Washington and Lee Law Review

Volume 25 | Issue 2 Article 8

Fall 9-1-1986

Contribution By Feeder Corporation To Parent Foundation: Crosby Valve Revisited

Follow this and additional works at: https://scholarlycommons.law.wlu.edu/wlulr

Part of the Business Organizations Law Commons, and the Tax Law Commons

Recommended Citation

Contribution By Feeder Corporation To Parent Foundation: Crosby Valve Revisited, 25 Wash. & Lee L. Rev. 258 (1968).

Available at: https://scholarlycommons.law.wlu.edu/wlulr/vol25/iss2/8

This Comment is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact christensena@wlu.edu.

However, the existence of a sale is without value because the disclaimer prevented the warranties from attaching to this transaction, and strict liability was held not applicable. As *Jackson* now stands, its sole significance would be that it protected hospitals by another approach than that utilized by *Perlmutter*. However, because the disclaimer and strict liability are based upon public policy, courts in the future may reach a different conclusion than that in *Jackson*. Starting with *Jackson's* premise of a sale, a warranty would be applicable by voiding all disclaimers as unreasonable. Likewise, a more "patient orientated" public policy would probably result in strict liability being applicable.

ROY G. HARRELL, JR.

CONTRIBUTION BY FEEDER CORPORATION TO PARENT FOUNDATION: *CROSBY VALVE* REVISITED

Charitable tax-exempt foundations[1] have often derived income by operating feeder corporations: manufacturing or service businesses whose purposes are profit orientated rather than for the eleemosynary purposes of the tax-exempt foundation.[2] When a charitable foundation owns a feeder corporation, a tax problem is created when the feeder corporation attempts to take a section 170(b)(2)[3] corporate charitable

---

[1]The INT. REV. CODE of 1954, § 501(c)(3) provides:

Corporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

[2]Section 502 of the Code provides:

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to one or more organizations exempt under section 501 from taxation. For purposes of this section, the term 'trade or business' shall not include the rental by an organization of its real property (including personal property leased with the real property).

INT. REV. CODE of 1954, § 502.

[3]Section 170 of the Code provides:

(a) .... There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if

contribution deduction for payments made to the parent tax-exempt foundation.

Such a situation arose in *United States v. Knapp Brothers Shoe Manufacturing Corporation*[4] when a feeder corporation attempted to take a section 170(b)(2) charitable contribution deduction for payments made to a tax-exempt institution, New York University.[5] The Commissioner disallowed the deduction contending that the payments to New York University were constructive dividends. Taxpayer-corporation paid the deficiency and instituted an action for refund in the District Court of Massachusetts.

Three lawyers[6] acquired Knapp Brothers Incorporated, a shoe manufacturing business, to "confer an ultimate benefit on New York University."[7] The corporation was reorganized and the lawyers became the shareholders of record of all the stock of the corporation. A clause within the certificate of incorporation provided that no stockholder would ever be entitled to dividends on his shares of stock or entitled to the assets of the business in event of dissolution. Instead, New York University was designated the sole recipient of income and property derived from the business, irrevocably in perpetuam. The three lawyers transferred the entire outstanding stock of the corporation to a voting trust,[8] at whose discretion funds could be distributed to the University. The voting trust provided that after its termination, or its last extension, the stock of the corporation would be transferred to New York

---

verified under regulations prescribed by the Secretary or his delegate....
(b)(2) Corporations—In the case of a corporation, the total deductions under subsection (a) for any taxable year shall not exceed 5 percent of the taxpayer's taxable income....

INT. REV. CODE of 1954, § 170. *See* Note 18 *infra.*

[4]384 F.2d 692 (1st Cir. 1967), *cert. denied,* 390 U.S. 989 (1968).

[5]"Neither New York University, nor any of its officers, trustees or employees had any part in the organization of plaintiff or provided any of its capital. The University has never owned any stock in the plaintiff. Since the organization of plaintiff no director, officer, trustee or employee of plaintiff has ever been an officer, trustee or employee of the University. The University has never participated in any way in the selection of the voting trustees or of plaintiff's directors or officers. No trustee, officer or employee of the University has ever participated in, influenced or attempted to influence, or consulted with the plaintiff's directors in connection with the conduct of plaintiff's affairs. No trustee, officer or employee of the University has ever directed plaintiff to make a contribution to it, or requested such a contribution, and plaintiff's directors have never consulted with the University as to what contributions should be made." Knapp Bros. Shoe Mfg. Corp. v. United States, 265 F. Supp. 133, 134 (D. Mass. 1967).

