foundation's tax-exempt status gives it an unfair advantage over its taxpaying competitors.

For example, because contributions to tax-exempt foundations are deductible by the contributor for Federal income tax purposes, a foundation can capitalize its business much easier than a taxpaying business. Furthermore, when a foundation owns or controls a business it is relatively free from the demands of shareholders for current income distribution, and thus can accumulate such income for investment in the business to improve its competitive position, or can absorb a loss when the business is declining; taxpaying businesses, on the other hand, are subject to pressure from stockholders and must usually return part of their current income to the stockholders. In addition, many tax-exempt foundations, particularly those involved in scientific research and development, actively compete for research and development contracts and are often able to bid for business at a break-even figure that cannot be matched by their taxpaying competitors.

The only significant action taken to curb these abuses was the Revenue Act of 1950, which subjected the unrelated business income of foundations to ordinary taxes; Section 513(a) of the act defines "unrelated trade or business" as "any trade or business the conduct of which is not substantially related (aside from the need of such organizations for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption." This section was written to prevent tax-exempt organizations from competing unfairly with ordinary, taxpaying businesses.

Experience has shown, however, that there are many loopholes in this restriction on the unrelated business income of tax-exempt foundations. For example, the 1950 statute does not apply to rents derived from unrelated business property. Foundations can rent business assets to one of their own business subsidiaries, receive most of the profits by charging high rent which is exempt from the unrelated business tax, and thus accumulate large amounts of tax-free capital.

The 1950 statute also exempts rent from a lease that is not longer than five years if the lessor has an outstanding indebtedness with respect to the leased assets. This enables a foundation to obtain the stock of a corporation, liquidate the corporation, and then lease the assets to a newly formed corporation for a five year period. The rent charged this new corporation is usually about 80% of its before-tax income, and thus the foundation is able to rake-off most of the income of the corporation without paying any tax. One side effect of this problem is that because foundations are able to get most of the income of a business operation through tax-exempt rent, they are able to pay a much higher price than a taxpaying business when they obtain new business property.

One obvious remedy, of course, would be to close the loopholes in the existing statute to insure that all unrelated business income is taxed. Such a remedy, however, is based on the assumption that the only problem is that of loopholes in the existing law, and such an assumption is not accurate. The fact is that even if foundation-owned businesses are subject to tax, the very fact the business is owned by a tax-exempt organization gives it an unfair advantage over its competitors, for reasons I mentioned earlier.

The basic problem, therefore, since taxing unrelated business income is insufficient, is how to prevent foundation-owned and operated businesses from holding an unfair competitive advantage over taxpaying business. The Treasury Department, in a 1965 study, recommended dealing with this problem by limiting participation by private foundations in active business. They recommended that foundations be prohibited from owning, either directly or through stock holdings, 20% or more of a business unrelated to the exempt functions for which the foundation received its tax-exempt status. The Treasury recommendation, however, is incomplete in at least two respects: it fails to deal with the foundational problem of defining "unrelated business", and fails to recognize that any business operated by a tax-exempt organization, unrelated or related, has a competitive advantage over taxpaying businesses. Officials of the Treasury Department and the Internal Revenue Service have testified before this Subcommittee about the difficulty of working with the present definition of "unrelated business."

A related problem is that involving tax-exempt organizations doing what is called "basic research." This type of activity is exempt from taxation, and yet it