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# Revenue Ruling 77-290 - Recent Interpretations of Agency Law Inequitably Taxes Members of Religious Orders

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# REVENUE RULING 77-290—RECENT INTERPRETATIONS OF AGENCY LAW INEQUITABLY TAXES MEMBERS OF RELIGIOUS ORDERS

## I. INTRODUCTION

Historically in the United States religious organizations have been exempted from paying federal income tax.[1] The underlying rationale for the tax exemption of churches is that the benefits and services which they provide to the public would otherwise have to be provided by the government out of tax revenues.[2] Currently, each of the fifty states[3] and the Federal Internal Revenue Code[4] provide for the tax exemption of churches.

Under the current Federal Code, an organization may be exempted from federal income tax if it is organized and operated exclusively for a "religious" purpose.[5] Therefore, churches and their auxiliary organizations

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1. Schwarz, *Limiting Religious Tax Exemption: When Should the Church Render Unto Ceasar?*, 29 U. FLA. L. REV. 50, 54 (1976) ("The practice of granting tax benefits to religious organizations has a long history, dating back to pre-Revolutionary times."). *See* Walz v. Tax Comm'n, 397 U.S. 664, 676 (1970) (religious organizations have always been expressly exempt from federal income taxes); P. TREUSCH & N. SUGARMAN, TAX EXEMPT CHARITABLE ORGANIZATIONS 4 (2d ed. 1983) (discussing the historical origins and statutory development of tax exemption for charitable organizations); Zollman, *Tax Exemptions of American Church Property*, 14 MICH. L. REV. 646 (1916) (history of tax exemptions accorded religion).

2. *See* Trinidad v. Sagrada Orden, 263 U.S. 578, 581 (1924) (tax exemption for religious organizations is made in recognition of the benefit the public receives from the organization's activities); B. HOPKINS, THE LAW OF TAX EXEMPT ORGANIZATIONS 5 (5th ed. 1987); ("[T]he exemption for charitable organizations is a derivative of the concept that they perform functions which, in the organization's absence, government would have to perform; therefore, government is willing to forego the otherwise tax revenues in return for the public services rendered."). For another view, see D. KELLEY, WHY CHURCHES SHOULD NOT PAY TAXES 46 (1977) (religion enjoys a preferred position because it performs the special function of satisfying the need for ultimate meaning in life and thereby provides a sense of hope and purposefulness to members of society).

3. *Walz*, 397 U.S. at 676 ("All of the 50 States provide for tax exemption of places of worship, most of them doing so by constitutional guarantees.").

4. I.R.C. § 501(c)(3) (1954). This section describes the organizations that are exempt from taxation: "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals. . . ." *Id.*

5. Treas. Reg. § 1.501(c)(3)-1(d)(1)(i)(a) ("An organization may be exempt as an organization described in section 501(c)(3) if it is organized and operated exclusively for one or more of the following purposes: (a) Religious, . . . .").

that further a religious purpose are exempt from federal income tax.[6] Qualifying auxiliary organizations include parochial schools and religious orders.[7]

A religious order is a communal group, a relatively small group of persons who live together and share their work and earnings.[8] As such, the members of a religious order do not pursue their own personal goals. Rather, each member acts in furtherance of the order's religious purposes.[9] The members relinquish personal independence and agree to accept the authority of the church.[10] This agreement is formally expressed by a requirement that the member take vows of poverty, chastity, and obedience to the order.[11]

Members of religious orders are often required to provide services for their supervising church and are paid wages for doing so.[12] The IRS recognizes that the wage a member earns in this way is income to the order and not to the member.[13] The member did not act on his or her own behalf.[14] Rather, the member was an agent of the religious order and acted to further the religious purposes of the church.[15] Therefore, income that the member earned is tax-exempt income to the order.[16]

A similar situation arises where a member of a religious order performs services for an employer who is not affiliated with the supervising church.[17] If the member receives wages from this outside employment but, as required by his vow of poverty, turns all of his wages over to his order, a

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6. B. HOPKINS, *supra* note 2, at 190.

7. *Id.*

8. *See generally* SACRAMENTUM MUNDI 67-70 (K. Rahner ed. 1970) (discussing religious orders).

9. *See* NEW CATHOLIC ENCYCLOPEDIA 287-93 (McGraw-Hill 1967) (discussing religious life).

10. *Id.* (the members commit their present and future possessions, earnings, and services to the community; in return, the order provides its members with food, shelter, and all other necessities of life).

11. *Id.*

12. For example, a nun with a business degree may be ordered to work in the business office of the church's community college. The nun will typically be paid wages the same as a lay person, but the nun will be required by her vow of poverty to turn the remuneration over to the order.

13. Rev. Rul. 77-290, 1977-2 C.B. 26 [hereinafter Rev. Rul. 77-290].

14. *Id.*

15. *Id.* In Rev. Rul. 77-290, the Service held that a member of a religious order under a bona fide vow of poverty who worked directly for her church business office was an agent of the religious order and was not required to include the remuneration remitted to the order in gross income.

16. *Id.* (provided, however, that the order qualifies as a tax-exempt entity).

17. For example, a nun with a nursing degree may be required to work in a local charitable hospital that provides services to the poor, even though the hospital is not operated by the church.

critical question is raised: Should the wages be considered income to the individual member and subject to taxation or income to the order and, therefore, tax exempt? Until 1977, an early pronouncement of the Bureau of Internal Revenue, Office Decision 119,[18] answered this question.

Since 1919, O.D. 119 has provided that if a member of a religious order, pursuant to his vows of poverty, turned in all income to the order, the member was not taxed on that income.[19] Under O.D. 119, when a member of a religious order earned income while working for the supervising church *or* while working for a secular employer, but remitted that income to the order, the income was recognized as the income of the order and was not subject to federal income taxation.[20]

In 1977, the IRS published Revenue Ruling 77-290 which drastically changed the settled practice that resulted from the consistent application of O.D. 119. Under Revenue Ruling 77-290, the IRS currently imposes a tax on remuneration received by members of religious orders from employment outside the order.[21] Apparently the IRS issued Revenue Ruling 77-290 to

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18. 1 C.B. 82 (1919). In 1919 the IRS was titled the Bureau of Internal Revenue and its official pronouncements were cited as Office Decisions (O.D.); the official pronouncements of the IRS are now cited as Revenue Rulings.

19. O.D. 119, 1 C.B. 82 (1919) provided:

> A clergyman is not liable for any income tax on the amount received by him during the year from the parish of which he is in charge, provided that he turns over to the religious order of which he is a member, all the money received in excess of his actual living expenses, on account of the vow of poverty which he has taken.
>
> Members of the religious orders are subject to tax upon taxable income, if any, received by them individually, but are not subject to tax on income received by them merely as agents of the orders of which they are members.

*Id.*

*See also* Maryland v. United States, 251 U.S. 342, 347 (1920) (receipt of income by an agent is regarded as receipt by his principal when the agent, acting within his scope of agency, earns income on behalf of the principal and remits the income to the principal); 2 MERTENS, LAW OF FEDERAL INCOME TAXATION § 17.11, at 70 (J. Doheny ed. 1982) (money received by a minister as an agent for a church is not taxable to him); Reed, *Revenue Ruling 77-290—Vow of Poverty*, 24 CATH. LAW. 217 (1979) (O.D. 119 was based on agency law).

Since 1919, O.D. 119 was the settled law regarding the levying of federal income taxes on members of religious orders who were under a vow of poverty. *See generally* Philipps, *But Reverend, Why Does Your Baptismal Font Have a Diving Board? Equitable Treatment for Vows of Poverty Under the Federal Income Tax*, 44 WASH. & LEE L. REV. 19, 22-24 (1987) [hereinafter Philipps, *Vows of Poverty*] (discussing the history and policy of O.D. 119).

20. *See* Priv. Ltr. Rul. 8,104,005, *reprinted in* 1981 Fed. Taxes (P-H) 696 (1981 private letter rulings). *See also* Gen. Couns. Mem. 24,316 (1944) (interpreting O.D. 119 to exclude from gross income money received by religious members "who individually perform services under circumstances resulting in compensation being paid for such service by organizations other than the religious order of which they are members.").

21. Rev. Rul. 77-290 (In Rev. Rul. 77-290, the Service took the position that a member of a religious order under a bona fide vow of poverty who was employed as an attorney with a private law firm had to include remuneration received from the firm in his gross income

prevent the use of bogus church schemes to avoid taxation.[22] In bogus church schemes, taxpayers create organizations that are purportedly churches or religious orders but in reality are hollow entities designed to shield the taxpayers' income from taxation.[23] The taxpayers assign all their income to their organization and claim they have given the organization their money because they have taken a vow of poverty.[24] As a result, before Revenue Ruling 77-290 was issued, the IRS had difficulty collecting taxes from the taxpayers or their organizations in these situations.

The IRS' issuance of Revenue Ruling 77-290 has distressed the religious community, which believes that the ruling is an unjust response to the rise of bogus church schemes. Members of bona fide religious orders who have been subjected to taxation have litigated cases in an attempt to establish precedent overturning Revenue Ruling 77-290.[25] Unfortunately for bona fide religious orders and their members, the IRS has defeated this attempt. The IRS has successfully defended Revenue Ruling 77-290 as a valid, equitable ruling by asserting that members of religious orders are not agents of their order when they are employed by someone other than their supervising church.[26] The acceptance of the IRS' narrow definition of agency has prevented bogus church schemes from sheltering the income of taxpayers who do not abide by vows of poverty. Needlessly, however, this solution to the schemes inequitably taxes religious members who have taken bona fide vows of poverty and who historically have been granted tax-exempt status.

This note will begin with a history of the tax exemption of churches and explain how this favorable tax treatment has resulted in the use of bogus church schemes for tax avoidance purposes.[27] This note will then evaluate the methods that the IRS currently employs to suppress these schemes.[28] Also, the agency theories that the IRS has developed will be

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even though the remuneration was turned over to the order.).

22. Philipps, *Vows of Poverty*, *supra* note 19, at 43 (discussing the unfairness of the Service's abrupt change in position in the vow of poverty situation).

23. *See infra* notes 59, 69-72 and accompanying text.

24. *See infra* notes 60-64 and accompanying text.

25. Dessingue, *Discrete Tax Issues for Clergy and Religious*, 28 CATH. LAW. 149, 156 (1983). *See* Reed v. United States, No. 16-82T (Ct. Cl. filed July 30, 1982); Sampson v. United States, No. 17-82T (Ct. Cl. filed Jan. 12, 1982); Kircher v. United States, No. 694-81T (Ct. Cl. filed Dec. 1, 1981); Waldschmidt v. United States, No. 695-81T (Ct. Cl. filed Dec. 1, 1981).

26. The courts have accepted this formulation of agency law and have held that if a member of a religious order contracts individually with a secular employer, then the member has an employee-employer relationship with that employer and cannot be acting as an agent on behalf of the order. *See infra* text accompanying notes 128-169 for an extensive discussion of agency law.

