

G. UPDATE ON CHURCHES

1. Introduction

In prior years, the CPE program has included a topic that discussed significant developments in litigation and administration that have affected churches and related organizations. Once again in 1986, there have been significant developments that impact on this area. This topic presents an overview of these developments. If there is an underlying theme in this topic, it is the challenge that the Service faces in fairly administering the federal tax laws as they apply to organized religion.

2. IRC 501(c)(3) - Abortion Rights Mobilization, Inc. v. Baker

A. Background

In 1980, Abortion Rights Mobilization (ARM) and a number of other "pro-choice" organizations and individuals filed suit in the Southern District of New York, challenging the Service's enforcement of the IRC 501(c)(3) prohibition on political campaign activity. The plaintiffs allege that the U. S. Catholic Church has persistently intervened in political campaigns to support or oppose candidates according to their views on abortion and the Service has done nothing about it. The plaintiffs claim that this is an unequal and discriminatory enforcement policy that violates the mandate of the Internal Revenue Code and the Establishment Clause of the First Amendment.

The plaintiffs seek an injunction ordering the federal defendants (1) to revoke the tax-exempt status of U. S. Catholic Church entities and to take any other action necessary to enforce IRC 501(c)(3); (2) to assess and collect all taxes resulting from the revocation of tax-exempt status; and (3) to notify or cause the Church entities to notify their contributors that they are not entitled to deduct contributions on their tax returns.

This case raises profound implications not only because it involves the exemption of the U. S. Catholic Church, but also because of its precedential value. At issue is whether a third party can challenge the tax status of a given taxpayer; whether it is proper for the judicial system to determine the Service's administrative priorities; and whether in an action of this kind a third party can obtain access to tax return information protected by IRC 6103.

Earlier reported decisions in this case, Abortion Rights Mobilization, Inc. v. Regan, 544 F. Supp. 471 (S.D.N.Y. 1982); Abortion Rights Mobilization, Inc. v. Regan, 552 F. Supp. 364 (S.D.N.Y. 1982); and Abortion Rights Mobilization, Inc. v. Regan, 603 F. Supp. 970 (S.D.N.Y. 1985), dealt with whether or not the United States Catholic Conference and the National Council of Catholic Bishops were properly joined as defendants and whether the plaintiffs had standing to sue.

In the most recent action in the case, the United States Catholic Conference (USCC) and the National Council of Catholic Bishops (NCCB) refused to produce documents (demanded under subpoenas served in March, 1983). In a letter to the trial judge, Hon. Robert L. Carter, the USCC and the NCCB explained that they could not, in conscience, produce the documents called for because there had been no appellate review of the threshold jurisdictional issues. The district court then granted the plaintiffs' request to hold these organizations in contempt and imposed a daily fine of \$50,000 against each if the documents were not produced. Subsequently, the district court stayed the fine pending the USCC's and the NCCB's appeal of their contempt citation to the Second Circuit.

In the meantime, the government's petition to the Supreme Court asking for a review of the lower courts' holdings on the standing issue was denied. When the trial resumes, it will be in the discovery phase.

B. Retention of Records

In 1982, ARM filed a request for production of documents to which the Service was required to respond. Therefore, on August 20, 1982, and September 27, 1982, telegrams were issued by the Assistant Commissioner (EP/EO) to all Regional Commissioners and all EP/EO key District Directors asking that certain records be sent to the National Office.

In 1983, ARM filed a series of interrogatories requesting information on specific organizations and individuals affiliated with the U. S. Catholic Church, as well as information on specific pro-life groups. In order to assure that the Service could respond as accurately and completely as possible to these interrogatories, the Assistant Commissioner (EP/EO) issued another telegram, on February 23, 1983, to all Assistant Commissioners and key District Directors. This telegram requested that each office (regional, district and EP/EO post of duty), search its files for documents involving information regarding the organizations and individuals referred to in ARM's interrogatories. The telegram listed documents requested, and

noted that, where documents were not available, a brief summary of the recollection of the staff should be provided.

On November 14, 1986, MS 1(15)G-140 was issued. This Manual Supplement, which incorporates the text of the February 23, 1983, telegram, and asks for the retention and storage of the documents described in ARM's 1983 interrogatories. Section 3 provides a list of documents that are to be segregated and maintained. Section 4 provides that each office should search its files and the memories of its staff for the documents listed in section 3, that any existing documents called for in section 3 should be stored in a special file, and that where documents are not available a brief summary of the recollections of the staff should be prepared and associated with the special file. Furthermore, it provides that any documents received after the issuance of MS 1(15)G-140 should be added to the special file.

Should the Service have to respond further in the discovery proceedings and should it be necessary to refer to the documents retained under MS 1(15)G-140, the National Office will retrieve these files.

3. IRC 501(c)(3) and IRC 170(b)(1)(A)(i) - Janaluska Assembly Housing, Inc. v. Commissioner 86 T.C. 1114 (1986)

Janaluska Assembly Housing, Inc. (Housing) was formed to contract for the construction of housing at a conference and retreat center of the United Methodist Church. Housing is owned and controlled by an organization, exempt from tax under IRC 501(c)(3) and classified as a "church" under IRC 170(b)(1)(A)(i), which owns the assembly grounds and conducts the religious programs and activities at the retreat center. Housing's application for exemption under IRC 501(c)(3) was denied on the grounds that the housing units to be constructed would substantially further the nonexempt purpose of providing recreational and vacation opportunities to the purchasers.

