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Op. 58-70

TERRITORY OF HAWAII

DEPARTMENT OF THE ATTORNEY GENERAL

HONOLULU

April 7, 1958

Honorable Earl W. Fase
Tax Commissioner
Territory of Hawaii
Honolulu, Hawaii

Attention: Mr. J. A. Bell
Deputy Tax Commissioner

Dear Sir:

This is in reply to your letter of February 25, 1958 requesting our advice on the application of Dillingham Transportation Building, Ltd., for a refund of net income taxes paid in the years 1952 to 1956 inclusive. We have reached the conclusion that the refund should be allowed.

The corporation was organized in 1929 as an ordinary corporation for profit. During 1945 all of the shares of stock were acquired by Kauikeolani Children's Hospital. This hospital is an eleemosynary corporation. The hospital itself is exempt from net income taxes.

As of the end of 1951 the corporation transferred to the hospital all of its property except the garage. During the years 1952 to 1956, involved in the refund claim, the corporation was operating the garage as an auxiliary to the Dillingham Transportation Building, which at that time as above noted was owned by the hospital.

Operation of the garage included rental of space for parking, such services as washing, polishing, lubricating and minor repairs, and sale of gasoline, oil, batteries, tires, tubes and automobile accessories.

The corporation sought in the Court of Claims a refund of federal income taxes for certain years during the period 1945-1951, and was successful in obtaining this refund. The case is Dillingham Transportation Building, Ltd. v. United States, 146 F. Supp. 953.

The real property and the gross income therefrom undoubtedly are subject to the real propexty tax and the general

excise tax, respectively. No suggestion has been made to the contrary. As far as the real property tax law as concerned, the point is that the property is not used for any charitable purpose; it is used to raise income. As stated in Benjamin Rose Institute v. Myers, 110 N.3. 924, 928, Ohio 1915: "It is the use of the property which renders it exempt or nonexempt, not the use of the income derived from it."

As to the general excise tax law, section 117-20 specifically prohibits the exemption of "any activity the primary purpose of which is to produce income even though such income is to be used for or in furtherance of the exempt activities of such persons."

The question is whether the net income tax law, as it read during the years in question prior to the enactment of the Income Tax Law of 1957, provided for the exemption of net income in a situation of this kind when:

1. The income is from a business.

2. The organization earning the income is not itself dispensing charity but merely producing income for a charity administered by another tax exempt organization, and hence the organization earning the income is a "feeder" organization.

3. The form of organization is that of an ordinary corporation.

So far as we have been able to ascertain, the question identified above as No. 1 has not previously arisen under the Income Tax Law of 1932, which governs the period here involved. For federal income tax purposes, prior to enactment of the Revenue Act of 1950 there were a number of cases applying the "destination of income" test under which commercial enterprises could be conducted without loss of exemption so long as these were not an adjunct to an enterprise conducted for private profit. 6 Martens Law of Federal Income Taxation, 1957 ed. Sec. 34.14. This matter was resolved for federal income tax purposes by the enactment of the Revenue Act of 1950, and has been resolved for territorial income tax purposes by enactmant of the Income Tax Law of 1957 which trees "unrelated business taxable income" (section 121-7). Because the issue has been so resolved, it is our advice that you treat the decision in Dillingham Transportation Bldg., Ltd. as applicable to this refund claim.

As to the question listed above as No. 2, the Territorial income tax law, unlike the federal, has no specific provision

for exemption of any feeder organization. Compare Sec. 101(14) of the Internal Revenue Code of 1939 and Sec. 501(c) (2) of the Internal Revenue Code of 1954. This feeder organization provision of the federal law is limited to the mere holding of title of property, collecting income therefrom and turning over the entire net amount to an exempt organization. This provision does not include the conduct of a business such as the garage business here involved, as held in, Roche's Beach, Inc. v. Commissioner, 96 P.2d 776 (2d Cir. 1938). In that case the presence in the federal law of a feeder organization provision which was too narrow to include the type of business involved gave the court concern, but the exemption nevertheless was sustained under the general provision covering charitable purposes. In so ruling the court cited I.T. 1945, C.B. III-1, p. 273. which reads as follows:

> "A corporation formed to dispense charity which does not actually engage in charitable undertakings itself but distributes its income to institutions organized and operated exclusively for the purposes named in subdivision (6) of section 232 is exempt from taxation under said section."

The above quoted principle is one which has been followed by the Territory in the administration of the income tax law. That is, certain foundations the purpose of which is not to engage in charitable undertakings but instead to make grants to exempt institutions have been considered as coming within Sec. 121-(2)(b) of the Income Tax Law of 1932.

In connection with such foundations emphasis must be placed upon the purpose for which the corporation, trust or the like as organized. Obviously, tax exemption cannot be attained merely by giving to charitable institutions all of the net income of a given year, since this would violate the limitation on the deductible amount of charitable contributions. Only when all the earnings "must inure to a charity" (to quote from Dillingham Transportation Bldg., Ltd.) can there be an exemption. But so long as the earnings are dedicated to charity, it does not matter whether the one earning the income itself engages in charitable undertakings or does this by selecting others so engaged to receive the funds.

It is argued in the application for the refund that the federal law, since it contains the words "organized and operated", differs from the Territorial Law which contains only the word "conducted". It is further argued that because of the word

"organized" more difficulty has been encountered in attaining exemptions under the federal law than would be encountered under the Territorial law. It is true that there has been litigation under the federal law as to whether the purpose for which the institution was organized could be shown by extrinsic evidence. It has been held that this is permissible. There also has been litigation under the federal law as to whether it is possible to show that an entity originally formed for a non-charitable purpose has become a different type of organization. Indeed this was involved in the Dillingham Transportation Bldg. case above cited. That case held that it can be shown that an entity originally formed for noncharitable purposes has become a charitable organization. Using the word "organized" in that sense, that is as turning on the purpose for which the entity was organized in the taxable year in question, we have concluded that the word "conducted" in Sec. 121-(2) (b) of the Income Tax Law of 1932 means the same as "organized and operated" in the federal law. That is, the entity must be one which actually and obligatorily so, is conducted for charitable purposes.

An organization of a kind which insures that the entire income is destined for charity is essential. Herein lies a principal difference between the income tax law and the other Territorial tax laws, that is, that under the net income tax law the kind of organization can cause the charitable destination of the income to be considered but under the other tax laws it cannot.

The third question above raised was whether it was fatal to the exemption that this is an ordinary business corporation, not holding a charter as an eleemosynary corporation. In other words, is the above quoted principle (that an organization which does not itself engage in charitable undertakings nevertheless may be an exempt charitable organization) limited to foundations, as they usually are called, formed for the specific purpose of dispensing funds to charitable undertakings. As already indicated, stress should be placed upon the dedication of the funds to charity rather than upon the exact manner by which this has been accomplished. When a charitable institution is the sole stock-holder and moreover is the sole owner of the securities issued by the corporation, as is the case here, and when the officers and directors of the charitable institution and the earning corporation are practically identical, as is also the case here, the type of corporation is not fatal to the exemption.

Sincerely,

Rhoda V. Lewis

RHODA V. LEWIS
Deputy Attorney General

APPROVED:

Herbert Y. C. Choy

HERBERT Y. C. CHOY
Attorney General