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TAX AUDITS OF CHURCHES

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I'd like to begin with a bit of a disclaimer. I am not a tax lawyer and I had planned to say something deferential to those of you who are tax experts, but last night at the dinner I sat next to Father Murray of Lansing, Michigan, and I asked him how many in the group, as far as he knew, were tax experts and his response was, "Judging by the questions that were asked last year, not one."

I love the tax experts, and I love my tax partners, but there's plenty of room for the rest of us in the field of IRS and the churches, because the proscenium over that whole subject matter, of course, is the Constitution, to which tax lawyers very seldom refer. And I hope that none of us, in dealing with Internal Revenue or any other taxing authority, ever forget the prohibition against excessive entanglement between church and state embedded in the first amendment, as expounded in all of the Supreme Court decisions of late, and that in representing churches we invoke the Constitution when it's proper to do so.

My topic today is IRS audit of the religious activities of churches. By definition, therefore, I am not going to deal with an audit of unrelated business income. That kind of audit, of course, would be the garden variety type audit of financial records of income, outgo, and net income. As to that, at least on its face, there is no constitutional problem. My subject is what I call a Section 501(c)(3) audit, and I emphasize, of a recognized church. I am not going to deal with the question of IRS determining whether a given organization is a charlatan or a real church. I am assuming a recognized church or church organization such as we all here represent.

Specifically, the purpose stated by IRS for the type of audit I am going to discuss, is to determine whether the church organization is being "operated exclusively for religious or charitable purposes" and whether a "substantial part" of its activities is "carrying on propaganda or otherwise attempting to influence legislation," within the meaning of those phrases in Section 501(c)(3), as well as other sections of the Internal Revenue Code providing tax exemption for churches. The National Council of Churches, my client, was subjected to just such an audit several years ago, and I am going to use that audit as a case history in discussing the problems that arose, some of the hoped for solutions, and how we went about it, in order that we may all learn if it ever happens to us again.

Long after the audit started and we had pressed again and again, IRS finally gave us in writing a statement of the reason why they had undertaken this audit, and also of the scope of the audit. The reason, stated by IRS was as follows: "When, as is the case of the National Council of Churches, an exempt organization delivers numerous policy statements of apparently 'political' and 'legislative' issues, and devotes part of its resources to the sponsorship or support of groups actively engaged in the political and legislative process, the Service is clearly charged with the responsibility of periodically determining whether this activity is within the permissible limits of exemption set forth in the Code."

Now, there was no gainsaying that the National Council of Churches has taken or is taking any stand on legislative and political issues. Indeed, it was formed in 1950, at least in part, for that very purpose. The National Council acts, according to its constitution, as "a cooperative agency of Christian communions," presently comprising 33 Protestant and Greek Orthodox denominations. It was granted a full 501(c)(3) exemption in 1950 as an association of churches, even though one of its constitutional purposes as IRS was fully informed then was and still is "to study and to speak and act on conditions and issues in the nation and the world which involve moral, ethical and spiritual principles inherent in the Christian Gospel." Speaking out on this type of legislative or policy or political issue is, of course, in the great tradition of the American churches. The issues of independence, of abolition, of social justice, were some in which the churches took a great role. The idea that they should remain silent on one of those great moral issues of the day because it might involve legislation would certainly never have occurred to anybody then.

Working conditions, civil rights, there are a whole host of political issues, legislative issues, which are also moral and ethical issues in which all of the churches within this country, almost without exception, from time to time have engaged and involved themselves. The Catholic Church certainly has been a leader. *Rerum Novarum* and *Mater et Magistra* are two of the great encyclicals calling for social justice and certainly by any definition involved the legislative or political scene in the sense that any remedial action would have to be taken in the legislature. Accordingly, as I see it, all churches invite audit on the basis of what the IRS gave us as the reason for the audit of the National Council of Churches.

As to the scope of the audit, IRS said to us: "Unlike the examination of business corporations, in which the focus is primarily upon the examination of receipts and expenditures and the determination of taxable income, the examination of exempt organizations, because compliance with the conditions of their exemption must be verified, requires an audit of virtually all the organization's activities, including its records, evidences of programs, publications, and personnel functions." In other words, they were stating that there was virtually nothing, in terms of the National Council's records and functions which was outside the scope of the audit, which made it utterly different from the audit of a business corporation or of an individual. However, none of this was clear to the National Council when the whole thing first began.