Housing sought a declaratory judgment that it is an organization described in IRC 501(c)(3) and that it is also described in IRC 170(b)(1)(A)(i). The Tax Court concluded that Housing's construction program was required by the need to develop housing for the spiritual community that plans, operates, and participates in the religious programs or activities, that Housing had instituted controls to assure that only active participants in religious activities at the center would be permitted to acquire and use the housing, and that there was no competition with commercial contractors. Accordingly the Court decided that Housing was

organized and operated exclusively to further religious purposes and therefore was exempt from tax under IRC 501(c)(3). The court noted, however, that if in actual operation the housing program becomes more ambitious than religious needs require or if the predominant use of the housing is for vacation and recreation, a different result would obtain.

As to the issue of whether Housing is described in IRC 170(b)(1)(A)(i) the court decided that while the record demonstrates Housing's close relationship with its controlling organization, which is a church, Housing is not a church in its own right. The court concluded, instead, that Housing is an organization described in IRC 509(a)(3).

The Service is not appealing this decision.

4. IRC 501(d) - Twin Oaks Community, Inc. v. Commissioner - 87 T.C. No. 71 (December 3, 1986)

Twin Oaks Community is a commune modeled on the lifestyle described in B. F. Skinner's book, Walden Two. All earnings from the organization's business activities are deposited in the communal treasury maintained by the organization. Members are provided with food, clothing, housing, and other necessities from this treasury.

The Service determined that the organization did not qualify for treatment as an organization described in IRC 501(d) because it failed to satisfy the requirement for a "common treasury" or "community treasury". The Service's position was that these terms mean that members must take a vow of poverty and irrevocably contribute their property to the organization upon becoming members. In this case the organization had no such requirement.

The Tax Court, however, held that an organization has a "common treasury" or "community treasury" for purposes of IRC 501(d) when all the income generated internally by the communal business and any income generated from property owned by the organization is placed into a common fund maintained by the organization with all members having equal undivided interests in such fund, but no right to claim title to any part thereof. The court concluded that the organization in this case satisfied these requirements. The court characterized the "vow of poverty requirement" as "irrelevant" to the meaning of the terms "common treasury" and "community treasury" for purposes of IRC 501(d).

5. IRC 513(a)(1) - Religious Orders and the "Uncompensated Labor" Exception

St. Joseph Farms of Indiana v. Commissioner, 85 T.C. 9 (1985), involved the issue of whether, for purposes of the IRC 513(a)(1) "uncompensated labor" exception from the definition of "unrelated trade or business," Roman Catholic brothers subject to the vow of poverty who receive room, board, and various benefits while operating a large farm are performing services without compensation.

The organization is a large farm operated by an order of Roman Catholic brothers. It is exempt from tax under IRC 501(c)(3) under the group ruling issued to the USCC. Every brother has taken a vow of poverty under which he renounces all right to compensation for services rendered or for any benefit the order may have been able to gain from him. All brothers assigned to the farm receive room, board, clothing, medical care, and other necessities, whether they work on the farm itself or perform other work of the religious community. In addition, FICA payments are made for the brothers on the farm based on their living expenses. For financial accounting purposes, the organization treats the brothers' support as salary.

The Tax Court concluded that the operation of the farm constitutes unrelated trade or business. However, the court's ultimate conclusion was that the farm activity was excepted from the definition of unrelated trade or business under IRC 513(a)(1) because the brothers performed substantially all of the farm work without compensation. In reaching this conclusion the court adopted (without discussion or analysis) a "but for" test to determine whether benefits received constitute compensation. Under this test, the support received by the brothers was not compensation because they would have received the same support even if they had not worked.

In 1986-30 I.R.B. 4, the Service announced its nonacquiescence in the decision of the Tax Court insofar as that decision relates to the issue of "uncompensated labor" under IRC 513(a)(1). The legislative history of IRC 513(a)(1) specifically, and IRC 511-513 generally, indicate that the exception was intended to exclude only businesses in which work is performed by volunteers. The brothers here were not volunteers because only through their collective efforts could they support themselves.

6. IRC 6033 - Filing Requirements of Church-Affiliated Organizations

Congress, in enacting IRC 6033 as part of the Tax Reform Act of 1969, set forth a general requirement that tax-exempt organizations file information returns. In explaining its reasons for the statute's enactment, the Senate Finance Committee made the following statement:

The primary purpose of these (filing) requirements is to provide the Internal Revenue Service with the information needed to enforce the tax laws. The House and Finance Committee concluded that more information was needed on a more current basis from more organizations and that this information shall be made more readily available to the general public, including state officials (Sen. Rep. 91-552, 1969-3 C.B. 423, 457).

The statute does, however, establish certain mandatory exceptions to the filing requirement. Among the excepted organizations are "integrated auxiliaries" of a church or a convention or association of churches (IRC 6033(a)(2)(A)).