[6]One of the lawyers, John Gerdes, was General Counsel for New York University, and was a specialist in corporate finance and corporate reorganizations. *See* J. GERDES, CORPORATE REORGANIZATIONS (1936).

[7]Knapp Bros. Mfg. Corp. v. United States, 265 F. Supp. 133, 134 (D. Mass. 1967).

[8]*See* 5 W. FLETCHER, PRIVATE CORPORATIONS § 2075 (perm. ed. rev. vol. 1967).

University. The District Court of Massachusetts[9] allowed the deduction reasoning that the payments were not motivated by a legal duty to the University; they were made at the discretion of the voting trustees. Therefore the payments were determined to be charitable contributions. However, the First Circuit Court of Appeals disallowed the deduction, reasoning that New York University possessed the beneficial ownership of the corporation and that the shareholders of record held the stock of the corporation in trust for New York University; therefore the distributions were dividends.

Income of charitable, educational and scientific organizations has been exempt from federal taxation since 1913.[10] One of the consequences of this exemption prior to 1954 was the ability of charitable foundations to operate manufacturing businesses on a tax-exempt basis because the "destination of income"[11] of such corporations was for eleemosynary purposes. Such feeder corporations had a competitive advantage over private enterprise as their tax-exempt status enabled them to use their profits tax-free to expand operations while their competitors could expand only with profits remaining after taxes.[12] The competitive advantage that feeder corporations derived by being owned by charitable foundations gave rise to extensive congressional hearings prior to 1950.[13] These hearings resulted in the removal of exemption of feeder corporations from taxation and the imposition of the federal income tax upon them.[14]

However, the 1954 Internal Revenue Code does not specifically prohibit a feeder corporation from taking a section 170 deduction for contributions to its parent charitable foundation. Congressional intention in removing the tax exemption of feeder corporations is therefore important in determining whether such a deduction is allowable. The congressional reports indicate that "unfair competition" was the principal reason for removing the exemption of such corporations.[15] Congressional purpose was to equalize the tax burden borne by private enterprise and by feeder corporations. The deduction should, therefore, be allowed if the feeder corporation would derive no

---

[9]265 F. Supp. 133 (D. Mass. 1967).

[10]*See* Act of Oct. 3, 1913, ch. 16, § II G (a), 38 Stat. 172. Provisions exempting religious, charitable and educational organizations were contained in the Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 112, and the Act of Aug. 27, 1894, ch. 349, § 32, 28 Stat. 556.

[11]*See* Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924).

[12]H.R. REP. NO. 2319, 81st Cong., 2d Sess. 36 (1950); S. REP. NO. 2375, 2d Sess. 28 (1950).

[13]*Hearings Before a Subcomm. of the Senate Comm. on Interstate and Foreign Commerce*, 80th Cong., 2d Sess. (1948).

[14]INT. REV. CODE of 1954, § 502..

[15]H.R. REP. NO. 2319, 81st Cong., 2d Sess. 36 (1950).

competitive advantage thereby, but disallowed if such a competitive advantage would be realized. The Code, merely imposes the same tax on income derived by feeder corporations as is borne by their competitors.[16]

In *Crosby Valve & Gage Company v. Commissioner*[17] the United States Court of Appeals for the First Circuit was confronted with the question of whether a feeder corporation could deduct contributions to its parent charitable foundation. The court determined that the payment could be considered equally within the literal meaning of a charitable contribution under section 170(c)[18] and of a dividend under section 316(a).[19] If the payment were held to be a charitable contribution, the feeder corporation could make a partially tax-free distribution of earnings to its only stockholder. Such a distribution of earnings would obtain a competitive advantage for the feeder corporation,[20] which is precisely the inequality that Congress sought to pre-

---

[16] *See* S. REP. NO. 2375, 81st Cong. 2d Sess. 29 (1950).

[17] 380 F.2d 146 (1st Cir. 1967), *cert. denied,* 389 U.S. 976 (1967). See 36 U. CIN. L. REV. 331 (1967); 15 U. KAN. L. REV. 207 (1967).

