Audit of Church-Related Schools and Churches

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I'd like to begin this morning with a few comments and observations. Ordinarily, in an institute such as this, I've tended to plunge right in with a discussion of several Revenue Rulings, Code Sections, and IRS manual transmittals—all of which have a tendency to put the average audience into a mild comatose state within a very short period of time. And, today, in view of the fact that we've been asked to go on first in this 2-day program, I thought I would try to avoid hitting you with code sections and limit my technical references as much as possible.

I am proud to say that I am a product of the Catholic school system, having attended a parochial school in Virginia—across the river—and the Jesuit High School here in Washington—Gonzaga—which is certainly an experience I am never going to forget. Here at the outset, I would like to try to put across a couple of thoughts that I think are very important.

Having served as an attorney for the IRS National Office here in Washington in the Exempt Organization Division for the better part of seven years, I can assure all of you that the Service is not out to "get" our parochial schools. They are in the unfortunate position of having to enforce our revenue laws as fairly as is practicable, given their limited manpower. Whenever an abuse situation is brought to the attention of the public in the newspapers or on television, the Service tends to react—or perhaps I should say overreact—in an effort to appease public sentiment.

Clearly, all administrative agencies are subject to some degree of congressional pressure and if a certain church group or other category of tax exempt organizations gets into trouble with IRS, there is a predictable, almost knee-jerk reaction by the Service to bring that particular category of exempt organizations into compliance. This is often accomplished through a directive from the IRS National Office to its field personnel to focus its audit emphasis on the category of exempt organization which has, for whatever reason, risen to the top of what I like to call the list of "suspected" organizations.
When I was with the IRS National Office beginning in the early seventies, which as most of you know was the period following the enactment of the 1969 Tax Reform Act, all of our emphasis was upon private foundations. Toward the middle part of the seventies, we shifted our focus over to the large tax exempt organizations with assets exceeding $10 million and in this regard we naturally focused on hospitals. The attention and study we gave hospitals in the National Office was ultimately translated into a policy among our local field offices which, as many of you may be aware, will now result in the certainty of an audit of all hospitals in the United States on an every-other-year basis.

We completed a series of legal institutes for the Catholic Hospital Association last fall. As part of our program we presented a mock IRS audit of a Catholic Hospital, and we are going to follow that format today a little later on in the program. We will show you some of the things than can happen in the course of an audit which, if at all possible, you should avoid, and will then follow up with a description of some of the appeals procedures available to you if you do not agree with proposed adjustments to either your tax status or income tax liability that an examining agent might make.

You may be aware of the fact, as I mentioned earlier, that hospitals are going to bear the brunt of IRS audit activity in the years to come. But just as I noticed our focus at the National Office shift from private foundations to hospitals, at just about the time I was preparing to leave the Service, another shift became noticeable. Actually, what I saw was a number of events that culminated with the serious evaluation of IRS policy toward private schools.

The Civil Rights Commission in the mid-seventies did a major study of the Internal Revenue Service as part of its overall study of the administration of government programs designed to halt discrimination. The Commission conducted an evaluation of the Service enforcement policies which were adopted originally in 1970.

During this same period, the Supreme Court issued its opinion in *Norwood v. Harrison*. The lower court in Mississippi, on remand from the Supreme Court, held new proceedings to determine whether certain schools in Mississippi had a discriminatory policy and, therefore, could not be provided with free school textbooks by the State. In a related development, the Supreme Court issued its decision in the *Bob Jones University* case upholding the Anti-Injunction Act.

A Task Force was formed within the Service, primarily made up of exempt organization personnel. This Task Force had the specific charge of reexamining Rev. Rul. 71-447, which announced the basic policy against discrimination in education, and Rev. Proc. 72-54, which was the basic Revenue Procedure complementing Rev. Rul. 71-447. The Task Force was also charged to review Service training manuals to evaluate the overall compliance program. The purpose of this internal study project was to look at the entire field of discrimination in education and determine if the
Service was doing everything it should be doing to administer the revenue laws properly.

I was with the Task Force which worked on Rev. Proc. 75-50 and Rev. Rul. 75-231, both of which we will review a little later. More importantly, however, all of the developments back in the mid-seventies—the various Supreme Court cases on racial discrimination in education—as well as the efforts of the IRS Task Force culminated in Manual Supplement 75G-33, issued January 5, 1978. This Manual Supplement confirms my own personal suspicions that all of the efforts by the Task Force at IRS National Office have now been translated into an audit policy for IRS field offices.

As most of you are aware, the Service is gradually reducing its Pension Department. As a matter of fact, Commissioner Kurtz in a recent hearing of the House Ways & Means Subcommittee on the Treasury asked that some eighty-seven Pension staff personnel be diverted to Exempt Organizations. Now, the January Manual Supplement states that any Exempt Organization personnel previously transferred to the Pension Department will be returned by June 30, 1978. In addition, the Pension staff who would otherwise be terminated because of the reduction of the compliance end of that department will also be added to the Exempt Organization area.

Among the mandatory examinations spelled out in the January Manual Supplement are private schools and, in particular church-related schools. I would like to point out that there are only seven specific categories of exempt organizations upon which this new audit emphasis has been brought. The category of private schools and church-related schools is the first of the “suspected” organizations on the list. I want to emphasize to you that the directive is that each key district must examine at least five church-related schools annually. The important point is that the numerical reference represents a “floor” in terms of the number of church-related schools to be examined rather than a “ceiling.”

I think it very likely that the Service will exceed the 5-school floor spelled out in the Manual Supplement. This is particularly predictable for this year and the next several years, until church-related schools either move down the list as a category of “suspected” organizations or are altogether removed from that list.

The Manual Supplement issued on January 5, 1978, refers to an earlier Manual Supplement, issued last May, which provides comprehensive instructions to IRS examining agents of procedures to follow in conducting private school examinations. The May Manual Supplement talks a little about Rev. Proc. 75-50 and Rev. Rul. 75-231, both of which we should look at briefly since they form the framework within which parochial school examinations will be conducted. Rev. Proc. 75-50 provides general guidelines and record-keeping requirements for determining whether private schools that are applying for recognition of exemption under section 501(c)(3), or that are presently exempt under that section, have racially non-discriminatory policies as to students.

At this point, I would better point out that we are going to assume that
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the Service has a constitutional basis for examining parochial schools and, for that matter, any church-related schools notwithstanding the fact that this may or may not have been conclusively litigated before the Supreme Court. So, if you will, I would like you to assume with me that the Service does have a legal basis for examining parochial schools to determine compliance with the Revenue laws that they contend apply to such schools.

The primary justification for Rev. Proc. 75-50 was the need to conform IRS determination letter and examination procedures for private schools to a uniform, nationwide standard. Since 1971, the IRS has been subject to the injunction issued in Green v. Connally, as far as Mississippi schools are concerned. The court in that case set forth the kind of information a school has to provide at the time it applies for exemption and what it has to do to maintain its exemption. Once again, the standard in the Green case was applicable only to the Mississippi schools, and the schools in the rest of the United States were subject to Rev. Proc. 72-54, the companion to Rev. Rul. 71-447. This clearly presented the Service with a difficult situation for equal tax administration. The second justification for Rev. Proc. 75-50 was that it would increase the ability of the Service to give substance and meaning to the ruling policy against discrimination in education. The IRS National Office felt the need to give its field agents clear, unambiguous guidelines for measuring compliance. The third justification for Rev. Proc. 75-50, which the IRS tends to lose sight of, was that there was a need to eliminate ambiguities and uncertainties as to how the schools themselves were supposed to comply with the policy. When you look at Rev. Proc. 75-50, you will find it to be very detailed. For example, it sets a standard on type size and column inches for the publication of the racially non-discriminatory policy with respect to students.