Originally, the agents came to the National Council and announced simply a routine audit, indicating that this was the kind of audit that was going on with other 501(c)(3) organizations. The National Council was so convinced that it would be a short routine audit that it didn't even advise us as outside counsel.

The agents requested space and desks, and they got space and desks right plunk in the middle of the administrative heart of the National Council. They asked for cabinets, they got cabinets. Above all, they asked for and received voluminous records. One of our great problems, when we did finally come aboard, was that no record was kept by anybody of the National Council of exactly what documents the agents had or with whom they had spoken, and what had been said to those to whom they did speak.

The audit actually began in approximately January 1970 and continued in this uncontrolled (from the National Council's standpoint) fashion for about nine

months. Then, sometime in the fall of 1970, all of a sudden, the agents began concentrating on the National Council's efforts for peace in Vietnam, and it became very hostile. And it was at that point that the National Council consulted my firm, and more specifically, my late senior partner, who for many years was general counsel to the Council.

He promptly came into the scene. He had some quick research done and he found the Bennett Amendment, the second sentence of Section 7605(c) of the Code, and on the basis of the Bennett Amendment, he insisted that the agents leave the premises at once, which they did under protest.

Now, let me give you a little background on the Bennett Amendment. As you know, the Tax Reform Act of 1969 for the first time provided for a tax on unrelated business income. When the bill, the Tax Reform Act of 1969, came to the floor of the Senate, Section 7605(c) consisted of one sentence which placed restrictions on audits of churches for the purpose of determining unrelated business income. The first sentence, beyond question, relates only to an audit for business income. The second sentence was added by floor amendment of Senator Wallace Bennett of Utah, a Mormon, who stated that the Department of the Treasury and the Finance Committee had both agreed to the Amendment. This is what he said about the Amendment, and it is the only legislative history expanding on the text itself. From the Congressional Record: "Mr. President, the other Amendment refers to what I think is a desirable clarification of the language in the bill, which for the first time allows Internal Revenue Service to audit churches. This has not been possible under the previous law. And the language of the bill, I think, is too loose. . . There is a fear the language would open it up so that the IRS could go through all the church books that pertain to religious activities." And so he offered and there was adopted his Amendment, the second sentence of 7605(c) which reads as it relates to religious activities: "No examination of the religious activities of such an organization (that is an organization that purports to be a church) shall be made, except to the extent necessary to determine whether such organization is a church, or a convention or an association of churches. . . ."

In citing the Bennett Amendment to IRS, we inquired whether there was any contention that the National Council of Churches was not an association of churches. Answer: No such contention. So we said that in that case, the single exception does not apply and we read the second sentence as prohibiting any examination of our religious activities. IRS's response some months later was a letter stating that it was the position of the Service that the restrictions imposed by the whole of 7605(c), both sentences, are directed solely to auditing action in connection with the imposition of the unrelated business income tax. They went on to assert that the Bennett Amendment imposes no restriction on the examination of religious activities of a church to test whether it was being operated exclusively for religious purposes, or whether a substantial part of its activities was seeking to influence legislation. They concluded with the statement that if the National Council refused to go on with the examination, then IRS would discontinue its advance assurance of deductibility of contributions. IRS has a Cumulative List of organizations to whom IRS has given advance assurance that contributions to them will be tax deductible by their donors. All foundations and sophisticated donors insist on such advance assurance that their donations will be deductible. If

advance assurance is removed by Internal Revenue, which is simply an administrative action, the effect is profoundly difficult, if not fatal, upon a church organization, or any other 501(c)(3) organization dependent upon donations.

There ensued several conferences. It was clear to us at this point that the whole matter was being directed from the National Office, but we only were given audiences with the local director. Those really resolved nothing. In part, though, IRS was hampered because it had not yet adopted any regulations pursuant to 7605(c) and suggested that we wait to see the regulations.

In December, 1970, IRS published the Proposed Regulations which were completely consistent with the position they had taken, namely that 7605(c) imposes no restriction on the examination of religious activities to determine whether a church continues to be qualified under 501(c)(3). This IRS set of Proposed Regulations resulted in instant ecumenism. Bud Consedine, General Counsel for the United States Catholic Conference, Marvin Braderman, General Counsel for the Union of American Hebrew Congregations, and we, as General Counsel for the National Council, as well as quite a number of other denominations acting separately, all attacked the Proposed Regulations, and we all pretty much consistently made three points: (1) That the Proposed Regulations were contrary to the clear text as we read it in the second sentence; (2) That even if there were any ambiguity, which we didn't concede, then resort to the legislative history showed clearly that Senator Bennett, who was the only one who had spoken on this subject, intended to prevent the examination of religious activities; and (3) Perhaps above all we cited the constitutional considerations based upon *Walz v. Tax Commissioner*, 297 U.S. 664 (1970), which had only recently come down.

