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Tax Exemptions of Private Schools - The Impact of Internal Revenue Service Proposals on the Catholic School System

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TAX EXEMPTIONS OF PRIVATE SCHOOLS — THE IMPACT OF INTERNAL REVENUE SERVICE PROPOSALS ON THE CATHOLIC SCHOOL SYSTEM

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On February 9, 1979, the Internal Revenue Service issued a revision of its proposed revenue procedure dealing with the determination of whether tax-exempt private schools operate on a racially nondiscriminatory basis. These actions relate to church-sponsored schools as well as other nonpublic schools. The Internal Revenue Service solicited public comments on the new, revised proposals by April 20, 1979.

This represents another step in a continuing major controversy: whether the Service should undertake to deny tax exemptions and charitable contribution deductions on the ground that private schools discriminate in their operations against racial minorities. The House Ways and Means Oversight Subcommittee held public hearings on this subject on February 21 and 22, 1979, and issued a report in April of 1979; the Subcommittee on Taxation and Debt Management of the Senate Finance Committee held a public hearing in April of 1979. Legislation dealing with the issue is a distinct possibility. There is a real question whether action by Congress would best serve the interests of the Catholic Church or the country in general.

The issue has provoked a bitter debate, the Service having allegedly received almost 200,000 separate items of correspondence, far more than any other issue has generated in the history of the Service. The mail has run heavily against any action by the IRS in the area, without apparent recognition by many that the IRS has already been deeply involved,

though on a less intrusive basis, since 1970. The Service is probably committed by court actions to some involvement in the matter. The issue is an unusually interesting one, involving as it does substantial elements of the first amendment right to the free exercise of religion.

The Catholic Church, through the U.S. Catholic Conference, has deliberately taken a low pressure, lawyer-like approach and has had significant success in having the special problems of our parochial school system reflected in the revised, proposed action of the Service. The following effort to trace the development of the issue will lead to suggestions whereby the impact in the parochial school system can be made even less burdensome, as indeed it should, given the Church's strong and uncompromising policy against any racial discrimination in its schools as a matter of fundamental Christian conviction.

PRIOR INTERNAL REVENUE SERVICE ACTIONS

In 1970, the Internal Revenue Service announced for the first time that it would no longer recognize the tax exempt status of, or allow deductions for charitable donations to, any private school practicing racial discrimination in its admission and operating policies. The policy was announced in the midst of vigorous litigation to enjoin the Service from according tax exempt status to racially discriminatory private schools in Mississippi, which clearly had been organized as an alternative to integrated public schools. It is significant that this is the genesis of this entire, ongoing controversy — primarily, efforts other than by church-related schools to avoid the effects of court ordered desegregation plans in the public schools. The question remains, however, whether the Service action should properly extend to religious schools as well, with possible infringement upon sincerely held religious beliefs which may not conform to federal public policy.

In any event, the Internal Revenue Service originally adopted a fairly reasonable position. The Service announced that it would ignore the past and give every school the opportunity to wipe the slate clean and make a new start by adopting and giving reasonable notice to the public of a nondiscriminatory admissions policy. The Service would thereafter conduct field examinations to insure good faith compliance by the schools adopting such policies.

The Service required submission by the schools of various data — racial breakdowns of student population and applicants for admission, the disposition of available scholarship and loan funds, racial composition of faculty and administrative staffs, information as to the schools' incorporators, founders, board members and donors and their identification, if any, with organizations supporting segregated school education, and other such information.

The Service's position was thereafter largely approved, in the litigation then pending, by a three judge federal court in *Green v. Connally*[1] and by the Supreme Court which affirmed that decision without opinion.

In Rev. Rul. 71-447, the Service set forth the basis for its position. The Service reasoned that whether exempt as organized and operated exclusively for religious, charitable, or educational purposes, an organization to be exempt under 501(c)(3) had to meet common law concepts of "charity." Under the common law of charitable trusts, organizations, educational or otherwise, could not have a purpose that was illegal or contrary to public policy. The Service found a strong federal public policy against racial discrimination in *Brown v. Board of Education*,[2] the 1954 Supreme Court decision outlawing segregation in public schools, in the Civil Rights Act of 1964,[3] and in many other federal statutes and cases.

