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VOW OF POVERTY RULING

JACK MYERS

The Vow of Poverty Ruling is one of those cases where the Internal Revenue Service in its infinite wisdom found out that it was wrong for 56 years and changed the rules accordingly. What are the religious trying to do through their combined groups to deal with this situation? We have an immediate problem which I would like to discuss at the outset. Tax returns are due on April 15 for the members of the religious order who would be covered by this change, whatever the change is. George and Father Whelan, when they submitted their brief, specifically called attention to the problem of compliance and requested that, whatever happened, the ruling be made prospective from January 1, 1978. As George has indicated, that has not happened. We jointly went back to the Internal Revenue Service and, after a conference, submitted a specific request that the ruling be prospective only from January 1, 1978. If that is approved, then hopefully virtually all of the immediate problems will be postponed until this year. However, it has been nearly two months since the written request was submitted. There is no indication of difficulty. The only problem which we anticipate is whether the ruling is to be prospective as of August 15, the date it was filed, or as of January 1, 1978.

Those of you who are working with religious may have gotten the bulletins which the LCWR and the CMSM have been sending out. In the last bulletin, we suggested that religious who would come under the purview of this change obtain an automatic extension of time to file their tax returns until June 15. Hopefully, we will obtain a determination from the Internal Revenue Service within the next month. We expect it will be prospective from January 1, but it could be prospective from August 15.

This raises all kinds of interesting questions as to what kind of income will be treated as taxable. We are assuming that most religious, although they have never filed a return before and, therefore, could file a return on a fiscal year basis, will be filing a return on a calendar year basis.

I might just mention one important point. The rulings, particularly the 1976 ruling, make it clear that the religious are entitled to a deduction for the contributions of cash they are making to the order. Because they are under vows of poverty and obedience and are acting as agents of the order, if they are taxable on the earnings, they should get a deduction for the contribution of the earnings. Both George and I feel that the deduction should be for 50 percent, assuming that we are talking about cash income, which I assume we always are. Fifty percent would be the normal deduction, so there would be a reduction in the tax. We have also recommended

that those religious who are subject to tax, and therefore subject to withholding, should file a special Form W-4 to take advantage of the fact that they will have a significant charitable contribution. This will reduce the withholding.

We do not know how many Internal Revenue Service agents are now trying to collect taxes from religious, but some are attempting to do this retroactively. An Internal Revenue Service ruling on the prospective application of the 1977 ruling should go a long way toward eliminating this issue.

What then is the meaning of Revenue Ruling 77-290 read in conjunction with other prior rulings, Revenue Ruling 76-323 and the nurse ruling in 1968 (Revenue Ruling 68-123)? Unfortunately, these do not provide a clear or rational idea of what the Service has in mind. In one ruling, the Internal Revenue Service emphasized "agency" and necessity of a contract between the order and the entity which is actually employing a member. In the other ruling, the Internal Revenue Service seems to realize that this cannot be carried to its logical extreme. If there is an "agency," all of the income would be excluded from taxation, regardless of its nature. The 1968 Revenue Ruling with respect to a nurse religious, working in a private non-Catholic hospital, is still in effect. Thus, the nature of the service and, perhaps, the characteristics of the entity to which the services are rendered are important.

For the religious orders, we have taken a fairly strong position—but one based on a reasonable interpretation of the Internal Revenue Service rulings. Just a word of caution before I discuss what we believe to be the tax status of income earned by religious outside the order itself. All of the rulings point out that, if the member of the order is not taxed on the income generated, a second question must be faced with respect to the income thus "earned" by the order rather than its member. Was the income generated by an activity related to the exempt purposes of the order? If the activity pursued by the member which gave rise to the income did not contribute importantly to the carrying out of the religious, charitable, and other exempt purposes of the order, it has received unrelated trade or business income which is subject to Federal taxation.

