

F. CHURCHES AND OTHER RELIGIOUS ORGANIZATIONS

Introduction

IRC 501(c)(3) exemption for "religious purposes" has always been a sensitive matter, because the First Amendment sets strict limits on government regulation of religion in any form -- church, sect, denomination, ministry, etc. Some self-proclaimed churches may use the administrative and judicial limitations on Service regulation to hinder our review of their activities. We have always been aware of the possibility of abuse, i.e. hiding non-charitable, non-religious activities under privileged church status. See the 1978 EOATRI textbook topic on Churches, pp. 1-29.

Public interest in religious groups (exempt or not) is very keen. There is an increase in the number of "religious" tax-avoidance schemes, e.g., mail order ministries, family churches, vows of poverty, etc. Congress has been investigating Reverend Moon's Unification Church and related organizations for illegal activities. The recent mass suicide at the People's Temple in Jonestown, Guyana, drew international comment and much Congressional interest. And, the press is filled with reports of "brainwashed" disciples and parents "re-kidnapping" their children.

The 1978 EOATRI textbook topic on Churches is a good summary of the major problems we encounter in administering the IRC 501(c)(3) "religious purposes" exemption. This discussion is meant to supplement that topic. We intend only to highlight new developments and the increased interest in the area.

1. Inurement and Tax Avoidance Schemes

IRC 501(c)(3) clearly precludes exemption for all organizations (churches and religious organizations too) whose net earnings inure to the benefit of a private shareholder or individual. The Founding Church of Scientology v. U.S., 412 F.2d 1197 (Ct. Cl. 1969).

Equally as clear is the Federal income tax principle that a taxpayer's assignment or similar transfer of compensation for personal services to another individual or entity (e.g., a "church") does not relieve the taxpayer of Federal income tax liability on such compensation, regardless of the motivation behind the transfer. Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Horst, 311 U.S. 112

(1940), 1940-2 C.B. 206; Helvering v. Eubank, 311 U.S. 122 (1940), 1940-2 C.B. 209. The usual pattern of these tax avoidance schemes is: An individual claiming to be a minister organizes a "church," transfers his business or personal assets to the "church" (often claiming a charitable deduction), and uses the "church" income and assets to pay for food, shelter, and other personal expenses.

As the 1978 EOATRI topic on Churches points out, the problem is not in the law but in the proof. The IRC contains several sections limiting Service access to information about church operations and finances. IRC 508(c)(1)(A) excepts churches from the requirements of filing notice with the Service and requesting a ruling that it is exempt under IRC 501(c)(3). IRC 6033(a)(2) excepts churches from filing Form 990 information returns. IRC 7605(c) requires Regional Commissioner approval of any church examination, and the regs. implementing IRC 7605(c) call for at least two pre-examination letters before the Regional Commissioner's approval is sought. There is no question that certain taxpayers have taken unfair advantage of these (and other) statutory provisions protecting legitimate churches. The Service has informed Congress that these provisions are limiting the Service's effectiveness in preventing individual taxpayers from using the exemption provisions as tax-dodges for their own benefit.* Whether renewed Congressional interest will result in any changes liberalizing these provisions is an open question.

In the meantime, the National Office has just developed a comprehensive manual supplement on these church problems. It is entitled Examination of Certain Organizations Claiming Tax Exempt Church Status and Related Individual Returns, and it is reproduced at the end of this topic. Specialists should refer to this new supplement for guidance in church cases involving inurement, tax avoidance schemes, etc.

2. Congressional Interest in Non-Traditional Churches

On February 3, 1977, the Subcommittee on International Organizations (chaired by Rep. Donald M. Fraser) of the House Committee on International

* The Commissioner has made this point in several speeches, and we understand that the point will be made in the Commissioner's 1979 Report to the Congress on the Administrative Problems with Respect to Enforcement of Exempt Organizations Tax Law.

Relations was authorized to investigate Korean-American relations. It undertook "a full and complete investigation and study of ... all aspects of the political, military, intelligence, economic, educational, and informational relationship, between the Republic of Korea and ... the United States." A very important subject of the investigation was the operation of the Unification Church and other organizations controlled by Reverend Sun Myung Moon. The subcommittee's 10/31/78 report, entitled Investigation of Korean-American Relations (U.S. Government Printing Office, Stock Number 052-070-04729-1), concluded that: "The Moon Organization used church and other tax-exempt components in support of its political and economic activities." (p. 388, conclusion 12). The subcommittee also found that: "Although many of the goals and activities of the Moon Organization were legitimate and lawful, there was evidence that it had systematically violated U.S. tax, immigration, banking, currency, and Foreign Agents Registration Act laws, as well as State and local laws relating to charity fraud, and that these violations were related to the organization's overall goals of gaining temporal power." (p. 388, conclusion 13). The subcommittee recommended (p. 390) that the executive branch agencies (including the IRS) investigating the Moon Organization and its affiliates coordinate their efforts; the subcommittee suggested that abuses by tax-exempt Moon Organization affiliates should be investigated. The report brought the IRC 501(c)(3) exemption for non-traditional churches and religious organizations before the public eye.

The People's Temple massacre at Jonestown, Guyana, did more to focus public attention on non-traditional churches and religious organizations than any other recent event. The disaster attracted international attention and touched Congress directly through the murder of Representative Ryan. Many Congressmen have contacted the State Department, the Department of Justice, and the Service (to name only a few governmental agencies) about the regulation of organizations like the People's Temple. The Service has been responding to inquiries from several prominent legislators concerning non-traditional churches, religious movements, and so-called "cults". It is very possible that this increased interest will lead to legislative changes in the tax provisions dealing with churches and religious organizations. The National Office will follow these events closely.