In addition to the mandatory exceptions, Congress gave the Commissioner discretionary authority under IRC 6033(a)(2)(B). This discretionary authority permits the Commissioner to excuse organizations from filing if returns were not needed for the efficient administration of the revenue laws.

On December 29, 1976, regulations under IRC 6033 were promulgated. Reg. 1.6033-2(g)(5)(i) defines an integrated auxiliary as an organization:

- (a) Which is exempt from taxation as an organization described in IRC 501(c)(3);
- (b) Which is affiliated with a church; and
- (c) Whose principal activity is exclusively religious.

For purposes of these regulations, an organization is affiliated with a church if it is either controlled by or associated with a church or convention or association of churches. Reg. 1.6033-2(g)(5)(ii) has the following explanation of the term "exclusively religious:"

An organization's principal activity will not be considered to be exclusively religious if that activity is

educational, literary, charitable, or of another nature (other than religious) that would serve as a basis for exemption under IRC 501(c)(3).

Churches have seen this test as an unwarranted intrusion into their domain since the government would be required to decide whether a given activity is exclusively religious. Certain organizations refused to file annual information returns, the Service asserted penalties, and the organizations sued for referral. In Lutheran Social Services of Minnesota v. United States, 758 F.2d 1283 (8th Cir. 1985), the Eighth Circuit concluded that the "exclusively religious" test in Reg. 1.6033-2(g)(5) is inconsistent with IRC 6033 and is therefore invalid. This conclusion was adopted in a 1986 case, Lutheran Children and Family Service of Eastern Pennsylvania v. United States, 58 A.F.T.R. 2d 86-5662 (E.D. Pa. 1986). In yet another case, Tennessee Baptist Children's Homes, Inc. v. United States, 791 F.2d 534 (6th Cir. 1986), the Sixth Circuit refused to overturn a jury verdict that the operation of an orphanage was "exclusively religious."

In an effort to alleviate the concerns that gave rise to this litigation, the Service met with a group of representatives of major religious denominations to seek a solution that would satisfy the need for returns without containing the kind of language that was objectionable to churches. The result of these meetings was the drafting and eventual publication of Rev. Proc. 86-23, 1986-20 I.R.B. 17. In Rev. Proc. 86-23, the Service announced, through the exercise of the Commissioner's discretionary authority under IRC 6033(a)(2)(B), that it will excuse organizations affiliated with a church or convention or association of churches from filing annual information returns beginning after December 31, 1975, if certain requirements are met. The requirements are as follows:

- (a) The organization must be described in IRC 501(c)(3) and 509(a)(1), (2), or (3);
- (b) The organization must be affiliated with a church or convention or association of churches; and
- (c) The organization meets an "internal support test" described in the revenue procedure.

Affiliation is defined in Sec. 4 of the revenue procedure and is met if any one of the three following criteria is satisfied.

1. The organization is covered under a group exemption letter under Rev. Proc. 80-27, 1980-1 C.B. 677, or subsequent revision; or
2. The organization is operated, supervised, or controlled by or in connection with, as defined in Reg. 1.509(a)-4 a church or convention or association of churches; or
3. Relevant facts or circumstances show it is so affiliated. The factors to be considered include:
 - (a) The organization's enabling instrument (corporate charter, trust instrument, articles of association, constitution, or similar document) or by-laws affirm that the organization shares common religious doctrines, principles, disciplines, or practices with the church or convention or association of churches.
 - (b) The church or convention or association of churches has authority to appoint or remove or to control the appointment or removal of at least one of the organization's officers or directors.
 - (c) The church or convention or association of churches receives reports, at least annually, on the financial and general operations of the organization.
 - (d) The corporate name of the organization indicates an institutional relationship, which relationship is affirmed by the church or convention or association of churches or a designee thereof; or if the corporate name of the organization does not indicate an institutional relationship is affirmed by the church, or convention or association of churches, or designee thereof.
 - (e) In the event of dissolution, the assets are required to be distributed to the church or convention or association of churches or to an affiliate thereof within the meaning of this revenue procedure.

(f) Any other relevant fact or circumstance.

Sec. 4 specifically provides that the absence of one or more of the above factors does not necessarily preclude classification of an organization as being affiliated with a church or convention or association of churches.

The organization meets the "internal support requirement" referred to above unless it both:

- 1 Offers admissions, goods, facilities, or services for sale, other than on an incidental basis to the general public (except goods, services, or facilities sold at a nominal charge or substantially less than cost), and
- 2 Normally receives more than 50 percent of its support from a combination of governmental sources; public solicitation of contributions (such as through a community fund drive); and receipts from the sale of admissions, goods, performance of services, or furnishing of facilities in activities that are not unrelated trades or businesses.

The underlying principle of Rev. Proc. 86-23 is that church-affiliated organizations should be required to file returns if they offer admissions, goods, etc., to the public and if their support consists primarily of receipts from sales, etc.; contributions from public solicitations or government funding. Generally, these are quasi-public organizations of the sort described in several of the examples under Reg. 1.6033-2(g)(v) (e.g., hospitals, universities, etc.). This principle is derived from IRC 6033, the legislative history, and the principles underlying the 1984 enactment of IRC 3121(w). IRC 3121(w) concerns social security coverage for the lay employees of churches and certain controlled organizations.