At the outset of the discussion of the tax status of earnings of religious, we would call attention to one aspect of the facts set forth in both the 1976 and 1977 rulings. The clear implication is that the activities, particularly those considered taxable, are carried on solely to earn money for the order. A second, and very important, comment is that Revenue Ruling 68-123, holding that a nurse religious is not taxable on earnings from a private nonprofit hospital, is still in full force and effect. It is specifically recertified in the 1976 ruling, and the 1976 ruling is "clarified" by the 1977 ruling, with the "clarification" making no mention of Revenue Ruling 68-123. If a nurse can work in a hospital without the income earned being taxed to her, we believe that logically the same ruling must apply to a member of an order with a mission of education who works in an educational institution. In our opinion, many important decisions in this area have yet to be

made by the Internal Revenue Service. We feel that many issues are clearly open for discussion. In the interim, we have adopted George's original position. This was that, if a member of a religious order under vows of poverty, obedience, and chastity is carrying on an activity which is in furtherance of the exempt purposes of the order, and which is consistent with his or her vocation, the income received by the member is not taxable to the member provided the activity is carried on within a charitable framework. For the purpose of this test, we define a charity as being a 501(c)(3) entity under the Internal Revenue Code or a public entity which is carrying on a 501(c)(3) activity. An example of a charitable setting would be a nonprofit educational institution or a hospital, private or public.

We hope to test these issues with the Internal Revenue Service in an orderly fashion which puts our contention in the best possible light. If we must appeal to the Internal Revenue Service National Office, we might begin with a nurse working in a private hospital, placing reliance on Revenue Ruling 68-123, which the Service continues to recognize as valid. We may be forced to take up another area where we think the religious under vows of poverty and obedience should not be taxed on income regardless of the employer, namely, the rendering of purely religious services, such as acting as a chaplain anywhere or as a religious advisor in a drug rehabilitation center.

It should be recognized that the procedural mechanics are such that the Internal Revenue Service has the final say on rulings and technical advice memoranda which determine the outcome of audits. Revenue Ruling 77-290 clarifies Revenue Ruling 76-323 and "supersedes" Office Decision 119. That leaves some force to the O.D. Added to this is the clear recognition by the Internal Revenue Service of the continued validity of Revenue Ruling 68-123 which, based on the O.D., held a member of a religious order under vows of obedience and poverty not taxable on income paid her for services rendered to a private nonprofit hospital. The rulings read together *seem* to say:

1. Income from service outside the order but within the church will not attract a tax on the member (e.g., a religious working as a secretary for a parish priest);
2. Income from service outside the order and the church for the principal purpose of providing funds for the order is taxable to the member (e.g., a plumber, construction worker, or lawyer);
3. Income from service outside the order and the church may not be taxable (e.g., a member of a religious order whose mission includes providing care to the sick);
4. For income earned by an order member to escape taxation to the member, he or she must be acting as an "agent" (but, presumably, even if he or she is an agent, the tax would attach if the service is performed merely to produce income for the order).

It is not at all clear what is meant by "agent," although the concept was utilized in the original 1919 ruling. We believe that members of religious orders who are under vows of poverty, obedience, and chastity would

normally be agents of the order in rendering services outside the order because of the nature of those vows. We further believe that the 1968 ruling with respect to a religious serving as a nurse in a private nonprofit hospital, when read in conjunction with the 1976 and 1977 rulings, can only mean that the nature of the services rendered is an especially important factor. If they carry out the religious mission of the order and are consistent with the vocation of the member, income earned should not be taxed to the member, provided the services are carried on at the direction of the order or a superior in the order. This should be presumed if the member is under vows of poverty, obedience, and chastity as applied in the Catholic Church. We believe that, where the member is serving in any capacity in an Internal Revenue Service-recognized charitable, religious, educational, or similar organization defined in IRC section 501(c)(3), the activity should be presumed to be consistent with an order's mission and a member's vocation. The same presumption should apply if the entity to which the service is rendered is the governmental counterpart of a 501(c)(3) entity and, as indicated above, the services rendered are primarily religious.

We, of course, will be working very closely with George and Father Whelan as we go ahead and try to develop this approach. Just as a side-light, I personally do not believe that this problem has its origin in the activities of any member of an order of the Catholic Church. The problem has developed out of Internal Revenue Service difficulties with the emerging new "churches." Some of these new churches have discovered the 1919 ruling. They have tax counselors who are writing vows of poverty and obedience for the members with the aim of avoiding taxes on membership earnings whatever their nature.