The question arose whether the Service's policy extended to church-sponsored schools and, if so, whether it violated the constitutional guarantee of free exercise of religion. In Rev. Rul. 75-231, the Service made it clear that its position did extend to such schools, reasoning that all non-public schools had to be treated alike for federal tax exemption purposes. The Service ruled that there was no first amendment violation because the provision of such education, while induced by religious belief, was not inherently itself religious belief, and that in any event, there are limitations on actions induced by religious belief which violate federal public policy, such as polygamy or the use of drugs.

In Rev. Proc. 75-50, the Service restated and developed its essential policy that all exempt private schools must in fact operate in a bona fide racially nondiscriminatory manner and must communicate their policy effectively to the community they serve. Extensive obligations were imposed upon schools to supply information to the Service and to maintain various records bearing upon their nondiscriminatory policies.

On March 10, 1976, the U.S. Catholic Conference obtained a very important private ruling from the Service with respect to the application of Rev. Proc. 75-50 to Catholic schools. The Service ruled that the procedures whereby the diocesan administrative officers enforced the Church's nondiscrimination policy for Catholic schools in each diocese were acceptable. The publication of the nondiscrimination policy in diocesan newspapers and parish bulletins was ruled to be adequate except for schools in inner city areas with substantial minority enrollment. The Service also explicitly recognized that inasmuch as many faculty members were members of religious orders, it was not appropriate to look to the number of minority faculty and staff members in parochial school systems. Instead,

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[1] 330 F. Supp. 1150 (D.D.C.), *aff'd mem.*, 404 U.S. 997 (1971).
[2] 349 U.S. 294 (1954).
[3] 42 U.S.C. §§ 1981 to 2000h-6 (1976).

the relevant inquiry was whether membership in those orders was open on a nondiscriminatory basis.

COMMENCEMENT OF THE CURRENT CONTROVERSY

Meanwhile, the plaintiffs in *Green v. Connally*, the original litigation, were dissatisfied with the results of the Service's efforts because in their view tax exemption was not being denied rapidly enough to schools which they asserted were practicing discrimination. They commenced new litigation, and in September, 1978, the plaintiffs and the government agreed to suspend the litigation pending settlement discussions. The Service's first proposed revenue procedure, issued on August 22, 1978, was in response to those settlement discussions and gave rise to the current, bitter controversy.

The Service's original proposed revenue procedure was very mechanistic in its application. A school which either had been adjudicated to be discriminatory or was a so-called "reviewable school" would lose its tax exemption unless it could prove it operated on a nondiscriminatory basis. This could be proved only by demonstrating either (1) actual enrollment of minority students of at least twenty percent of the percentage of minority school age population in the community, or (2) the existence of four out of five objective factors designed to show good faith operation to achieve nondiscrimination. Further, it was provided that only in rare and unusual circumstances would a school be considered to be operated in good faith on a nondiscriminatory basis if it does not in fact enroll some minority students. In tax terms, "rare and unusual circumstances" means virtually "never."

A school would be a "reviewable school" if it was formed or substantially expanded at or about the time of desegregation of public schools and if the percentage of minority students was less than twenty percent of the percentage of minority age school population in the community served by the school. The "time of desegregation of public schools" for this purpose was a period which extended from one year *before* implementation of a public school desegregation plan in the community (whether court-ordered or voluntary) until 3 years *after* final implementation of such desegregation plan (or modificatons thereof). Obviously, for many communities this might be an open-ended period which could never end; desegregation proponents would continue to seek court-ordered modifications in the local plan.

If more than one minority group were the object of the adjudication or desegregation plan, the appropriate percentage of minority students was to be determined separately — blacks and Hispanics, for example. Thus, a high percentage of Hispanics in the school would not justify an absence of blacks.

The critical term "community" served by the school was defined, with minor exceptions, as the public school district within which the private school was located. The revenue procedure contained a cryptic sentence that where a number of schools in different locations are operated by the same organization, "community" was to be defined separately for each school. No indication was given, however, as to how this would be done.