3. Caveat on Language and Definitions

The 1978 EOATRI on Churches accurately states that the terms "church", "religion", "religious purposes", etc. have not been defined in the IRC or regulations. Case law has left the definition to "the common meaning and usage" of the term church. De La Salle Institute v. U.S., 195 F. Supp. 891 (N.D. Cal., 1961).

In fact, the Supreme Court has ruled that government has no authority to pass on the legitimacy of a religious belief or to define permissible religious belief. Fowler v. Rhode Island, 345 U.S. 67 (1953); United States v. Seeger, 380 U.S. 163 (1965). It is, therefore, improper for us to distinguish between organizations seeking IRC 501(c)(3) exemption, because they are termed "non-traditional" or "cults" or "messianic" or anything else.

The word "cult" may be the most charged of all the nebulous catch-words current in the media. It seems to be a shorthand term used to categorize certain religious or quasi-religious organizations whose views, practices, or activities are perceived as unorthodox by the majority. We recognize that, historically, one man's cult has been another's religion. The Service's concern is tax administration (compliance with IRC 501(c)(3)'s legal requirements with regard to churches and religious organizations) and not defining "cults" or passing on the merits of their beliefs.

This is not to say that the Service should ignore "cults", "non-traditional" religious groups, etc. It is to say merely that the Service should take each organization claiming exempt church or religious status as an IRC 501(c)(3) organization on its individual merits regardless of labels.

4. Governmental Regulation of Civil Activities of Churches and Religious Organizations

Although they are spiritual bodies, churches and religious organizations do have civil law existence and deal with civil society. The First Amendment does not bar the civil authorities from dealing with the civil consequences of actions taken by churches and religious organizations. Mormon Church v. United States, 136 U.S. 1 (1890). The Constitution requires only that, in dealing with civil actions, the government apply the rules neutrally and equally among all churches and religious organizations. Walz v. Tax Commissioner, 397 U.S. 664 (1970); Lemon v. Kurtzman, 403 U.S. 602 (1971).

The Service's legitimate governmental concern with churches and religious organizations is determining whether they qualify for exemption under IRC 501(c)(3). IRC 501(c)(3) imposes several requirements on these organizations -- operation for exclusively charitable, religious purposes; no inurement; no political action; no substantial lobbying activities; no illegal activity or activity contrary to Federal public policy. The Service is obligated to determine that churches and religious organizations seeking IRC 501(c)(3) exempt status meet these

requirements, and the First Amendment does not preclude the Service determination.

A very recent United States Tax Court decision reinforces the Service position that it has a right (legitimate governmental interest) to inquire into the actions of a self-proclaimed church in determining whether it meets the requirements of IRC 501(c)(3). In General Conference of the Free Church of America v. Commissioner of the Internal Revenue, 71 T.C. No. 82 (2/28/79), the court held that the Constitution did not justify the church's refusal to answer Service questions about its operations. The Service's inquiries were objective and nondiscriminatory attempts to obtain the information sufficient to evaluate whether the church operated for IRC 501(c)(3) exempt religious purposes. The court concluded that the Service inquiries were not violations of the church's First Amendment rights. (See also the cases below.)

5. Judicial Precedents

Several summaries of high court decisions follow. They illustrate the difficult problems the Service encounters in evaluating the civil actions of churches and religious organizations for the purpose of determining whether they qualify for tax exemption under IRC 501(c)(3).

a. THE FOUNDING CHURCH OF SCIENTOLOGY V. UNITED STATES, 412 F. 2d 1197 (Ct. Cl. 1969).

The court upheld the Service's denial of exemption under IRC 501(c)(3) to this religious organization claiming church status. The Service found that the organization's operation was primarily for the personal benefit and inurement of the founder and his family. The court agreed and said that the denial of tax exemption in accordance with IRC 501(c)(3) was not a First Amendment violation.

b. CHRISTIAN ECHOES NATIONAL MINISTRY, INC. v. UNITED STATES, 470 F. 2d 849 (10th Cir. 1972), rev'g 28 A.F.T.R. 2d 71-5934 (N.D. Okla. 1971) cert. denied, 414 U.S. 864 (1973)

Service successfully revoked a recognized church for substantial legislative activity, inconsistent with exemption under IRC 501(c)(3). Court sustained Service action despite First Amendment defense of church. (Please note that section 1307(a)(3) of the Tax Reform Act of 1976, P.L. 94-455, 1976-3 (Vol. 1) 198, states that the intent of Congress, in enacting the new public charity provisions

under IRC 501(h), 4911, etc., should not be regarded as an approval or disapproval of the Christian Echoes case.)

- c. UNIVERSAL LIFE CHURCH, INC. v. UNITED STATES, 327 F. Supp. 770, (E.D. CAL. 1974)

The Service denied exemption to this "church" because its primary activity was the issuance of honorary divinity degrees to individuals seeking membership. The tenet of the church is that each member is entitled to his own personal convictions. The Service based denial on the issuance (and sometimes sale) of degrees, which individuals used as a basis for avoiding tax. The court found nothing inconsistent with "church" status and the issuance of minister's credentials. The court refused to consider the merits of the organization's beliefs. The court ordered that exemption be recognized.