Before I conclude, I would like to review several matters which George touched upon at the outset. Obtaining the extension is crucial. If we do not have it before June 15, we are going to have to face filing returns for a significant number of members of religious orders. In addition, we must worry about the problem of exposure to payment of taxes at a later date if our construction is wholly or partially rejected. The orders should put aside a reserve to make sure that, if the Internal Revenue Service does not agree with us, either in part or in whole, they are prepared to pay the amounts of taxes which will be assessed against their members. In our bulletins, we have provided some suggestions in this regard.

George mentioned social security and withholding. If you read Revenue Ruling 77-290, you will find cited both the social security and the withholding statutes. Both appear to exclude from their purview religious under vows of poverty and obedience. We have reason to believe that some social security officials disagree with the Internal Revenue Service and, if so, we hope they say so.

We also have the problem of state taxation. Fortunately, in most of the states, except the District of Columbia, there are tax statutes which "piggyback" the federal law. But religious do have a problem of getting a separate extension of time to file. We have mentioned the problem of unrelated trade or business, which should always be kept in mind.

I will close with a comment on litigation and legislation. I do not believe that either can provide a satisfactory solution. I am satisfied that this is not the appropriate time to seek legislative relief. Although litigation may be inevitable, it may be unrewarding, even if successful. This is because the Internal Revenue Service can and does ignore unfavorable decisions.

QUESTIONS

TO

GEORGE REED, FATHER WHELAN AND JACK MYERS

Q. Father, I am Kevin Kennedy from Buffalo. I would like to ask you a question. Seven or eight years ago, Fordham University came under the provisions of the Bundy Act and changed its corporate structure so that lay people now control the University and it is no longer a "Catholic" university. How does that affect the tax treatment of salaries of Jesuits teaching at Fordham?

A. Well, as George mentioned, in the text of Revenue Ruling 77-290 there is a phrase "or an associated institution," an agency of the supervising church or an associated institution. That phrase "associated institution" was put in there explicitly to take care of the colleges and universities like Fordham and Georgetown. George and I discussed that matter at that meeting with Treasury and IRS. We raised the problem that you are talking about. Here, Fordham says to the attorney general and the Board of Education and Regents of the State of New York that they are not under the control of any church in whole or in part. Having said that, they qualify for the Bundy money. Well, Treasury is taking a more realistic view of the situation and has said that Catholic identification in the public mind, and an identification of an institution by membership in the National Catholic Education Association, the Jesuit Association, etc., is enough of a connection with the Church as far as Treasury is concerned.

Q. I wonder if that would take care of a situation that took place in our law office some years ago, when a sister who was taking law came to the office and was working one summer. A large part of our business is for Catholic institutions. Would that take care of that?

A. I do not know.

Jack: Taking the arbitrary position, and we have taken the arbitrary position, fairly far along in favor of the exemption, I would say that service is clearly indicated with her working for a private law firm just takes it completely out of the exemption. That is, in essence, what they said for the priest who was working for a private law firm.

Q. This question is directed at George or anyone else who may have knowledge of section 170. A comment was made that the deduction for the sister or religious who was subject to tax should be eligible for a 50% of adjusted gross income contribution if all the money is turned in to the order. Now, assuming the order is not an educational institution, but just a plain old nonprofit civil corporation to run the business affairs of the

religious community, what provision of section 170, in your judgment, qualifies that member for a 50% limitation, rather than 20% or some other limitation?

A. The law is very limited with respect to charities that qualify for the 50% limitations. All of the institutions, of course, within the structure of the Church are considered to be public charities.

Q. We have found out that the Christian Brothers are not part of the Church for certain purposes.

A. Well, for certain purposes they are not, but they would still be considered public charities.

Q. So you are relying on subsection (s), that it is a member of a church or association?

A. A publicly supported organization is a public charity also. There are about four or five categories.

Q. But very few of the religious orders would get more than 50% of their support from the public?

A. That is true. But, for example, ever since the 1956 regulations came out, IRS has treated religious orders as churches for section 170 purposes.

