

L. UPDATE ON CHURCHES

1. Introduction

This topic provides an overview of developments during 1985 that affect churches. The developments, which include significant litigation matters, reinforce the continuing sensitivity and complexity of the relationship between religion and the Internal Revenue Code.

2. Litigation Update

In 1985, litigation involving churches and related religious organizations focused on issues involving exemption from federal income tax, unrelated business income tax, and the IRC 6033 exemption from the annual information return filing requirement. A number of the cases, particularly a number of the currently pending cases, contain a potential for dramatic impact that could easily spread beyond the Internal Revenue Code and raise philosophical questions of Constitutional magnitude. The following discussion will highlight the developments and place them in an appropriate context for assessing their importance.

A. Exemption Issues

One of the more significant church cases pending before the courts is Abortion Rights Mobilization v. Baker (ARM) in the U.S. District Court for the Southern District of New York. The case, as mentioned in prior CPE discussions on churches and standing-to-sue issues, involves a third party suit brought by various pro-abortion groups alleging that the involvement of the U.S. Catholic Church in the abortion controversy has, on occasion, resulted in political involvement in contravention of IRC 501(c)(3). The plaintiffs further claim that the Service's failure to take action against the Church's alleged political activity, while imposing the strictures of IRC 501(c)(3) against other religious organizations, violates both the statutory mandate of the IRC and the Establishment Clause of the First Amendment. Earlier reported decisions in the case, 552 F. Supp. 364 (SD NY 1982), 544 F. Supp. 471 (SD NY 1982), and 603 F. Supp. 970 (SD NY 1985), have concerned the question of standing to sue the government.

In the most recent action in the case, the government argued that the criteria for determining standing discussed in the 1984 Supreme Court decision in Allen v. Wright, 104 S. Ct. 3315, indicate that the plaintiffs in ARM did not have the

requisite standing to sue the government, that is, to request the district court to compel the IRS to revoke the IRC 501(c)(3) exempt status of the Catholic Church. The District Court disagreed, however, and found standing on February 27, 1985. On April 26, 1985, the government filed a motion to certify the standing issue for immediate appeal. The motion to certify was denied on July 15, 1985, and the government has now asked the Second Circuit Court of Appeals to issue a writ of mandamus requiring certification.

If the District Court's standing decision holds, the barriers to third party taxpayer suits reflected in Allen v. Wright, Simon v. Eastern Kentucky Welfare Rights Organization, 426 U.S. 26 (1976), and Valley Forge Christian College v. Americans United for the Separation of Church and State, 454 U.S. 464 (1982), will have been breached.

The issue of religion was also the subject of a Tenth Circuit Court of Appeals decision in Mutual Aid Association of the Church of the Brethren v. U.S., 759 F.2d 792 (10th Cir. 1985). The Appeals Court reviewed a District Court decision that considered the situation of an association which lost its federal income tax exemption under IRC 501(c)(15) in 1972 when its gross income exceeded the \$150,000 statutory limit. Since 1972, the Association has filed Form 1120M as a mutual insurance company. For years 1975 through 1980, it also filed refund claims based on an assertion that it qualifies for exemption under IRC 501(c)(4). The Association provides members of the Mennonite Church with fire and property insurance.

The Association, a legal entity separate from any church, claimed that it is organized and operated to carry out the longstanding Mennonite tenet or belief of sharing losses. As such, the Association asserted it is advancing the Mennonite religion and promoting social welfare. Membership in the Association is restricted to members of the Church of the Brethren. The District Court held that advancement of a religious purpose is not per se promotion of social welfare and that the Association's conferral of economic benefits upon its members in the form of rebates or reduced premiums through operation as a mutual insurance company is a substantial nonexempt purpose and is not a necessary incident of its provision of mutual aid for members of the church. Accordingly, exemption under IRC 501(c)(4) is precluded.

After the District Court issued its decision in Mutual Aid, the Seventh Circuit, in reversing a Tax Court decision in Bethel Conservative Mennonite Church v. Commissioner, 746 F.2d 388 (7th Cir. 1984), concluded that a medical

aid program, similar to an insurance program, operated by a particular Mennonite congregation for its members, was a religious activity within the meaning of IRC 501(c)(3). (These decisions are discussed in greater detail in the 1985 CPE text at pp. 59 & 60, q.v.)

With the preceding background, the Tenth Circuit considered the Mutual Aid appeal and affirmed the lower court decision, concluding that the Mutual Aid Association does not qualify for exemption under IRC 501(c)(4). The Court noted that the Association operates as a mutual insurance company, engaging in underwriting practices consistent with those of the industry in general, and that the activity constitutes a substantial nonexempt purpose. The Tenth Circuit distinguished Bethel on the basis that the amounts collected from members of the Church to fund the Bethel medical aid program were free-will contributions. The Appeals Court did not go so far as to affirm the District Court conclusion that a religious purpose does not per se advance social welfare. With this appellate decision, albeit under IRC 501(c)(4), the expansive approach given to a definition of religious activity in Bethel appears to have been limited.