27. *See infra* text accompanying notes 31-104.

28. *See infra* text accompanying notes 105-27.

compared with Restatement agency law for the purpose of showing that a proper application of agency law to the relationship between religious orders and their members will preserve the tax-exempt status of bona fide religious members.[29] Finally, this note will discuss the power of the IRS to revoke the exempt status of bogus churches as a fair and effective way to suppress bogus church schemes.[30]

## II. TAX EXEMPTION FOR CHURCHES

### *A. Internal Revenue Code Section 501*

Religious organizations were given tax-exempt status under the Revenue Act of 1894,[31] and they still retain this preferred position.[32] Internal Revenue Code Section 501(a)[33] allows an exemption from taxation for an organization that is described in section 501(c).[34] Section 501(c)(3) lists the various entities that may qualify for tax exemption and includes those organizations that are organized and operated exclusively for a religious purpose.[35] Further, section 501(c)(3) sets out two tests that a religious organization must meet before it will be granted exempt status: an organizational test and an operational test.[36] An organization must meet both tests before it will qualify for exemption from federal income taxation as a religious entity.[37]

The organizational test of section 501(c) discloses the standard an organization must meet before the IRS will view it as an organization formed exclusively for "religious" purposes.[38] Specifically, the organization's char-

29. *See infra* text accompanying notes 128-228.

30. *See infra* text accompanying notes 229-42.

31. Internal Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556 (1894) (charitable, religious, and educational organizations were given exempt status).

32. I.R.C. § 501(c)(3), *supra* note 4.

33. I.R.C. § 501(a) (1954) ("An organization described in subsection (c) . . . shall be exempt from taxation under this subtitle . . . .").

34. *See supra* note 4.

35. *See supra* note 4.

36. Treas. Reg. § 1.501(c)(3)-1(a)(1) ("In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section.").

37. *Id.* ("If an organization fails to meet either the organizational test or the operational test, it is not exempt."). *See also* Harding Hospital, Inc. v. United States, 505 F.2d 1068, 1072 (6th Cir. 1974) (the requirements in section 501(c)(3) are stated in the conjunctive; the organization must meet both tests to qualify for tax exemption).

38. Treas. Reg. § 1.501(c)(3)-1(b)(1)(i) provides that:

> An organization is organized exclusively for one or more exempt purposes only if its articles of organization . . . (a) limit the purposes of such organization to one or more exempt purposes; and (b) do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

ter must limit its purposes to "religious" purposes and not expressly authorize the organization to carry on, other than as an insubstantial part of its activities, those activities that do not further "religious" purposes.[39] Although the availability of tax-exempt status for a religious organization is contingent upon the organization having a religious purpose, neither the courts nor the legislature have provided a definition of the terms "religious" or "religion" for tax purposes.[40] Consequently, the IRS has difficulty challenging the validity of a religion or a church as a means of revoking its tax-exempt status. Due to the intrinsic difficulties in applying the organizational test to religious organizations, the IRS must also look to the operational test when attempting to revoke the tax-exempt status of bogus churches.[41]

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*Id.*

39. *Id.*

40. *See* B. HOPKINS, *supra* note 2, at 184-98 (discussing the concepts of "religion" and "religious" as used for tax purposes); Kurtz, *Difficult Definitional Problems in Tax Administration: Religion and Race*, 23 CATH. LAW. 301 (1978) [hereinafter Kurtz, *Difficult Definitional Problems*] (discussing the difficult first amendment concerns of the IRS). *See also* United States v. Seeger, 380 U.S. 163 (1965) (the IRS cannot evaluate the content of a religious belief to determine if an organization is formed for a religious purpose as long as that belief is parallel to a belief in God); United States v. Ballard, 322 U.S. 78 (1944) (the IRS will not question the nature of religious beliefs if no clear showing exists that the beliefs are not sincerely held); Worthing, *"Religion" and "Religious Institutions" Under the First Amendment*, 7 PEPPERDINE L. REV. 313, 332 (1980) ("In summary, 'religion' under federal and state statutes has been held to encompass nontheistic beliefs which occupy a place in the lives of their possessors parallel to that occupied by belief in God in a person with traditional religious faith."); Note, *Mail Order Ministries, The Religious Purpose Exemption, and The Constitution*, 3 TAX LAW. 959, 964 (1980) [hereinafter Note, *Mail Order Ministries*] (the IRS cannot revoke exempt status from a church merely because of the lack of a theistic creed).

In some rare cases, however, the practices of a religion are so extreme that the courts will rule that the religious practices can be prohibited without violating the first amendment. United States v. Kuch, 288 F. Supp. 439 (D.D.C. 1968), is a case on point. In *Kuch*, the defendant was convicted of possessing and selling marijuana and LSD after unsuccessfully arguing that her religious beliefs, as a member of the Neo-American Church, required her to ingest psychedelic drugs. The court concluded that the dividing line between what is and what is not a bona fide religion is difficult to draw. Nevertheless, the court held that the members of the Neo-American Church were not engaging in the practice of religion, but were merely mocking established institutions. *Id.* at 452. In support of its position the court cited the following: (1) the head of the Church was referred to as the Chief Boo Hoo, a position roughly corresponding to a bishop; (2) the principles of the Church were that "psychedelic substances, such as LSD, are the true Host of the Church, not drugs" and "it is the Religious duty of all members to partake of the sacraments on regular occasions"; (3) the Church's official "Catechism and Handbook" stated that "we have the right to practice our religion, even if we are a bunch of filthy, drunken bums"; (4) the Church's symbol is a three-eyed toad; (5) the Church key is the bottle opener; (6) the Church's official songs are "Puff the Magic Dragon" and "Row, Row, Row Your Boat"; and (7) the Church motto is "Victory over Horseshit!". Describing the church as being "full of goofy nonsense", the court ruled that the church was not a religion within the meaning of the first amendment. *Id.* at 444.

41. Note, *Mail Order Ministries*, *supra* note 40, at 964 (the difficulty of defining "religious purpose" precludes the use of the organizational test to prevent bogus church schemes;

The operational test, an additional test that a religious organization must meet to obtain exempt status, requires that the organization be operated exclusively for one or more exempt purposes.[42] According to the Department of Treasury regulations, the operational test must be satisfied independently of, and in addition to, the organizational test.[43] Four elements must be met for an organization to satisfy the operational test.[44] First, the organization must engage primarily in activities that accomplish an exempt purpose as specified in section 501(c)(3).[45] The purpose of the activities, and not the nature of the activities, determines if the organization will qualify for an exemption.[46] The important question is whether the church's primary purpose in conducting a trade or business is to further religious purposes or whether its primary purpose is a non-exempt one of producing net profits for the church.[47]

The second element of the operational test states that the organization's net earnings may not inure to the benefit of private individuals.[48] To satisfy this element of the test, a church must show that it is not operated to benefit designated individuals, the founder or his family, or the share-

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the Service must rely on the operational test in examination of bogus churches).

42. Treas. Reg. § 1.501(c)(3)-1(c) (defining the operational test); *see infra* notes 45, 48, 51-52.

43. *See supra* notes 36-37. *See also* P. TREUSCH & N. SUGARMAN, *supra* note 1, at 73-78 (discussing the operational test).

44. Church of Scientology v. Commissioner, 823 F.2d 1310 (9th Cir. 1987) (applying the four elements of the operational test to the Church of Scientology).

45. Treas. Reg. § 1.501(c)(3)-1(c)(1) provides that:

> An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

*Id.*

*See* Church by Mail, Inc. v. Commissioner, 765 F.2d 1387, 1391 (9th Cir. 1985) (church failed the operational test because it was operated for the substantial non-exempt purpose of providing a market for services of an advertising agency owned and controlled by ministers).

46. B. HOPKINS, *supra* note 2, at 88 (discussing the "exempt purposes" criterion of the operational test). *See also* Miss Georgia Scholarship Fund, Inc. v. Commissioner, 72 T.C. 267 (1979) (organization did not qualify for tax exemption because the organization's sole activity was the granting of scholarships, which had the primary purpose of providing compensation).

47. B. HOPKINS, *supra* note 2, at 89. Thus, a church can engage in a trade or business, such as a bakery, and retain tax-exempt status provided the activity furthers an exempt purpose, *i.e.*, the money earned from the bakery is used to send underprivileged children to summer camp. *See also* B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352, 356 (1978) (applying the operational test to an organization's commercial business).

48. Treas. Reg. § 1.501(c)(2) ("An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individual."). *See also Church by Mail*, 765 F.2d at 1391 (tax exemption properly revoked upon a finding that income from church inured to the benefit of private persons).

holders of the organization.[49] The church may, however, receive reasonable compensation for goods or services that it provides to others, such as a reasonable amount of rent received from couples using church facilities for wedding receptions.[50]

A third element of the operational test provides that the religious organization may not expend a substantial part of its resources attempting to influence legislation or political campaigns.[51] This element of the test prevents "action" organizations, such as those that expend substantial amounts to support voter registration drives, from obtaining exempt status.[52] Nonetheless, an organization is allowed to advocate, as an insubstantial part of its activities, the adoption or rejection of legislation.[53]

The fourth and final element of the operational test requires the organization to serve a valid public purpose and to confer a public benefit.[54] This element of the test ensures that the legislative intent of the Code is not frustrated.[55] Tax-exempt status for religious organizations is intended to be available only to those organizations that are charitable under the common-law standards.[56] These common-law standards require that an organization not act contrary to public policy.[57] If an organization satisfies each of these

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49. P. TREUSCH & N. SUGARMAN, *supra* note 1, at 162.

50. *Id.* at 163 ("To a certain extent, inurement in the broader sense is entirely acceptable, such as reasonable compensation for goods and services.").

51. Treas. Reg. § 1.501(c)(3)-1(c)(3)(i) ("An organization is not operated exclusively for one or more exempt purposes if it is an 'action' organization . . . .").

52. Treas. Reg. § 1.501(c)(3)-1(c)(3)(ii) provides:

> An organization is an "action" organization if a substantial part of its activities is attempting to influence legislation by propaganda or otherwise. For this purpose, an organization will be regarded as attempting to influence legislation if the organization: (a) contacts, or urges the public to contact members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or (b) advocates the adoption or rejection of legislation.

*Id.*

53. *Id.*

54. Bob Jones Univ. v. United States, 461 U.S. 574, 586 (1983) (tax-exempt institution must not act contrary to public policy).

55. *See* B. HOPKINS, *supra* note 2, at 142-45.

56. *Id.* at 65-70 (discussing the federal tax law definition of "charity"). *See also Bob Jones*, 461 U.S. at 586 ("Underlying all relevant parts of the code is the intent that entitlement to tax exemption depends on meeting certain common-law standards of charity. . . . "); Rev. Rul. 77-290 (the organization's resources must be devoted to purposes that qualify as exclusively charitable within the meaning of section 501(c)(3) of the Code and the applicable regulations).