The *Walz* case, I am sure most of you know, was the case in which the United States Supreme Court at last resolved the question of whether tax exemption of churches was an unconstitutional establishment of religion. In that case, the Court for the first time articulated the religious clauses of the First Amendment as prohibiting "excessive entanglement" of church and state in the stead of the "wall of separation" approach in prior decisions. The Court said:

We must . . . be sure that the end result, the effect, is not excessive governmental entanglement with religion. The test is inescapably one of degree. Either course, taxation of churches or exemption, occasions some degree of involvement with religion. Elimination of exemption would tend to expand the involvement of government by giving rise to tax valuation of church property, tax liens, tax foreclosures, and the direct confrontations and conflicts that follow in the train of those legal processes. Granting tax exemptions to churches necessarily operates to afford an indirect economic benefit and also gives rise to some, but yet a lesser involvement than taxing them. In analyzing either alternative, the questions are whether the involvement is excessive, and whether it is a continuing one calling for official and continuing surveillance leading to an impermissible degree of entanglement.

It was our position that the IRS's undertaking to audit religious activities of churches was just such an impermissible degree of entanglement and that the Bennett Amendment served precisely the purpose of avoiding such church-state confrontations inevitably generating issues of constitutional magnitude.

A hearing was held by IRS on the Proposed Regulations. A number of the organizations testified, but all the ecumenical eloquence was totally in vain and IRS adopted the Regulations almost precisely as they had published them. Having

adopted these Regulations, IRS then wrote to the National Council and said that the adoption of the Regulations had resolved its Bennett Amendment contention of the NCC council, and so much for that.

The IRS letter went on to explain in a little more detail what they intended to do. IRS stated with emphasis that a church must be operated exclusively, that word is underscored, for religious or charitable purposes, and said: "Among other things, this means that all of the funds, property and personnel of the organization must be devoted on an exclusive and continuous basis to the advancement of the religious or other charitable purposes upon which its claim to exemption is founded." This letter disclaimed any intention to review particular beliefs or forms of worship, but it did say that the agent's job will be to "ascertain that a particular program is reasonably germane to a religious activity or function." Those statements were of the most concern to the National Council, because they necessarily implied that IRS had some definition of religion, or of religious function, or of religious purpose. As I am sure you all know, although the term "religious" and "religion" is used in the Constitution, and in the Internal Revenue Code, there is no definition of it in any statute anywhere. The Supreme Court has indicated in the conscientious objector cases, particularly *Seeger*, that it may very well be constitutionally impossible to define, certainly on an exclusionary basis. In this very case, for example, the National Council was of the firm view that seeking peace in Vietnam was a religious purpose, and it was just as plain that IRS, and for that matter, the Administration, would not at all share that view. It was the position of the National Council, which we took in its behalf, that once a church is acknowledged as a church, only that church can define its religious purposes, and the state must accept that definition.

Accordingly, we wrote Internal Revenue and said that we assumed the agent who is going to have to make this decision whether a particular program is reasonably germane to a religious activity or function, is going to have to have some working definition, and we'd like to know what it is.

IRS's reply, again in writing, was as follows: "Finally, you inquire whether the Service intends to apply a definition of religious purposes, or of religious activities in connection with the currently suspended examination. Since, as indicated in *Washington Ethical Society v. District of Columbia*, 249 F.2d 127 (D.C. Cir. 1957) at 129, the term 'religious' is not a rigid concept, questions as to whether activities or purposes are religious can be resolved only in the light of particular facts and circumstances developed in the course of an examination. Generally, any such characterization will depend on the application of the law, including concepts common to the law of charity, as well as the relevant decisional law, to the particular facts developed in the course of the examination."