- d. BOB JONES UNIVERSITY v. SIMON, 416 U.S. 725, 40 L. Ed. 2d 495, 94 S. Ct. 2038 (1974); Ct. D. 1962, 1974-1 C.B. 354.

Bob Jones sued to enjoin the Service from revoking the exempt status on the ground that it was racially discriminatory. Bob Jones was recognized by the Service as a school not a religion, but it claimed a religious basis for its discriminatory policy. Dicta indicated that religion might be a legitimate basis for discrimination (and protectible under the First Amendment). The case was decided against Bob Jones, not on the merits, but on the basis that the Anti-Injunction Statute (IRC 7421) precluded such actions. (But, see new Bob Jones decision below.)

- e. RUNYON v. McCRARY, 427 U.S. 160 96 S. Ct. 258 (1976).

Private racially discriminatory schools violated the 13th Amendment rights of barred students. Supreme Court intimated religious motivation may not change result.

- f. GOLDSBORO CHRISTIAN SCHOOLS, INC. v. UNITED STATES, 436 F. Supp. 1314 (E.D.N.C. 1977)

The court held that a schools' racially discriminatory policy even though religiously based, was contrary to public policy and not protected from denial of tax exemption by the First Amendment.

g. BOB JONES UNIVERSITY v. UNITED STATES, C.A. No. 76-775,
U.S.D.C. Greenville, South Carolina, 12/26/78.

Recently, the District Court held Bob Jones a religion. It stated that the organization's belief on interracial marriage was a legitimate religious belief and that the Service could not deny exemption on the basis of racial discrimination.*

* The decision is contrary to Green v. Connally, Norwood v. Harrison, and Goldsboro Christian Schools, Inc. v. United States. Appeal is likely but the decision indicates how the First Amendment religious label can be used to shield organizations from Service (or other government) regulation.

Examination of Certain Organizations Claiming Tax Exempt Church Status and Related Individual Returns

[Supplementary by MS CR 7(10)G-36]

Section 1. Purpose

The purpose of this Supplement is to provide guidelines to the various Service functions involved in the identification and examination of certain churches and religious orders and related returns.

Section 2. Background

.01 A number of organizations involved in the sale of minister's credentials (mail order ministries) and church charters are offering "plans" which purport to reduce an individual's income taxes. A typical "plan" calls for an individual to become an ordained minister, form an organization that claims to be a church, and contribute 50% of his/her taxable income to it. The organization in turn furnishes him/her with a residence and certain living expenses. Another plan calls for an individual to take a "vow of poverty" and to assign his/her assets (house, car, savings account, etc.) and the income earned from his/her current employment to the organization. The assigned income is used for housing, food, clothing, etc., for the individual.

.02 It is a basic principle of Federal income tax law that an assignment or similar transfer of compensation for personal services to another individual or entity is ineffectual to relieve the taxpayer of Federal income tax liability on such compensation, regardless of the motivation behind the transfer. See *Lucas v. Earl*, 281 U.S. 111 (1930); *Helvering v. Horst*, 311 U.S. 112 (1940), 1940-2 C.B. 206; *Helvering v. Eubank*, 311 U.S. 122 (1940), 1940-2 C.B. 209.

.03 Similarly, a member of a religious order who has taken a "vow of poverty" and is instructed by the order's superior to obtain employment with a secular employer must generally include his/her total remuneration in gross income even if remitted to the order.

Section 3. Identification of Mail Order Ministries

.01 Service Center Procedures

1 Form 4361, Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders, and Christian Science Practitioners, and Form 4029, Application for Exemption from Tax on Self-Employment Income and Waiver of Benefits, will be used to identify individuals and churches. The correspondence function will forward to the Chief, Criminal Investigation Branch, at the service center, a copy of all Forms 4029 and 4361

involving a "vow of poverty" or listing an organization suspected of being a so-called mail order ministry.

a Upon receipt of Forms 4029 and 4361, the Chief, Criminal Investigation Branch, will review and evaluate each of these forms, and determine which appear to be questionable. For each individual identified on questionable forms, an attempt will be made to secure the prior year's return.

b If a valid return was filed, the Chief, Criminal Investigation Branch, will hold the Form 4361 or 4029 in suspense until the individual is required to file the next return. The Chief, Criminal Investigation Branch, will attempt to secure this return and, if filed, determine whether it has criminal potential. If criminal potential is lacking, but the return involves an assignment of income or a contribution of the type described in this Supplement, the Chief, Criminal Investigation Branch, will forward the return to the service center Examination Branch to be processed in accordance with established procedures. If both criminal and audit potential are lacking, the return will be forwarded to the service center Processing Division to be processed in accordance with established procedures. If a valid return is not filed, the Chief, Criminal Investigation Branch, will process the information in accordance with IRM 9311.

2 Through the Taxpayer Delinquency Investigation Program and the Information Returns Program, the Collection function will identify stopfilers and nonfilers claiming a "vow of poverty." Upon identification, a referral will be made to the Chief, Criminal Investigation Branch, for evaluation. If criminal potential is lacking, the Chief, Criminal Investigation Branch, will refer the case to the service center Examination Branch for processing. If criminal potential is present, the information will be processed in accordance with IRM 9311.

3 The Entity Control Section should be alert for Forms SS-4 filed by alleged churches or orders associated with mail order ministries. Questionable Forms SS-4 should be referred to the appropriate Employee Plans/Exempt Organizations Division for follow-up after issuance of Employee Identification Numbers.