57. *Bob Jones*, 461 U.S. at 586. *See also* Simon, *Applying the Bob Jones Public-Policy Test in Light of TWR and U.S. Jaycees*, 62 J. TAX'N 166, 168 (1985) ("After *Bob Jones* no organization will be entitled to exempt status if it violates a 'fundamental public policy' . . . the implementation of the public policy test should be free of problems and should result in an effective and careful adminstration of the tax laws."); Galvin & Devins, *A Tax Policy Analysis of Bob Jones University v. United States*, 36 VAND. L. REV. 1353, 1354 (1983) ("[T]he

four elements of the operational test, and is formed exclusively for "religious" purposes as required by the organizational test, then the organization will be recognized as a tax-exempt entity.[58]

### *B. Bogus Church Schemes*

The availability of tax exemptions for churches under section 501 resulted in a proliferation of bogus churches: organizations that fit the form, but not the substance, of a tax-exempt church.[59] As a device to shelter income from taxation, the purpose of a bogus church or religious order is to circumvent the tax law that prevents a mere assignment of income from relieving a taxpayer of liability.[60] This law provides that if a taxpayer has the right and power to receive income, but donates the income to another, the taxpayer and not the actual recipient of the income is liable for the tax on the income.[61] Agency law, however, provides that when a person earns income while acting as an agent on behalf of a principal, the principal and

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Court interpreted the applicable Code provisions under which Bob Jones University claimed tax exemption [I.R.C. § 501(c)(3)] as requiring that the institution confer a 'public benefit' and have a purpose in harmony with a 'common community conscience'.").

58. Harding Hospital, Inc. v. United States, 505 F.2d 1068, 1072 (6th Cir. 1974). *See also* B. HOPKINS, *supra* note 2, at 660 (discussing the requirements of tax-exempt status).

59. *See, e.g.*, Mathis v. Commissioner, 51 T.C.M. (CCH) 1067 (1986); Starks v. Commissioner, 51 T.C.M. (CCH) 443 (1986); Roben v. Commissioner, 51 T.C.M. (CCH) 407 (1986); Grew v. Commissioner, 51 T.C.M. (CCH) 405 (1986); Martin v. Commissioner, 51 T.C.M. (CCH) 403 (1986); Van Cleve v. Commissioner, 50 T.C.M. (CCH) 1353 (1985); Gambardella v. Commissioner, 50 T.C.M. (CCH) 1331 (1985); Neil v. Commissioner, 50 T.C.M. (CCH) 1254 (1985); Gookin v. Commissioner, 50 T.C.M. (CCH) 1162 (1985).

60. *See* Stephenson v. Commissioner, 79 T.C. 995 (1982), *aff'd*, 748 F.2d 331 (6th Cir. 1984). In *Stephenson*, a taxpayer created a branch of the Life Science Church to escape taxation. When the IRS assessed additional tax for attempted tax evasion, the taxpayer asserted that he had no intent to evade taxes as he honestly believed he was legally exempt from taxation. The court held that the church was simply a camouflage that the taxpayer tried to use to shelter himself from taxes. When the taxpayer executed a "vow of poverty" and created the "church," he understood the supposed tax benefits he might receive by assigning his income to a church. Although the vow of poverty purported to transfer all his assets and income to the "church," it also provided that all the property was to revert to him if "civil government officialdom were to 'void' this act . . . by blocking the rightful tax exempt status of the church or order." *Id.*

61. Lucas v. Earl, 281 U.S. 111, 114-15 (1930) (expressing the hornbook law regarding the assignment of income):

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motive leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

*Id.*

not the agent has the right and the power to receive the income.[62] The principal has a superior claim of right to the income; the agent has not "merely assigned" the income to him.[63] Therefore, the principal and not the agent is liable for the tax on that income.[64] Consequently, in a bogus church scheme the taxpayer's motive is to create the appearance that he earned his income while he was acting as an agent on behalf of a church or religious order.

When a member of a religious order earns income while acting as an agent of the order, such income belongs to the order and not to the member.[65] If the religious order qualifies for tax-exempt status,[66] all income that a member earns as an agent for the order is free from taxation.[67] Therefore, if a taxpayer is able to contend that he earned his income while acting on behalf of a religious order, he is in a position to assert that as an agent of the order he did not have the right or the power to receive the income that he earned. Furthermore, the taxpayer can assert that his principal, the church or order that he formed, is a tax-exempt entity. Under such a scheme the taxpayer is arguably not liable for tax on income that he earned, because he remitted it to his church or order. The taxpayer in this bogus church scheme, however, is in complete control of the church that he created; he has the authority to direct that the church's funds be used as he believes is appropriate. In other words, he is able to use the tax-free income to satisfy his personal needs and desires.[68]

In a typical bogus church plan, a taxpayer receives, either through the mail or directly from the church's founder, a set of minister's credentials and a charter for a church or religious order.[69] In a bogus church plan, the

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62. Maryland Casualty Co. v. United States, 251 U.S. 342 (1920).

63. *Id.* at 347.

64. *Id.*

65. Rev. Rul. 77-290, restating O.D. 119: "Income earned or received by a taxpayer as a principal, and not as an agent, is taxable to the taxpayer . . . [but] where an agent receives income on behalf of a principal, the income is not taxable to the agent but to the principal." *Id.*

66. *See supra* notes 37-53 and accompanying text.

67. *See* Maryland Casualty Co. v. United States, 251 U.S. 342 (1920) (principal is taxed on amounts agent earns); I.R.C. § 501(c)(3), *supra* note 4 (a religious organization is tax exempt if it is organized and operated for a religious purpose).

68. *See infra* notes 69-104 and accompanying text.

69. Kurtz, *Difficult Definitional Problems*, *supra* note 40, at 305:

> While the "plans" vary in certain respects, a common theme calls for an individual to obtain minister's credentials and a charter for a church or religious order by mail for a fee from churches that may or may not be recognized as exempt from federal income tax under I.R.C. § 501(c)(3). No profession of adherence to a creed, dogma, or moral code is required and no duties of fiduciary responsibilities are undertaken in order to receive and administer these charters or credentials.
>
> The "plan" then calls for the individual to take a "vow of poverty". . . . Under the "plan" less then ten percent of the remaining assigned income is utilized for gifts to the

taxpayer does not join a communal group that is bonded together by common vows to support the church and its purposes. Rather, the taxpayer creates the entity solely to enable him to pursue his personal goal of sheltering his income from taxation.[70]

A religious order created under a bogus church plan is necessarily constructed so as to closely resemble a bona fide religious order. The taxpayer frequently takes a "vow of poverty" and claims that he has given the religious order his income in accordance with that vow.[71] Similar to a member of a true religious order, the taxpayer remits his assets and income to the church or order. Unlike members of true religious orders, however, the taxpayer is not subject to the authority of the church, but instead retains control over the church and is able to hold and dispense with the funds and property of the church.[72]

The Calvary Temple Church[73] is a recent example of a bogus religious order whose members took a sham vow of poverty. Robert E. McCurry founded the Calvary Temple Church in East Point, Georgia in 1958 and served as the church's first and only pastor.[74] In 1984, the church had approximately 300 members and roughly twenty "religious orders,"[75] each comprised only of the members of one family.[76] Additionally, each order executed identical preprinted documents entitled "Statement of Christian Faith and Application" and "Irrevocable Gift and Vow of Poverty."[77] Nevertheless, the taxpayers managed their finances as they wished and took their checks home rather than depositing the checks in their order's account or lockbox.[78] The church placed no restrictions on the taxpayers' use of the money.[79] Some of the taxpayers used the income they purportedly turned

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poor, prayer books, bibles, and other church functions.

Typically, the solicitations conclude that a vow of poverty can make a person rich.

70. *See, e.g.*, United States v. Ebner, 782 F.2d 1120, 1122 (2d Cir. 1986) (the principal belief of the Life Science Church, a bogus church created by a disbarred lawyer, was that Americans were overtaxed and had the right to choose not to pay taxes).

71. *See, e.g.*, McGahen v. Commissioner, 76 T.C. 468 (1981), *aff'd mem.*, 734 F.2d 664 (1983).

72. *See id.*

73. *See* Pollard v. Commissioner, 48 T.C.M. (CCH) 1303 (1984), *aff'd*, 786 F.2d 1063 (11th Cir. 1986).

74. *Pollard*, 48 T.C.M. (CCH) at 1306.

75. *Id.*

76. *Id.*

77. *Id.*

78. *Pollard*, 786 F.2d at 1065 (appellants continued to handle their financial affairs in the same manner before and after their vows of poverty).

79. *Pollard*, 48 T.C.M. (CCH) at 1311. As the court noted:

> The members of each order retain complete control over their assets and income at all times. Although the members of some of these "religious orders" have opened checking accounts in their order's names and have transferred title to land and automobiles to their order, they still use and deal with these assets for personal purposes as if they were

over to the order to purchase cars, boats, and real estate in their own names.[80] In short, the members of the Calvary Temple Church retained the same control over their property after taking their alleged vows of poverty as they had before.

In contrast, members of a bona fide religious order have no right to, or control over, their property after taking a vow of poverty.[81] Upon admission to the order the member must either legally transfer his property to others, such as friends or family members, or make such a transfer to the order so that the order holds valid title to the property.[82] If a member leaves the order, the property that he turned over to the order while he was a member remains with the order.[83] The member cannot regain control over the property.[84] Also, although the order provides food and shelter for the members, the members' needs are met by the mutual efforts of all.[85] The necessities of life that are provided to each member do not exceed what is strictly necessary for communal existence.[86] The members are required to forego the material rewards of their work efforts so that the religious order can engage in charitable programs for the public benefit.

Despite the obvious sham that the Calvary Temple Church "religious orders" were devising, the taxpayers claimed that, by reasons of their vow of poverty, they did not receive any taxable income for the years in question.[87] One taxpayer, Eric Pollard, was a member of the "Pollard Christian Religious Order of Saints," which was purportedly an integrated auxiliary

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in their own names.
*Id.*

80. *Id.*

81. *See generally* CODE OF CANON LAW, INSTITUTES OF CONSECRATED LIFE AND SOCIETIES OF APOSTOLIC FAITH 668 (A. Mitchell trans. 1983) [hereinafter CODE OF CANON LAW], section 3 of which provides in pertinent part: Whatever a religious acquires by personal labor or on behalf of the [order] belongs to the [order] . . . *Id.*

82. *Id.*

83. *See id.* at Canon 702 § 1, which provides in pertinent part: § 1 Whoever lawfully leaves a religious [order] or is lawfully dismissed from one, cannot claim anything from the [order] for any work done in it. *Id.*

84. *Id.*

85. *See generally* L. FANFANI & K. O'ROURKE, CANON LAW FOR RELIGIOUS WOMEN 75-82 (discussing life in a religious order); B. HOPKINS, *supra* note 2, at 191 (discussing a 1981 general counsel memorandum which describes communal groups that qualify as religious organizations).