The five objective factors, four of which had to be shown to evidence operation in good faith on a nondiscriminatory basis, were as follows:

1. Provision of scholarships or other financial aid to minorities on a significant basis.
2. Vigorous recruitment programs directed at minority students.
3. An increasing percentage of minority enrollment.
4. Employment of minority teachers or professional staff.
5. Other efforts, such as more extensive advertising of a nondiscriminatory admissions policy than was required by Rev. Proc. 75-50, significant efforts to recruit minority teachers, participation with integrated schools in sports, music, or other programs, making school facilities available to outside integrated groups, minority-oriented curriculum or programs, minority participation in the founding of the school, or current minority board members.

The proposed revenue procedure was explicitly made applicable to church-related and church-operated schools.

U.S. CATHOLIC CONFERENCE OBJECTIONS TO REVENUE PROCEDURE

The storm of protest built up rapidly following issuance of this proposed revenue procedure. In its written statement of October 19, 1978, and at the public hearing on December 5, 1978, the U.S. Catholic Conference emphasized the very significant enrollment of minority students in Catholic schools in general, particularly in urban areas. The extensive policy of the Church in most dioceses to *prohibit* admission of students fleeing from desegregation actions in public schools was emphasized. While not directly attacking the authority of the Service to deny exemption to church-related schools on segregation grounds, the U.S. Catholic Conference vigorously attacked the effects the proposed revenue procedure would have on Catholic schools.

Thus, the U.S.C.C. attacked the prima facie presumption of discrimination based on the absence of a specified percentage of minority students. The reference to the school being established or expanded during the period of a desegregation plan in the public schools would often be a meaningless limitation because, as already indicated, this could well be an open-ended period. Furthermore, of critical importance, the definition of "community" made it virtually impossible for many Catholic schools to meet the required quota of minority students and thus avoid the pre-

sumption of discrimination. By equating "community" with the public school district, a Catholic school would not be judged by the community which it in fact served. This would be particularly absurd in some major cities, such as Los Angeles, in which a single public school district encompasses the entire city.

Further, such a comparison would completely overlook the religious preferences of minority families. A parish school should be evaluated by reference to the number of minority *Catholic* families in the community it serves, not total minority families. Perhaps of greater importance, the procedure would have ignored the first amendment right of church-related schools to prefer members of their own religion. Parochial schools should not be prejudiced to any extent because they prefer Catholics (without regard to race) in Catholic school admissions irrespective of the percentage of minority families in the area served by such schools.

The net result of the proposed revenue procedure was that many Catholic schools would automatically have become "reviewable schools." As a result, they would automatically have been presumptively discriminatory because of the absence of the required percentage of minority students, even though they clearly were not formed or operated with any degree of discriminatory purpose. The five factors which could be used to rebut the prima facie case of discrimination were completely inappropriate to Catholic schools. Usually there would be little in the way of scholarship aid to minorities or anyone else. An increasing percentage of minority enrollment might never occur even though there was absolutely no discriminaton; recruitment efforts would tend to be directed at Catholics, regardless of race, rather than at minorities as such; it might well be impossible to employ minority teachers or staff, particularly where members of religious orders make up the faculty; and minority participation in the founding or management of the school might never be feasible.

The U.S. Catholic Conference presentation made a significant impression on the Service. U.S.C.C. representatives were thereafter invited to a meeting with Commissioner Kurtz and his principal advisers, and a thorough analysis of the Catholic school system and exchange of views occurred.

REVISED PROPOSED REVENUE PROCEDURE

As stated at the outset, the Service issued a completely revised revenue procedure on February 9, 1979. The Service attempted, not too successfully, to get away from the mechanistic approach of its earlier proposal and to give more weight to the particular facts of each school.

Under the revision, a school is a reviewable school only if, in addition to formation or expansion during a period of public school desegregation in the community and the absence of a significant minority enrollment,

its creation or expansion was related *in fact* to public school desegregation in the community. Curiously, however, the proposal then provides that, ordinarily, formation or expansion at a time of public school desegregation in the community *will be considered to be* related in fact to that desegregation. Thus, an additional test is added but then largely neutralized by a presumption that says ordinarily it will be deemed to be satisfied. The school may rebut the presumption by showing that its formation or expansion was not related in fact to the public school desegregation.

