeded, is indicative of lack of arms-length negotiation and presence of the exempt organization solely for the operation of the business for the seller, bootstrap transactions should be classified as sales for capital gains purposes, as indeed they are in economic reality.

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32 39 T.C. 1027 (1963).

33 See Emmanuel N. (Manny) Kolkey, 27 T.C. 37 (1956), in which the original business had retained earnings of $600,000; the new corporation renting the assets had paid-in capital of only $1,000; the purchase price was four million dollars, where the fair market value of the company was no more than one million dollars; and the business was highly speculative and perhaps illegal.