86. *See* L. FANFANI & K. O'ROURKE, *supra* note 85, at 190. *See also* CODE OF CANON LAW, *supra* note 76, at Canon 600, which provides: "The evangelical counsel of poverty in imitation of Christ . . . entails a life which is poor in reality and in spirit, sober and industrious, and a stranger to earthly riches." *Id.*

87. Pollard v. Commissioner, 48 T.C.M. (CCH) 1303, 1324-25 (1984) (the members argued that any remuneration received for their services performed for third parties was as the agent of their respective "religious orders" which are "integrated auxiliaries" of Calvary Temple Church).

of Calvary Temple Church.[88] Pollard worked for Federal Express Corporation as a courier.[89] In 1980 he received $25,031.85 as remuneration for his services.[90] He was paid with checks payable to "Eric Pollard" and no other person had a right to cash the checks.[91]

On his 1980 tax return, Pollard listed his occupation as a member of a religious order and did not report the receipt of any taxable income.[92] When the IRS conducted an audit, Pollard, like other members of Calvary Temple Church "religious orders," argued that the remuneration he received while working for a third party, Federal Express, was earned while he was acting as an agent of his "religious order."[93] As O.D. 119 provides, when a member of a religious order earns income while working for a secular employer, but remits that income to the order pursuant to a vow of poverty, the income is not subject to taxation.[94] The member is held to be an agent of the church and is not acting in his individual capacity.[95] Thus, Pollard, a member of a "religious order" who had taken a "vow of poverty," argued that he was not liable for any tax on his 1980 income.[96]

Yet, although Pollard signed a "vow of poverty," stating that he gave all of his property and future remuneration to the "Pollard Christian Religious Order of Saints," the money never left Pollard's possession.[97] No accounting records were kept by Pollard's "religious order" to ensure that the money was spent to further religious purposes.[98] The vow of poverty that Pollard signed provided that Pollard should receive a modest allowance to be used for living expenses.[99] Accordingly, Pollard submitted a "Request for Allowances and Allotments" to Pastor McCurry.[100] Pastor McCurry then gave Pollard permission to use his entire yearly income as he wished, and Pollard subsequently purchased numerous personal items, including a home and a car to which he received exclusive title.[101]

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88. *Id.* at 1320.
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.* at 1326.
94. *See supra* note 19 and accompanying text.
95. *See supra* note 19 and accompanying text.
96. Pollard v. Commissioner, 48 T.C.M. (CCH) 1303, 1326 (1984). The Tax Court stated: "[W]e must hold that these petitioners have also failed in their burden of proving that their receipt of remuneration from third parties for services rendered was merely as the agent of Calvary Temple Church. *Id.*
97. *Id.*
98. *Id.* at 1325.
99. *Id.* at 1326.
100. *Id.*
101. *Id.* at 1320.

Pollard's church, the Calvary Temple Church, is only one of many churches that create bogus religious orders to enable taxpayers to evade the IRS.[102] The key to the bogus church schemes is the use of agency principles to shift the taxpayer's income to a tax-free entity.[103] The IRS, however, became acutely aware that taxpayers were relying on previous liberal interpretations of O.D. 119 to evade taxation and began to tighten up agency law as it pertained to members of religious orders.[104]

## III. IRS RESPONSE TO BOGUS CHURCH SCHEMES

Before the rapid growth of bogus church schemes in the 1970s, the IRS applied O.D. 119 liberally.[105] The IRS had not yet found it necessary to distinguish between a member who worked for a secular employer and a member who worked for an employer who was affiliated with the order.[106] The IRS did not doubt that members of bona fide religious orders who worked for secular employers were acting on behalf of their order and in furtherance of sincere religious purposes.[107] Unlike the individuals who later employed the guise of heavenly devotion to God as a scam to avoid their earthly duty of paying taxes, members of bona fide religious orders clearly did not benefit in monetary terms from their preferred status as agents of a tax-free entity.[108] In practice, until the late 1970s when bogus churches became a major problem, the IRS held the position that members of religious orders were agents of their orders when they received wages for rendering services to secular employers.[109]

An example of the liberal application of O.D. 119 is found in a 1968 revenue ruling,[110] which held that a nun who worked for a private nonprofit hospital was acting as an agent of her order even though she was an employee of the hospital.[111] The nun had no claim of right to the wages

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102. *See, e.g.*, Larsen v. Commissioner, 765 F.2d 939 (9th Cir. 1985) (Universal Life Church); Uhrig v. Commissioner, 49 T.C.M. (CCH) 1355 (1985) (Glenelg Church of Divine Blessings); Owens v. Commissioner, 45 T.C.M. (CCH) 157 (1982) (Objectivist Assembly); Schilberg v. Commissioner, 44 T.C.M. (CCH) 148 (1982) (Church of United Brotherhood); Brown v. Commissioner, 41 T.C.M. (CCH) 542 (1980) (Church of the Brothers).

103. *See supra* notes 60-68 and accompanying text.

104. *See infra* notes 110-27 and accompanying text.

105. *See supra* notes 19-20 and accompanying text.

106. *See supra* notes 19-20 and accompanying text.

107. *See infra* notes 110-13 and accompanying text.

108. *See supra* notes 81-86 and accompanying text.

109. *See supra* notes 19-20 and accompanying text.

110. Rev. Rul. 68-123, 1968-1 C.B. 35.

111. *Id.* Rev. Rul. 68-123 states in pertinent part: "[A]mounts received from a hospital for services performed by a registered nurse who is a member of a religious organization exempt from Federal income tax [under § 501(c)(3) of the Internal Revenue Code of 1954] are excludable from her gross income." Rev. Rul. 68-123, 1968-1 C.B. 35.

that the hospital paid to her, and she was under the general control of the order at all times.[112] The order made the arrangements for the nun's employment at the hospital and expected the nun to follow the rules of the order while carrying out her employment, although the hospital supervised the nun's day-to-day activities.[113] Thus, as late as 1968 the IRS did not question the fact that members of religious orders who performed outside employment were agents of their order and therefore were tax exempt.

Throughout the 1970s there was a steady increase in the number of taxpayers who utilized the agency principles that are the foundation of bogus church schemes as a means of evading taxation.[114] In an attempt to stem this abuse, the IRS issued several new rulings that narrowed the class of persons who qualify as agents of religious orders.[115] After issuing these new rulings the IRS began taxing the wages of members of bona fide religious orders when they worked outside of their orders.[116] In effect, the IRS taxed the member's principal, the religious order.[117] Yet when Congress enacted the Internal Revenue Code, Congress did not authorize the IRS to assess taxes on a religious organization unless the organization failed the operational test or the organizational test.[118] The IRS, however, declined to utilize these tests to determine if it could lawfully tax the organization but, instead, simply claimed that the individual member was the proper taxable unit because the member no longer functioned as an agent of his order if he performed outside employment.[119]

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112. *Id.*

> [The nurse] was assigned by the Society's director to serve as a registered nurse in a hospital which was in need of doctors and nurses. The details of her activities while working there were under the supervision of the hospital. . . . It is apparent that the taxpayer was performing services for the hospital as agent of the Society since at all times she remained under its general direction and control. Because of this relationship she had no right to receive or direct the use or disposition of the checks issued to her by the hospital for her own benefit.

Rev. Rul. 68-123, 1968-1 C.B. 35.

113. *See supra* note 112. *But see* Rev. Rul. 83-127, 1983-2 C.B. 25, which states:

> Although not specifically stated in Rev. Rul. 68-123, the hospital described in that revenue ruling was an associated institution of the church that exercised administrative supervision over both the religious order and the hospital. Thus, with respect to the services performed for the associated hospital, the nurse is an agent of the religious order.

Rev. Rul. 83-127, 1983-2 C.B. 25.

114. *See generally IRS Response to the Illegal Tax Protest Movement, Hearing Before the Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations*, 97th Cong., 1st Sess. 2 (1981) (extensive discussion of the history and development of various tax protest schemes).

115. Rev. Rul. 76-323, 1976-2 C.B. 18; Rev. Rul. 77-290, *supra* note 13.

116. *See infra* notes 128-31 and accompanying text.

117. *See supra* notes 62-64 and accompanying text.

118. *See supra* notes 36-58 and accompanying text.

119. *See infra* notes 141, 162 and accompanying text.

In 1976 the IRS issued Revenue Ruling 76-323,[120] the first of a series of rulings that created a narrow definition of agency as it relates to members of religious orders. This ruling concerned the issue of whether members of a religious order were acting as agents of their order while they were employed in "nontraditional" jobs such as plumbing and construction.[121] The ruling held that a member is an agent acting on behalf of the religious order only if the order, as the principal, is engaged in the performance of the services that the member is providing to the secular employer.[122]

For example, a religious member worked for a plumbing company pursuant to the regulations of his order that required all members to obtain outside employment and to turn over their wages to the order. To obtain such employment, the member entered into the legal relationship of employer-employee with a third party, the plumbing company. According to agency law as formulated in Revenue Ruling 76-323, the member could not be acting as an agent of the religious order because "ordinarily an order is not engaged in the performance of services as a principal where the legal relationship of employer and employee exists . . . with respect to the performance of such services."[123] In other words, Revenue Ruling 76-323 asserted that since the member was an employee of the plumbing company, he was the agent of the plumbing company and thus he could not also be an agent of the religious order. Further, the ruling emphasized that the IRS did not consider the services the member performed as a plumber to be the equivalent of required religious duties.[124] In effect, Revenue Ruling 76-323 gave the IRS authority to tax the income that a member of a religious order earned when the services were not of the type that a religious order ordinarily requires members to perform, and the services were performed for someone other than the order or supervising church.

One year later, in Revenue Ruling 77-290,[125] the IRS carried the policy of taxing members of religious orders one step further. According to

120. 1976-2 C.B. 18.
121. *Id.*
122. *Id.* at 19.
123. *Id.*
124. *Id.* Rev. Rul. 76-323 seems to be making a distinction between members of religious orders who perform "traditional" charitable services such as teaching and nursing and members who perform "nontraditional" services such as plumbing and construction work. After stating that plumbers and construction workers are not agents and must include remuneration in gross income, Rev. Rul. 76-323 ends with this comment: "Compare Rev. Rul. 68-123, 1968-1 C.B. 35, which holds that amounts received from a hospital by a registered nurse who is a member of a religious society exempt from Federal income tax under section 501(c)(3) of the Code are excludable from gross income under section 61(a) and are not wages subject to Federal income tax withholding." Rev. Rul. 76-323, 1976-2 C.B. 19.
125. *Id.* at 26.