4 The code and edit function will screen tax protester returns to identify "vow of poverty" cases. All individuals claiming a "vow of poverty" and not showing income from religious sources will be referred to the Chief, Criminal Investigation Branch. The Chief, Criminal Investigation Branch, will evaluate for criminal potential. If criminal potential is lacking, the case will be returned to the service center code and edit function, where it will be assigned an unallowable code 83 to identify the return and to freeze the refund. If criminal potential is present, the information will be processed in accordance with IRM 9311.

.02 Collection Activity Procedures. Through the Taxpayer Delinquency Investigation Program, the district Collection Activity will identify stopfilers and

nonfilers claiming a "vow of poverty." All cases that appear to involve fraud will be forwarded to the district Criminal Investigation Activity for evaluation. All others will be forwarded to the district Examination Activity for processing in accordance with Form 3449 procedures.

.03 Examination Activity Procedures. As part of the package audit procedure, the employer will be asked whether any employee has filed a "vow of poverty" statement. (See Manual Supplement 42G-382, dated July 31, 1978.)

.04 EP/EO Division Procedures.

1 During examinations conducted in connection with the tax liability of alleged churches and orders described in this Supplement, specialists should be alert for information contained in the books of account of such entities pertaining to individual tax avoidance. Any information collected should be promptly referred to the appropriate Examination Activity, using Form 5666, EP/EO Information Report, with a reference to this Supplement.

2 Specialists may examine lists containing names of purchasers of alleged church charters or individuals claiming ministerial status from alleged churches, third parties or other divisions of the Service. The list may be sought from a church in its capacity as a third-party witness. In situations where the tax liability of the alleged church is at issue, a list of the alleged church's charter purchasers may be requested in a pre-examination letter or during an audit provided that the list may be relevant to ascertaining the tax liability of the church under examination and that ascertaining the tax liability of the alleged church is a purpose for requesting the list; however, National Office authorization (E:EO:O:P) should be obtained in writing prior to seeking such a list.

3 Taxpayer assistance requests and informants' correspondence will be used to identify alleged churches and individuals involved in mail order ministries. Referrals will be made to the appropriate EP/EO Division and/or Examination Activity.

4 Various sources from outside the Service, including news articles, county records, state franchise and licensing departments, state attorneys general offices, and post offices will be used to identify alleged churches and individuals involved in mail order ministries. Referrals will be made to the appropriate EP/EO Division and/or Examination Activity.

.05 Any project undertaken to identify alleged churches and individuals involved in mail order ministries must be authorized in accordance with Manual Supplement 79G-2, Information Gathering Guidelines, dated December 29, 1978.

Section 4. Claim to Church Status

.01 The filing of an incomplete Form 1023 or the filing of a Form 1023, Application for Recognition of Exempt Status, that fails to establish an organization's exemption under IRC 501(c)(3) does not affect the organization's entitlement to claim church status and the application of IRC 7605(c) concerning restrictions on the examination of churches.

.02 An individual may claim a charitable contribution deduction to a church that has not been recognized by the Service as tax exempt. Such deduction is not barred merely because the church has never applied for recognition of exempt status. Similarly, when an organization has applied but has not provided the Service with sufficient information upon which to make a favorable determination of exempt status, a charitable deduction is not automatically barred.

Section 5. Coordination of IRC 170(c) Deduction Cases

.01 If an IRC 170 deduction has been disallowed because the individual claiming the deduction made the contribution in the expectation of receiving benefits designed for his/her maintenance and comfort, it will generally not be necessary for the EP/EO Division to conduct a concurrent examination of the church. A referral using Form 5346, Examination Information Report, should be made to the appropriate EP/EO Division concerning examination of the involved church or religious order. This is for information purposes only. The church will be examined only when in the judgment of the Division such examination is necessary based on Service concerns. The amount of potential tax liability should not be a decisive consideration isolated from other concerns. If an examination of the church is conducted, it will not be necessary for Examination Activity to suspend closing the case until the EP/EO Division has completed action on the referral. However, there should be close coordination to insure that the case is not litigated prematurely.

.02 In some instances the individual may claim that he/she is entitled to the parsonage allowance exclusion from income under IRC 107. In such cases, Examination Activity will determine whether the individual has performed services that are ordinarily the duties of a minister of the gospel. In the case of *Boyer v. Commissioner*, 69 T.C. 521 (1977), the Court held that no portion of an ordained minister's salary was excludable under IRC 107 as a ministerial rental allowance where he secured secular employment and was subsequently assigned to that task by the governing body of his church. This decision was reached despite a general church policy purporting to authorize such an exclusion to all ordained assignees. See, also, Rev. Rul. 78-229, 1978-1 C.B 305, which similarly provides that ordinary nonreligious services performed for a manufacturing company on the company's assembly line by an ordained minister, who had worked several years for the company prior to receiving written instructions from the church to do so, are not "in the exercise of his ministry" for purposes of IRC 3121(b)(8)(A), and that the remuneration received for the services is not excepted from income tax withholding under IRC 3401(a)(9). Further, an amount received

by a minister of the gospel and designated as "rental allowance" may not be excluded from gross income under IRC 107 to the extent it exceeds the reasonable compensation for the minister's service. See Rev. Rul. 78-448, 1978-521 R.B. 8. If it is determined that the individual has not performed services that are ordinarily the duties of a minister of the gospel, it will not be necessary for EP/EO Division to examine the church. If it is necessary to determine whether services are performed in accordance with the tenets and practices of the church, a referral using Form 5346 shall be made to the appropriate EP/EO Division for a concurrent examination.