Then we get to Rev. Rul. 75-231; this is the Service's attempt to extend the public policy supporting its predecessor, Rev. Rul. 71-447. This ruling applies to private schools that are tied to a particular church. This Service attempted to state in unqualified terms that the public policy against discrimination in education based on race, color or national or ethnic origin was so fundamental to national values that even a church could not engage in it and retain a favored tax status. Of course, as many of you might know, there are far more church-related private schools in the country than nonchurch-related private schools.

There are four elements of Rev. Proc. 75-50 that the Service considers to be of the greatest importance. And, of course, if the Service thinks that a particular aspect of the operation of a private school is important, it thereupon becomes important to you as counsel for the school. The first point is that the Service believes there is an obligation for a school to adopt and carry out a clear, unequivocal admissions policy that does not discriminate against any child on the basis of race, color or national or ethnic origin. This is the fundamental premise of the Rev. Proc. The second element is the effective communication of the policy of nondiscrimination to the community that the school serves. With regard to diocesan schools,
you will remember that back in March 1976, the IRS issued a ruling to the United States Catholic Conference, primarily as a result of the efforts of George Reed, whereby the notice of nondiscriminatory policy may be set forth in diocesan newspapers and parish bulletins. This will be deemed the effective communication of a policy of nondiscrimination consistent with the requirements of Rev. Proc. 75-50. The third point is that as far as the IRS is concerned, all school programs—and this means everything from athletics to financial assistance programs for participants in the school band—all of these school programs must be operated on a nondiscriminatory basis. The fourth, and final, point is that the agent which is examining your school in order to determine whether it’s being operated consistent with the nondiscriminatory policy is going to look for a very tight and comprehensive system of recordkeeping.

Going back for a minute to the May 1977 Manual Supplement, if a church-related school is a separate legal entity, the agent is directed not only to determine whether the school is complying with the racial nondiscrimination requirements, but also whether its operations in general satisfy all the other requirements of section 501(c)(3). If the school is not a separate legal entity, which is the case in most diocesan parochial schools, the examination generally is limited to determining compliance with the racial nondiscrimination requirements. The problem here is that if the examining agent identifies any other problems, the scope of his examination can be extended to cover whatever areas he wants to pursue. This is very, very important, and something we’ll see dramatized in our mock audit later on.

If the church-related private school is not a separate legal entity, then certain preexamination procedures called the “advance approval notification” procedures outlined in section 4(11)95 of the Internal Revenue Manual are directed to be followed. Essentially, the Service tries to obtain the information necessary to determine the school’s compliance with Rev. Rul. 75-231 and Rev. Proc. 75-50 through its preexamination procedures.

I think that in the future, although the Service will stick to its policy of attempting to acquire through correspondence all the information it needs to determine whether the school is operating in a nondiscriminatory fashion, almost every examination will involve some personal contact with an IRS agent due to the audit emphasis on church-related schools as mandated this past January.

The preexamination procedures that we have talked about are all byproducts of the income tax regulations under section 7605(c) of the Code. In general, before beginning an examination of a church (and this would include churches operating schools), the Service will attempt to obtain necessary information for its examination through a written request to the organization.

Before we get into the “mock audit,” I would like to outline for you some of the basic audit concepts with which you should be familiar so you will have some sort of a feeling for who the adversary is going to be. Your
first contact will be with the IRS agent, and if you have not dealt with
these guys before, you will find them to be particularly skeptical by na-
ture—that is the way they are trained to be. They are skilled at acquiring
the kinds of information that permit them to make adjustments to income
tax returns. Not that an agent considers his primary duty to be the maxim-
ization of tax liabilities or revocation of exempt status, but agents are
judged by their results. In order to succeed, they are taught methods of
developing information that requires that you carefully watch what they
do so that they don’t overstep reasonable boundaries in their enthusiasm
to acquire such information.

I want to make a very important point here; that is, we assume that
each school is operating consistent with the revenue laws that apply to tax
exempt organizations, but there will always be areas in which reasonable
people will differ, and our comments today are not designed to conceal
matters from IRS but, rather, to insure that we do not do the agent’s work
for him. Also, we live in an era where institutions are constantly under
attack, and the response, “Yes, but we’re a church,” has not saved other
churches from intense and critical IRS examination, e.g., the Unification
Church, and the Church of Scientology.

The underlying philosophy of IRS audit programs for exempt organi-
zations in general is to maintain a high level of voluntary compliance by
developing a fear on the part of every such organization that it might be
audited. This is part of the reason for the establishment of a minimum
number of church-related private schools that each IRS key district must
examine annually. It is all part of a nationwide IRS policy to achieve the
level of audit coverage for exempt organizations, including parochial
schools, that is achieved in connection with the returns filed by other
taxpayers. So, from the school’s point of view, it should be prepared at all
times to deal with an IRS audit, and this is possible only if the school keeps
the type of records that will allow it to present an accurate and complete
picture of itself.

I would like to emphasize the point that the best protection against
problems with IRS is going to be clear, complete and accurate records. As
a matter of fact, failure to maintain proper books and records and make
them available to the IRS agent may result in loss of exemption. Although
parochial schools are not subject to the filing requirement as are other
church-related organizations that do not qualify as “integrated auxilia-
ries,” in the face of the accelerated audit program for church-related pri-
ivate schools, your contact with IRS agents will increase and it is very
possible that you are going to make some damaging admissions in the
process of the examination.

The IRS examining officer does not have to wait until a manual settle-
ment such as the January Supplement is issued before examining a par-
ochial school if he learns that it may be engaging in activities that are
inconsistent with exempt status—the IRS gets this information primarily
through publicity, including news articles and other reports that are made
directly to the local district offices. Therefore, whenever there is evidence that the school may have engaged in an activity which is inconsistent with exempt status, an immediate examination is ordinarily made. This means that a school can be audited any number of times in a relatively small span of time if the Service has reason to believe that its activities are inconsistent with continued exemption.

I want to make another important point here, and this is something to keep in mind as we get into specific problem areas. An IRS examination of a parochial school will be primarily a review of its policies and activities rather than an organizational or financial audit. This does not mean that the examining agent will limit the audit to a review of the school's racial policy for admissions, despite the fact that such policy is clearly the primary interest of the IRS National Office. The reason for this is that the IRS agent examines all categories of exempt organizations and ordinarily develops a general approach to such organizations that he will use regardless of the procedures and guidelines set out in official audit manuals. Each agent will generally bring his own particular brand of examination, if you will, into a hospital, foundation, or school and use the approach with which he is most comfortable and with which he has achieved the best results.

As I mentioned previously, when a parochial school has been selected for audit, it will be notified, generally in writing, and then contacted by a representative of IRS. We would advise that in all cases you insist on a written letter for your tax files.

Now, the first thing we would suggest is that the principal contact the school's tax advisor, which in most cases will be counsel, but may be special counsel, or a CPA brought in to handle the examination. In order for the tax advisor to represent the school before IRS, the school must execute a Power of Attorney (authorizing the tax advisor to give and receive confidential tax information on the school's behalf).