[18] INT. REV. CODE of 1954, § 170(c) reads in part:

> Charitable Contribution Defined—For purposes of this section, the term 'charitable contribution' means a contribution or gift to or for the use of—(2) A corporation, trust, or community chest, fund, or foundation (B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals; (C) no part of the net earnings of which inures to the benefit of any private shareholder or individual....

[19] INT. REV. CODE of 1954, § 316 reads in part as follows:

> For purposes of this subtitle, the term 'dividend' means any distribution of of property made by a corporation to its shareholders—(2) out of its earnings and profits of the taxable year....Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits....

[20] "For example, suppose a competing business corporation not owned by a charity (call it Hope Valve & Gage Co.) and the petitioner (Crosby Valve & Gage Co.) each has net earnings before taxes of $10,000,000 and each wishes to produce the maximum return to its stockholders. Then if Crosby can deduct 5% of its earnings by distributing that amount to its charitable sole stockholder and calling it a charitable contribution rather than a dividend, the result is as follows:

	Crosby	*Hope*
Net earnings (N):	$10,000,000	$10,000,000
Charitable deduction (D):	500,000	0
Taxable income (N-D.):	9,500,000	10,000,000
Tax (T) [47% (N-D) —$5,500]:	4,459,500	4,694,500
Earnings available for distribution to stockholders (N-T):	$ 5,540,500	$ 5,305,500

If, on the other hand, Crosby's charitable stockholder is content with the same

vent. Accordingly, the court held the payment to be a constructive dividend and disallowed the deduction.

The lower court in *Crosby Valve*[21] disallowed the deduction upon other grounds. The court equated charitable contribution and gift, then determined that a gift proceeds from "detached and disinterested generosity."[22] The payment was found to have resulted from the foundation's control over the feeder corporation, and not from detached and disinterested generosity. The court of appeals rejected this line of reasoning. The court stated that if a charitable motive were the determining factor in ascertaining a charitable contribution, "an important area of tax law would become a mare's nest of uncertainty woven of judicial value judgments irrelevant to eleemosynary reality."[23]

It has long been held that, "perhaps the most basic principle of taxation [is that] economic realities determine tax consequences."[24] *Crosby Valve* determined that a wholly owned feeder corporation will not be allowed a charitable deduction for payments made to its shareholder of record, the parent foundation. In *Knapp Shoe* the court extended the doctrine it enunciated in *Crosby Valve,* and determined that a feeder corporation cannot make a charitable contribution to its beneficial owner. It was held that when the beneficial owner of a corporation receives an economic benefit from the corporation, for no consideration, the benefit is a constructive dividend. "The crucial concept in a finding that there is a constructive dividend is that the corporation has conferred a benefit on the stockholder in order to

---

return earned by its competitor, Crosby has the option of retaining the difference of $234,000 in earnings to finance competition in services, etc., or of cutting prices to a level that produces $9,575,429 in net earnings, with the following effect:

	Crosby	Hope
Net earnings:	$ 9,575,492	$10,000,000
Charitable deduction:	478,771	0
Taxable income:	9,096,578	10,000,000
Tax:	4,269,929	4,694,500
Earnings available for distribution to stockholders:	$ 5,305,500	$ 5,305,500

In either case, Crosby would have precisely the competitive advantage that Congress sought to prevent. Furthermore, if Hope chose to contribute any amount to charity, even to Crosby's parent charity, that amount would reduce the amount available to Hope's stockholders and thus would increase the disparity." Crosby Valve & Gage Co. v. Commissioner, 380 F.2d 146, 149 n.3 (1st Cir. 1967).

[21]Crosby Valve & Gage Co. v. Commissioner, 46 T.C. 641 (1966).

[22]*See* Commissioner v. Duberstein, 363 U.S. 278, 289 (1960).

[23]380 F.2d 146 (1st Cir. 1967).

[24]Estate of Weinert v. Commissioner, 294 F.2d 750, 752 (5th Cir. 1961). *See also* Commissioner v. Hansen, 360 U.S. 446, 461 (1959); Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 255 (1939).

distribute available earnings and profits without expectation of repayment."[25] The Code makes no distinction between legal and equitable stockholders; that is between the shareholders of record and the beneficial owners.