This latter showing may be made by demonstrating that the school's enrollment is not drawn from the public school grades subject to desegregation, that the expansion is not greater than expansion in years prior to the public school desegregation, that the expansion is due to an increase in school age population of the community, that the expansion results from the merger of private schools, neither of which is otherwise a reviewable school, or that the expansion is attributable to adding grade levels as the enrollment advances. Of greater significance to the Catholic school system, the showing also may be made by demonstrating that the school was formed or expanded in accordance with a long-standing practice of a religion or religious denomination which is not itself discriminatory. This would occur where the religious denomination provides schools for religious education when circumstances make it practical to do so, such as a sufficient number of persons of that religious belief in the community to support the school, and there is no purpose to exclude minorities. This factor obviously was almost directly tailored to the ordinary case of creation or expansion of a parish school.

Notwithstanding this more discreet approach, the presumption might still exist, requiring the Catholic school to make the showing in rebuttal. This could impose substantial administrative burdens on many Catholic schools. The Service attempted to reduce this burden by also adopting a so-called systems provision that had been suggested by the U.S.C.C. representatives in the meeting with Commissioner Kurtz.

As stated earlier, a school is a reviewable school only if its percentage of minority students is less than twenty percent of the percentage of minority school age population in the community served by the school. Thus, if fifty percent of the school age population in the community is minority, a school is not reviewable if it has at least ten percent minority enrollment (that is, 20 percent x 50 percent). The revised revenue procedure provides, in effect, that a school is not a reviewable school if it is part of a *system* of commonly supervised schools in the community and (1) the system in the aggregate meets the test; (2) the separate schools in the system serve designated geographical areas based on considerations other than race; and (3) there is no evidence that the system is operated to achieve discrimination.

EFFECT OF REVISED PROPOSED REVENUE PROCEDURE ON CATHOLIC SCHOOLS

The revised, proposed procedure would have far less impact on the Catholic school system than the earlier version, but the burden would not be completely eliminated. In testimony before the Subcommittee on Oversight of the House Ways and Means Committee on February 21, 1979, George Reed criticized the residual presumption of discrimination and pointed out the burdens on Catholic schools of rebutting a presumption which, in the case of the Catholic school system, obviously seems wrong *ab initio*. It was suggested that the Service should be required to make a finding based on evidence that the creation or expansion of the school was related to the public school desegregation before imposing any burden of rebuttal on the school.

The U.S. Catholic Conference testimony also criticized the factors which may be used to rebut the presumption as possibly involving first amendment violations. A religious school cannot be made subject to forfeitures, such as loss of tax exemption, for failure to actively recruit students or teachers who are not members of the religion sponsoring the school. Similarly, pressure cannot be applied to cause a Catholic school to adopt a minority-oriented curriculum or other program.

The U.S.C.C. testimony also criticized the provisions requiring separate testing for different minority groups where the public school desegregation plan has reference to more than one distinct minority group. This could create severe problems in inner city areas with substantial Hispanic and black groups; even the systems rule could fail to carve individual schools out of the reviewable school category.

The U.S.C.C. testimony concluded with a strong recommendation for legislation requiring advance publication in proposed form and opportunity for public comment wherever proposed agency actions would affect a broad class of 501(c)(3) organizations. While that was done voluntarily by the Service in the case of these two proposed revenue procedures, frequently it is not done. Such a process would avoid much difficulty and inequity, as is evident from the improvements in the revised revenue procedure in the present case as compared to the August, 1978 version.

There was some criticism of the Service in the public hearings before the Oversight Subcommittee for making special provisions for the Catholic and Jewish school systems. This could intensify in the upcoming public hearings of the Senate Finance Committee. The systems test and the special consideration for church schools formed or expanded pursuant to long-standing practices of the religious denominaton *should be strongly defended* at all costs. They are absolutely necessary to minimize the burdens of the proposed Service action on Catholic schools and they are entirely justified by, and in accordance with, the objectives of the Service

and its regulatory authority.