Rev. Proc. 86-23 is intended as a comprehensive statement of filing requirements applicable to church-affiliated organizations that, for practical purposes will supplant, on an interim basis, the existing regulation defining an integrated auxiliary of a church until that regulation can be modified to incorporate the affiliation and funding tests established in the revenue procedure. On May 1,

1985, Chief Counsel initiated a project to amend Reg. 1.6033-2(g)(5) to redefine "integrated auxiliary of a church."

Note that Rev. Proc. 86-23, in Sec. 6, contains special return filing procedures. These procedures provide that any IRC 501(c)(3) church-affiliated organization that failed to file a required return on Form 990 for any tax year ending on or before December 31, 1986, but which files such return or returns by May 15, 1987, on the basis of Rev. Proc. 86-23, will not be subject to a late filing penalty under IRC 6652(d)(1). Such return should be marked at the top, "Filed under Rev. Proc. 86-23."

7. IRC 7611 - Publication of Regulations 301.7611

As part of the Deficit Reduction Act of 1984, IRC 7611 was enacted to establish special procedures regarding any tax inquiry or examination of a church, effective January 1, 1985.

T.D. 8077, issued February 20, 1986, published regulations under IRC 7611.

The 1985 CPE contained a discussion of the church audit procedures based on the Conference Committee Report on P.L. 98-369 (Deficit Reduction Act of 1984). The recently published regulation under IRC 7611 merely codifies the principles discussed in the Conference Committee Report. Following this topic is an exhibit that reprints the 1985 CPE church audit procedures topic with annotations. The annotations (appearing in the margin) provide a cross-reference to specific questions under the regulations.

8. IRC 7428 - Declaratory Judgment Cases

The following cases involved procedural issues in declaratory judgment actions: Basic Bible Church of America v. Commissioner, 86 T.C. 110 (1986); Church of Gospel Ministry, Inc. v. U.S., 640 F. Supp. 96 (D.C. D.C. 1986); Universal Bible Church, Inc. v. Commissioner, T.C.M. 1986-170 (4-24-86); and The Church of the New Testament v. U.S., 783 F.2d 771 (9th Cir. 1986).

In The Church of the Eternal Life and Liberty, Inc. v. Commissioner, 86 T.C. 916 (1986), the court held that a two-member organization did not qualify as a church within the meaning of IRC 508(c)(1)(A), and therefore, was required to satisfy the notice requirement of IRC 508. The court also held that the organization

was not entitled to exemption under IRC 501(c)(3) because it did not accomplish any religious purpose and there was substantial private benefit.

EXHIBIT

DEFICIT REDUCTION ACT OF 1984 CHURCH AUDIT PROCEDURES

1. Introduction

The Deficit Reduction Act of 1984 has added a new section, IRC 7611, that greatly expands the statutory restrictions on IRS inquiries and examinations on church tax status or tax liabilities. (The current restrictions on church examinations contained in IRC 7605(c) are repealed, effective January 1, 1985.)

Congress' actions were motivated by two competing considerations. First, Congress was aware of the special problems, including problems of separation of church and state and the special relationship of a church to its members, that arise when the IRS (or any governmental agency) examines the records of a church. These problems may be compounded by the relative inexperience of churches in dealing with the IRS and the resulting occasional misunderstandings between churches and the IRS. Congress also believed that while prior law imposed limitations on the examination of church records, these limitations were somewhat vague and relied heavily on internal IRS procedures to protect the rights of a church in the examination process. Additionally, there was some uncertainty regarding the scope of the investigations to which prior law applied and the nature of the records that were protected by the law.

While desiring to protect churches from undue interference by the IRS, Congress recognized that an increasing number of taxpayers had, in recent years, utilized the church form primarily as a tax-avoidance device. Congress believed that the IRS must retain an unhindered ability to pursue individuals who use the church form in this manner. The Act attempts to resolve these competing considerations by providing detailed rules that the IRS is to follow in making tax inquiries to churches, both as to tax-exempt status and as to the existence of unrelated business income. These provisions emphasize the need for a speedy determination of church tax liabilities and, where possible, a determination without unnecessary examination of church books and records. Congress believed that these provisions will protect the rights of legitimate churches without unduly hindering IRS efforts to eliminate tax-avoidance schemes posing as religious organizations. Further, the Congress believed that the adoption of detailed statutory rules will reduce misunderstandings between churches and the IRS and allow for a more stable and cooperative examination process.

IRC 7611 requires (1) approval by an IRS regional commissioner before an inquiry may be begun, (2) notice before beginning an examination, (3) an offer of pre-examination conference, (4) completion of any audit of tax liabilities within two years after the date on which the notice of examination is supplied to the church. IRC 7611 also provides (5) a definition of "church records", (6) limitations on the period of assessment, (7) limitations on additional inquiries and examinations and coordination with IRS regional counsel at various stages, (8) remedies for any IRS violation of church audit procedures, and (9) an expansion of IRC 7428 jurisdiction for declaratory judgments.

"Church" is defined as including (1) any organization claiming to be a church or (2) a convention or association of churches. It does not include organizations incorporated separately from the church, such as church-related schools. Church audit procedures do not apply to criminal investigations or to "routine inquiries". These procedures also do not apply to the examinations of third parties.