It has been suggested that the use of the dividend approach to determine the deductibility of payments made by a feeder corporation to its parent foundation is difficult when a case in an analogous area is considered.[26] In *Campbell v. Carter Foundation Production Company*,[27] taxpayer-feeder corporation borrowed funds from its sole stockholder, a charitable foundation. The issue was whether certain payments made to the foundation were interest on indebtedness as claimed, therefore deductible, or constructive dividends and not deductible. The court held that in the particular factual situation genuine indebtedness existed between the feeder corporation and the parent fundation and the payments were deductible as interest. The case is distinguishable from *Crosby Valve* and *Knapp Shoe* in that there was "expectation of repayment,"[28] consequently the payments were not constructive dividends.

Crosby Valve and *Knapp Shoe* are the only cases resolving the question as to the deductibility of payments made by a feeder corporation to its parent foundation on a dividend theory. In a related case, *SICO Foundation v. United States*,[29] a corporation's certificate of incorporation provided that the corporation's earnings were payable, at the discretion of its board of directors, to various state teachers colleges for scholarship purposes. Several presidents of state teachers colleges were directors of the corporation. The charitable deduction was allowed, subject to the five percent limitation. Perhaps under the doctrine of *Knapp Shoe* the charitable contribution in *SICO* might now be disallowed.

Congressional purpose in taxing the income of feeder corporations was to equalize the tax burden borne by feeder corporations and their competitors. The question arises as to whether a feeder corporation is penalized when its charter, as in *Knapp Shoe,* requires it to distribute its earnings to its parent foundation. *Crosby Valve* and *Knapp Shoe* disallow a charitable deduction when such a distribution occurs. These decisions do not penalize such feeder corporations, as they do not deny such feeder corporations charitable deductions. They only deny a

---

[25]1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 9.07, at 16 (1962, Supp. 1968). "Proof of an 'economic benefit' is essential." *Id.*

[26]36 U. CIN. L. REV. 331, 333-34 (1967).

[27]322 F.2d 827 (5th Cir. 1963).

[28]*See* note 25 *supra* and accompanying text.

[29]295 F.2d 924 (Ct. Cl. 1961).

feeder corporation a charitable deduction for distributing earnings to its beneficial owner. The feeder corporation may deduct contributions to any charity other than its beneficial owner. If a competitve disadvantage is suffered by such a feeder corporation, it is imposed by the founders of that corporation.

Exemption from taxation was a congressional balm granted to *charitable foundations* for motives begotten of public policy.[30] The resulting losses in tax revenues were deemed compensated for by the value of the charitable work done.[31] When it became apparent that foundations were operating profit-orientated business on a tax-free basis in competition with private enterprise, Congress taxed foundations on their "unrelated business income."[32] Charitable foundations accordingly, have both exempt and taxable income. Thus charitable foundations may take a charitable contribution deduction from their taxable income for contributions made to *other* charitable foundations, but not for payments to itself.[33] If the management of a charitable foundation controlled the management of a feeder corporation, or if the management were identical as in *Crosby Valve,* the fundation could direct the corporation to "contribute" to the foundation. If a feeder corporation were allowed a deduction for charitable contributions to its parent foundation, then a foundation might be able to do indirectly what it is proscribed from doing directly. A foundation cannot contribute to itself. While such a distribution may be a charitable contribution in form, economic substance rather than form is determinative of tax consequences.[34]

---

[30]Helvering v. Bliss, 293 U.S. 144, 151 (1934).

[31]*See* Helvering v. Bliss, 293 U.S. 144 (1934); Erie Endowment v. United States, 316 F.2d 151 (3d Cir. 1963); SICO Foundation v. United States, 295 F.2d 925, 930 n.19 (Ct. Cl. 1961).

[32]INT. REV. CODE of 1954, § 511. Section 513 of the Code defines the term unrelated business as, "in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related ... to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption ...." INT. REV. CODE of 1954, § 513. *Accord,* INT. REV. CODE of 1954, § 512(b)(1).

[33]Treas. Reg. § 1.512(b)—1(g)(3) (1958) states:

> The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a university described in section 501(c)(3) which is exempt from tax and which operates on unrelated business, shall be allowed a deduction, not in excess of 5% of its unrelated business taxable income, for gifts or contributions to another university described in section 501(c)(3) for educational work but shall not be allowed any deduction for amounts expended in administering its own educational program.

See also S. REP. No. 2374, 31st Cong., 2d Sess. 109 (1950).

[34]Commissioner v. Hansen, 360 U.S. 446, 461 (1959); Commissioner v. Court