Now, the reason counsel is sought is that a lawyer or CPA is in a legitimate position to say to many questions posed by the agent, "I don't know the answer to that, but I'll get back to you on it." This will permit him to analyze the question and present supporting data in its most favorable light. On the other hand, if the agent puts a question directly to a school principal, it is not quite as easy for him to claim ignorance without creating a severe credibility gap with the agent, and this can only lead to trouble for the school.

At this point, we would like to emphasize—and we can say this based on years of experience—that the key to success in dealings with the IRS is a very carefully planned and controlled approach to the examination. Prior to the agent's initial visit, the school's diocesan counsel, treasurer, and other financial or business people should also be alerted to the fact that an audit is about to begin. At the initial meeting, the procedure that the agent intends to follow and the kind of records he will require should be discussed in detail. The school should also request that the agent provide a plan of the audit, preferably in writing, describing in detail the kinds of
records he wants to be made available, the time he intends to spend on the audit, and the procedures for providing him the information. Once again, I would like to point out that documents requested by the agent should always be delivered to him personally, and under no circumstances should he ever be permitted to go on a “fishing expedition” through the school’s books and records.

The agent’s initial request for records is likely to include the following:

(a) All brochures, catalogs and other written advertisements used for the present academic year if the school is currently in session (last academic year if not in session);
(b) A copy of the most recent advertisement publicizing the school’s racially and ethnically nondiscriminatory policy during periods of solicitation for students or, in the alternative, during registration periods in a manner that makes such policy known to all segments of the general community served by the school;
(c) Records indicating the racial/ethnic composition of the school’s student body, faculty, and administrative staff;
(d) Records documenting that scholarship and other financial assistance is awarded on a racially and ethnically nondiscriminatory basis;
(e) Copies of all materials used by or on behalf of the school to solicit contributions;
(f) Data showing the racial and ethnic composition of enrolled students, faculty, and administrative staff at the close of the last academic year, if the school is not currently in session, or at the start of the present academic year, if the school is currently in session; and
(g) Data showing the racial and ethnic composition of enrolled students who have received scholarship and loan funds, and the amount of such scholarship and loan funds.

In addition to the foregoing, the agent may very well request the following:

(a) Minutes of meetings of officers, directors, trustees, and all special committees, if any, for the period under audit, plus several previous years;
(b) Copies of the school’s charter and bylaws, if you have any (or trust documents), and any amendments to these documents;
(c) Monthly bank statements and cancelled checks for all bank accounts;
(d) Passbooks for all savings accounts;
(e) General ledger and all supporting journals;
(f) Cash receipts and disbursements journal;
(g) Latest financial statements;
(h) Payroll records—your 941’s and W-2’s, etc.;
(i) Evidences of indebtedness;
(j) Contracts—in particular, teachers’ contracts; and
(k) Leases.

It is important for the school to retain sufficient control over the audit so that it becomes aware of all information developed by the agent. To accomplish this, the school should attempt to follow these guidelines:

(a) A particular individual should be designated to represent the school
during the course of the audit. This individual should coordinate all aspects of the examination with the CPA or lawyer and control all requests for documents and information and all arrangements for interviews;

(b) A desk or room, depending upon the anticipated length of the audit, should be set aside for the agent—and set aside well out of earshot of school employees (who may know nothing about the school's policies but nevertheless may have a lot to say about them). The agent may conduct the audit in a continuous manner over a period of days or he may return from time to time over several months to examine the materials he has requested;

(c) Insofar as possible, to reemphasize the point, all the records and documents requested by the agent should be provided to him personally at the desk or in the room set aside for him;

(d) The school's control individual should keep a written record or log of the material furnished to and reviewed by the agent and should retain copies of all such materials. If the control individual has any question as to the propriety of providing various records, he should immediately seek the advice of the CPA or lawyer. In this connection, it is obviously best to cooperate fully with the agent in the provision of materials, copies of documents, and the like. However, the tax advisor, for one reason or another, may wish to limit the responses and require formal demands, or even subpoenas, for certain documents and information; and

(e) If the agent desires to interview employees of the school, those interviews should be scheduled through the control individual, who with the CPA or lawyer should be present at the interview or, in the alternative, should arrange to have a representative of the school present to keep a record of the information provided by the person or persons being questioned.

Well, we have looked at the basic framework for private school audits. Now, let us see how the audit actually takes place and what pitfalls to avoid as the agent begins reviewing the school’s educational activities and delving into its financial records. So, imagine if you will, that we are in the offices of the principal of Blessed Blunders High School.

AGENT: “Good morning. My name is agent Darth Vadar. How are you today?”

PRINCIPAL: “Fine, thank you. I’m Brother Kennedy.”

AGENT: “Well, I noticed a little booth near the entrance of your parking lot.”

PRINCIPAL: “Well, we have a restaurant across the street, and since we have the space available in the evenings, we feel we might as well make a little money on it.”

AGENT: “Well, we’re really going to have to look into that situation very carefully. By the way, is your CPA or attorney going to be with us today?”

PRINCIPAL: “You mean I can have someone else here with me?”

MODERATOR: “Let’s break in at this point and analyze the mistake made here.”

Although the ostensible purpose behind the examination of a church-related school is the verification of compliance with Rev. Proc. 75-50, the agent will be alert to everything. The principal made a damaging admis-
tion with regard to the school parking lot. As most of you are probably aware, churches consistently had been accorded favorable treatment under the unrelated business tax provisions prior to 1969. Churches and conventions or associations of churches were specifically excepted from the unrelated business tax. This exception did not extend to other religious organizations (including religious orders) which were not themselves churches or conventions or associations of churches. In addition, the exception did not extend to other organizations formed and operated under church auspices, even though such organizations engaged in religious, educational, or charitable activities approved by a church.

I'm sure you've heard of the De LaSalle case, in which a federal district court held that an educational organization was not a church, although all of its members belonged to one church or religious order. All of the members of the De LaSalle Institute were Christian Brothers. The court held that operation of parochial schools and novitiates did not make the organization a "church," and the fact that under canon law its income belonged to the Catholic Church or the Christian Brothers Order was irrelevant. Under those circumstances, income derived from the operation of a winery and distillery was held to be subject to the unrelated business tax.

Although the exemption of churches from the tax and unrelated business income was eliminated by the 1969 Tax Reform Act, the impact of that change on churches was deferred. The tax remained inapplicable with respect to all taxable years beginning before January 1, 1976, so long as the unrelated business income was from businesses carried on prior to May 27, 1969. Therefore, churches were provided a period of time to dispose of unrelated businesses or to spin them off into separate taxable subsidiary corporations.

Now, with respect to 1976 and afterward, churches still have special treatment in connection with selection for unrelated business income audits due to section 7605(c), which we will talk about in more detail a little later.

In our situation, providing parking spaces for a charge to patrons of commercial facilities results in the unrelated business income tax. This is why it is prudent to let the school's CPA or attorney handle the questions posed by the agent. They can suggest that the audit proceed until they get the information needed to resolve a particular question that comes up, as follows:

AGENT: "Could I please see your admissions catalog and any other materials you use in soliciting enrollment?"

PRINCIPAL: (Puts catalog, etc., on table).

AGENT: (Spends a lot of time poring over catalog in conference room).

MODERATOR: "As I suggested earlier, it's a good idea to leave the agent alone at this point and give him an extension number where you can be reached by phone. We are going to assume that the agent has identified specific areas he wishes to pursue based on his review of the admissions materials."
AGENT: "Well, I have the responses to the questionnaire I sent to you several weeks ago, and after having reviewed that material and these brochures, I have several questions for you."