.03 If Examination Activity proposes to disallow an IRC 170 deduction on the grounds that the donee organization is not described in IRC 170(c), a referral using Form 5346 shall be made to the appropriate EP/EO Division. The donee organization should, if possible, be examined concurrently with the IRC 170 deduction. Cases currently in Examination or Appeals Offices that are in some state of appeal and that have not previously been coordinated with the appropriate EP/EO Division, should be referred using Form 5346. EP/EO Division should immediately begin to examine these cases. Examination or Appeals offices should suspend closing related cases until EP/EO Divisions have completed action on referrals made under these instructions, except when closing action is required to protect the interests of the Government.

Section 6. Coordination of Assignment of Income Cases

.01 An individual claiming a "vow of poverty" and assigning his/her income to a church may be employed by a party other than the church. In such cases the individual may not be acting as an agent of the church, and must include the remuneration in his/her gross income. See Rev. Ruls. 77-290, 1977-2 C.B. 26, and 78-229, 1978-1 C.B. 305. An individual is not an agent of the principal unless he/she is carrying out a purpose of the principal. The mere fact that an individual turns over money that he/she has earned to another does not necessarily constitute him/her an agent of that person. See *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949); *Kelly v. Commissioner*, 62 T.C. 131 (1974); and Rev. Rul. 76-323, 1976-2 C.B. 18.

.02 In the case of a mail order minister who, for example, is an electrician working for wages, if he/she transfers the income to a church, the minister is not acting in the capacity of an agent of the church. Performing work as an electrician does not carry out any of the stated purposes of the church. Furthermore, the employer, and not the church, has sole control over the work performed by the electrician. Thus, the minister in this case is not an agent of the church and income derived from the work performed is taxable to the minister. See Rev. Ruls. 76-323, 1976-2 C.B. 18, and 78-229, 1978-1 C.B. 305.

.03 On the other hand, when a nurse is a member of a religious society one of the purposes of which is to provide personnel to missions and hospitals, which

retains general direction and control over the nurse, and which makes all arrangements for the nurse's assignment to the hospital to perform nursing services, he/she is an agent of the religious society. The religious society requires all remuneration earned by members to be placed in the society's treasury to be used in its works for its benefit. Although the hospital issued the checks to the nurse who in turn endorsed them over to the society, the nurse had no right to receive or direct the use of the remuneration. Therefore, amounts received by the nurse from the hospital are excludable from his/her gross income. See Rev. Rul. 68-123, 1968-1 C.B. 35.

.04 Situations may arise in which an employee claims a "vow of poverty" and either assigns part or all of his/her earnings to a church that he/she has formed through the purchase of a church charter and ministerial certificate. In such case, the individual whose principal activity is that of an employee can have his/her income determined without an examination of the church when he/she is employed by a party other than the church. Under these circumstances, Examination Activity may complete the case without a concurrent examination of the church by EP/EO Division. However, EP/EO Division should be notified of the church's existence for information purposes only.

.05 An individual may claim to have assigned income, donated services, or transferred business activity to an organization claiming to be a church. If Examination Activity can determine the amount of the individual's income without resort to the church's books of account, they should continue with the audit. A referral using Form 5346, Examination Information Report, should be made to the appropriate EP/EO Division concerning the involved church. This is for information purposes only. If it becomes necessary to examine the church's books of account a referral using Form 5346 should be made to the appropriate EP/EO Division for a concurrent examination. See Section 7.03 for definition of books of account.

Section 7. EP/EO Division Procedures

.01 Referrals on Form 5346 from Examination Activity will be reviewed by the Chief, Technical Staff. When it is determined that examination is required under this Supplement, the case will be assigned and given priority consideration. Chief, EP/EO Division, will report to Chief, Examination Division, (or District Director in streamlined districts) monthly on the status of the examination.

.02 Section 301.7605-1(c)(3) of the Treasury Regulations provides that the requirement that the Regional Commissioner give notice prior to examination of the books of account of an organization does not apply to an examination of the religious activities of the organization (i) to the extent necessary to determine the initial or continuing qualification of the organization under IRC 501(c)(3); (ii) to determine whether the organization qualified as one, contributions to which are deductible under IRC 170, 545, 556, 642, 2055, 2106, or 2522; or (iii) to

determine whether the organization is a church or convention or association of churches. Although not required by the regulations, the pre-examination procedures including furnishing advance notice (see IRM 4(11)95 (to be reissued in IRM 7(10)00)) should be followed before any examination of an organization's religious activities.

.03 Books of account are the accounting and bookkeeping records kept in the regular course of business to provide a detailed financial history of business transactions. They include all books of original entry.

.04 When examining an organization involved in the sale of church charters and ministerial certificates, the issue of whether the organization qualifies for tax exempt status under IRC 501(c)(3) should be considered. In addition, the issue of whether the sale of these items is in furtherance of religious purposes under IRC 501(c)(3) should be raised. Examining agents should look to such issues as whether the organization is organized and operated exclusively for religious purposes; whether it serves private rather than public purposes; and whether its net income inures to the benefit of any private shareholders or individuals. If the issue of exempt status is considered in a case involving a tax avoidance scheme, technical advice procedures should be utilized, as described in Rev. Proc. 73-8, 1973-1 C.B. 754.

