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# VOW OF POVERTY RULINGS AND UPDATE ON UNRELATED BUSINESS

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**PATRICK GEARY:**

Father Whelan is going to deal with two topics. We're going to first have a talk and questions on the vow of poverty, and later we will be discussing unrelated business. Without further ado, I think that most of you are familiar with Father Whelan. He is a professor of law at Fordham University and serves as a counselor to the Office of General Counsel with USCC. He has spoken to this group on many occasions and without further ado, I give you Father Charles Whelan.

**FATHER WHELAN:**

The developments with respect to the Vow of Poverty rulings are of obvious importance to religious orders. I'm sure you understand how important they are to the dioceses and archdioceses, too. If the sisters, brothers and priests who are members of religious orders have to pay income tax and Social Security taxes as individuals in the future, then that will create an immediate demand for an increase in the salaries and wages that the dioceses and archdioceses pay them. So it's a matter of common concern to the bishops and the religious orders.

It was on August 30 of last year that the Internal Revenue Service issued Revenue Ruling 76-323. You have all received copies from the Office of General Counsel. As you know, the ruling dealt with the tax liability of two members of a religious order. This order required all of its members to secure employment outside the religious order, and to turn over all the remuneration they received for their services. One of the members had a job as a plumber, the other as a construction worker. The plumber had a job near the religious community he belonged to. He continued to live in that religious community. But the member who got the job as a construction worker was going to be working a considerable distance from the religious community, so he secured lodging near the construction site. The ruling held that these two members were not acting as agents of their order

with respect to their employment and, therefore, that the amounts paid to them were includable in their individual gross income, were subject to Social Security taxes and were also subject to withholding. The ruling concluded by saying that the members were entitled to a charitable contribution deduction in the manner and to the extent provided by Section 170 of the Code for the amounts that they turned over to the religious order. Of course, that phrase, "in the manner and to the extent provided by Section 170," means that they could not get a deduction for everything they turned over.

First of all, it's a basic rule, as you know, in charitable contributions that if the donor is receiving a benefit from the donee, the value of the benefit has to be deducted from the amount of the charitable gift. Secondly, there's a 50% limitation, so they could not get a deduction for everything that they turned over, even if they turned over everything.

One week later the Service issued Revenue Ruling 76-341. Again, the Office of the General Counsel has made that available to you. This ruling dealt with the tax liability of a religious organization specified in the ruling itself not to be a religious order. The ruling dealt with the liability of the organization and its members with respect to money that some private landowners were paying the religious organization for planting trees on their private land.

There was a formal contract between the religious organization and the private landowners. Under that contract the religious organization provided all of the labor necessary to plant the seedlings and also provided all the supervision necessary for the completion of the job. This ruling held that the amounts that the private landowners paid the organization were income to the organization, not to its individual members. As you know, the ruling also held that it was unrelated business income to the organization. The ruling went on to say that the small amounts that the organization paid its members for the work they performed in planting the seedlings were subject to income tax, Social Security tax and withholding, because the ruling said explicitly that, with respect to this work and this pay, the members were employees of the religious organization.

After these two rulings came down, very quickly after they came down, in a matter of days, the Office of General Counsel initiated inquiries at the National Office of the Internal Revenue Service about the impact of these two rulings on the traditional administrative practice of IRS under Office Decision 119, the Vow of Poverty ruling.

The Office of General Counsel was informed that a ruling revoking O.D. 119 had been prepared and was on the point of being issued. Through appropriate channels the USCC protested to the Commissioner of Internal Revenue and the Secretary of the Treasury and asked for a conference.

After some delay, the conference request was granted. At the conference the Office of General Counsel was asked by the government to submit a brief on the entire matter. So the Office consulted with CMSM, the

Conference of Major Superiors of Men, the Leadership Conference of Religious Women, and the USCC Tax Advisory Committee, and then submitted the brief to the Internal Revenue Service on November 15, 1976. Most of you have seen the brief, or a summary of the brief, so I will just emphasize a few key points.

The brief argues that the traditional administrative practice of the Service under the Vow of Poverty ruling was legally correct and should be continued. But the brief did recognize that there are certain situations in which it would be appropriate for the Service to attribute income to an individual religious, rather than to the order to which the religious belongs, even though the religious order approved of the work that the religious was doing, and even though the religious turned over all compensation to the order. The primary situations in which the Office of General Counsel conceded the appropriateness of this individual attribution of income were (1) all members of religious orders holding elected public office (like Father Drinan), and (2) members of religious orders performing secular services in private businesses. The Office of General Counsel's brief argued that the traditional administrative practice should be continued with respect to most religious, including teachers in public schools, nurses in public hospitals, and chaplains in government institutions.