That's about as close, as far as I know, as IRS has ever come to giving a definition of religious purposes and some of you theologians here may want to make notes on that definition. Incidentally, the *Washington Ethical Society* case, the only one cited, is to the effect that religion has been used in many different ways, that word, and that there is no one definition of religion. Having given that thoroughly ambiguous definition of religion as a standard to which we were going to be held by the agent, IRS proceeded again, very emphatically, to warn that if the examination was prohibited further, IRS would not continue the National Council on its Cumulative List, and would suspend its advance assurance of deductibility.

At this point we were presented with a procedural dilemma. Actually, the National Council would have welcomed a test both of the Bennett Amendment and indeed, of the limiting language of 501(c)(3) itself. The problem was, however, that there was no procedure available for a reasonably quick test and the immediacy of the threat of loss of deductibility for donors clearly made vindication only after prolonged litigation most unattractive. Procedurally, lawyers, of course, would consider the appropriate remedy in such a situation to be a temporary injunction until a court could rule on the matter. But the Anti-Injunction Act of the Code prohibits any suit for the purpose of restraining the assessment or collection of any tax before any court. That provision had been very broadly construed by lower federal courts in favor of IRS, disallowing injunctions against it practically in any circumstance, and this was our view of the law at the time. Since then, on May 15, 1974, the Supreme Court ruled on this very question in two cases, the *Bob Jones University* case and the *Americans United* case. In both cases, the organization involved, among other things, was claiming violation of its rights to free exercise of religion. The plaintiff in each of them had sought an injunction against IRS's suspending its advance assurance of deductibility. In each case IRS opposed on the ground that any such injunction was prohibited by the statute, regardless of the merits of the case, and that was the issue that came before the Court. The Court upheld the prohibition against injunctions against Internal Revenue. It recognized that suspension of advance assurance could result in irreparable injury, but it said there are three remedies: 1. You could go to the Tax Court for a review of an IRS Notice of Deficiency, assuming, of course, that IRS served such a notice; 2. You could pay a federal tax such as social security or unemployment and then sue for a refund; or, 3. You could have a donor make a donation, deduct it, and then sue for a refund when the deduction was disallowed.

The Court itself clearly recognized the inadequacy of these procedures. These post-revocation avenues, said the Court, of review take substantial time during which the organization is certain to lose contributions from those donors whose gifts are contingent on entitlement of charitable deductions under Section 170. Nevertheless, the court said, the only exception to the Anti-Injunction Act would be where the organization could meet a two-pronged test: First, it would have to show irreparable injury. This was simple in our case and would be in almost any case. But the second requirement was this: It would have to demonstrate certainty of success on the merits. "An injunction will issue against IRS only if it is clear that under no circumstances could the Government ultimately prevail." I am a litigator and I have never known a case ever in which there was no circumstance under which either party might not prevail. As a practical matter, that is exclusionary. The Court noted that it was endorsing a very harsh result. It said: "In holding that the Anti-Injunction Statute blocks the present suit, we are not unaware that the Congress has imposed an especially harsh regime on Section 501(c)(3) organizations threatened with loss of tax-exempt status or with withdrawal of advance assurance of deductibility of contributions." The Court went to the length of quoting from an article which Commissioner of Internal Revenue Throver had written in 1971, in which he himself said: "This is a terrible situation." He said: "When this issue is presented to the courts in the way that the courts had acknowledged it could be, namely, principally by suit for refund, the issue under the best of circumstances could hardly come before a court until at least a year after the tax

year in which the issue arises. Ordinarily, it would take much longer for the case of the organization's status to be tried. While all of this time is passing, the organization is dormant for lack of contributions and those otherwise interested in its program lose their interest and move on to other organizations blessed with the Internal Revenue Service imprimatur. The right to judicial review is not pursued. This is an extremely unfortunate situation for several reasons. First, it offends my sense of justice. [Mind you, the Commissioner of Internal Revenue is speaking.] It offends my sense of justice for undue delay to be imposed on one who needs a prompt decision.

Second, in practical effect, it gives a greater finality to IRS decisions than we would want, or Congress intended. Third, it inhibits the growth of a body of case law interpretative of the exempt organization provisions that could guide IRS in its further deliberations. And I think that all of you lawyers know that there are very few cases on this whole issue because nobody's ever had the money or the time, or maybe the heart, to carry it all the way through. And that incidentally, included *Bob Jones University* and *Americans United*, neither of which pursued its case further.

Justice Powell, speaking for the Court, ended up by saying: "The degree of bureaucratic control that, practically speaking, has been placed in the Service over those in petitioner's position is susceptible to abuse, and regardless of how conscientiously the Service may attempt to carry out its responsibilities, specific treatment of not-for-profit organizations to allow them to seek pre-enforcement review, may well merit consideration, but this is a matter for Congress."

