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REPORT ON TAX AND LITIGATION DEVELOPMENTS

GEORGE E. REED, ESQUIRE

Your letters and telephone calls definitely portray concern regarding the impact of the tax law during the last 10 years. There is no doubt that churches and charitable institutions progressively have been affected by rulings and regulations during the last decade. Each year gives rise to new issues which demonstrate the rapid evolution of our tax law and its impact on tax-exempt organizations. Ironically, tax exemption has now developed into a basis for social and institutional control. As stated in a recent article in the *Washington Star*, where once it was felt that tax exemption, not only of schools, but of churches, museums, and other charitable institutions, reflected the view that certain areas of private discretion can and should flourish without governmental hindrance, there is an increasing tendency to regard tax exemption as a privilege—a privilege to be enjoyed on the government's terms, even if taxation was never before contemplated.

I think that sums up the situation which has confronted us during the last 10 years. Now, I will consider a few of the rules and regulations with which we have been faced. Some of them have been resolved, others will continue to present problems. In 1976, Revenue Ruling 76-323, in effect, eliminated the tax exemption accorded to the religious who took a vow of poverty and obedience. In 1977, we secured another ruling which enabled us to retrieve seventy-five percent of the loss sustained in 1976. Ever since then, there has been a series of conferences with the Internal Revenue Service (IRS). Primarily we are there as advisors. Cases constantly are coming up. Last week, we had a very interesting development. The Chief Counsel of the IRS requested a meeting on this subject. Our tax advisory committee met with the Chief Counsel, his deputy, the Assistant Commissioner on Technical, and others. It was very interesting. They obviously were concerned that they possibly had gone too far in trying to take a completely negative position with respect to religious orders. They now are conducting a complete review of the vow of poverty situation. I do not know what the result will be, but we now have a basis

for hope.

In 1977, the IRS published the "integrated auxiliary" regulation after 7 years of negotiation. The only thing salvaged was an exemption for parochial schools. In 1978, there was a report at our annual meeting on voter education and a report to you on the revenue procedures for minority enrollment. We will probably hear more about the minority enrollment within a year or two. At the present time, however, there is no activity because of an amendment to the Treasury Appropriations Bill which states that the IRS may not implement the minority enrollment revenue procedure. I have been informed that even though this Dornan Amendment will expire in October of this year, nothing will be done until after the election, because, politically, the situation is too controversial. I am sure, however, that an amendment containing somewhat different language will be introduced after the election. This will allow the IRS to deprive an organization of its tax-exempt status once there has been an adverse adjudication, but not before.

This year, we were confronted with a disturbing regulation in another area—Revenue Ruling 79-99. This has caused considerable concern. The critical facts set forth in the ruling pertain to a section 5013(c) church-related organization, which operated a religious school. No tuition was charged. It was supported by contributions from various churches, from parents who had children in the school, from members of these churches without children in this school, and from interested parties. The money received by this institution was placed, without designation, in a general operating fund. The funds were solicited on the basis of what a person could afford to give, rather than on a *per capita* basis. I am going into detail because in all these rulings, every fact is critical. The IRS cannot move outside of the factual structure which it sets up in a ruling. On the basis of these facts, the IRS asserted the right to determine the market value of the education. Then, having determined the market value of the education, the Service disallowed the contributions to the extent that those contributions equalled the market value of the tuition. In other words, if the market value of the tuition was \$700 and the parent contributed \$1,000, there would be a disallowance of \$700. The parent would be allowed a deduction of \$300. Obviously, this generated a great deal of concern among us and among others. On the heels of this ruling, an auditor in Houston challenged the parents who sent their children to a Lutheran school which charged no tuition—all contributions were made to the church. The money was used for the support of the church and the school. The auditor tentatively disallowed most of the contributions and then asked for technical advice from the national office. There was a conference between the representatives of the Lutheran church and the IRS. Frankly, we did not know anything about it until 2 weeks later. We were told by the Lutherans, who filed a very fine brief, that the IRS took a