.05 In order to be recognized as a religious organization described in IRC 501(c)(3), an organization must establish that it is in fact "religious"; that it is organized and operated in conformity with the basic principles of charity law; and that it does not violate any of the specific prohibitions of IRC 501(c)(3) and the regulations thereunder. An organization will be considered "religious" only if its members have a sincere and meaningful belief in whatever doctrine is espoused, and this belief occupies in the lives of those members a place parallel to that filled by God in the lives of traditionally religious persons. Under the First Amendment, the Service is precluded from considering the content or sources of doctrine which is alleged to constitute a particular religion, and can make no attempt to evaluate the content of whatever doctrine a particular organization claims is religious. However, a mere allegation that a specific doctrine is religious is not sufficient to warrant that doctrine's designation as a religion.

.06 When examining a church of the type described in this Supplement, examining agents should be alert for evidence that income assigned to the church or order by an individual has been set aside for, or used for, the benefit and enjoyment of the individual. Such evidence could indicate inurement of the organization's earnings, and would be relevant not only to the issue of exempt status under 501(c)(3), but also to the deductibility of the assigned income under IRC 170 as well.

.07 Revenue Ruling 78-232, 1978-1 C.B. 69, provides that an individual who claims to be a minister, organizes a church, deposits salary checks for salary

earned from outside employment in the church's bank account, and uses the funds of the account for lodging, food, clothing and other living expenses, is not entitled to a charitable deduction under IRC 170 for the amount of the salary checks. Under the circumstances described, allowance of a charitable deduction was precluded not only because the benefits which the donor reasonably expected to obtain by making the transfer were sufficiently substantial to provide a quid pro quo for it, but also because the donee "church" was not a qualified recipient under IRC 170(c)(2). The facts of the case indicated that the donee organization was operated for the private purposes of the taxpayer, rather than for exclusively exempt purposes, as required by the statute. Furthermore, since funds of the donee organization were used by or on behalf of the taxpayer, there was inurement of the type proscribed by the statute.

.08 Revenue Ruling 69-266, 1969-1 C.B. 151, similarly provides that an organization formed and operated by its creator essentially as an attempt to reduce his/her personal Federal income tax liability while still enjoying the benefits of his/her earnings, is not exempt under IRC 501(c)(3). Like the recipient church in Rev. Rul. 78-232, supra, the organization was operated for a private purpose, rather than for exclusively exempt purposes.

.09 A summons may be directed to the organization under examination or to a third party recordholder, if necessary, to obtain information from records of correspondence or financial records. All summonses proposed to be issued by EP/EO specialists under this Supplement should be submitted to District Counsel for pre-issuance review.

Section 8. Examination Activity Procedures

.01 When Form 5346 is prepared for referral to EP/EO Division, items 1, 12, 13, 14, 15, 16, 17 and 22 should be completed. All other items should be blocked out to prevent subsequent use.

.02 Referrals on Form 5666, EP/EO Information Report, forwarded from EP/EO Division will be reviewed by the Returns Program Manager or his/her representative. Returns should be examined based on audit potential, with consideration that a tax avoidance scheme of the general class outlined in this Supplement is involved. If assigned for examination, the case will be given priority consideration with the examination being initiated within 30 days after assignment.

.03 When EP/EO Division or Examination Activity decides, after review of Form 5346, 5666 or a request for collateral examination, that an examination should not be conducted or should be terminated prior to resolution of a related examination being conducted by another Division, the interested Division will be informed within 30 days of this decision. In the event the interested Division desires that the matter be reconsidered, the matter will be reviewed and resolved

by the Division Chiefs, the District Director, the Assistant Regional Commissioners and the Regional Commissioners involved, in the order named. Every effort will be made to resolve the matter at the lowest possible level. Since a tax avoidance plan is involved, the amount of potential tax liability in controversy should not be a decisive consideration isolated from other legitimate Service concerns.

.04 If it is necessary to obtain information from the books of account of a church for the purpose of verifying payments made by the organization to another person in determining the tax liability of the recipient, the pre-examination procedures as prescribed in section 301.7605-1(c)(2) and the summons procedure as prescribed in section 301.7603-1 of the Treasury Regulations should be followed.

Section 9. Examination Activity Guidelines for Cases Involving IRC 170(c) Contribution Deductions and Assignment of Income

.01 The guidelines provided herein are intended to aid examiners in gathering sufficient facts in each case to resolve the issues. The examiner's goal is to complete the examination whenever possible, without having to request a collateral examination by the EP/EO Division.

1 However, under no circumstances are examiners to request books of account belonging to the church.

2 Section 301.7605-1(c)(2) of the Treasury Regulations does not apply when church books of account are provided to the Service without first being requested by the Service. Therefore, an examiner may verify specific items to church books of account voluntarily provided by taxpayers which are not requested by the examiner. When the church offers to provide its books of account, the examiner should secure from such taxpayers a signed and dated written statement that the books of account have been voluntarily provided and have not been requested by the Service. The statement should be included in the workpapers.

.02 Examiners should be especially alert to the situation in which an individual, who claims to be a minister and organizes a church, deposits salary checks earned from outside employment in the church's bank account, claims a contribution deduction of up to 50% of adjusted gross income, and subsequently receives payments from the church which are used for the individual's personal living expenses. In such instances, the individual is not entitled to a charitable contribution deduction. See Rev. Rul. 78-232, 1978-1 C.B. 69.

1 Examiners should determine whether the individual received a "parsonage allowance" described in IRC 107, an automobile expense allowance,

an entertainment expense allowance, a vacation allowance, etc. Receipts of such items may indicate a quid pro quo situation as described in Rev. Rul. 78-232.