PRINCIPAL: "Fire away."

AGENT: "First, I'd like to see some evidence that you have been recognized as a 501(c)(3) organization, and by this I mean a copy of a determination letter if you have one."

PRINCIPAL: "Wait just a minute. I think we are listed in the National Catholic Directory under our Diocesan subheading. Yes, here we are—Blessed Blunders High School."

AGENT: "Well, this is satisfactory proof that you are included in the group exemption for the United States Catholic Conference. I notice that this promotional brochure does not contain a statement of nondiscrimination. Are you aware of this?"

PRINCIPAL: "Let me take a look at that. Oh—this brochure is from an old supply that was published before the requirement for the nondiscrimination statement came out. Here's a more recent brochure."

AGENT: "Thank you. As you know, or should know, every school must include a statement of its racially nondiscriminatory policy as to students in all its brochures and catalogs dealing with student admissions, programs, and scholarships. Furthermore, all schools must include a reference to their racially nondiscriminatory policy in other written advertising that it uses as a means of informing prospective students of its programs."

PRINCIPAL: "Well, the statement in our brochure you're holding is pretty brief. Is it acceptable?"

AGENT: "The statement that Blessed Blunders High School admits students of any race, color, and national or ethnic origin is perfectly satisfactory. However, I want to emphasize to you that in printing any new brochures, and in any ads or solicitations that you publish in the future, the type of statement printed in this brochure must be included or else you will be in violation of Revenue Procedure 75-50. I'll be noting this in my audit files so we can check on this in the future."

MODERATOR: "Well, no serious problems have arisen up to this point, but if you are wondering why all the fuss about Rev. Proc. 75-50, the procedures and guidelines outlined in the Rev. Proc. are taken very seriously by IRS. And, if you're wondering whether these procedures have any teeth, the Service is prepared to revoke the exempt status of any school which is not in compliance."

AGENT: "I notice here some sort of advertisement in what appears to be a newspaper. Is this supposed to be an attempt to make your racially nondiscriminatory policy known to the general community you serve?"

PRINCIPAL: "Yes, it is. It is my understanding that this advertisement would meet the requirements of the Revenue Procedure."

AGENT: "Well, I suppose this is satisfactory."

MODERATOR: "This is an example of an issue the IRS agent can appear to be conceding and thereby give the general impression that he is
bending over backward in his attempt to be reasonable during the examination. However, had the attorney or CPA for the school been present, in all likelihood he would have been aware of a private letter ruling to the United States Catholic Conference permitting the publicity of the nondiscriminatory policy among diocesan schools in parish bulletins or the diocesan newspaper. This is generally accomplished by a relatively brief statement that schools in a particular diocese admit students of any race, color, national and ethnic origin to all the rights, privileges, programs, scholarships, and activities generally accorded or made available to students at the schools. A further statement should also be included to the effect that the schools do not discriminate on the basis of race, color, national and ethnic origin in administration of educational policies, admissions policies, loan programs, and athletic and other school-administered programs. The statement should follow with a list of all diocesan schools which are in compliance with the prohibition against a racially discriminatory policy."

AGENT: "I notice here that nowhere in your charter and bylaws is there a statement as to your racial policy regarding students."

PRINCIPAL: "Well, that occurred to me. Is there anything we can do about it?"

AGENT: "Well, I might be willing to accept a resolution by your governing body, or some other provision, that your have a racially nondiscriminatory policy."

MODERATOR: "Once again, the presence of tax counsel could have spared the embarrassment the principal is now feeling. And, if there is one thing you cannot allow to happen—if at all possible, it is to put yourself in a defensive posture, because the agent will then begin to control the entire direction of the examination, and there is little you can do to confine his attention to areas in which you are strong from the compliance standpoint. The private letter ruling for the United States Catholic Conference to which I referred earlier describes how Catholic church-related schools are subject to diocesan control in the structure of the church's government. Generally, a diocesan administrative officer is responsible for the admissions policies of schools within the diocese. Under the requirements of the predecessor to Rev. Proc. 75-50, Catholic school nondiscriminatory policies were certified to the church by the appropriate diocesan officers on an annual basis when the schools were listed in the Catholic Directory. As mentioned earlier, such schools are subordinates under the group exemption issued to the United States Catholic Conference, and the Catholic Church has assumed responsibility for insuring that the policies of these subordinates are nondiscriminatory before they are included in the group roster.

As far as the requirement in Rev. Proc. 75-50 that a school's organizational documents contain the nondiscrimination statement, IRS has accepted as full compliance the fact that the person authorized to set school policy in the diocese traditionally enforces the nondiscriminatory policy among subordinate schools. Now, let's see what other problems the agent can create here."
AGENT: "On the way up to your office I didn't notice any black students in the classrooms. Are there any in the school?"

PRINCIPAL: "Uh—well—uh, there sure are. It's just that they're spread out a little thin. Just wait until lunch—they all sit around the same table."

AGENT: "Well, maybe you can take me on a tour of the school a little later. Are you sure you understand the policy set out in Revenue Procedure 75-50?"

PRINCIPAL: "Maybe you'd like to refresh my memory a little bit?"

AGENT: "Well, your school may select students on the basis that they are Catholics so long as membership in the Catholic denomination is open on a racially nondiscriminatory basis. Beyond this, you ordinarily must include a statement in your governing instrument or a resolution as to your racially nondiscriminatory policy. This policy statement must be included in your brochures, catalogs, and advertising for students. As far as publishing this policy is concerned, you must make the nondiscriminatory policy known to all segments of the community you serve. All of your facilities and programs and, in particular, your scholarship and loan programs, must be operated in a racially nondiscriminatory manner."

PRINCIPAL: "Now, that's what I thought it meant."

AGENT: "Well—you know—I still can't get over the lack of blacks in this school. After all, you are right in the middle of an integrated area of the city. Sure doesn't seem right to me."

PRINCIPAL: "Well, there are very few blacks in the Catholic population. And, in this part of the community, very few could afford the tuition and other expenses at our school, even if they were Catholic and wanted to attend. Our entrance examination doesn't improve their chances either."

MODERATOR: "Now, as I mentioned earlier, we should never do the agent's work for him. Brother has volunteered some potentially damaging information concerning an entrance examination. Let's see where all this leads us."

AGENT: "Do you happen to have a copy of your most recent entrance examination?"

PRINCIPAL: "Yes I do—here it is."

AGENT: "It appears to be drafted from the purely academic perspective. We'll have to have our agents check it more carefully. Mind if I take a copy? I still have a problem with the lack of black students in the school."

PRINCIPAL: "Maybe this will help. Only 1% of all blacks in this community are Catholic and yet almost 3 to 4% of the students enrolled here are black. And, if you don't believe me, take a look at our yearbook and you will see I'm pretty accurate."

AGENT: "Hmmm, never seen so many different Polish names in one place since the last Bobby Vinton concert I attended."

PRINCIPAL: "We've always had a proud tradition of . . . ."
AGENT: “Don’t suppose the percentage of Poles in the school is roughly equivalent to the percentage in the community?”

PRINCIPAL: “Oh, boy. But what about the very high comparative percentage of black students?”