IRC 7611 applies to tax inquiries begun after December 31, 1984.

2. Limitations on the Scope of IRC 7611 Church Audit Procedures

a. Routine Requests

Routine IRS requests are not subject to the church audit procedures set forth in IRC 7611. Routine requests for this purpose include (but are not limited to) questions regarding (1) the filing or failure to file any tax return or information return by the church; (2) compliance with income tax or FICA (social security) tax withholding responsibilities by the church; (3) any supplemental information needed to complete the mechanical processing of an incomplete or an incorrect return filed by the church; (4) information necessary to process applications for exempt status and ruling requests; (5) information necessary to process and periodically update registration for tax-free transactions (excise tax), elections for exemption from windfall profits tax or employment tax exemption requests by the church; (6) information identifying a church that is used by the IRS to update its Cumulative List of Organizations Described in Section 170(c) (Publication No. 78), and other computer files; and (7) confirmation that a specific business is or is not owned and operated by a church.

The IRS may also request a church to provide information necessary to locate third-party records (e.g., bank records), including information regarding the church's chartered name, state and year of incorporation, and location of checking and savings accounts without following the church audit procedures of IRC 7611.

Repeated failures (i.e., two or more failures) by a church or its agents to reply to such routine inquiries will be considered a reasonable basis for commencement of a church tax inquiry by the appropriate IRS regional commissioner under the applicable church audit procedures of IRC 7611. Repeated (two or more) failures by a church to provide information necessary to locate third-party records is to be a factor (but not a conclusive factor) in determining if there is reasonable cause for commencing a church tax inquiry.

b. Investigations, Other Than Routine Requests, That Are Beyond the Scope of IRC 7611

IRC 7611 does not apply to (1) any inquiry or examination of any person other than a church, (2) any termination assessment under IRC 6851 or jeopardy assessment under IRC 6861, or (3) any case involving a knowing failure to file a return or a willful attempt to defeat or evade tax. Additionally, the church inquiry and examination procedures do not apply to any criminal investigations.

Inquiries or examinations that relate primarily to the tax status or liability of persons other than the church (including the tax status or liability of a contributor or contributors to the church), rather than the tax status or liability of the church itself, will not be subject to the church audit procedures of IRC 7611. These may include, but are not limited to, (1) inquiries or examinations regarding the inurement of church funds to a particular individual or individuals or to another organization, which may result in the denial of all or part of the individual's or organization's deduction for charitable contributions to the church; (2) inquiries or examinations regarding the assignment of income or services or excessive contributions to a church; and (3) inquiries or examinations regarding a vow of poverty by an individual or individuals followed by a transfer of property or an assignment of income or services to the church. The IRS may make inquiries to a church regarding these matters without being considered to have commenced a church tax inquiry under IRC 7611 and may proceed to examine church records relating to these issues (including enforcement of a summons for access to such records) without following the requirements contained in IRC 7611. The examination would, of course, be subject to the general IRC rules regarding examinations of taxpayer books and records.

c. Limitations on IRS Actions Where an Inquiry or Examination Is Outside the Scope of the Church Audit Procedures of IRC 7611

Inquiries or examinations outside the scope of the church audit procedures of IRC 7611 will be limited to a determination of the facts and circumstances specifically relating to the tax liabilities of the individuals or other organizations in question. Examples of how such inquiries or examinations are to be conducted are set forth below:

1. In an inurement case against an individual or other organization, the IRS may request information or examine church records regarding amounts of money, property or services transferred to the individual or organization in question (including wages, loans, or the use of church funds for personal expenses, or other similar matters) without having to follow the church audit procedures.
2. In an assignment of income case against an individual or other organization, the IRS could request information or examine church records relevant to an individual's assignment of particular income, donation of property, or transfer of a business to a church.

However, unless the IRS follows the church audit procedures, it cannot make use of inquiries or examinations regarding individuals' or other organizations' tax liabilities to avoid the intended purpose of the church audit procedures. Nevertheless, the failure of a church to respond to repeated inquiries regarding individuals' or other organizations' may be considered a reasonable basis for commencement of a church tax inquiry.

3. Pre-examination Procedures

Before a church may be examined for purposes of determining its tax status, five steps must be taken:

- (a) The IRS regional commissioner must reasonably believe that the organization may not qualify for tax exemption as a church or that it engaged in an unrelated trade or business or other taxable activity;

- (b) written notice of the beginning of an inquiry (first notice) must be sent to the organization;
- (c) if the IRS wishes to examine church records, written notice of examination (second notice) must be sent to the organization;
- (d) the organization must be given an opportunity to have a pre-examination conference with the IRS; and
- (e) the IRS regional counsel must be given a copy of the notice of examination.