As a general set of criteria, the Office of General Counsel proposed three guidelines for adoption by the Internal Revenue Service. The first guideline provides that when a religious order enters into a contract with another party for the delivery of services, and the religious order retains the type of control over performance of the services that is detailed in Rev. Ruling 76-341, any compensation paid for the services is clearly the income of the order, not of the members of the order whom the order directs to perform the services. If the services that have been contracted for are within the Section 501(c)(3) exempt functions of the religious order, then any compensation paid to the order is exempt from federal income tax under Section 501(a). If the services that have been contracted for are not within the exempt functions of the order, the compensation paid will be taxable or nontaxable, depending on the application of the provisions of Section 511 to 513 of the Code (the unrelated business income tax). In no event, however, shall the maintenance of the members of the religious orders be deemed to be compensation to members. That's the first guideline, where there is a formal contractual arrangement between the religious order and an outside party for the services of members of the order.

The second guideline says that when the first guideline does not apply, but a member of a religious order with a Vow of Poverty is performing services at the direction of his order for an institution listed in the Official Catholic Directory, then the Vow of Poverty ruling will continue to apply as long as the order exercises dominion and control over compensation paid for the services rendered by the member. So in the second guideline there is no formal contract between the religious order and the institution in the Catholic Directory, but the order has directed the member to perform the

services and the order retains dominion and control over the compensation.

The third guideline: When neither guideline 1 nor 2 applies, then the Vow of Poverty ruling will continue to apply only in the situation in which all three of the following conditions are met: First, the member of the religious order has been directed by his order to perform the services in question. Secondly, the services performed by the member constitute activities within the scope of Section 501(c)(3) and are consistent with and in furtherance of the exempt purposes and functions of the order of which he or she is a member. And this part of the guideline recognizes that the production of income is not by itself an exempt purpose, so the services have to be contributing directly by their nature to the exempt purposes of the order. And finally, the third condition that has to be met is that the order continues to exercise dominion and control over any compensation paid for the services rendered by the member.

At the conclusion of the brief, the Office of General Counsel made certain requests of IRS. First, that a new ruling should be issued embodying the three guidelines as suggested in the brief. The new ruling should reaffirm O.D. 119 and Revenue Rulings 68-123 (the sister working in a hospital) and 76-341 (the tree planting ruling) but explicitly supersede Revenue Ruling 76-323 (the plumber and the construction worker ruling). Secondly, the new ruling should be prospective only. It should not apply to tax years beginning before January 1, 1978, but this protective application would not defer any religious order's liability for tax on unrelated business income. So if it is an unrelated business income situation, the prospectiveness of a new Vow of Poverty ruling would not defer that kind of a liability. Thirdly, the Office of General Counsel requested the Service and Treasury to propose a new regulation under Section 61 that would embody the three guidelines and a number of examples of application of those guidelines that the brief contains.

As the brief pointed out, the applicability of the Vow of Poverty ruling has been a matter of recurrent concern to the Internal Revenue Service, the Treasury, and the religious orders. And now that the matter has been thoroughly reexamined twice, once back in 1943 and 1944, and again at the present time, it seems appropriate that a regulation be added to those already issued under Section 61 so that there will be greater security and stability in this area of the income tax law. There are over 160,000 members of religious orders in the United States, and that large a group of potential taxpayers would certainly seem to justify the issuance of a regulation.

And finally, the Office of General Counsel requested that there be another conference between the Office and appropriate representatives of the Treasury and the Internal Revenue Services before any new ruling or regulation is issued. Now, as I told you, the brief was submitted on November 15, 1976. As of today, neither the Treasury nor the Internal Revenue Service has made any response to the brief of the Office of General Counsel. Neither has IRS issued any new ruling strictly in the area of religious orders or religious organizations.

Part of this delay in response is undoubtedly attributable to the change from the Ford to the Carter Administration. But the complexity of the legal questions involved is almost certainly an independent cause of delay. In addition to the basic rules governing the attribution of income, the Service must consider: (1) the Social Security ramifications of attributing income to an individual religious; (2) the effect of the unrelated business income tax on amounts received by religious orders for services performed by their members; (3) the question whether amounts spent by religious orders to maintain their members are compensation within the meaning of Section 61 or Section 513(a)(1) of the Code; and (4) the retroactivity of any changes that IRS adopts.