completely negative view and said they definitely would enforce Revenue Ruling 79-99 against the Lutherans and continue with the disallowance of the deduction. We then contacted the IRS and officials there said not to worry about the ruling because it did not affect our schools because they charge tuition. It should be noted, however, that some of our schools do not charge tuition. In any event, we did not like the principle. Thus, we joined forces with the Lutherans and challenged the position of the IRS. We formally asked that the entire ruling be withdrawn. We did not hear from them, and, in the meantime, legislation was introduced to rectify the situation. Simultaneously, we knew there were certain civil rights organizations in the wings which would endeavor to secure restrictive amendments. Then, we met with our tax advisory committee and worked out an arrangement for administrative relief, which would have resulted in a new ruling. After this session, we met with the representatives of CAPE, an organization composed of nonprofit organizations which operate private schools. Working with them, we met again with the Treasury. It was a very successful meeting. We already had prepared a ruling with a number of models. I will read from one of the models:

While taxpayer's children attend a school X, operated by church X in the furtherance of its religious mission, children of parents who are not members are enrolled in the school. Church X receives contributions from all of its members who support its activities. Contributions received are placed in the general operating funds of the church and are expended when needed to support the various activities of the school. The church has full control over the use of the contributions which it received. Parents who have children enrolled in the school are required to pay \$300 tuition for each child enrolled. The taxpayer paid \$300 tuition for his child, and then as a member of the church made periodic offerings amounting to about \$200.

We took the position that under these facts, which adequately characterized our situation, there should be no disallowance of the deduction. In the next model, school Y operated by church Y does not charge tuition. The taxpayer paid \$200 to church Y. Again, we took the position that there should be no disallowance of the \$200. Finally, another factual situation which we have met frequently is where the school operated by the church required the payment of \$300 tuition for children of parents who are not members of the church, but did not charge tuition for children with parents who are members of the church. Taxpayer member of church Z paid \$200 to church Z for support. These three situations I just have set forth were the subject of negotiation with the Treasury. The Treasury agreed that in these three situations, it would rule in our favor. As a matter of fact, it was going to rule favorably right after the negotiations, but we had a controversy over situation four, which reflected Revenue Ruling 79-99:

Organization *W* operates a private school, solicits contributions from parents with students during periods other than the periods of school solicitation for students and the period when applications are pending. Solicitation materials indicate that parents of students have been singled out as a class. Solicitation, and the solicitation materials include a report of the organization's cost per student to operate the school. Enrollment in school is not contingent upon a contribution to organization *W*.

This is the one which caused the Treasury considerable difficulty. At the latest, 10 days ago, I was told that the Treasury had agreed to go along with the three models set forth, namely five, six, and seven, which reflect the parochial school situation as we understand it. They still remain concerned with model number four. We have encountered, it seems, some last-ditch opposition from the IRS. With the Treasury, we are all clear. The Treasury does set policy and this has risen to the level of a policy situation. The Treasury knows and the IRS should know, but does not really care, that we are going to support the legislation in the event that they do not arrive at a satisfactory resolution of this issue. We are ready. We agreed to hold back for several months to give them an opportunity to arrive at an appropriate administrative resolution.

That is where we are now, but even if we win, the issue will still remain in some respects. For example, if there is earmarking, regardless of how we resolve this issue, contributions will be disallowed. It is not a deductible contribution if it is earmarked—it is tuition. There are several variations of this. Personally, I do not think that we can control this situation. I think the only ones who really can control the situation are the Diocesan Attorneys working in conjunction with the Superintendent of Education and the Chancery Office. It is not just the IRS. There are at least three circuit court decisions on these issues upon which the IRS relies. The essence of these decisions is that we no longer use the subjective test, that is, the intention of the donor. On the contrary, the IRS relies on the offset test—the objective test. If, objectively, my contribution has a direct or indirect result in reducing the tuition which I have to pay, then my contribution is subject to disallowance. There are at least three circuit court opinions to that effect.