The commercial activities of a religious organization were also the focus of the Ninth Circuit in Church by Mail v. Commissioner, 765 F.2d 1387 (9th Cir. 1985). The Appeals Court reviewed a Tax Court determination, TCM 1984-349, made pursuant to IRC 7428 that Church by Mail, Inc., did not qualify for federal income tax exemption under IRC 501(c)(3). The Tax Court had found that the organization was operated for the nonexempt purpose of providing a market for the services of a commercial advertising agency that is owned by the two individuals who control the Church. The Tax Court also found that a substantial portion of the Church's net earnings inured to the benefit of those in control and their relatives through excessive salaries and benefits. The Tax Court, in analyzing the compensation paid to those in control, considered together the benefits derived from both the Church and the advertising agency. The Tax Court decision was affirmed on appeal by the Ninth Circuit which approved the combining of compensation in the context of considering the issues of inurement and excessive compensation.

The use of Church status for private benefit is also the central issue in the pending Claims Court case of Universal Life Church, Inc. v. U.S., Cl. Ct. No. 583-84-T, filed November 8, 1984. This case involves a petition for declaratory judgment under IRC 7428 filed by the Universal Life Church of Modesto, California. The Church is the parent mail-order ministry church and was recognized as exempt from federal income tax in 1974 pursuant to the District

Court decision in Universal Life Church, Inc. v. U.S., 372 F. Supp. 770 (ED CA 1974). On August 28, 1984, the Service revoked the IRC 501(c)(3) status of the Church, effective May 1, 1977. The revocation action was based on the Service's conclusions that the net earnings of the Church had inured to the benefit of private individuals, that the activities of the Church and affiliated organizations were conducted in a manner to privately benefit church insiders, that the Church engaged in the substantial nonexempt purpose of providing tax avoidance advice, and that the Church was operated for purposes beyond those described in IRC 501(c)(3), including the operation of a residential construction business. The Church has asserted that the Service conclusions are erroneous and has raised First Amendment arguments, including freedom of speech and association, in its complaint.

The Service considers the Universal Life Church case significant as the mail-order ministerial certificates issued by the organization have been involved in widespread attempts by individuals to avoid federal income tax. As in previous years, in 1985 the courts issued numerous decisions adverse to taxpayers involving deductibility of contributions to ULC congregations. At least 17 such decisions were issued by the Tax Court. In one of the more noteworthy of the decisions, the Ninth Circuit, in Kalgaard v. Commissioner, 764 F.2d 1322 (9th Cir. 1985), in addition to upholding disallowance of contributions to a ULC congregation, imposed double costs and \$1,000 attorneys' fees with the plaintiff and his counsel, Peter Stromer, being jointly and severably liable. The sanctions were imposed based on a determination that the plaintiff's claims were without merit and were raised in intentional disregard of applicable rules. An identical result was reached in Larson v. Commissioner, 765 F.2d 939 (9th Cir. 1985), and double costs and attorneys' fees were also charged to the taxpayer and his attorney. Again, Peter Stromer was the attorney.

B. Unrelated Business Income

A potentially significant unrelated business income tax decision involving a religious organization was recently issued in St. Joseph Farms of Indiana Brothers of the Congregation of Holy Cross, Southwest Province, Inc. v. Commissioner, 85 T.C. No. 2 (1985). The Tax Court concluded that the Congregation, which is exempt from tax under IRC 501(c)(3), is engaged in unrelated trade or business in its operation of a farm on which it produces cattle and crops for the commercial market. However, the Court's ultimate conclusion was that the income from the cattle and crop sales is not subject to the tax imposed by IRC 511 because substantially all the work in operating the farm is performed without compensation

and therefore avoids unrelated business income tax by virtue of the exception in IRC 513(a)(1) for activities conducted with substantially all volunteer labor. Although the Brothers of the Congregation are provided with living expenses, the Court determined that the living expenses are provided regardless of whether the individuals involved actually worked on the farm. The Court then determined that there must be a "but for" connection between the payments and the services (living expenses would not be provided to individuals "but for" the fact that the individuals performed services) for such a payment of living expenses to be characterized as salary or wages for purposes of the IRC 513(a)(1) uncompensated labor exception.

We are concerned with the use of such a "but for" rule in this sort of factual situation as it has no basis in the statute, the regulations, or the legislative history. Current Service position remains that the IRC 513(a)(1) exception appropriately applies only if labor is performed on a truly unpaid basis.

C. Filing Requirements

Two significant decisions were recently issued with respect to what constitutes an "integrated auxiliary" for purposes of the filing requirements of IRC 6033. Since the definition of "integrated auxiliary" has become an increasingly fertile field for litigation, a brief introduction to the issue seems in order.

Congress, in enacting IRC 6033 as part of the Tax Reform Act of 1969, has set forth a general requirement that the tax-exempt organizations file annual 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 the Finance Committee concluded that more information is needed on a more current basis from more organizations and that this information should be made more readily available to the general public, including state officials. (S. Rep. 91-552, 1969-3 C.B. 423, 457).

The statute does, however, establish certain exceptions to the general filing requirement. Among the excepted organizations are "integrated auxiliaries" of a church.