THE CONSTITUTIONAL QUESTION — FREE EXERCISE OF RELIGION

The question remains whether the Service has authority, in the first instance, to deny tax exemptions or charitable contribution deductions because a school has a discriminatory admission policy. A more discreet question is whether the Service's action would violate the constitutional guarantee of free exercise of religion in the case of church-sponsored schools.

Court decisions have split on the question whether the Service is right in reading into all of 501(c)(3) the law of charitable trusts forbidding purposes which would violate public policy. If the organization is exempt as "religious" or "educational," as opposed to "charitable," is it subject to such a limitation dealing with "charities?" It seems more likely that the Service's position will be upheld in this respect. A further question is whether the tax exemption or charitable contribution deduction operates to frustrate public policy against discrimination; the district court in the recent *Bob Jones University*[4] case held that the connection is too remote. Here again, it seems more likely the Service's position will eventually be upheld. Some will argue that tax exemption for churches and church-sponsored schools is itself a first amendment right which permits free exercise of religion and cannot constitutionally be denied. Others argue that if a racially discriminatory admissions policy is based upon a sincerely held religious belief, the Service's action violates the free exercise clause. They also argue that it violates the constitutional provision prohibiting the establishment of religion because it would prefer (through tax exemption) those religions which conform to those secular purposes reflected in federal public policy.

It seems more likely than not that the Supreme Court would reject these positions. The Court has held on several occasions in the past that a secular legislative purpose is constitutional and may be enforced by Congress even though it is contrary to the beliefs of a particular religion so long as its principal effect is neither to enhance nor inhibit religion and it serves to avoid excessive entanglement with religion. There is a legitimate secular purpose in denying tax-exempt status to schools maintaining a racially discriminatory admissions policy. Since it operates across-the-board to *all* tax-exempt schools, whether or not religious schools, and evenly with respect to religious schools of all religious denominations, it neither enhances nor inhibits religion. It avoids governmental entanglement; any other policy would require determinations as to whether discriminatory admissions policies of religious schools were attributable to

[4] Bob Jones Univ. v. United States, 468 F. Supp. 890 (D.S.C. 1978).

sincerely held religious beliefs, as opposed to secular motivations.

Indeed, an argument can be made that the denial of tax exemption to racially discriminatory religious schools is *constitutionally required* if exemption is to be denied on that basis to nonchurch private schools. Some would read the Supreme Court's decision in *Walz v. Tax Commission*[5] as justifying tax exemptions and charitable contributions deductions in the case of religious schools only because they are part of a broader class of nonprofit, charitably oriented groups so treated under the Internal Revenue Code. Such persons argue that these tax benefits are in reality indirect subsidies which can be justified under the first amendment prohibition on establishment of religion only because religion and religious schools do not receive special benefits, but rather the same benefits which go to this broader class of nonprofit organizations. Under this line of reasoning, it is unconstitutional to allow benefits to religious schools with discriminatory admissions policies if such tax benefits are denied to other tax-exempt schools with such policies.

I do not read the *Walz* case so broadly. Nonetheless, the argument, which is made by eminent constitutional law authorities, points up the extremely sensitive nature of the tax benefits which are at issue in this current controversy.

RISKS OF CONGRESSIONAL INVOLVEMENT IN THE ISSUE

It is this very constitutional sensitivity that leads me to conclude that the interests of the Catholic Church might be better served by congressional abstinence of efforts to deal with this issue. The Internal Revenue Service has made some reasonable accommodations to the special problems of religious schools. The great virtue in IRS handling of a policy issue lies in the flexibility with which solutions can be devised and even quickly changed if they do not work well.

In its revised form, the revenue procedure will have a very limited impact, in actual practice, on Catholic schools. The "systems" provision and the special factor for religious schools organized pursuant to long-standing practices are signals to field offices of the Internal Revenue Service that religious schools ordinarily are deemed not to discriminate in their admissions policies.

There is always the risk that the relatively inflexible and politically charged legislative process would devise a highly complex solution, such as the provisions dealing with private foundations or unrelated business income. While it is highly likely that there would be provisions to insure continuation of tax exemptions and charitable deductions for religious schools of denominations which have nondiscrimination policies, they

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[5] 397 U.S. 664 (1970).

could become buried in a maze of complex rules. There is also always a risk that extensive reporting and information gathering would be required, with the attendant costly administrative burdens that are thereby required.