Each of these requirements will be discussed below.

a. Requirement of Regional Commissioner's Reasonable Belief

The IRS may begin a church tax inquiry only if the IRS regional commissioner reasonably believes, on the basis of the facts and circumstances recorded in writing, that the organization (1) may not qualify for tax exemption as a church, (2) may be carrying on an unrelated trade or business within the meaning of IRC 513, or (3) may be otherwise engaged in taxable activities.

b. Written Notice of Commencement of the Inquiry (First Notice)

A church tax inquiry is defined as any inquiry made to a church (other than an "examination," which is defined in 3c, below), that serves as a basis for determining whether the church (1) qualifies for exemption as a church or (2) is engaged in an unrelated trade or business or other taxable activity. (Certain routine requests as defined in 2a, above, might also involve information that would serve as a basis for determining whether an organization is exempt - for example, a request for information in connection with a church's application for recognition of exemption. Routine requests are excepted from the application of IRC 7611, even though they might otherwise meet the definition of a church tax inquiry.)

A church tax inquiry is considered to commence when the IRS requests information or materials from a church of a type contained in "church records" (a term that will be discussed in 5b, below), other than routine requests for information.

Upon commencing a church tax inquiry, the appropriate IRS regional commissioner must provide written notice to the church of the commencement of the inquiry. This notice must include (1) an explanation sufficiently specific to allow the church to understand the particular area of church activity or behavior which is at issue in, or gave rise to, the inquiry; (2) an explanation of the general subject matter of the inquiry; (3) a general explanation of the IRC provisions that may be involved in the inquiry; and (4) a general explanation of the administrative and constitutional provisions applicable to the inquiry, including the right to a conference with the IRS prior to any examination of church records.

The IRS, however, is not precluded from expanding its inquiry beyond the concerns expressed in the notice of inquiry (first notice) as a result of facts and circumstances that subsequently come to its attention (including, where appropriate, an expansion of an unrelated income inquiry to include questions of tax-exempt status, and vice-versa).

The notice of inquiry (first notice) requirement does not require the IRS to share particular items of evidence with the church, or to identify its sources of information regarding church activities, where providing such information would be damaging to the inquiry or to the sources of IRS information. Also, the IRS would not be required to reveal the existence or identity of any so-called "informers" within a church (including present or former employees).

c. Written Notice of Examination (Second Notice)

A "church tax examination" is defined as any IRS examination of the religious activities of a church or of "church records." A church tax examination may be conducted only if the IRS observes the following procedures: (1) at least 15 days prior to the examination, the appropriate IRS regional commissioner provides written notice of examination (second notice) to the church, which must include an offer of a pre-examination conference; and (2) also, at least 15 days prior to the examination, the regional commissioner notifies the appropriate IRS regional counsel of the proposed examination.

The notice of examination (second notice) must include (1) a copy of the church tax inquiry notice (first notice) previously provided to the church; (2) a description of the "church records" and activities that the IRS seeks to examine; (3) a copy of all documents that were collected or prepared by the IRS for use in the examination, and that are required to be disclosed under the Freedom of

Information Act (5 U.S.C. 552), as supplemented by IRC 6103; and (4) an offer of pre-examination conference.

The documents to be supplied by the IRS will be limited to documents specifically concerning the church whose records are to be examined and will not include documents relating to other inquiries or examinations or to IRS practices and procedures in general. Disclosure to the church will be subject to the restrictions of present law regarding the disclosure of the existence or identity of informants.

With respect to the requirement that the IRS provide a description of the materials to be examined, those materials (and the documents disclosed by the IRS to the church) do not restrict the ability of the IRS to examine the church records or religious activities that are properly within the scope of the examination.

The notice of examination (second notice) cannot be sent earlier than 15 days following the day on which the notice of inquiry (first notice) is sent.

d. Pre-examination Conference

As part of the notice of examination (second notice), the church must be afforded an opportunity to meet with the IRS to discuss the concerns that gave rise to the inquiry and the general subject matter of the inquiry. The church may request such a conference at any time prior to the examination. If a conference is requested, the IRS is required to schedule the conference within a reasonable time, and may proceed to examine church records only following the conference. It is intended that the holding of one conference with the church will be sufficient to satisfy the requirements of IRC 7611, and that churches will not be able to utilize the conference requirement in order to unreasonably delay an examination.

The purpose of the conference between the church and the IRS is to encourage discussion of the relevant issues that may arise as part of the inquiry and examination in an effort to resolve the issues of tax exemption or liability without the necessity of an examination of church records. Congress therefore intended that the church and the IRS make a reasonable effort to resolve outstanding issues at the conference. To avoid misunderstandings, Congress intended that the IRS remind the church at the conference, in general terms, of the church tax inquiry and examination procedures and the church's rights under such procedures. However, the IRS will not be required to reveal information at the conference that is properly

excludable from a written notice (including information regarding the identity of third-party witnesses or evidence provided by such witnesses).

e. Notice to IRS Regional Counsel

At the time the notice of examination (second notice) is provided to the church, the IRS is required to provide a copy of the same notice to the appropriate IRS regional counsel. The regional counsel is allowed 15 days in which to file an advisory objection to the notice. (This is concurrent with the 15-day period during which the IRS is prohibited from examining records pending a request for a conference.) Any objection by the regional counsel will be taken into account by the regional commissioner when determining whether to proceed with the examination or any other action.