In 1977, regulations under IRC 6033 were promulgated. Reg. 1.6033-2(g)(5)(i) defines "integrated auxiliary" as an organization:

- a) Which is exempt from taxation as an organization described in IRC 501(c)(3);
- b) Which is affiliated (within the meaning of paragraph (g)(5)(iii) of this section) with a church; and
- c) Whose principal activity is exclusively religious.

Reg. 1.6033-2(g)(5)(ii) adds the following additional requirement:

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).

It is the "exclusively religious" requirement that has given rise to litigation in recent years and is the subject of the two cases discussed below.

In Lutheran Social Services of Minnesota v. U.S., 758 F.2d 1283 (8th Cir. 1985), the Appeals Court, in overturning a District Court decision (583 F. Supp. 1298 (DC MN 1984)), held that a tax-exempt nonprofit social service agency, which is affiliated with various synods of the Lutheran Church, is an integrated auxiliary of a church within the meaning of IRC 6033 and is, therefore, not required to file annual information returns. The Eighth Circuit's holding rests on a finding that the exclusively religious test in the regulations that define "integrated auxiliary" is "inconsistent with clear congressional policy" and is, therefore, invalid.

In the second significant case, Tennessee Baptist Children's Homes, Inc. v. U.S., 604 F. Supp. 210 (DC MD TN 1984), in a jury trial, the organization, a separately incorporated child care facility that is governed by the Tennessee Baptist Convention, was found to be operated exclusively for religious purposes. The organization was thus found to qualify for exemption from filing annual returns as an integrated auxiliary of a church. This was despite the fact that Reg. 1.6033-2(g)(5)(iv), Example 3, uses a church-affiliated orphanage as an example of an organization that is not an integrated auxiliary because its principal activity (the housing and care of children), could serve as a basis for IRC 501(c)(3) exemption if it were not affiliated with a church. The District Court nevertheless denied

government motions for judgment as a matter of law, and permitted the jury to find, on the basis of the religious motivations of the organization's officers, that its principal activity was "exclusively religious." The government has filed an appeal with the Sixth Circuit asserting that the organization's activities made it indistinguishable from the example in the regulation. (Unlike the Eighth Circuit in Lutheran Social Services, the District Court in Tennessee Baptist did not dispute the validity of the regulation.)

3. Other Matters

A. Legislation

The single significant matter proposed for legislation would deny IRC 501(c)(3) exempt status to organizations that practice witchcraft. In the Senate, Senator Jesse Helms (R-NC) added a provision to this effect to the Treasury-Postal Service appropriations legislation (HR 3036), while in the House of Representatives, Representative Robert Walker (R-PA) proposed identical legislation (HR 3389). In both bills witchcraft organizations are defined as those purporting to exercise powers derived from evil spirits, to practice sorcery, or to use supernatural powers with malicious intent. Senator Helms' provision, however, was dropped from the appropriations bill in the House/Senate conference on the legislation. The House and Senate conferees approved the appropriations bill on October 30, 1985; however, it was vetoed by President Reagan.

B. Administrative Matters

(1) Publication of Church Audit Guidelines

Text 321.2 of IRM 7(10)69 has been revised to reflect the enactment of IRC 7611 in the Deficit Reduction Act of 1984 regarding any tax inquiry or examination of a church, effective January 1, 1985.

With respect to regulations regarding the new church audit procedures, on March 11, 1985, the Federal Register published proposed amendments to the Procedure and Administration Regulations (26 CFR 301), in the form of temporary regulations under IRC 7611. The publication of temporary regulations coincided with a Notice of Proposed Rulemaking soliciting public comments.

After receipt of public comments on the proposed regulations, a public hearing was held on July 16, 1985. These comments are being considered as work on regulations under IRC 7611 progresses.

(2) Issues of Inurement and Political Activities Involving Churches and Other Religious Organizations

G.C.M. 39414, September 25, 1985, discusses whether a religious organization's exempt status under IRC 501(c)(3) should be revoked because of intervention in political campaigns and inurement of net earnings. The G.C.M. deals with such issues as under what circumstances political activities of the members of the organization may be imputed to the organization and inurement of an organization's net earnings in ways other than the actual distribution of dividends or payment of excessive salaries (in this case, extensive loans were made pursuant to a policy to extend loans preferentially to members on an interest-free basis).

In the U.S. District Court for the District of Columbia, a Bible teaching ministry, The Way International, has filed suit for declaratory judgment. The organization's brief alleges that the Service improperly revoked its IRC 501(c)(3) exempt status because loans were made to private individuals and members engaged in political campaigns.

4. Filing and Reporting Requirements of Churches and Related Entities

Code provisions relating to exempt organizations contain differing application and filing requirements for various types of religious entities. The following chart describes the various types of religious entities that are mentioned in Code provisions relating to exempt organizations and sets forth the basic filing and reporting requirements for each. (Unrelated business income tax returns (Form 990-T) are not set forth on the chart since all entities are required to file these returns.)

[APPENDIX 1 not shown here]