MODERATOR: “Unfortunately, the principal, in his enthusiasm to demonstrate a strong racial policy with respect to blacks, has raised serious questions with regard to possible ethnic discrimination. Don’t misunderstand me. A strong racial policy is very important. But a weak ethnic policy can cause serious problems and even lead to revocation of exemption. This is particularly true if a school prefers enrollment from among a particular ethnic category whether by tradition or for any other reason. If the percentage of ethnic enrollment in the school indicates a clear preference for a specific ethnic category of student, the school has, in effect, a “reverse discrimination” policy with respect to other ethnic categories and is in jeopardy of losing its exempt status. At a minimum, the school will be placed in a defensive posture and the agents love that type of situation.”

AGENT: “By the way, now that I think about it, I don’t remember seeing a single faculty member in the yearbook who wasn’t white. As a matter of fact, the only black on your entire staff is on the maintenance crew.”

PRINCIPAL: “Well—uh—as far as our teachers are concerned, we’ve tried to attract blacks and other ethnic groups to our school, but they can obtain positions in the local public school system where the financial advantages are far greater than we can offer.”

AGENT: “Well, that makes sense. I would like to see a financial statement for the year ending December 31, 1977.”

PRINCIPAL: “Gee, I’m not sure we have one. Besides, I thought IRS had to notify a church in the event that it intended to examine any of its financial records.”

AGENT: “Oops, sorry about that. I didn’t realize you were claiming to be a church.”

MODERATOR: “I wouldn’t gloat if I were the principal. At least not yet. As a general rule, where the church-related school is not a separate legal entity, the IRS examination is limited to determining compliance with the racial nondiscrimination requirements, as we mentioned a little earlier. However, if the agent identifies other problems, such as unrelated business income, the scope of the examination may be extended to cover these areas.

Section 7605(c) of the Internal Revenue Code severely limits the authority of IRS to examine the books of a church. Generally, an IRS agent may examine the books and financial records of a church only if a Regional Commissioner has reason to believe that the church is carrying on an unrelated trade or business and, acting on this belief, notifies the organization in advance of the examination. The authority of IRS to examine the religious activities of a church is limited to the determination of whether the organization is, in fact, a church. The authority to examine books of a church is limited to determining the amount of any unrelated business income tax.
As far as we can tell, IRS does not feel itself confined within the limitations I've just mentioned. During private school examinations, the Service will generally limit its examination to determining compliance with the racial nondiscrimination requirements of Rev. Proc. 75-50, especially if the school is not a separate legal entity as in our case. However, in the Manual Supplement issued by the Service in May of last year, there is a directive to examining agents to expand their audit coverage into any area in which the agent identifies a problem.

Without belaboring the point, it suffices to say that whenever an agent strays from the racial discrimination issue, you should immediately contact your tax advisor, since he may wish to limit responses and perhaps require a formal demand, or even a subpoena, for any additional information. At a minimum, the agent should be requested to comply with the advance notification procedures set forth in the Internal Revenue Manual.

Now, we're going to assume at this point that the question of unrelated business income has been brought to the attention of the Regional Commissioner through a "squealer" letter sent by a follower of the Universal Satanic Brotherhood and that the agent has complied with all the advance notification requirements prescribed in Section 7605(c)."

AGENT: "I noticed some of the cars in the parking lot had "Bo Diddley College" decals on their bumpers. Aren't they located on the other side of town?"

PRINCIPAL: "Yes, they are, but due to space limitations, they rent class space in one of our buildings for several of their classes. Now, you can't tell me we've got a problem here."

AGENT: "Well, do you own the building outright?"

PRINCIPAL: "Well, we are the sole owners if that's what you mean, although we had a difficult time borrowing the funds to complete the purchase."

AGENT: "Oh—then there's a mortgage on the property?"

PRINCIPAL: "Well, you don't really think we have half a million dollars lying around in petty cash for that type of acquisition, do you?"

MODERATOR: "Better brace yourself, Brother, because here it comes." (Agent barely able to contain himself with glee)

AGENT: "Well, rental income from real property is generally exempt from the unrelated business income tax, as are other types of "passive" income such as interest, dividends, and royalties. The reason for this is that the income does not result from the active involvement of a tax exempt organization in unrelated activities in order to produce such income. However, the Tax Reform Act of 1969 added section 514 to the Code, and now rental income from real property is subjected to the unrelated business tax to the extent of any acquisition indebtedness on that property. For example, if an exempt organization borrows half of the cost of the building, half of any rental income it derives will be subject to tax. Of course, as the debt is gradually liquidated, the proportion of rental income subject to tax will be similarly reduced.
I'm afraid we're going to have to take a look at your books and records and establish how much of your rental income from Bo Diddley College is subject to tax and, while we're at it, I'd like to see records for the past three years indicating the racial composition of your student body, faculty, and administrative staff for each academic year. I also would like to see evidence that scholarships and other financial assistance are awarded on a racially nondiscriminatory basis.

PRINCIPAL: "Wait a minute. I've had just enough of this; all that information is somewhere down in the basement of the rectory, and I don't have time to get it right now. I've got more important things to do."

MODERATOR: "I think it should be clear that the quickest way for an examination to go sour is by adopting a hostile or belligerent attitude toward the agent. As I pointed out, you should be cooperative and friendly while refraining from doing the agent's work for him. On the other hand, what about this?"

AGENT: "Now, I'm going to ask you one more time for your financial statements, and if you don't turn them over to me right now, I'm going to make your life miserable—and you can believe I'll be back next year, and the year after that . . . ."

PRINCIPAL: "I really think you're being unreasonable on this point since we had no way of knowing in advance you would want this information. You have to first request it in writing. I'd like to talk to your supervisor. What did you say his name was?"

MODERATOR: "Well, our principal is now on the right track. Arbitrary and unreasonable conduct on the part of the IRS agent, although unusual, need not and should not be tolerated. Although we suggest this as an extreme measure, and one you should not resort to except in unusual circumstances, this step generally has immediate effect."

AGENT: "You're right, I'm sorry. By the way, I see here in your parish bulletin a reference to 'this month's raffle?'"

PRINCIPAL: "That's right, and for just $2, you might win a brand new Rolls Kinardly."

AGENT: "Well—gee—never heard of that make, Rolls Kinardly?"

PRINCIPAL: "Sure—it rolls down one hill but can hardly get up the next."

(Unbridled hysterical laughter.)

AGENT: "Well, I'm afraid I should point out to you that sponsoring a monthly raffle in order to raise funds is an activity unrelated to your religious and educational purposes. The unrelated business tax applied to a business activity which is 'regularly carried on,' as distinguished from commercial transactions which are sporadic or infrequent. A number of examples indicating the intended scope of the term 'regularly carried on' may cause a problem here. For example, a business is not regularly carried on by an exempt organization that gives an occasional social dance to which the public is admitted for a charge and for which an orchestra and entertainers are hired. Further, an exempt organization that operates a
sandwich booth during the week of an annual county fair is not engaged in a business which is regularly carried on. As far as your parking lot is concerned, there would be no liability for the unrelated business income tax if you only charged for parking one day each week.

Now, activities that are conducted on an intermittent basis will ordinarily not be considered to be regularly carried on if they are pursued without the competitive and promotional efforts typical of comparable commercial affairs. Fund raising activities carried on only for a short period of time each year will not be considered regularly carried on just because they are conducted on an annually recurrent basis. Once again, income derived from the conduct of, say, an annual dance or similar fund-raising event for you would not be deriving income from a trade or business regularly carried on.”

MODERATOR: “Sounds to me like the agent knows his unrelated business law cold.