4. Service Actions After Issuance of the Examination Notice (Second Notice)

a. Various Service Alternatives

As previously discussed, after the examination notice (second notice) is issued, the church may request a conference. If the matters of concern that gave rise to the issuance of the examination notice (second notice) are not resolved at the conference, or if the organization does not request a conference, the examination will ordinarily begin. In certain exceptional circumstances the IRS may in lieu of an examination propose to revoke the organization's exemption based upon the facts and circumstances which form the basis for a reasonable belief to commence an inquiry under IRC 7611 and any other appropriate information that becomes apparent as a result of the inquiry, the conference, or both. (The proposed adverse action must be based upon the facts and circumstances that form a reasonable belief to begin an inquiry under IRC 7611 and any other appropriate information that becomes apparent as a result of the inquiry and/or the conference, if held.)

b. Coordination with Regional Counsel

Pursuant to IRC 7611(d), the IRS regional counsel must approve, in writing, (1) the determination of whether the organization is exempt from tax (IRC 501(a)); (2) the determination of whether such an organization is a church that is entitled to tax-deductible contributions (IRC 170(c)); (3) the issuance of a tax deficiency notice to a church following a church tax examination; and (4) in cases where

deficiency procedures are inapplicable, the assessment of any underpayment of tax following an examination.

The regional counsel must also state in writing that the IRS has substantially complied with the church audit procedures of IRC 7611.

5. Rules Relating to Examination of Records and Activities

a. Time Limitations Relative to Beginning Examination

As previously discussed, the notice of examination (second notice) may be sent to a church not less than 15 days after the notice of inquiry (first notice). Therefore, at least 30 days must pass between the first notice and the actual examination of church records, since the IRS may not begin an examination until 15 days after the notice of examination (second notice).

If the church does not request a conference prior to day 30, the IRS may proceed to examine church records, or make a determination based on the information already in its possession.

However, if the IRS does not send a notice of examination (second notice) within 90 days after sending the notice of inquiry (first notice), the inquiry would be terminated. The running of this 90 day period is suspended for any period during which (1) a judicial proceeding brought by the church or its agents against the IRS with respect to the church tax inquiry or examination is pending or being appealed, (2) a judicial proceeding brought by the IRS against the church or any of its officials to compel compliance with any reasonable request for examination of church records or religious activities is pending or being appealed, or (3) the IRS is unable to take action with respect to the church tax inquiry because of an order issued in a suit involving third-party records under IRC 7609.

If the inquiry is terminated under this provision, any further inquiry regarding the same or similar issues within a five-year period requires approval of the Assistant Commissioner (Employee Plans and Exempt Organizations).

b. Examination of "Church Records"

As previously noted, in cases where IRC 7611 applies, the IRS may examine "church records" only after complying with the notice provisions of IRC 7611. In such cases, the IRS may examine "church records" only to the extent necessary to

determine any liability for, and the amount of, any federal tax. This examination authority extends to a determination of (1) initial or continuing qualification for exempt status under IRC 501(c)(3) of the church whose records are being examined; (2) the qualification of the church to receive tax-deductible contributions under IRC 170(c); or (3) the amount of tax (including unrelated business income tax), if any, which is to be imposed on the church.

"Church records" include all corporate and financial records regularly kept by a church, including (but not limited to) corporate minute books, contributor or membership lists, and any materials that qualified as church books of account under prior law, that is, a cash disbursements journal, general ledger of account, etc. "Church records" include private correspondence between a church and its members that is in the possession of the church.

"Church records" do not include records previously filed with a public official or newspaper or newsletters distributed generally to the church members. In addition, "church records" do not include records held by third parties - for example, cancelled checks or other records in the possession of the bank. Therefore, while the IRS must adhere to the rules of IRC 7609 regarding third party summonses, the IRS is permitted access to such records without regard to the church audit procedures of IRC 7611. However, either the IRS or the third party recordkeeper generally is required to inform the church of any IRS requests for materials.

While the IRS may acquire third party materials without complying with IRC 7611 procedures, the IRS may not determine that a church is not entitled to an exemption or assess tax for unrelated business income solely on the basis of third party records, without first complying with the church audit procedures of IRC 7611. This limitation, however, does not apply to assessments of tax other than for unrelated business income, for example, for social security or other employment taxes.

c. Examination of Activities

As under IRC 7605(c), the IRS may examine the religious activities of an organization claiming to be a church only to the extent necessary to determine if the organization qualifies, or did qualify, as a church for any period.

6. Time Limitation for Completion of Inquiry and Examination

The IRS must complete any inquiry or examination and make its final determination no later than two years after the date on which the notice of examination (second notice) is supplied to the church. (As previously noted, where a church tax inquiry is not followed by an examination, the IRS must complete its inquiry and make its final determination no later than 90 days after the date the notice of inquiry is provided to the church.)

As with the 90 day period for duration of a church tax inquiry not followed by an examination, the running of the two year period for completion of an examination is suspended for any period during which (1) a judicial proceeding brought by the church or its agents against the IRS with respect to the church tax inquiry or examination is pending or being appealed, (2) a judicial proceeding brought by the IRS against the church or any of its officials to compel compliance with any reasonable IRS request for examination of church records or religious activities is pending or being appealed, (3) the IRS is unable to take actions with respect to the church tax inquiry because of an order issued in a suit involving third party records under IRC 7609. Unlike the 90 day period, however, the two-year period is also suspended for any period in excess of 20 days (but not in excess of six months), in which the church or its agents fail to comply with any reasonable IRS request for church records or other information. In addition, the running of the limitation period may be suspended for any period mutually agreed upon by the IRS and the church.