Q. Is there a specific ruling that when it overrules an old ruling, the overruling is prospective in nature only? Could we cite that?

A. There are revenue procedures and a regulation on which this whole situation is predicated. I think I set them forth in the bulletin that went out sometime in August. The reaction of IRS was that this Rev. Proc. and the regulation, in conjunction with the 1944 ruling, "tied their hands." In short, the relevant regulations preclude IRS from giving a retroactive effect to religious not exempted by Rev. Rul. 77-290. IRS asserted that the ruling would be prospective. There is a general doctrine of law that, where the Service has published a ruling, and the O.D. is a published ruling, individuals have a right to rely on that until the Service reverses it. There was a case, recently, just last week, in which the court invoked that doctrine indirectly. Secondly, you have got two bases in the Internal Revenue Service: One, if it is a published ruling, then there is in the procedures a suggestion that ordinarily the Service should give that ruling prospective effect only. And then, even stronger in the regulations and procedures, where somebody, a taxpayer, has had a ruling, a private-letter ruling, from the Internal Revenue Service, he has a right to rely on that until the Service gives him notice to the contrary. Your 1944 ruling from the Internal Revenue Service was to the National Catholic Welfare Conference, acting for all the member orders, so each member order has a private ruling from the Internal Revenue Service in which they were told that this was not taxable, and they have a right to rely on it. That is why George said their hands are practically tied.

Q. I am John Connor from the Diocese of Columbus, Ohio. The Dominican Sisters have set up a separate corporation aside from the order to take in federal funds to pay salaries, because if they show the expense of the salaries they get more federal money. Would that be an associated

corporation, even though they operate out of two different corporations? I am not sure whether the second corporation is controlled by them, I know their order is. They have a separate corporation that takes federal funds and also some people who can afford to pay for nursing care, and, of course, it is all done within the purpose of the exempt organization. Then they pay salaries, and the salaries are contributed back by the sisters, the nurses that go out into the homes. Would they be associated?

A. It sounds like St. Vincent's Hospital. To me, that would clearly be an association. But I know of a situation where an order of brothers has set up a corporation which is purposely labeled as nonsectarian and where the charter and the bylaws do not vest control in the brother order. I think that that would be beyond the pale of the associated institution.

Q. Is it listed in the Directory?

A. I do not think the separate corporation is listed in the Directory, although the order is, and everything furthers the purpose of the order to provide nursing care. IRS has frequently taken the position, and we have not even referred to this, that a legitimate activity, a natural activity of an organization, does not have to be listed in the Directory in order to be considered exempt.

Q. I think this corporation is purely for bookkeeping purposes so they can keep it separate from the order, and the funds separate from the other funds. It is purely for bookkeeping, and it is all in furtherance of their exempt purposes to care for people in their homes outside hospitals, such as people who cannot afford institutional care.

A. I cannot give you much rationale for the '43 ruling; maybe George can. The '44 ruling is a private-letter ruling from the Internal Revenue Service to the Conference. Nothing public about that. That basically confirms O.D. 119, which goes back to 1919, and says in two paragraphs that a member of the religious under a vow of poverty is not taxable because he is acting as an agent. Let us state again that he is taxable on individual income received by him. In 1976 there were two rulings. One I did not mention was on unrelated trade or business. And the other, 76-323, was a ruling that if there was a religious working in construction activity, and a person working as a plumber, just to raise money for the order, income earned was to be taxable. That, in effect, seems to completely revoke the O.D. without so stating. It also specifically referred to the '68 ruling we have been talking about, which dealt with a nurse in a private hospital and said that she was not taxable. That is where you stood in '76. In '77, after these gentlemen had gotten together with the Treasury and the Service, you had the '77 ruling, the one we are working with now, 77-290. As I read it, that gives you two examples. A member of an order who is working in what would appear to be a nonreligious activity, namely, acting as a secretary, but within the Church, would be covered by the O.D. and still not be subject to taxation. The second example was the priest who was assigned to work in a private law firm. There were no further facts, and they say he is taxable. Then IRS cites the statute and regulations, and that is about it.