Revenue Ruling 77-290, a member of a religious order is not acting as an agent of the order if the member works for a third party who is not affiliated with the order's church. Presumably, under this ruling, a member is not acting as an agent even when performing services that further the purposes of the religious order.[126] The following situation illustrates the problem. Two members of a religious order that emphasizes teaching as a traditional religious mission work outside the order for a third party, a large inner-city high school. One member teaches history and the other is a janitor. According to Revenue Ruling 76-323, which was issued a year earlier, the janitor is not acting as an agent of the order because he is performing "nontraditional" services that arguably do not further the purposes of the religious order. Thus, the janitor will be subject to tax liability on his wages even if he remits the wages to the order pursuant to a vow of poverty.

However, under the later ruling, Revenue Ruling 77-290, neither the teacher nor the janitor is acting as an agent of the order while performing services for a secular employer, the city high school. Even though the teacher's services directly further the purposes of the order and he remits his remuneration to the order, the IRS will hold him liable for tax on the income that he earns. The teacher, however, has no money with which to pay the tax. He never received nor had a right to receive any of the money that he earned. He was under the control of the order and acted on its behalf. He obeyed his vow and complied with the law, both of which obligated him to remit his earnings to the order. Nevertheless, successive revenue rulings further implement this new IRS policy of classifying the wages that a member receives from outside employment as the member's own taxable income.[127]

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126. *Id.* Rev. Rul. 77-290 does not specifically state that a member is not acting as an agent even if the services performed for a third party are of the type that further the purposes of the religious order. Rather, Rev. Rul. 77-290 states that if a member of a religious order is instructed to perform services for an employer affiliated with the supervising church, then the member will be considered an agent of the order. *Id.*

Rev. Rul. 77-290 then gives the example of a member of a religious order who works at a private law firm and performs legal services. Since the private practice of law is not the performance of services of the type ordinarily required by members of the religious order, the member is required to include in gross income the entire remuneration paid by the law firm.

Rev. Rul. 77-290 does not state whether a member is an agent when the services performed are of the type ordinarily required by members of religious orders but the services are performed for a secular employer rather than for an employer associated with the supervising church.

127. Rev. Rul. 84-13, 1984-1 C.B. 21 ("Amounts received by a member of a religious order, who has taken vows of poverty and obedience, from the member's private practice as a psychologist are includible in the member's gross income."); Rev. Rul. 81-267, 1981 C.B. 196 ("Pay received from a hospital by a member of a religious order who has taken a vow of poverty and is instructed by the order to obtain outside employment is wages paid by the hospital under sections 3121(a) and 3401(a) of the Code."); Rev. Rul. 80-332, 1980-2 C.B. 34 ("A member of a religious organization who has taken a vow of poverty and is instructed by

## IV. THREE THEORIES DEFINING THE AGENCY CONCEPT IN REVENUE RULING 77-290

Two recent cases illustrate how the agency principles in Revenue Ruling 77-290 have been defined and applied to members of religious orders who have taken bona fide vows of poverty. In *Fogarty v. United States*[128] and *Schuster v. Commissioner*,[129] the courts acknowledged that the members were acting under sincere vows to genuine religious orders.[130] Nevertheless, the courts required the members to pay taxes on income earned from services rendered to a secular employer even though the services, teaching and nursing, furthered the purposes of the orders.[131] As the two

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the organization's superiors to obtain outside employment must include the remuneration remitted to the organization in gross income, and the remuneration is subject to FICA and income tax withholding."); Rev. Rul. 79-132, 1979-1 C.B. 62 ("Remuneration received from the Armed Forces by a military chaplin who is a member of a religious order, has taken vows of poverty, and is required by the order to serve in the Armed Forces and turn over the remuneration to the order, is includible in the chaplain's gross income and is subject to the FICA and income tax withholding."); Rev. Rul. 78-229, 1978-1 C.B. 305 ("Ordinary nonreligious services performed for a manufacturing company on the company's assembly line by an ordained minister, who had worked several years for the company prior to receiving written instructions from the church to do so, are not 'in the exercise of his ministry' for purposes of section 3121 of the Code, and the remuneration received for the services is not excepted from income tax withholding under section 3401.").

128. 6 Cl. Ct. 612 (1984), *aff'd*, 780 F.2d 1005 (Fed. Cir. 1986).

129. 84 T.C. 764 (1985), *aff'd*, 800 F.2d 672 (7th Cir. 1986). *See generally* Comment, *Seventh Circuit's Taxation of Members of Religious Orders — A Change of Habit*, 31 CATH. LAW. 62 (1987) (discussing the *Schuster* decision).

130. In *Fogarty*, the court noted:

> The facts are not in dispute. . . . [Father Fogarty] is bound to the Order by vows of chastity, poverty, and obedience. Teaching is an essential and traditional mission of the Order. In keeping with this mission, Father Fogarty was directed by his religious superior to pursue an invitation that had been extended to him to interview for a teaching position.
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> . . .

Fogarty v. United States, 780 F.2d 1005, 1006 (Fed. Cir. 1986). Similarly, in *Schuster* the court stated:

> The instant case is unlike many of the so-called "vow of poverty" cases decided recently by this court in that Sister Francine Schuster at all times acted strictly in accordance with her vows of poverty and obedience, and at no time after endorsing the checks did she exercise any sort of control over the funds. Petitioner is part of a long tradition that is respected in our society, and these private arrangements with her Order arise from deeply held convictions. The fact that we feel her life is a sincere and worthwhile example should not, however, alter the tax results.

Schuster v. Commissioner, 84 T.L.C. 764, 773 (1985).

131. In *Fogarty* the Claims Court found that "Teaching is an essential and traditional religious mission of [Fogarty's order]. Since its founding in the early 1500s, the [Order] has been publicly committed to education, and to higher education in particular." Fogarty v. United States, 6 Cl. Ct. 612, 613 (1984). Similarly, in *Schuster* Judge Korner noted in his dissent that:

> The purpose of [Schuster's] Order, as expressed in its articles included, *inter alia*: 'to conduct hospitals and institutions for the care and treatment of suffering humanity and to

cases progressed through the trial and appellate courts, three tests were developed to determine whether a member was an agent of the religious order and thus entitled to tax exemption under Revenue Ruling 77-290.

### *A. Loaned-Out Employee Test*

In *Fogarty*,[132] Father Fogarty was a member of a religious order. The purpose of the order was to further higher education.[133] As directed by his order, Fogarty obtained a teaching position at the University of Virginia.[134] Fogarty did not file an income tax return for the years that he worked for the University because he believed that the wages he received from the University were tax exempt.[135] The IRS audited Fogarty's income tax return, determined that under Revenue Ruling 77-290 he did not earn the income while acting as his order's agent, and thus required him to report the income as his own.[136]

In support of its position that Fogarty was not acting as an agent of the order, the government analogized the situation to loaned-out employee cases.[137] The government argued that if a religious member asserted that he was an agent of the order, then the member was essentially asserting that he was a loaned-out employee.[138] The Court of Claims accepted this argument. The court defined a loaned-out employee to be an employee who is working for a third party, someone other than his original employer, but who remits the money earned from the third party to his original employer. The employer and the third party must have entered into a contract in which the employer undertook the obligation to ensure that the employee would provide the services to the third party.[139] Further, the third party must have accepted the employer's control over the employee's physical conduct while the employee performed the services for the third party.[140]

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do all and everything necessary or convenient for the accomplishment of any purposes or objects and powers above mentioned or incidental thereto.'

Schuster v. Commissioner, 84 T.C. 764, 782 (Korner, J., dissenting).

132. 6 Cl. Ct. 612 (1984).

133. *Id.*

134. *Id.* at 613. Fogarty subsequently received an associate professorship at the University. *Id.* He received a monthly paycheck in his name but he deposited each check in the order's checking account. *Id.* at 614. Under the law of Fogarty's church, he had no right to receive or control the use of the money he earned from the University. *Id.*

135. *Id.*

136. *Id.*

137. "[T]he Government also contends that the present situation is analogous to those cases in which personal services are rendered to a third party by an individual who claims to be acting as a "loaned-out" employee of the corporation. . . ." *Id.* at 615. The argument the government has presented is controlling here. It can be no other way. *Id.*

138. *Id.*

139. *Id.* at 614.

140. *Id.* at 615.

According to the Court of Claims, if a member fits within this definition then, and only then, is he to be considered an agent of his order. Applying the loaned-out employee test to Fogarty's situation, the court held that Fogarty was not acting as an agent of his order while teaching at the University because his relationship with his order failed both parts of the test: (1) the order did not control Fogarty's physical conduct while he was teaching at the University, and (2) the order did not contract with the University placing an obligation on the order to provide Fogarty's teaching services to the University.[141]

### B. *Triangle Theory*

In *Schuster*,[142] the Tax Court adopted a "triangle theory"[143] of agency to determine if a member of a religious order was acting as an agent of the order while performing outside employment. Francine Schuster, a nurse, was a member of a religious order.[144] One of the stated purposes of the order was to aid hospitals in providing services to those who would otherwise be without medical care.[145] With the permission and direction of her order, Schuster sought and obtained employment in a health care clinic.[146] Like Father Fogarty, Sister Schuster believed the income she received from her employment was tax exempt under Revenue Ruling 77-290.[147] Therefore, she did not pay taxes on the amounts that she received from the clinic.[148]

The IRS, however, determined that Revenue Ruling 77-290 did not exempt Schuster's income from taxation because Schuster was not acting as an agent of her order as required by the ruling.[149] The Tax Court held that Schuster was not an agent of her order because all three parties (nun,

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141. *Id.* at 616. The Court of Claims concluded with this statement: "The University contracted with plaintiff and not his Order. Accordingly, it follows that he is taxable on the income generated by his services. The court therefore grants the Government's motion for summary judgment and directs that the complaint be dismissed." *Id.*

142. Schuster v. Commissioner, 84 T.C. 764 (1985).

143. *See id.* at 775-76.

144. *See supra* note 130 (describing Schuster's relationship with her order).

145. *See supra* note 131.

146. *Schuster*, 84 T.C. at 768-71. Schuster was assigned by a federal agency to work in a city that was designated a health manpower shortage area because the region lacked adequate medical services. *Id.* at 768-69. Although Schuster received paychecks in her own name, she remitted each check to the order and retained no control over them. *Id.* at 771.