2 If the issue of whether ministerial duties are performed in accordance with the tenets and practices of the church arises during the examination process, the examiner must refer the case to the EP/EO Division using Form 5346. (See Section 8 of this Supplement.)

.03 Guidelines for the examination of contribution deductions are found in 679 and 741 of IRM 4231, Audit Technique Handbook for Internal Revenue Agents.

1 Examiners should secure from the taxpayer, a statement from the church as prescribed in Regulation 1.170A-1(a)(2)(iii).

2 Ascertain that, in instances where merchandise, goods, etc. are received by the donee in return for a contribution, the deduction is limited to the excess of the amount of the contribution over the fair market value of the item. See 741 of IRM 4231, Audit Technique Handbook for Internal Revenue Agents.

.04 An assignment or transfer of compensation for personal services to another individual or entity is ineffectual in relieving a taxpayer of Federal income tax liability. The taking of a "vow of poverty" alone also does not render an individual immune from Federal income tax on income earned or received as an individual. See *Lucas v. Earl*, 281 U.S. 111 (1930); *Helvering v. Horst*, 311 U.S. 112 (1940), 1940-2 C.B. 206; *Helvering v. Eubank*, 311 U.S. 122 (1940), 1940-2 C.B. 209; Rev. Ruls. 77-209, 1977-1 C.B. 165, and 77-436, 1977-2 C.B. 25.

.05 In all cases involving assignment of income, examiners should secure certain facts from the taxpayer.

1 Examiners should determine whether the organization is of the type described in IRC 170(c)(2) and/or whether the organization is also tax exempt under IRC 501(c)(3). If the organization is of the type described in 170(c)(2) and certain other conditions are met, a contribution deduction may be allowable. If the organization is tax exempt under IRC 501(c)(3) and certain other conditions are met, the income may be excludable by the individual. This determination may be made by securing a statement from the recipient organization as prescribed in Regulation 1.170A-1(a)(2)(iii). See Rev. Ruls. 76-323, 1976-2 C.B. 18, and 68-123, 1968-1 C.B. 35.

2 Examiners should determine whether the taxpayer is acting as an agent of the church, or whether there is an employer-employee relationship between the taxpayer and the church, or between the taxpayer and the outside employer, which may make the salary taxable to the individual. See Rev. Ruls. 76-323, 1976-2

C.B. 18; 68-123, 1968-1 C.B. 35; 76-341, 1976-2 C.B. 307; and 78-229, 1978-1 C.B. 305.

3 Examiners should also determine whether the individual had any control over the disposition of any of the funds received by the church.

.06 If the Examination Activity after using any of the above guidelines in its examination determines that the question of the donee organization's exempt status is necessary to conclude its examination, a referral should be made to the appropriate EP/EO Division on Form 5346. See Section 5 of this Supplement.

Section 10. Referrals to Criminal Investigation Activity

.01 Examination Activity

1 Guidelines concerning the indications of fraud that could surface during an examination are found in IRM 4231 Audit Technique Handbook for Internal Revenue Agents. In addition to these general guidelines, the examiner should be alert to fraudulent situations peculiar to mail order ministries, including the following:

a In assignment of income cases where a taxpayer claims to have assigned all his/her "worldly goods" to the church or religious order, the examiner should be alert to situations indicating that a valid transfer of the taxpayer's assets did not occur and/or it is clearly a "sham" transaction.

b In cases where the taxpayer claims an IRC 170(c) contribution deduction to the church or religious order, the examiner should be alert to situations where the taxpayer has exclusive control and use of the funds of the church or religious order and these were used for his/her own benefit.

c In cases where a taxpayer claims to have received a parsonage allowance from the church or religious order, facts could surface which indicate that the taxpayer received substantially more than the parsonage allowance.

2 When indications of fraud are discovered during an examination, the procedures in IRM 4565 will be followed.

3 The procedures relative to joint investigations as outlined in IRM 4565.3 will be followed.

.02 EP/EO Division

1 EP/EO specialists should be alert to potential fraudulent schemes employed by mail order ministries. Some of the fraudulent devices used include the following:

- a Keeping a double set of books;
- b Giving of false information/documents to the examining specialist;
- c Concealing or destroying financial records;
- d Closing out checking and savings accounts at banks and thereafter conducting financial affairs in currency;
- e Disguising income from an unrelated trade or business as non-taxable income;
- f Controlling and using funds in the church bank accounts by the reputed minister for his/her own benefit;
- g Using funds claimed as contributions to the church for personal use of the reputed minister; and
- h Falsifying application forms which are signed under penalties of perjury.

2 If, during an examination of a mail order ministry, and EP/EO specialist discovers any firm indications of potential fraudulent schemes, the specialist will suspend his/her activities and prepare a Referral Report, Form 2797, to the Criminal Investigation Activity. Six copies of Form 2797 will be prepared. One copy of the report is retained with the case file. The original and five copies are forwarded through the group manager to the Chief, EP/EO Division, for comments and signature. One copy is sent to the Examination Activity. The original and three copies of the report will be transmitted to the Chief, Criminal Investigation Division, (or District Director in the streamlined districts) in the district in which the entity/taxpayer is located. The remaining copy is retained in the EP/EO Division's referral pending file. A separate Form 2797 will be prepared for each person or entity involved.

3 When a specialist is requested to participate with a special agent in an investigation, the Chief, EP/EO Division, will assign either the referring or another specialist. Any disagreement between the Criminal Investigation Activity and the EP/EO Division, as to whether a specialist should be assigned to cooperate with a special agent in an investigation, will be resolved by the District Director of the district in which the entity is located.