7. Limitations on Period of Assessment and on Additional Inquiries and Examinations

a. Limitations on Period of Assessment

There are two special categories here - revocation and unrelated business income, where no return is filed.

- (1) For examinations regarding the revocation of tax exempt status, where no return is filed: The IRS is limited initially to an examination that is relevant to a determination of tax status or liability for the three most recent taxable years preceding the date on which the notice of examination (second notice) is provided to the church. If the church is proven not to be exempt for any of these years, the IRS may examine relevant records and assess tax (or proceed without assessment), as part of the same audit, for a total of the six most recent taxable

years ending before the examination notice date. (Church records of a year earlier than the third or sixth completed taxable year may be examined but only to the extent material to a determination of tax-exempt status during the three or six year period.)

- (2) For examinations regarding unrelated business income, where no return is filed: The IRS may assess or collect tax for the six most recent years preceding the date on which the notice of examination is sent. However, there is no additional limit on the period of church records that may be examined.

For examinations involving issues other than revocation of exempt status or unrelated business income, such as examinations relating to social security or other employment taxes, no limitation period applies if no return was filed. Also, no limitation period applies in any case of fraud, willful tax evasion, or knowing failure to file a return that should have been filed.

The special limitation periods do not increase an otherwise applicable limitation period. Therefore, a three-year limitation period applies where a church filed a tax return and did not substantially understate income.

The applicable limitation periods may be extended by mutual agreement of the church and the IRS.

b. Limitations on Additional Inquiries and Examinations

IRC 7611 provides special rules for repeat examinations of churches. The IRS Assistant Commissioner (Employee Plans and Exempt Organizations) is required to approve, in writing, certain second inquiries or examinations of a church, where the first inquiry or examination did not result in (1) revocation of tax exemption or an assessment of tax or (2) a request by the IRS for any significant changes in church operational practices (including the adequacy or sufficiency of records maintained to reflect income).

The Assistant Commissioner's written approval is necessary only for second inquiries or examinations which (1) involve the same or similar issues as the prior audit and (2) are undertaken within 5 years of the date on which the notice of examination (second notice) was sent to the church during the prior audit (If no notice of examination was sent, the date used is the date of notice of

commencement of inquiry.) This 5-year period is to be suspended for any period during which the two-year period for completion of audit is suspended, unless the prior audit was actually concluded within 2 years of the notice of examination.

The requirement of the Assistant Commissioner's approval does not apply where the second church tax inquiry or examination does not involve the same or similar issues as the preceding inquiry or examination. In determining whether a second examination involves similar issues to a prior examination, the substantive factual issues involved in the two examinations, rather than legal classification, will govern. For example, where a prior examination and a current examination of unrelated business income involve income from different sources, the current examination involves issues different from the prior examination and the Assistant Commissioner's approval is not necessary.

8. Remedy Available for an IRS Violation of the Church Audit Procedures

IRC 7611 provides an exclusive remedy for any IRS violation of church audit procedures. Failure of the IRS to comply substantially with (1) the requirement that two notices be sent to the church, (2) the requirement that the regional commissioner approve the commencement of a church tax inquiry, or (3) the requirement that an offer of an IRS conference with the church be made (and a conference held if requested), will result in a stay of proceedings in a summons proceeding to gain access to church records (but not in dismissal of such proceeding) until these requirements are satisfied. The two-year limitation on duration of a church audit will not be suspended during stays of summons proceedings resulting from the violations described above; however, the IRS may correct such violations without regard to the otherwise applicable time limits prescribed under the church audit procedures. In determining whether a stay is necessary, a court will consider the good faith effort of the IRS and the effect of any violation of the proper audit procedures.

Aside from the exclusive remedy described above, there is no judicial remedy for an IRS violation of the church audit procedures of IRC 7611. IRS failure to comply with any of these requirements may not be raised as a defense or an affirmative ground for relief in any judicial proceeding, including, but not limited to, a summons proceeding to gain access to church records; a declaratory judgment proceeding involving a determination of tax-exempt status under IRC 7428; or a proceeding to collect unpaid tax. Additionally, failure to comply substantially with the requirements that two notices be sent, that the appropriate IRS official approve an inquiry, and that a conference be offered (and the

conference held if requested) may not be raised as a defense or as an affirmative ground for relief in a summons proceeding or any other judicial proceeding other than as specifically set forth above. Therefore, a church or its representative will not be able to litigate the issue of the reasonableness of the appropriate IRS official's belief in approving the commencement of a church tax inquiry in a summons proceeding or any other judicial proceeding.

These provisions, however, are not intended to impair a church's right to raise any substantive or procedural argument that would be available to taxpayers generally in an appropriate proceeding.

9. Declaratory Judgment Actions Regarding Tax-Exempt Status

Under IRC 7611(g), a revenue agent's final report (30 day letter) shall be treated as a determination of the Secretary under IRC 7428(a) and any church receiving such a report shall be treated for purposes of IRC 7428 and 7430 as having exhausted the administrative remedies available to it.