147. *Id.*

148. *Id.* Schuster reported $18,771.20 in wages to the IRS but stated on her return that the compensation was not subject to taxation "by reason of taxpayer being an agent of a religious order pursuant to Rev. Rul. 77-290." *Id.*

149. *Id.* "[The Commissioner] issued a notice of deficiency in which he determined that petitioner's wages were taxable because she was not working as an agent of a religious order when she earned her wages." *Id.*

clinic, and order) did not participate directly in the agency relationship.[150] Under this triangle theory of agency, a member of a religious order is not performing services as an agent of the order unless the order is under an obligation to perform the services.[151] The court held that if the order is not under a duty to perform the services or to ensure that they are performed, then the member cannot be acting on the order's behalf.[152] In this case, the clinic did not contract with Schuster's order and did not place the order under any obligation.[153] Further, the order did not retain control over Schuster's daily activities while she worked at the clinic.[154] Thus, Schuster was found to have earned the income in her individual capacity.[155]

### C. *Six-Factor Test*

When the Court of Appeals for the Federal Circuit[156] decided *Fogarty*, the court developed a six-factor test to determine if a member had acted as

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150. *Id.* at 774, 778. The Tax Court stated that "the participation of three parties is required to create an agency relationship. . . . The Order is not involved at all, except as the recipient of petitioner's earnings. . . . We therefore conclude that petitioner earned the income at issue in her individual capacity. . . ." *Id.*

151. *Id.* "What [Schuster] has failed to recognize is that, in the legal sense, one can perform services for a third party on someone's 'behalf' only if some sort of obligation to perform the services rests initially with the person on whose behalf one wishes to act." *Id.* at 774.

152. *Id.* "If the 'principal' is under no duty to perform the services itself, or to ensure that the services be performed, but merely approves of the performance as an irrelevant bystander, then, in the legal sense of the word, one cannot act on the other's 'behalf'." *Id.*

153. *Id.* at 775. "[T]he issue is whether [Schuster] performed her services as an employee of the [clinic], or whether the [clinic] contracted to receive services from the Order, with [Schuster] performing the services as an agent of the Order. The facts in this case show that [Schuster] acted to affect only her own legal relationship with the [clinic]." *Id.*

154. *Id.* at 771. Schuster and the clinic acted in accordance with this agreement:

> [Schuster] shall remain at all times under the direct supervision and control of the DHEW (Dept. of Health, Educ., and Welfare) Regional Health Administrator or his designee. Observance of institutional rules and regulations by [Schuster] are mere incidents of the performance of her Federal functions and do not alter her direct professional responsibility to the Secretary. . . . Day-to-day administrative direction will be given by the Project Director (an employee of the clinic).

*Id.*

155. *Id.* at 778. The court stated that the rule that an agent should not be taxed on amounts he receives from his principal depends upon the existence of some form of legal relationship between the principal and a third party. *Id.* at 775. The court further stated that there must exist between the principal and the third party a contract recognizing the principal's controlling position. *Id.* at 775-76. *See also* Johnson v. Commissioner, 78 T.C. 882 (1982), *aff'd without published opinion*, 734 F.2d 20 (9th Cir. 1984) (income earned by an agent not imputed to principal because control of agent's activities and recognition by third party were lacking).

156. Created in 1982, the United States Court of Appeals for the Federal Circuit (Fed. Cir.) is the successor to the United States Court of Customs and Patent Appeals and also has appellate jurisdiction over the Court of Claims. 28 U.S.C. § 1295 (1982 & Supp. 1986).

an agent of the order and was entitled to report his individual earnings as tax exempt under Revenue Ruling 77-290.[157] This test was later nominally adopted by the Seventh Circuit Court in deciding *Schuster* on appeal.[158] According to these two appellate courts, six factors are relevant in determining if an agency relationship exists: (1) the degree of control exercised by the order over the member; (2) the ownership rights between the member and the order; (3) the purposes or mission of the order; (4) the type of work performed vis-a-vis the purposes or mission; (5) the dealings between the member and the third party; and (6) the dealings between the third party and the order.[159]

After listing these factors, the Federal Circuit Court declined to explain how an application of these factors to *Fogarty* would result in Father Fogarty not qualifying as an agent under Revenue Ruling 77-290. Basically, the Federal Circuit Court let the Court of Claims' decision stand.[160] This affirmation of the lower court allowed the inference that it was proper for a court to rule that an agency relationship does not exist if there is not a contract between the member's employer and the order in which it is agreed that the order is the party obligated to perform the services.

In *Schuster*, on appeal, the Seventh Circuit Court purportedly applied the Federal Circuit Court's six-factor test, but in reality it applied the two-part analysis of the loaned-out employee test that was favored by the Court of Claims.[161] The Seventh Circuit Court emphasized that the clinic, rather than the order, exercised day-to-day control over Schuster. Thus, the court held that Schuster performed her duties as an employee of the clinic and was acting on her own behalf and not as an agent of the order.[162]

An examination of the three theories used to determine if an agency relationship exists between the member and the order, allowing the member's income to be tax exempt under Revenue Ruling 77-290, shows that the courts have been requiring the presence of two factors in an agency relationship: (1) the order must have day-to-day control over the member's

157. Fogarty v. United States, 780 F.2d 1005, 1012 (Fed. Cir. 1986).

158. Schuster v. Commissioner, 800 F.2d 672, 677 (7th Cir. 1986) ("In adopting this flexible test approach, we reject the so called 'agency triangle'. . . ."). *But see id.* at 680 (Cudahy, J., dissenting) ("The majority ostensibly applies a 'six-part' test derived from [*Fogarty*] . . . . In fact, the majority's application of its own test looks somewhat like [the loaned-out employee test that was set out in] *Johnson*.").

159. *Schuster*, 800 F.2d at 678; *Fogarty*, 780 F.2d at 1012.

160. *Fogarty*, 780 F.2d at 1013. The court merely stated "our review of the decision indicates that the [lower] court considered all of the undisputed facts of record." *Id. See also Schuster*, 800 F.2d at 680 (Cudahy, J., dissenting) (pointing out that the Federal Circuit Court applied the six-factor test to *Fogarty* "with a minimum of analysis").

161. *See supra* note 158.

162. *Schuster*, 800 F.2d at 679 (stating the majority opinion that Schuster was acting on her own behalf because she was a clinic employee).

conduct, and (2) there must be a contract between the member's employer and the order placing the order under an obligation to ensure that the member actually provides the services to the employer.[163] Under this two-part test, Father Fogarty did not qualify as an agent of his order.[164] First, as an employee of the University, Fogarty was subject to general control by the University, rather than by his order, and was expected to conduct his classes in a University-approved manner.[165] Second, the University did not contract with the order placing the order under a duty to ensure that Fogarty's teaching services were provided.[166]

Similarly, Sister Schuster did not qualify as an agent of her order because Schuster's order and her secular employer, the clinic, did not enter into a contract agreeing that the order and not the clinic was responsible for overseeing Schuster's daily activities.[167] Also, there was no agreement obligating the order to make certain that Schuster provided nursing services to the clinic.[168] For these two reasons, Sister Schuster was not allowed tax exemption under Revenue Ruling 77-290 as an agent of her order.[169]

## V. RECENT AGENCY DEFINITION V. RESTATEMENT AGENCY LAW

### *A. IRS Definition Causes Inequitable Results*

The two-part test that the courts have developed to determine if a member is an agent creates a narrow definition of the agency relationship that is required for a member to qualify for tax exemption under Revenue Ruling 77-290.[170] This definition has served its purpose by denying tax-exempt status to taxpayers who are involved in bogus church schemes.[171] Al-

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163. Fogarty v. United States, 6 Cl. Ct. 612, 614 (1984), *aff'd*, 780 F.2d 1005, 1013; *Schuster*, 800 F.2d at 678, 679; Hogan v. United States, 47 A.F.T.R. 2d 86-338 at 342; McEneany v. Commissioner, 55 T.C.M. (P-H) ¶ 86,413 at 1890 (1986). *See also* Luechtefeld v. Commissioner, 54 T.C.M. (P-H) ¶ 85,227 (1985) (a nun working as para-legal at a legal aid clinic); Young v. Commissioner, 54 T.C.M. (P-H) ¶ 85,228 (1985) (a nun working as a librarian at a public library); Laurent v. Commissioner, 54 T.C.M. (P-H) ¶ 85,229 (1985) (a nun working as a secretary and counselor in an alcohol rehabilitation clinic); all applying the *Schuster* court's triangle theory and imposing taxes on members of religious orders working on missions related to their religious ministries. *See generally* Philipps, *Vows of Poverty*, *supra* note 19, at 32-36 (discussing the similarity of the three agency theories).

164. *See supra* note 141 and accompanying text.

165. *See supra* note 141 and accompanying text.

166. *See supra* note 141 and accompanying text.

167. *See supra* notes 150-54 and accompanying text.

168. *See supra* notes 150-54 and accompanying text.

169. *See supra* note 149 and accompanying text.

170. *See supra* note 163 and accompanying text.

171. *See supra* notes 73-74 and accompanying text. *See also* Philipps, *Vows of Poverty*, *supra* note 19, at 27 (suggesting that the Service has used agency principles to attack bogus church schemes in order to bypass the first amendment problems associated with questioning the validity of a church or religious order).

though such taxpayers "join" a religious order, they remain employed by their secular employer so that they can continue to receive the same amount of income as they did before taking their "vow of poverty."[172]

When a taxpayer joins a bogus religious order, the employer and the taxpayer retain the same relationship (employer-employee) that they had before the taxpayer joined a religious order. The employer does not contract with the taxpayer's new "order" to receive the same services from the taxpayer that the employer has already been receiving.[173] Further, the employer, and not the bogus religious order, controls the taxpayer's physical conduct while he is performing services for the employer.[174] Thus, the taxpayer will not qualify as an agent of his order under the court's strict two-part agency test. The courts and the IRS have found an effective, easy way to deny tax exemption to members of bogus religious orders who were relying on O.D. 119 to shelter their income from taxation.[175]

Unfortunately, as Father Fogarty and Sister Schuster's situations illustrate, the court's narrow definition of agency has also had the inequitable result of taxing the income of religious members who have taken bona fide vows of poverty.[176] This inequitable result occurred because the courts did not correctly apply agency law to the facts.[177] First, the courts failed to

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172. *See, e.g.*, Mone v. Commissioner, 774 F.2d 570 (2d Cir. 1985). Two taxpayers took bogus vows of poverty to the Life Science Church. One taxpayer remained a New York City sanitation worker and received $20,142 in 1980. *Id.* at 571. The other taxpayer remained employed as an electrical engineer and earned $38,684 in 1980. *Id.* Both retained control over their income but claimed exemption on their 1980 income tax return. *Id.* at 573. *See also* Stephenson v. Commissioner, 748 F.2d 331 (6th Cir. 1984) (taxpayer took a "vow of poverty" but continued practicing as a private physician and was paid wages of over $50,000 in 1976, which he used to buy a new home); Pollard v. Commissioner, 48 T.C.M. (CCH) 1303 (1984). This was a consolidated case involving 20 families who created religious orders under the Calvary Temple Church. *Id.* at 1306. Brooks remained employed by Delta Air Lines as a customer services agent and received $24,486 in 1980. *Id.* at 1313. Dollar remained employed by N.C.R. Corp. as an engineer and received $23,230 in 1980. *Id.* at 1314. Egerdahl remained employed as a courier for Federal Express and received $22,854 in 1980. *Id.* at 1315. Johnston remained employed by Eastern Airlines as a mechanic and received $27,806 in 1979. *Id.* at 1316-17. All of these taxpayers retained control over their income but claimed exemption on their income tax returns. *Id.* at 1311.