4 If the Criminal Investigation Activity accepts the referral for investigation, the conduct of the investigation becomes the responsibility of the special agent, and the EP/EO specialist will not take any action on the case without first consulting with the special agent who is assigned the investigation.

5 If an EP/EO specialist learns that an assigned case involves a taxpayer that is the subject of a criminal investigation, all activity on the case will be immediately suspended. The specialist's group manager will consult with the Criminal Investigation Activity concerning the continuance of EP/EO activity on the case. If agreement to either continue the suspension or to resume EP/EO activity on the case cannot be reached at the group or division level, the issue will be decided by the District Director. Where more than one District is involved, the District Director having jurisdiction over the criminal investigation will resolve the question.

6 In cases that are referred to the Criminal Investigation Activity, the specialist will summarize the results of the examination and include this in the case file. It is especially important that statements made by the individual with whom the examination was conducted, be accurately documented in the case file.

Section 11. Application of Penalties

.01 Penalties should be considered by the examiner and asserted when appropriate. This determination will be made on a case-by-case basis. The facts and circumstances in each case will govern the imposition of a penalty.

.02 Guidelines to be used in the application of the negligence penalty imposed by IRC 6653(a) are found in IRM 4563.1.

1 Examiners should not hesitate to recommend assertion of the negligence penalty in appropriate cases.

2 The burden of proof in a negligence penalty case is the same for the taxpayer as in a straight deficiency or overassessment case.

.03 Guidelines to be used in the application of the civil fraud penalty will be found in IRM 4563.41 and 4563.42.

1 Examiners will recommend the civil fraud penalty only in cases where there is clear and convincing evidence proving the underpayment of tax was due to fraud. Intent to evade taxes, as distinguished from mistake, honest difference of opinion, negligence or carelessness, must be shown.

2 Careful scrutiny of such cases will be made by the Review function to make certain that such penalties are asserted only in appropriate cases.

.04 If applicable, the private foundation excise taxes under Chapter 42 and related Code provisions should be considered. See IRC 509(b) and section 1.509(b)-1 of the regulations.

Section 12. Conspiracy

.01 Section 2, 18 U.S.C., Principals, provides:

"(a) Whoever commits an offense against the United States, or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal."

"(b) Whoever willfully causes an act to be done, which if directly performed by him or another would be an offense against the United States, is punishable as a principal."

.02 Section 371, 18 U.S.C., Conspiracy to Commit Offense or to Defraud United States, provides:

"If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than \$10,000 or imprisoned not more than five years, or both."

"If, however, the offense, the commission of which is the object of the conspiracy, is a misdemeanor only, the punishment for such conspiracy shall not exceed the maximum punishment provided for such misdemeanor."

.03 In the course of conducting examinations, agents and/or specialists may encounter flagrant situations which appear to be in contravention of the Internal Revenue laws and fall within the purview of either Section 2 or 371 of Title 18, U.S.C. If deemed appropriate, the procedures in Section 10, Referrals to Criminal Investigation Activity, should be followed with respect to these cases.

Section 13. Coordinated Service Procedures

.01 Regional and District representatives from EP/EO, Examination, Criminal Investigation, Collection, and District Counsel shall meet no less than quarterly to discuss developments in the program relating to examination of alleged churches and related individuals and to discuss problems that arise.

.02 Information from Collection and Criminal Investigation Activities concerning tax avoidance plans of the general class described in this Supplement should be carefully screened and assigned for examination by EP/EO Division or Examination Activity where it appears the matter would meet the criteria of Sections 5 and 6, above.

Section 14. Disclosure Provisions

.01 Investigative disclosures may be made as authorized by regulations approved under Section 6103(k)(6) of the Code.

.02 Certain rulings, determination letters and technical advice memorandums requested after October 31, 1976, are subject to public disclosure under either IRC 6104 or 6110. Procedures concerning these matters are contained in 26 CFR 601.105(b)(5) or 26 CFR 301.6110-1.

.03 Local Public Affairs and Disclosure offices should be advised of significant developments relating to mail order ministries, such as revocations and court decisions.

Section 15. Effect on Other Documents

.01 This supersedes Manual Supplement 7(10)G-19, CR 12G-176, 40G-124, 42G-359, 5G-134 (formerly numbered 5(11)G-80), and 9G-45, dated March 10, 1977. Annotations at IRM 7(10)00, 4020, 4260, and 926(11) referring to MS 7(10)G-19, 40G-124, 42G-359, and 9G-45, respectively, are removed. Pen and ink annotation on the first page of IRM 1272, Disclosure of Official Information Handbook referring to MS CR 12G-176 should be removed with a reference to this supplement.

.02 This supplements Chapter 100 of "Old" IRM 1272, Disclosure of Official Information Handbook, and IRM 8(24)10. This "effect" should be annotated by pen and ink beside the Handbook text and basic text cited, with a reference to this Supplement.

.03 This supplements IRM 4020; (10)71 of IRM 4231, Audit Technique Handbook for Internal Revenue Agents; IRM 5(11)62; IRM 7(10)00; and IRM 9311.

NOTE: Procedures formerly contained in memorandum of December 29, 1977 to All Regional Commissioners from Directors, Exempt Organization Division, Audit Division, and Appellate Division have been incorporated in Section 5.03 of this Supplement.

/s/ Jerome Kurtz
Commissioner