Questions like this which involve both the exempt organization provisions of the Code and the income tax provisions of the Code are handled by two separate branches of the National Office of the Internal Revenue Service. Obviously, the Social Security Administration has an interest in the resolution of this matter. So there are a lot of people involved in arriving at the final position that IRS and Treasury will take.

Now, as if to prove that IRS is not totally hard of heart, they did issue a ruling (76-479) toward the end of last year dealing with the attribution of income in a situation where the staff of a medical hospital formed a foundation to do medical research and particularly to take care of the so-called "teaching cases" in hospitals. These are indigent people who require special care, who present interesting medical problems. To be a member of this hospital staff, you had to agree to belong to this foundation that would provide the services, and to be a member of the foundation you had to agree that any money paid for services that you rendered while you were working in the foundation would belong to the foundation and not to yourself. The foundation also exercised control over the assignment of cases, the setting of fees and so on. So at the conclusion of the ruling, IRS held that in this case the amounts paid for the services rendered by the individual doctors were not the individual doctors' income, but the foundation's income. Thus, we have a very recent ruling in which IRS has recognized that the mere fact that one person is performing the services and that money is paid doesn't always mean that the money is that person's income within the meaning of Section 61.

But whether IRS will extend that kind of thinking to reaffirm O.D. 119 remains to be seen because the last paragraph in the medical foundation ruling (76-479) says, "Compare Rev. Ruling 76-323, which holds that amounts received by members of a religious order for work performed outside the religious community are includable in the gross incomes of such members since in performing these services the members are not acting as agents of the religious order."

During the last few months there have been several incidents in which local IRS officials have notified individual members of religious orders that they were personally liable for income and Social Security taxes. One such incident involved the chaplain at a state prison. These cases have been

referred to the Office of General Counsel and George has been successful in bringing these matters to the attention of the National Office, and in getting the National Office of IRS to notify the District Director not to pursue the matter at this time. So IRS is sitting on this one and has not yet come to a final conclusion.

I think that the basic recommendations that need to be made in this area are as follows (I'd like to emphasize that in writing these recommendations I have not had a chance to give them to George in advance so any comments that he wants to make will be most welcome). This is the way I see the picture myself:

(1) Until IRS clarifies its position, it doesn't seem wise to me for individual religious to pay income or Social Security taxes as long as any reasonable claim can be made that the work in which the religious is engaged is furthering the exempt function of his or her religious order over and above the production of money for the order. And I think that the usual claim for refund of any taxes that have been withheld should continue to be filed.

There are a couple of situations in which it certainly seems the more prudent course for the religious orders simply not to sit back and wait. In one case I have no doubt: If a member of a religious order has been elected to a public office, then I just don't see how any colorable claim can be made by the religious order that the member's fulfillment of his public duty is in furtherance of the exempt functions of the order within Section 501(c)(3). Father Drinan has been paying income taxes since he was elected. There are a number of other religious who have been elected to public office; I think there are at least 16 of them at the present time in this country. So in that situation my advice would be to go ahead and pay the tax.

A second situation, it seems to me, is pretty close to the first. Even so, until IRS has clarified its position, I feel that it would be safer to wait until IRS has done so. I mean a religious who is performing essentially secular services for a commercial business. I know a couple of sisters in New York who are working as travel agents in a big commercial travel agency. I don't know if they pray for their clients while they are doing the work, but their jobs are exactly like the other employees' jobs. Speaking for myself, I think that O.D. 119 is clearly inapplicable to that situation; or at least if it's not theoretically inapplicable, it is practically indefensible. Still, until IRS has clarified its position there could be some merit in not having individual religious orders, and especially not having individual members of religious orders, making the decision. So I think we can wait in that second situation at least for a while. If this time next year IRS still hasn't told us what their position is, I think my recommendation would be for those individuals to pay the tax at the direction of their religious superior. My recommendation is don't pay unless you've got Father Drinan's situation.

(2) But until IRS has clarified its position the religious orders them-

selves should be careful not to take the position that *none* of their members is subject to individual income taxes or Social Security taxes. Even if IRS were to accept such a contention, I think that at least some people in IRS would try to apply the unrelated business income tax. The unrelated business income tax definitely was not designed to reach the situation in which religious orders direct their members to go out and work in schools, hospitals, etc. That was not part of the legislative background or purpose of the unrelated business income tax. But if you think of the situation that Joe McGovern described this morning (a fairly common situation in religious communities), where the members of the community are each going his or her own way to a different outside employer, it seems to me that some colorable argument could be made that the religious order is functioning in part as an employment agency. I don't say that I agree with that. I'm talking about possible arguments that some people at IRS might raise and that would have to be countered.