173. In some cases the taxpayer's employer requires the taxpayer to sign a statement agreeing that the employer has no involvement with the taxpayers' religious order; the taxpayers usually stipulate that their secular employers had no contracts or agreements with any religious order. *See Mone*, 774 F.2d at 573.

174. *See infra* notes 184-85 and accompanying text for a discussion of the control in an employer-employee relationship.

175. Apparently the IRS has won every case against bogus church schemes when the taxpayer relied on agency principles.

176. *See supra* notes 132-55 and accompanying text.

177. *See infra* notes 178-97 and accompanying text. *See also* B. HOPKINS, *supra* note 2, at 193.

> The concern of the IRS about mail order ministries . . . are leading the IRS to many

consider that there is more than one type of agent.[178] The requirement that the principal have day-to-day control over the agent, the first part of the two-part test set out by the courts, described only one type of agent: the servant-agent.[179] Second, the existence of a contract between the order and the member's employer, expressly placing an obligation on the order, is not necessary to create an agency relationship between the member and the order.[180] Only two parties, the agent and the principal, need to enter into an agreement to form an agency relationship.[181] The party receiving the services from the agent, here the member's employer, must be aware that the agent is acting on behalf of a principal.[182] Thus, the second part of the court's two-part agency test is also contrary to settled agency law.

### *B. Restatement Agency Law Applied to Religious Members*

In general Restatement terms, an agency relationship is a fiduciary relationship that is created when two parties agree that one of the parties will act for the other party and be subject to his control.[183] The degree of the principal's control over the physical acts of the agent is the important factor in determining if the agent is a servant-agent (employee) or an independent contractor-agent.[184] If the principal controls the day-to-day activities of the

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adverse decisions which, in turn, are causing like decisions by the courts, so that the law is shaping up as being appropriately tough as regards the sham situations but it is formulating some legal principles that are highly questionable when applied outside the areas of abuse.

*Id.*

For further discussion, see Philipps, *Vows of Poverty*, *supra* note 19, at 20 ("The abrupt change in IRS policy during the 1970s was unfair from a policy standpoint and at least questionable from a legal standpoint."); Schuster v. Commissioner, 84 T.C. 764, 785 (1985) (Korner, J., dissenting) ("The 'triangle' theory applied here is premised upon an inaccurate appraisal of the law of agency as well as the facts of this case . . . only two parties are required to create an agency relationship.").

178. *See infra* notes 184-85 and accompanying text (discussing servant-agents).

179. *See infra* notes 184-85 and accompanying text.

180. *See* Philipps, *Vows of Poverty*, *supra* note 19, at 33 ("The triangle theory requires that the third party always be aware of and deal directly with the principal. The triangle theory would, therefore, if taken to its logical conclusion, preclude agency relationships involving an undisclosed principal.")

"An undisclosed principal is bound by contracts and conveyances made on his account by an agent acting within his authority . . . ." RESTATEMENT (SECOND) OF AGENCY § 186 (1957). "It may be said that the principal becomes a party to the contract by operation of law, without the will of the third party." *Id.* § 186 comment a.

181. *See infra* notes 183-216 and accompanying text.

182. *See supra* note 180 and accompanying text.

183. RESTATEMENT (SECOND) OF AGENCY § 1 (1957) provides: "Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control and consent by the other so to act."

184. RESTATEMENT (SECOND) OF AGENCY § 14 comment a (1957) provides: "The extent of the right to control the physical acts of the agent is an important factor in determining

agent, then the agent is a servant-agent.[185] A servant (employee) is an agent employed to perform services for a master (employer).[186] Employees are agents of their employer when acting within the scope of their employment if the employer controls, or has the right to control, the physical conduct of the employee.[187]

According to the courts in *Fogarty*[188] and *Schuster*,[189] a member is an agent of his order only if the member remains an employee (servant-agent) of the order while the member is performing services for a secular employer.[190] Thus, the member must remain subject to the order's control over his daily conduct.[191] In formulating this requirement, the courts have overlooked the fact that a member of a religious order can be an agent of the order without being the order's employee. A member of a religious order is an agent of the order if the member qualifies as an independent contractor-

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whether or not a master-servant relation between them exists." *See* Meister v. United States, 319 F.2d 875 (Ct. Cl. 1963).

> The existence of the state of employment, as we see it, consists of two primary factors which may exist in varying degrees. The first of these is the degree of physical proximity between the employee and the employer, and the second factor concerns the strength of the manifestations of the employee's intention to be doing his employer's business. These two factors create the substance of the classic common law test of the master-servant relationship — whether the employer has control or right to control the employee.

*Id.*

185. RESTATEMENT (SECOND) OF AGENCY § 2 (1957) provides:

> (1) A master is a principal who employs an agent to perform service in his affairs and who controls or has the right to control the physical conduct of the other in the performance of the service.
>
> (2) A servant is an agent employed by a master to perform service in his affairs whose physical conduct in the performance of the service is controlled or is subject to control by the master.

186. *Id.*

187. "The term 'scope of employment' refers to those acts which are so closely connected with what the servant is employed to do, and so fairly and reasonably incidental to it, that they may be regarded as methods, even though quite improper ones, of carrying out the employment." W. KEETON, D. DOBBS, R. KEETON & D. OWEN, PROSSER AND KEETON ON TORTS 502 (5th ed. 1984).

188. Fogarty v. United States, 6 Cl. Ct. 612 (1985), *aff'd*, 780 F.2d 1005 (Fed. Cir. 1986).

189. Schuster v. Commissioner, 84 T.C. 764 (1985), *aff'd*, 800 F.2d 672 (7th Cir. 1986).

190. *Fogarty* at 614-15 (a member is an agent of his order only if he remains an employee of his order and has been "loaned-out" to the third party); Schuster v. Commissioner, 800 F.2d 672, 679 (7th Cir. 1986) (member was not an agent of her order because she was an employee of a third party and not an employee of the order). *But see* Philipps, *Vows of Poverty*, *supra* note 19, at 33 ("Sister Francine's potential status as an employee of [the clinic] does not preclude her from remaining the Order's agent at the same time."); RESTATEMENT (SECOND) OF AGENCY § 226 (1957) (an agent can act at the same time with respect to two principals as long as service to one principal does not constitute abandonment of the other).

191. *See supra* notes 183-85 and accompanying text.

agent.[192]

An independent contractor, like an employee, performs services for another. Unlike an employee, however, he is not subject to the other's control with respect to the independent contractor's physical conduct.[193] Nevertheless, an independent contractor is an agent when he is performing services for another and is subject to the other's control, *except* with respect to his physical conduct.[194] Members of religious orders are acting as independent contractors of their orders when they work for secular employers and remit the remuneration they earn to their order.[195] The members are also agents of their order because they are acting as fiduciaries of their order, and the member and the order have agreed that the member will act for the order and be subject to the order's control.[196] The relationship between member and order meets the Restatement definition of agency.[197]

To qualify as an independent contractor-agent of his order, a member must satisfy four criteria. First, the member must have entered into a contract with the order agreeing to do something for the order.[198] When a member joins a religious order, he executes an agreement promising to abide by the rules of the order and to perform services that will further the

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192. *See infra* notes 193-216 and accompanying text.

193. *See* RESTATEMENT (SECOND) OF AGENCY § 2 (1957) (an independent contractor is not subject to control with respect to his physical conduct; he may or may not be an agent).

194. RESTATEMENT (SECOND) OF AGENCY § 14N provides: "One who contracts to act on behalf of another and subject to the other's control except with respect to his physical conduct is an agent and also an independent contractor." *See also* D.R.R. v. English Enterprises, CATV, 356 N.W.2d 580, 582 (Iowa App. 1984) (a person can be both an agent and an independent contractor); Columbia Broadcast Sys., Inc. v. Stokely-Van Camp, Inc., 522 F.2d 369 (2d Cir. 1975) stating that:

> We are also fully aware that an independent contractor, one who is not subject to the right of another to control his physical conduct in the performance of the undertaking, may or may not be an agent. . . .The usual "agent", broker, factor, attorney is an independent contractor (and not a servant) but also an agent. It is only colloquially that the terms independent contractor and agent are necessarily distinct.

*Id.* at 375 & n.14.

195. A member of a religious order is performing duties for his order in every undertaking. His vows to the order require him to act only in furtherance of the order's religious purposes. *See* Schuster v. Commissioner, 800 F.2d 672, 673 (7th Cir. 1986). *See also* Order of St. Benedict v. Steinhauser, 234 U.S. 640, 651 (1914) (vows held to be a binding agreement on both parties).

196. *See infra* notes 199-205 and accompanying text.

197. *See supra* notes 183-85 and accompanying text.

198. *See* RESTATEMENT (SECOND) OF AGENCY § 2 (stating that an independent contractor is one who contracts with another to do something for him). *See also* RESTATEMENT (SECOND) OF AGENCY § 2 comment b ("An agent who is not a servant is, therefore, an independent contractor when he contracts to act on account of the principal."); W. SEAVY, AGENCY (1964) § 6 ("For agency purposes, any one who acts for, or contracts with, the principal other than a servant, is an independent contractor.").

religious purposes of the order.[199] This agreement is a binding contract, enforceable against the member in a court of law.[200]

Second, for a member who is acting as an independent contractor to be an agent of the order, he must be a fiduciary of the order.[201] A member of a religious order is a fiduciary of his order because he has a duty to act primarily for the benefit of his order. As a participant in a communal group,[202] a religious member does not act on his own behalf but acts together with the other members to further the order's religious purposes.[203] The member's vows to the order place upon him the duties of loyalty and obedience.[204] The presence of these two duties further establish that the member is a fiduciary of his order.[205]

Third, although the member must be subject to the order's control, this does not imply that the order needs to exert day-to-day control over the physical acts of the member.[206] Rather, sufficient control exists if the order has ultimate authority over the member while the member works for someone outside the order.[207] A member of a religious order is always subject to the order's control. The order's control over the member is present even

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199. *See, e.g.*, Schuster v. Commissioner, 800 F.2d 672, 682 (7th Cir. 1986) (nun's vow of obedience required her to be completely subservient to the will of her superiors); Hogan v. United States, 57 A.F.T.R. 2d 86-342 (D. Me. 1985) (Catholic chaplain clearly required to abide by the requirements of his order); McEneany v. Commissioner, 55 T.C.M. (P-H) ¶ 86,413, 86,1890 (1986) (chaplain at state hospital for the mentally disabled required by vows to his order to follow the directions of the Archdiocese of Los Angeles); Fogarty v. United States, 6 Cl. Ct. 612, 613 (1984) (priest accepted teaching position upon instruction from his superior in conformance with his vow of obedience).