That was the state of the law when we had engaged in all this back and forth with IRS, and faced with immediate threat, which we didn't doubt would be carried out, that we would be removed from the advance assurance list, the NCC decided to agree to the audit. But we attempted to impose conditions. First, we said that we would submit, provided that all requests for documents and all requests for any kind of talk with any of our employees came through counsel, through us, the attorneys. They agreed to that. And that's the first thing that ought to be done. The second thing that we asked for is that if the National Council objected to any of the documents requested, that the IRS then subpoena those documents, so that we could move to quash the subpoena, and thus have a District Court rule on it. IRS never specifically agreed to that, but, of course if they had, and had then proceeded in that fashion, we could have gotten our test. In that posture, the audit then proceeded.

They now asked for more desk space, but this time they were considerably more removed from the heart of things than they had been the first time. They submitted several lists of requested documents which were not overly broad and to which no objection was made. As I recall, we did have a couple of dust-ups. I remember one of the things that they requested was a list of donors who had made donations in connection with the effort for peace in Vietnam. We flatly refused to give them that. They did not press the matter. To make a long story short, almost three years after the whole thing began, we received a one-line statement that our exemption was continued intact.

I'd like to think that all those marches and countermarches were not totally in vain. One thing that did happen was that late in 1973 the IRS, without any great fanfare, adopted some special internal procedures which did not rise to the dignity

of regulations, relating to the examination of "nationally-known churches and associations of churches" and without going into any detail at all, the essence of it is that no nationally known church can be audited under this internal procedure unless the National Office of IRS specifically approves it after an attempt has been made to get the information voluntarily from the church organization. And then if it does approve it, the audit proceeds under the direction of the regional office so at least we would know where to look if the same thing happened again. Another very hopeful sign, however, and this is critical, and I think Jim Robinson spoke about this yesterday, is that in the new Tax Reform Bill, which has passed the House and is now before the Senate, there is a provision permitting a declaratory judgment action immediately upon revocation of tax exempt status to test the legality of the revocation. We are working very hard to have a provision that the suspension of advance assurance would also give us the right to go into court for an immediate declaratory judgment. In both cases there is a provision that until the court rules on the matter donations up to \$1000 would continue to be deductible, even though the advance assurance had ceased to be given. IRS has supported the present House version, although I think Jim mentioned that they're trying to eliminate the provision in the House version that would permit us to go to the district court and relegate us to the Tax Court, which is a far less convivial circumstance for us.

So IRS has shown some sensitivity, I think, in the entanglement problem. I would emphasize this, that IRS has the absolute statutory duty to enforce the law. But I think it very unfortunate that IRS did not adopt our view of the Bennett Amendment because it would have taken them off the hook.

Nevertheless, to sum up: 1. IRS apparently insists on its right to audit religious activities of churches and its duty to do so with respect to churches which take positions on political or legislative issues; 2. IRS apparently claims the right to apply its own concepts of what constitutes religious activity in such an audit; 3. In my opinion, IRS has by regulation emasculated the Bennett Amendment; and 4. There is still no speedy or painless way to test either the regulation or the constitutionality of 501(c)(3) of a suspension of advance assurance. This legislation is badly needed, and I do hope that it does see the light of day in the very near future.

Meanwhile, despite this chilling picture, our general advice to our client at least remains unchanged, namely, that the National Council should not be deterred by the Internal Revenue Code or the threat of IRS examination from doing what it considers to be its religious imperatives. That has been our advice since the beginning, and it continues to be despite the audit. It's a certainty that the major church organizations in this country will continue with varying degrees of intensity to seek to influence legislation which they perceive as involving moral, ethical or spiritual principles. And that they will, in profoundly good conscience, proclaim such activity to be an exercise of their religion and religious purposes and hence, to be a religious activity. IRS will, therefore, constantly confront the question of whether to institute an examination and will no doubt be under pressure from interest groups opposed by the churches to do so. I think that you probably all know that there are pro-abortion groups which have been bringing severe pressure on IRS with respect to the stand of the Catholic Church on anti-

abortion legislation. Under these circumstances, further confrontations between church and state seem to me to be inevitable, and I suspect that the ultimate resolution may lie only with the Supreme Court.

Thank you.