Even worse, there is the risk that acrimonious controversy over special treatment of religious schools by Congress would open up new constitutional issues as to the tax exemption and charitable contributions deduction. The law is well settled that these provisions, in their present setting, are constitutional. We are best advised not to provoke constant, new challenges to this treatment. A reexamination of the constitutional issues on the ground that religious schools may discriminate on the basis of race or color without limitation is hardly a comfortable framework. Bad cases make bad law. The Catholic Church has no interest in preserving a right to discriminate on this basis; we believe such discrimination is morally wrong in all events.

CONCLUSION

I submit that the Catholic Church is best served by continued low-key, lawyer-like exchanges with the Internal Revenue Service and Treasury Department to insure that the unique problems of our school systems are adequately recognized. The U.S. Catholic Conference has been very effective in these efforts, and there is no occasion to quarrel with this success.

QUESTIONS TO GEORGE REED

Q. Tom Dupre, Diocese of Ogdensburg, New York: In my area, we have very little minority population. My question is, what does the principal of a school do when an auditor walks to the door? Do you let them in, do you show them the door, or what? Is there a national policy on this problem?

A. Mr. Reed: We have taken the position that if a church is going to be audited, then it will be necessary for the IRS to go through the procedure set forth in section 7605(c). That particular procedure sets forth limitations on the manner in which an audit of a church may be conducted. Now the big question is, is the school a part of the church? Initially, I think you could take the position that it is. At least there is a basis for doing so. That is the policy which we recommend and it has worked quite well. Sometimes an appeal might be necessary. We have not had much difficulty, however, when we have relied on it. Ordinarily, under these circumstances, there would have to be a decision by the head of the regional office in order to authorize this audit.

Q. Mr. Dupre: You mean I should advise my bishop that he shouldn't let anybody into the school unless they have this regional authority?

A. Mr. Reed: Yes, I think that's the advice we would give. For example, if you have a situation, there may be exceptions, depending on the type of situation you have and the purpose of the audit and so forth. But, basically, that is our recommendation. It is somewhat unusual in tax administration to require that an action be approved as at high a level as the regional commissioner and therefore this is somewhat of a safeguard against arbitrary action. I think you will find, as a practical matter, that a regional commissioner will be reluctant to authorize an audit of that nature unless he is personally convinced that there is a real problem in these investigations.

Q. Paul McMahon: I think a wrong impression may have been given in that answer because the audit we get refers only to the financial aspects. A 501(c)(3) investigation for compliance does not require that notice. The agent can notify the school that he's coming in for 501(c)(3) compliance and he does not have to have the regional commissioner's letter.

A. Mr. Reed: I know you went through that procedure, Paul. Did you contend that it was necessary to get clearance from the regional director?

Q. Mr. McMahon: Only when it came to the financial aspects. When he wanted to find the financial aspects I invoked the church feature and claimed that the school was a church. He then went to the regional commissioner for the letter and obtained it.

A. Mr. Reed: I appreciate your distinction. I know that that's how the limitation originally arose. It was in the context of examination of books of account and things like that. Nevertheless, I do know as a matter of practice some have taken a broader position and have been successful in that. I will grant, Paul, that this is a point which ultimately must be resolved by the Service.

Q. Mr. McMahon: As long as the current revenue procedures remain in proposed form they have no legal effect, and what does have effect are the 1970 and 1975 actions and the thrust of those actions is publication to the community of nondiscriminatory admissions policies. Pursuant to a ruling which the U.S.C.C. obtained it is ordinarily enough that that publication occur through diocesan newspapers and parish bulletins. Therefore, if there has been that kind of publication, then in the absence of some clear indication of actual discrimination in practice, there is compliance with those earlier rulings which are still the applicable regulations here.

A. Mr. Reed: John has just called to my attention, Paul, that the current manual states that if the school claims that it's a church, then it can rely upon that regulation with respect to clearance from the regional director. If anybody wishes, we can give you the relevant citation to the manual.