To summarize, in determining whether or not an activity that is conducted intermittently may be ‘regularly carried on,’ the manner of conduct of the activities is compared with the manner in which commercial activities are normally pursued by nonexempt organizations. In general, exempt organization business activities that are engaged in only periodically will not be considered regularly carried on if they are conducted without the competitive and promotional effort typical of commercial endeavors. For example, the publication of advertising and programs for sports events or music or drama performances will ordinarily not be deemed to be the regular carrying on of a business. Similarly, where an organization sells certain types of goods or services to a particular class of persons in pursuance of its exempt functions, as in the case of a church rosary shop, the sales in the course of such activity which would not qualify as related to the exempt function will not be treated as regularly carried on so long as they are casual in nature.

On the other hand, where the nonqualifying sales are not merely casual, but are systematically and consistently promoted and carried on by the organization, it will trigger the unrelated business tax provisions.”

AGENT: “I also noted that your yearbook has a pretty good amount of advertising in it. Do you mind telling me how these businesses are selected?”

PRINCIPAL: “Oh, well, we certainly don’t do any solicitation. I believe we have some outside people promote the yearbook.”

MODERATOR: “Well, our principal just can’t keep from volunteering potentially damaging information. Although the sale of advertising for an annual yearbook might, under appropriate circumstances, be exempt from unrelated business taxation because it is not ‘regularly carried on,’ it has been held that income derived by an exempt organization from the sale of advertising in its annual yearbook is unrelated business taxable income where an independent commercial firm under a contract covering a full calendar year conducted an intensive advertising solicitation campaign in
the organization's name and was paid a percentage of the gross advertising receipts for selling the advertising, collecting from advertisers, and printing the yearbook."

AGENT: "Oh well, we'll leave that for some future examination—yuk, yuk, yuk. Getting back to your car raffle, I also noticed that you have bingo games every Tuesday night. I suppose bingo somehow promotes religious or educational purposes."

PRINCIPAL: "Oh, no, now we're really in trouble. And to think all along we've been engaging in unrelated business activities. Our volunteers will be crushed."

AGENT: (Looks surprised) "You mean the people who work your raffle and bingo games donate their time and services? That sheds a new light on the whole situation. Revenue Ruling 59-330 provides that bingo games conducted on a semiweekly basis by a tax exempt organization constitutes the carrying on of a trade or business which is unrelated to the basis of its exemption. However, in a recent Revenue Ruling, we held that if the majority of individuals who run the bingo games donate their services, then the games will not constitute an unrelated trade or business.

I might point out that in this whole area of fund raising, there is an exception from unrelated business tax on any trade or business involving the sale of merchandise, substantially all of which has been received by an organization as gifts or contributions. By the way, I noticed that you're paying Social Security tax on your teachers' wages. The Internal Revenue Code excludes services performed for tax-exempt organizations from the definition of 'employment' for purposes of FICA tax. Therefore, salaries paid by a school for services performed by teachers functioning as employees are not subject to FICA taxes."

PRINCIPAL: "Well, if you check a little further you will find that these teachers joined with us in waiving our tax-exempt status for Social Security tax purposes several years ago."

AGENT: "Oops, sorry about that. You're absolutely right."

MODERATOR: "Once again, our principal is smugly sailing into unfamiliar waters. Let's hope he can swim.

A 1976 amendment to the Internal Revenue Code provides that payment of Social Security taxes by a nonprofit organization on behalf of its employees constitutes constructive filing of the certificate otherwise required to provide initial Social Security for these employees. The taxes imposed by the Social Security Act are those that have been paid with respect to the compensation paid by a school to its employees during any period of not less than three consecutive calendar quarters. The waiver of exempt status with respect to Social Security taxes has no effect whatsoever on the school's exempt status under other provisions of the Code pertaining to income, estate, gift, and excise taxes."

AGENT: "In addition to Social Security, do you offer any type of retirement plan for your teachers and other staff?"

PRINCIPAL: "What kind of plan would you suggest?"
MIDERATOR: "Needless to say, this is hardly the time or the place for seeking tax advice. Consultation with regard to pension plans is something that should be sought from counsel or a specialist in ERISA."

AGENT: "Well, you can adopt any plan you want which would be available to commercial entities. Of course, you would want the plan to qualify for exemption under section 401(a) of the Code. I'd like to recommend a deferred annuity described in section 403(b) of the Code."

PRINCIPAL: "Oh, yes, of course, a 403 deferred annuity. Could you elaborate just a bit?"

AGENT: "I would be delighted! Just a little background first. The so-called tax sheltered annuity or TSA could provide an attractive alternative to a qualified pension plan, which also enjoys certain tax benefits. The TSA is more flexible than a qualified plan, however, in several important respects. First, there are no coverage requirements under a TSA as there are with qualified plans, and an employer can therefore offer tax-sheltered annuities to employees on a selective basis. Second, there is no rule prescribing discrimination (no pun intended) in the amount of contributions in corresponding benefits under a TSA as is found in the case of qualified plans. This permits the amount of employee contributions to a TSA (versus, for instance, current compensation) to be tailored to fit an individual employee's situation. The interesting point here is that tax-sheltered annuity treatment is available only with respect to contributions by certain qualified employers.

Only section 501(c)(3) organizations and public educational institutions are qualified employers. An organization described in section 501(c)(3) of the Code which is exempt from tax under section 501(a) is a qualified employer. Therefore, any tax-exempt charitable, religious, educational, or other section 501(c)(3) organizations can establish a TSA for its eligible employees, and this includes your school.

Look for my bill a little later on in the week."

MIDERATOR: "Unfortunately, although the agent's advice on tax sheltered annuities may be helpful to the school in attracting qualified teachers to its staff, no mention has been made to the 'church plan,' which is in the unique position of being able to opt out of ERISA altogether. For all of the hundreds and thousands of corporations and partnerships which had adopted one or another form of qualified pension plan prior to 1974, there was the enormous task of restructuring their plans to conform with the new minimum requirements and standards of ERISA. Church plans were granted the privilege of staying where they were under the pre-ERISA existing rules, which defined certain requirements pertaining to many of the same subjects now covered by the new law. For example, vesting and coverage provisions were dealt with in a broad, somewhat vague sense under the nondiscrimination rules that pervaded the original statute when it was enacted in 1942.

The important point is that a church plan is not subject to numerous new provisions that are otherwise applicable to pension plans. For exam-
ple, the minimum participation standard is one of the things that a church plan is free not to adopt. Another one is that plan benefits may not decrease upon an increase in the Social Security limits. This new requirement is nonapplicable to church plans that choose not to be covered by the new law.

Keep in mind that the kinds of minimum provisions that the new law imposes would probably be provisions that institutions like churches would consider providing their employees. Clearly, the purpose of a pension plan would not be to deny suitable pension benefits to employees, and that is essentially what ERISA is all about. Don’t misunderstand me, I’m not suggesting that a church plan would choose to deny these benefits of ERISA to employees. The problem has been adjusting to ERISA and bringing these employees into its scope.

Another point is that the election by a church plan whether or not to take ERISA and all of its complicated regulations is an ‘all or nothing’ proposition. If the election is made, you wind up with the whole ball of wax. You are not permitted to choose some rules under which you will be regulated but not certain others that you don’t happen to like. And, again, this type of decision is hardly one to be reached during the course of an IRS audit, since the agent in all likelihood is not a pension expert.

Now, let’s get back to our audit and see if the principal can limit the school’s exposure in this area of employment taxes."