In any event, the religious orders have to be awakened to the fact that their legal position has changed since the adoption of the Tax Reform Act of 1969 and the passage of the grace period. They are considerably more vulnerable today than they ever have been in the past. I want to emphasize that the unrelated business tax is not aimed at the individual employment of individual religious. But when you look at Revenue Rulings 76-323 and 76-341, or at least when I look at them, what I see is IRS getting one group through the individual income tax and the other group through the unrelated business income tax. And I suspect that in the future IRS's position in cases where the services performed by individual religious are essentially of a secular or public official character will be that it's one tax or the other. It's not a question of tax or no tax, but a question of which tax.

(3) It's very important for the religious orders to be helped to understand that the religious nature of the work that members or religious orders perform is that the reason why the compensation for that work has been attributed in the past to the order and not to the individual. A number of religious orders today would say that in the spirit of Vatican II they are going out into the marketplace and all of the common areas of human endeavor. And they will cite documents of Vatican II to prove that the Pope and the General Counsel have encouraged an opening of the windows and a going forth, all of which is true. But diocesan priests, the bishops, the archbishops, the cardinals, all have to pay the individual income tax. And the work they do is certainly as religious as the work any Jesuit does. So it's not the religious character of the work that has anything to do with the attribution of income to the order rather than the individual. You understand that, but what I am encouraging you to do is to help religious orders understand it. I know from my own dealings with them that they will say: "You are selling us down the drain, you are not in harmony with Vatican II." When I reply, "But after all, Cardinal Cooke and Cardinal Cody pay income taxes," they say, "They do?" So there's a lot of information that has to be conveyed to my brothers and sisters in religious orders.

Now, theoretically, it is true that the special bond that the vows of poverty, chastity and obedience and the obligations of common life under canon law create should result in the attribution of all income to the religious orders, rather than to its individual members. Theoretically, that is correct. But my judgment is that this theory has to be tempered by recognition of the theoretical principles embodied in the unrelated business income tax and also has to be tempered by prudential considerations aimed at preserving traditional vow of poverty treatment for the vast majority of members of religious orders. There is a sister working as an IRS agent in the Manhattan District Director's Office. Theoretically, the Vow of Poverty ruling should result in the attribution of "her" salary to the order; but as far as I'm concerned, forget the theory. I think she's got to pay.

(4) My last suggestion to you is that if the Internal Revenue Service should revoke or greatly modify O.D. 119, it is not at all certain in my opinion that we could persuade the courts to reverse the Internal Revenue Service. There are sound legal arguments both for and against the traditional administrative practice under O.D. 119. In any event, litigation would be so protracted that I think it would be better to pursue a legislative solution. Two avenues seem worth exploring. The first would be the extension of Section 501(c) treatment to religious orders. Under Section 501(d), religious and apostolic associations like the House of David, the Shakers, and the Hutterites are taxed as though they were partnerships. The total income, and by the way this isn't just earned income but also investment income, is divided up among all of the members of that group, and then the individuals pay the taxes on that amount. I do not have any idea whether Congress could be persuaded to provide such treatment for religious orders; but if Congress did so, it could greatly mitigate the amount of ultimate tax liability.

The second suggestion I make is that consideration be given to designing the restoration of the unlimited deduction for charitable contributions, but only for individuals who have no capital gains or other items of tax preference income. The reason that the unlimited deduction was repealed by the Tax Reform Act of 1969 was that some very clever attorneys found a way to utilize that deduction in combination with the exclusion of part of capital gains from gross income, so that wealthy families were able to contribute after a required number of years (eight or nine) all of their taxable gross income to their family foundation and still live handsomely on the half of the capital gains excluded from gross income. Congress considered that an abuse and repealed the unlimited charitable deduction, which most of you know was put in there to begin with for the very special case of Mother Drexel. But perhaps it would be possible to persuade Congress to restore the unlimited charitable deduction for individuals who do not have any capital gains or any other items of tax preference income. In any event, I think some study should be given to that matter in the event that IRS hands down a seriously adverse decision in the O.D. 119 matter.

I discussed this question of the unlimited charitable deduction with one of the outstanding tax professors at Yale, and his reply to the idea was that perhaps it could be done on the basis of this kind of argument. People who have property and people who have money can make very large and significant contributions and deduct them. People who have only themselves to give cannot take a deduction. Perhaps in the case of members of religious orders, we could persuade Congress that something should be done to rectify that situation.