We will keep you informed, but as I say, we could win this across the board and your schools could lose if they indulge in a variation of earmarking. That is one aspect of the situation that has caused us trouble. Here is another. You know we have our group ruling which has worked well since 1946. Now we have the computer era. You know what computers can do. I will give you an example of the type of situation confronting us. A letter sent from the IRS to a diocese stated: "We have changed your name, you are now the United States Catholic Conference, Diocese of so and so," and another letter stating "we have changed your name, you are now the United States Catholic Conference, Society of

Jesus." You should see the letters we are receiving: why are you changing our name? This is coming from all over. Every time someone submits a 941, they get the response—we have changed your name. We have been negotiating with the IRS on this issue for at least 2 months. On May 7, I received the following letter:

This is in response to your letter and subsequent telephone conversations concerning incorrect preprinted forms which include the United States Catholic Conference as addressee. We are advising our service centers to utilize specific instructions for the name listings of organizations under the USCC. These measures should prevent the issuance of incorrect names on future labels. In the interim, for those subordinates which have already received forms with incorrect pre-addressed labels, we suggest that you have those organizations draw a line through the incorrect portion and enter their correct legal name before returning the form. If any of these organizations have questions regarding the label, please have them contact an appropriate exempt organization processing service center.

We will send a copy of this letter to everyone. Until it is received, tell your clients to cross the name out, insert the correct name, and return it.

This resolves one IRS problem. Another relates to Revenue Ruling 79-132. I will not discuss it in detail, but it demonstrates how the IRS will publish a ruling and then fail to adhere to it. Revenue Ruling 79-290 stated categorically that any religious person working within the structure of the Church was exempt from taxation. Then, without any notice, the IRS published Revenue Ruling 79-132, which subjected all military chaplains to taxation. We never had an opportunity to comment. Accordingly, we wrote to the IRS and to the Treasury. This resulted in a joint conference with the Treasury and the IRS. We said that we have additional facts. We have an eight page document from Rome, setting forth the facts relating to the Military Vicariate, subject to the Military Ordinariate, Cardinal Cooke. The Vicariate has a regular chancery office and an Ordinary. We had the Assistant Chancellor at the conference. He explained the continuing control which the Military Ordinariate has over all chaplains. He demonstrated that they are the agents of the Church and that the Vicariate is part of the structure of the Church.

After 3 months, we received a letter indicating that the IRS was not going to change its opinion. Accordingly, we said we could not accept that without some rationale. The last we heard was that the IRS was going to completely review the conference as well as their last decision.

One case I should call to your attention is *Surinach v. Pesquera de Busquets*.¹ Puerto Rico enacted a law giving the Secretary of Consumer Statistics broad investigatory powers enabling him to subpoena records

¹ 604 F.2d 73 (1st Cir. 1979).

and secure any documentation, or any other evidence he wished, in order to determine a policy of cost containment. He subpoenaed or tried to subpoena the records of parochial schools to determine whether their tuition was too high. The church schools in Puerto Rico brought an action in federal court challenging this investigatory power. The federal district court ruled against the church schools. The United States Catholic Conference was not involved until the case proceeded to the circuit court. At that stage we wrote an *amicus* brief. The appellate court ruled in favor of the schools. It should be a very helpful decision. The court said, *inter alia*, that Puerto Rico's effort to gather information was suspect in light of the purpose for which the information was sought. It has been recognized that compelled disclosure has the potential for substantially infringing upon the exercise of first amendment rights. The court based its decision on *Buckley v. Valeo*.² It indicated that there was a high degree of entanglement here, but in addition to the entanglement, there was a violation of the free exercise clause. Reliance was placed upon *Buckley* for the broad proposition that compelled disclosure infringing upon first amendment freedoms must survive an exacting level of judicial scrutiny. This proposition can be used with respect to any legislation or administrative action which demands financial information. In other words, the court laid down the proposition that the state must comply with the exacting legal scrutiny test, the most severe test, in order to sustain the constitutionality of the legislation. This is based squarely on the free exercise clause.

You also know, via communication from our office, that the *FEL* case, involving the use of hymns without permission of the copyright owners, was tried in the federal district court in Chicago. The action was brought against the National Conference of Catholic Bishops (NCCB) and approximately ten different dioceses and archdioceses. We particularly were concerned about this because the factual record was not good and the challenge was to the NCCB. The theory was that the NCCB had the right to direct every parish, to tell them what to do and what not to do, and if a parish was involved in some activity that violated the copyright law, the NCCB, as an association, would be liable. That case has been settled. The settlement takes care not only of the NCCB, but of all the named dioceses. The essence of the settlement is that we agreed to send out a letter saying that it is wrong to infringe upon a copyright. There was no money involved.

Thank you.

² 424 U.S. 1 (1976).