PRINCIPAL: “I’d like to point out that we also pay Federal Unemployment Taxes on behalf of our teachers.”

AGENT: “Are you serious? Didn’t you know that services performed by employees of tax-exempt schools are not subject to the Federal Unemployment Tax regardless of the amount of compensation attributable to such services?”

PRINCIPAL: “Well, I thought we had waived our exemption from these taxes just as we had with regard to the FICA taxes.”

AGENT: “Oh, no. Since there is no procedure or reason for waiving the exemption from the Federal Unemployment Taxes as in the case of the FICA tax, you should give serious consideration to requesting a refund of any FUTA taxes that you’ve paid in the past.”

PRINCIPAL: “Wow! That’s terrific. I’ve just changed my mind about where we will be having lunch today. Do you like French cuisine? I’ll cancel our reservations at McDonalds.”

AGENT: “McDonalds? Well—of—by the way, in the lobby on one of the bulletin boards, I noticed a poster advertising Al Szymanski for City Council. I also noticed several students with Szymanski buttons on their jackets. Sure looks like he’s the front runner in this school.”

PRINCIPAL: “You better believe it. His opponent is in favor of unlimited access to abortions and state funding of planned parenthood programs. What an appalling prospect! We’ve got to do everything we can to make sure Szymanski’s opponent is not elected to the Council.”

AGENT: (Grimacing while looking somewhat sympathetic) “Gee, I
know how you feel, but from the tax point of view, you might want to at least consider taking the posters down since your exempt status is in jeopardy. Not on account of anything I might do, but some other agent might get wind of your support for Szymanski and bring it to the attention of my supervisor. And at that point, my hands would be tied."

PRINCIPAL: "What are you talking about? Don't you realize how important it is to make sure he gets elected?"

AGENT: "Well, let me try to explain why there may be a problem here. Back in 1934, Congress added to the Revenue laws the requirement that no substantial part of the activities of an exempt organization can consist of carrying on propaganda or otherwise attempting to influence legislation. Further, an exempt organization such as your school may not participate to any extent in a political campaign on behalf of any candidate for public office. Unlike the prohibition against substantial legislative activities, the ban for involvement in campaigns of political candidates is absolute. There simply is no de minimus amount of involvement in these campaigns that you can engage in without the threat of losing your tax-exempt classification."

PRINCIPAL: "Well, isn't there some kind of election we can make to be certain that we are not overstepping the permissible boundaries for legislative activities?"

AGENT: "Well, the 1976 Tax Reform Act provided an alternative limitation on political expenditures by certain organizations described in section 501(c)(3), which permits expenditures up to specified amounts and penalizes any excesses. In order to take advantage of this alternative, a qualified organization must elect to be governed by it. However, the election is available to any organization described in section 501(c)(3) except churches, conventions or associations of churches, integrated auxiliaries, and several other categories of exempt organizations. Since it is my understanding you claim to be a church, you would be precluded from electing the lobbying ceilings set forth in the Code."

MODERATOR: "Sounds to me like the agent is giving our principal some pretty good information at this point.

One point to keep in mind: It was church groups that asked Congress specifically to exclude them from the application and availability of the 'safe haven' lobbying rules. The purpose was to preserve the integrity of their constitutional argument that the federal government cannot regulate their legislative activities on first amendment grounds. So, from the purely technical standpoint, legislative activities of churches must be considered within the framework of the 'insubstantial' test set forth in section 501(c)(3) of the Code."

PRINCIPAL: "Thanks for the information. But it sure is going to be difficult getting some of the parents of our students to understand why we don't take a more active role in the upcoming election. It's especially difficult in that some of our parents make sizable contributions to us, and we really can't afford to lose their support."
AGENT: “Is that right? What would you say is the average contribution by these parents?”

PRINCIPAL: “Well—just between you and me—we have an arrangement whereby a parent can make a contribution of $500 and we knock $200 off of the tuition charge for the child. I’m really not sure why we do this. As I recall, a representative of the ‘father-son club’ approached us with the idea several years ago. Since it didn’t seem to pose any threat to the income tax status of the school, we went along with it.”

AGENT: “Well—very, very interesting. You are right. There is nothing wrong with the tuition remission program insofar as the school’s tax status is concerned. However, I’m willing to bet that the parents are taking a full deduction for each contribution on their individual income tax returns.”

PRINCIPAL: “What’s wrong with that?”

AGENT: “Ordinarily, nothing—so long as it is a ‘no strings’ contribution. That is to say, the parent expects nothing in return for the gift. However, in your situation, each parent is being relieved of a portion of the normal tuition charge he would otherwise have to pay in full, and this clearly qualifies the entire contribution. Do you happen to have a list of your most recent contributors?”

PRINCIPAL: “I’ll see if I can find it for you and mail it a little later on this week.”

MODERATOR: “The point here is that an IRS agent will sometimes use the examination of a tax-exempt organization as a springboard to examine the personal income tax returns of individuals somehow associated with the organization. If the principal had counsel present with him during the audit, it is very unlikely the agent would have been tipped off to the tuition remission scheme. Special tax counsel, whether lawyers or CPA’s, are generally attuned to the various audit approaches IRS agents use to uncover hidden revenue issues that do not pertain specifically to the nature or category of the taxpayer officially under audit. Remember again: Don’t do the agent’s work for him.”

PRINCIPAL: “Now, how about lunch? Couldn’t you use a little fresh air?”

AGENT: “Well, it’s getting a little late in the day, and I have another appointment this afternoon, so if it’s all right with you, I’d like to postpone our session until tomorrow morning. Okay?”

PRINCIPAL: “It sure is okay, and I feel like praying anyway. Would you mind if I have our tax adviser sit in from here on out?”

AGENT: “Fine, I’ll see you tomorrow.”

MODERATOR: “I think our principal has learned his lesson.”

With regard to this whole area of racially nondiscriminatory admissions policy, the Service has stated that it will attempt to avoid applying any mechanical rules, since this is an area that requires a judgment based on all the facts and circumstances of a particular situation. Therefore, where the history of a school and the surrounding facts and circumstances
indicate that the school has a racially nondiscriminatory admissions policy revocation of such school's exemption under Rev. Proc. 75-50 is fairly unlikely. For minor transgressions, the Service will probably give the school an opportunity to take corrective action to conform to the particular requirement of the Rev. Proc. For example, if information obtained in a private school examination demonstrates that a school, by reason of its racial constituency or other facts, practices a racially nondiscriminatory admissions policy, except that its brochures don't contain a statement concerning that policy, the school will be told to revise the brochures to include the statement. In cases where private schools agree to take corrective action to conform to Rev. Proc. 75-50, the examining agent will prepare a no change letter, advising the organization of the nature of the corrective action that it has agreed to take.

Mandatory follow-up procedures have been instituted in the IRS key districts to certify that corrective action has in fact been taken. The follow-up action could be another examination, or it might simply involve contacting the school and soliciting certain information. For example, in the situation involving the brochure, the Service will be satisfied with receipt of the brochure containing the missing statement.

Where a school will not agree to take corrective action necessary to comply with Rev. Proc. 75-50, revocation of exemption will certainly be considered by IRS. However, at least in the early stages, it is my suggestion that a school at least take a shot at technical advice from the IRS National Office so that the matter can be reviewed at a higher level. I will explain about technical advice a little later.

I want to make the point that corrective action will not be the approach used by IRS where revocation is appropriate. Corrective action applies only where all the facts and circumstances indicate that the school practices a racially nondiscriminatory policy notwithstanding that a particular requirement of the Rev. Proc. may not have been met. However, if, after completion of the agent's examination and all administrative appeal procedures, the facts and circumstances show that the school does actually practice racial discrimination, exemption will be revoked even though the school may agree to change its policy and practice in the future. For example, if it is found that a school has, in fact, rejected qualified applicants for submission solely on the basis of their racial or ethnic background, then exemption will be revoked for the years in which the violations occurred. This is true notwithstanding that the school agrees to take steps to change its racially nondiscriminatory policy in the future. If the school's exemption is revoked, it may, of course, reapply for recognition of exemption after it has taken the necessary corrective action.

Now, in conclusion, we expect the onslaught of IRS private school audits to commence in earnest this summer. We've looked briefly into the typical conduct of an IRS audit and what you can expect as the agent reviews the activities and even the financial data to determine whether or not the school's operations are consistent with the Revenue laws applying to tax-exempt organizations.
Some of the points we have mentioned and I would like to reiterate are that an agent is always first going to look to see whether or not the school discriminates in its admissions policy on the basis of race or ethnic origin. Remember that a church-related school and the church that controls it will be denied exempt status if the school does not have a racially nondiscriminatory policy. The school must not discriminate on the basis of race in administration of educational policies, admissions policies, scholarship and loan programs, and athletic and other school-administered programs. The school may select students on the basis of membership in a religious denomination if membership in the denomination is open on a racially nondiscriminatory basis. As far as organizational requirements are concerned, the governing instrument of a school or resolution as to racially nondiscriminatory policy is mandatory. There must be a statement of policy in brochures, catalogs, and advertising for students. The nondiscriminatory policy must be published to all segments of the general community served by the school and all facilities and scholarships, and loan programs must be operated on a racially nondiscriminatory basis. There is a certification requirement whereby the school must annually certify, under penalties of perjury, that it has satisfied the applicable requirements of sections 4.01 through 4.05 of Rev. Proc. 75-50. This certification is made at the time for filing Form 990 by all schools required to file Form 990. There is a special certification form, Form 5578, for private schools not required to file Form 990.

A little reminder: Church-related schools which are part of the church, and this would be parochial diocesan schools, such as the one in our mock audit, are not required to file Form 990. Separately incorporated schools, below college level, are also not required to file Form 990. College level schools that are religious schools, such as seminaries, are exempt from filing Form 990, but any others whose primary activity is educational, or of some nature other than religious, that would serve as an independent basis for exemption under section 501(c)(3) would be required to file Form 990. The initial certification has to be made for the first calendar fiscal year accounting period beginning after December 31, 1975, and is to be filed with IRS on or before the 15th day of the fifth month following the close of the accounting period. There must be an absence of racial discrimination in employment of faculty and administrative staff. A failure to comply with any of these criteria will result in revocation.

With regard to the recordkeeping requirements spelled out in the Rev. Proc., records must be kept for a minimum of three years regarding facts on nondiscrimination. Failure to maintain and produce the required records and information creates the presumption of failure to comply with the Rev. Proc. guidelines.

Oftentimes the agent will use the racial discrimination examination of a school as a springboard to other areas, some of which include contributions to the school and the deductions taken by persons outside the school. He will also be interested in employment tax liabilities of the hospital. Another point of interest will be the income tax liabilities of individuals
associated with the school. This, of course, means indirect methods of compensating employees through the use of any fringe benefits. Unrelated business income will always be a source of interest.

After the agent has completed his basic examination, he may want to discuss informally with school representatives the issues with respect to which he is considering setting up an income tax deficiency. It is often possible, as a result of this conference, to talk the agent out of proceeding further by providing him with a legal memorandum dealing with the issues he has raised, since the auditing agent more often than not is really interested in settling any disagreements with the school that grow out of his examination without recourse to higher authority. Now, if the school agrees to any sort of settlement (other than a "no change"), it will be required to execute Form 870 or Form 4549. This form waives the right of the school to receive a statutory notice of deficiency, which otherwise must precede an assessment of a deficiency in income tax.

An agreement reached by the school and the Revenue agent is reviewed by the Review Group of the key District Director's Audit Division. If the agreement is approved, the matter generally is concluded on that basis, although the year is not technically barred from reexamination until the statute of limitations for assessment has expired (and this is ordinarily three years from the filing of the return).

If after the preliminary conference, the agent persists in proposing adjustments to which you are not inclined to agree, you should carefully examine the issues involved. You should make a determination whether one or more of these issues present problems of law on which there is no clear statement of policy in the rulings and regulations of the IRS. At this point, it should be noted that the agent is required to follow the policies the IRS has set forth in the rulings, regulations, and manuals it has published regardless of the fact that there may be court decisions indicating a contrary position.

Because of the nature of the disagreement between the school and the agent, it may be advisable to request "technical" advice from the IRS National Office. Technical advice is the opportunity to state your version of the facts and circumstances and to brief the issues of law. The request should be made while the audit is still pending at the District Director level, at which time it generally is granted. However, if you wait until the case has moved to the appellate level, "technical advice" from the National Office is available only if the appellate division agrees to request it and, in this event, you will not be entitled to a conference or hearing at the National Office.

If any issues remain in dispute between the school and the agent after one or more conferences, the agent will prepare a written report, a copy of which is sent to the school together with the 30-day letter and information as to rights of appeal. I might mention that IRS has proposed regulations that would eliminate the district level conference at the present time, and, therefore, these guidelines may be modified. If the school does not respond within thirty days, a statutory notice of deficiency will be issued by the
key District Director. This is the so-called “90-day letter.” At that point, the school has ninety days within which to file a petition with the United States Tax Court for a redetermination of the deficiency. If the school does not file a petition with the Tax Court, the tax will be assessed. If the school wishes to appeal, it must submit a written protest to the key District Director within thirty days from the date of the “30-day letter.” The protest generally includes full and detailed statement of facts and law in support of the school’s position.

Alternatively, the school may waive its rights to a district office conference and proceed directly to the appellate level in the office of the ARC. This point might be academic if the proposed regulations I mentioned are adopted. Attorneys and CPA’s often recommend this approach since the appellate conferee can settle the case on the basis of the hazards of litigation. Generally, the district office cannot do so. Upon receipt of the school’s protest and request for a regional office conference, the key District Director will review the protest, and if he maintains his position, forward the request and the case to the Assistant Regional Commissioner, who will contact the school regarding conference rights.

After receiving a 30-day letter, the school may decide to pay the tax and then protest the assessment by filing a claim for refund or credit for all or any part of the amount paid in the U.S. Court of Claims or federal district court for the jurisdiction in which the school is located. A claim for refund or credit is generally made by filing an appropriate amended return with the IRS service center to which the original return was sent.

In conclusion, now is the time for the school’s tax adviser to carefully consider its tax situation. The “learning curve” concept applies to schools, in that the first contact with IRS will be the most significant in terms of future IRS contact and follow up. The adviser should attempt to analyze whether there are any serious tax problems and take whatever remedial action is necessary before the IRS comes in and begins dictating the terms. The fact that unilateral remedial steps are taken prior to IRS contact establishes a strong element of good faith which has a generally favorable impact on the agent.

As I mentioned at the outset, the various IRS programs for private school audits insure the periodic examination for compliance review of every school. Unless the time is taken to analyze potential problems, corrective action will be taken pursuant to IRS direction, and it is certainly going to cost more in the long run than if such steps are taken before they come in.