200. *See* Order of St. Benedict v. Steinhauser, 234 U.S. 640, 651 (1914).

201. *See supra* note 193 and accompanying text. *See also* RESTATEMENT (SECOND) OF AGENCY § 2 comment b (an independent contractor is not an agent if is he is not a fiduciary).

"An agent is a fiduciary with respect to matters within the scope of his agency." RESTATEMENT (SECOND) OF AGENCY § 13. "The agreement to act on behalf of the principal causes the agent to be a fiduciary, that is, a person having a duty, created by his undertaking, to act primarily for the benefit of another in matters connected with his undertaking." *Id.* § 13 comment a.

202. *See supra* notes 8-11 and accompanying text.

203. *See generally* SACRAMENTUM MUNDI, *supra* note 8 (general discussion of religious orders).

204. *Id.*

205. *See* RESTATEMENT (SECOND) OF AGENCY § 14N comment a, which states:

> Most of the persons known as agents . . . are independent contractors . . . since they are contractors but, although employed to perform services, are not subject to the control or right to control of the principal with respect to their physical conduct in the performance of the services. However, they fall within the category of agents. They are fiduciaries; they owe to the principal the basic obligations of agency; loyalty and obedience.

*Id.*

206. RESTATEMENT (SECOND) OF AGENCY § 14, *supra* note 194.

207. *Id.* (defining an independent contractor-agent to be a person who is subject to the principal's general control, but not subject to control over his daily physical conduct).

when a member works for a secular employer.[208] Although the member's employer controls the member's daily activities while at work, the member is at all times expected to strictly adhere to the vows he made to his order.[209] The member must receive permission from his order before obtaining outside employment, the employment must further the purposes of the order, and the order can require the member to terminate the employment or to refrain from certain activities in the course of carrying out the employment.[210]

Finally, for the member to qualify as an agent and receive tax-exempt status under Revenue Ruling 77-290, the order must control the income that the member earns.[211] Any outside employment that the member undertakes must be a requirement of the member's religious duties to the order.[212] Futhermore, the order must have sole claim to the earnings that the member receives.[213] Again, the member's vows to the order satisfy this requirement.[214] Although a member is free to terminate association with the order at any time, any income earned by the member prior to that termination must be remitted to the order.[215] The member does not have a claim of right to any income earned or property acquired while he was a member.[216]

### C. *Restatement Agency Law Applied to Bogus Church Schemes*

In view of the Restatement agency law, a member of a genuine religious order who has taken a bona fide vow of poverty is the agent of the order while performing services for a secular employer.[217] The member is an independent contractor and is also an agent.[218] Thus, the member is entitled to tax exemption under Revenue Ruling 77-290.[219]

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208. *See supra* notes 10-11 and accompanying text.

209. *See, e.g.*, CODE OF CANON LAW, *supra* note 81, at Canon 601 which provides: "The evangelical counsel of obedience . . . obliges submission of one's will to lawful Superiors . . . . " *Id.*

210. *See, e.g.*, Schuster v. Commissioner, 84 T.C. 764, 766 (1985) (religious members are not allowed to undertake employment without permission of their Superior and the Superior can require the member to withdraw from employment if it is deemed necessary).

211. Maryland Casualty Co. v. United States, 251 U.S. 342, 347-48 (1920) (agent not taxed on amounts received on behalf of insurance company because the insurance company controlled the earning of the income).

212. *See* RESTATEMENT (SECOND) OF AGENCY § 1, *supra* note 183 (agent must be acting on another's behalf and with consent).

213. *Maryland Casualty Co.*, 251 U.S. at 346-47.

214. *See supra* notes 81-84 and accompanying text.

215. *See supra* notes 81-84 and accompanying text.

216. *See supra* notes 81-84 and accompanying text.

217. *See supra* notes 196-216 and accompanying text.

218. *See supra* notes 195-216 and accompanying text.

219. Under Rev. Rul. 77-290 a member of a religious order is not taxed on amounts received while working as the order's agent. Rev. Rul. 77-290, 1977-2 C.B. 26.

However, a taxpayer who is involved in a bogus church scheme is not necessarily an agent of *his* order and, therefore, is not entitled to tax exemption. First, the taxpayer is not a servant-agent of his order because the order does not exercise control over his physical conduct while he is working for a secular employer.[220] Second, the taxpayer is not an independent contractor-agent because the taxpayer's relationship with his order does not meet the four criteria set out above.[221]

Although the taxpayer who is a member of a bogus religious order may be able to show that he entered into a contract agreeing to do something for the order[222] and thus satisfy the first requirement of agency, the taxpayer must pass the other three parts of the agency test. An agent is under a duty, as a fiduciary, to act primarily for the benefit of his principal.[223] A taxpayer involved in a bogus church scheme is not acting as a fiduciary of his order. The taxpayer is acting primarily for his own benefit. He is using his religious order as a scam to evade taxes that he legally owes. There is no benefit to the order in this agreement; the order is used to benefit the taxpayer.[224]

Next, the taxpayer must be subject to his order's control.[225] In a bogus church scheme, the order does not retain any control over the taxpayer while he is at work. Rather, the taxpayer retains control over the order.[226] Finally, the order must control, and have sole claim to, the income that the taxpayer earns.[227] This requirement is not met in a bogus church scheme. Although the taxpayer may turn over his income to his order, the order is merely a conduit and the income flows back to the taxpayer.[228]

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220. *See supra* note 185 and accompanying text.

221. *See supra* notes 193-94 and accompanying text.

222. Members of bogus religious orders often execute agreements, sometimes called "vows," with their orders. *See, e.g.*, Pollard v. Commissioner, 48 T.C.M. (CCH) 1303, 1307 (1984).

223. *See supra* note 201 and accompanying text.

224. The Church of Scientology of California is an illustrative example. Between 1971 and 1972 the California church paid founder L. Ron Hubbard $115,680 in salary, over $100,000 in royalty payments, and over $3.5 million to Hubbard's bank account in Switzerland. Church of Scientology v. Commissioner, 823 F.2d 1310, 1314-15 (9th Cir. 1987). The court held that "L. Ron Hubbard's unfettered control over millions of dollars of Church assets . . . coupled with the church's failure to carry its burden of proof and to disclose the facts candidly, proved conclusively that the Church was operated for the benefit of L. Ron Hubbard and his family." *Id.* at 1317.

225. *See supra* note 194 and accompanying text.

226. *See supra* notes 78-80 and accompanying text.

227. *See supra* note 211 and accompanying text.

228. *See supra* notes 79-80 and accompanying text.

## VI. Operational Test Applied to Bogus Church Schemes

A taxpayer involved in a bogus church scheme will rarely be able to qualify as an agent under the four-part test of agency. If the taxpayer does not qualify as an agent of his order, he loses tax exemption and his bogus church scheme will be defeated.[229] If, however, an ingenious taxpayer is able to structure the relationship between taxpayer and bogus church so as to fit the form of the agency test, but not the substance, the IRS can defeat the scheme without creating unjust results. The IRS has the power to use the operational test[230] of section 501 to revoke the tax-exempt status of the church. Of the four elements of the operational test,[231] the second element, prohibiting inurement of organizational funds to private individuals, and the fourth element, requiring the organization to serve a valid public purpose, would be the most difficult for a bogus church to satisfy.

Most bogus churches would fail the operational test because of the presence of private inurement.[232] Inurement occurs when an individual, by virtue of his relationship with his organization, is able to apply the organization's financial resources to his private purposes that do not further the tax-exempt purposes of the organization.[233] Thus, an organization cannot be tax exempt if its primary purpose is to benefit private individuals even if the organization also engages in exempt activities.[234] If the IRS believes that private inurement has occurred in an organization, the IRS can challenge the organization's right to tax-exempt status.[235] The organization then has the burden of proving that none of its net earnings inured to a private indi-

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229. Rev. Rul. 77-290, 1977-2 C.B. 26.

230. *See supra* notes 14-20 and accompanying text.

231. The four elements of the operational test are: (1) activities further a religious purpose; (2) no inurement to private individuals; (3) resources not spent to influence legislation; and (4) organization serves a valid public purpose. Church of Scientology v. Commissioner, 823 F.2d 1310, 1315 (9th Cir. 1987).

232. *See id.*

233. *See generally* B. Hopkins, *supra* note 2, at 239-64 (extensive discussion of the concept of private inurement in charitable organizations).

234. B. Hopkins, *supra* note 2, at 240 ("In determining the presence of any proscribed private inurement, the law looks to the ultimate purpose of the organization: if the basic purpose of the organization is to benefit private individuals, then it cannot be tax-exempt, even though exempt activities may also be performed. . . ."). *See also* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) which provides that:

> An organization is not organized or operated exclusively for one or more [exempt purposes] unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

*Id.*

235. Tax Ct. R. of Prac. & Proc. 217(c)(2)(i).

vidual.[236] Requiring strict adherence to this element of the operational test would eliminate the vast majority of bogus churches.

In some cases where, in practice, the net earnings of a bogus church inured to a private individual, the church could conceivably prove that technically such private inurement did not occur and all net earnings were used for religious purposes. This possibility exists because the concept of "religious purpose" is broad.[237] In these cases the IRS should make further inquiry of the church to ascertain that the fourth element of the operational test is met, which requires an organization to serve a valid public purpose.[238] Thus, if the "religious purpose" of the church is to relieve its members of the burden of paying taxes,[239] the IRS should deny tax-exempt status for the church because it is not conferring a public benefit. The statutes providing tax exemptions are not construed to be applicable to organizations that act contrary to public policy.[240] Furthermore, the government has an overriding interest in protecting its ability to collect taxes and provide for the general welfare.[241]

## VI. CONCLUSION

The rapid spread of bogus church schemes has caused the IRS to require members of religious orders to comply with a narrow definition of agency before qualifying for tax exemption under Revenue Ruling 77-290. The IRS' overzealous reaction, however, inequitably taxes religious income that historically has been tax exempt. The government, in its zeal to suppress bogus church schemes, has convinced the courts that members of religious orders are not agents of their orders when they are employed by secular employers. The government has been able to do this by arguing that a principal-agent relationship has to meet the standards of an employer-employee relationship. The courts, which are also anxious to find a way to prevent tax avoidance, have accepted this argument. The courts, however, are not applying true agency law to the cases and are failing to recognize that religious members can work for a secular employer, under that employer's control, and still remain a non-servant agent of the order. Members of religious orders who perform services for secular employers are acting as independent contractors of their order and are also agents of their order

236. Note, *Mail Order Ministries*, *supra* note 40, at 980 ("Once the Service decides to challenge an exemption or deduction, the burden is on the organization or the taxpayer to prove entitlement to the benefit.").

237. *See supra* note 40.

238. *See supra* notes 54-57 and accompanying text.

239. *See supra* note 70 and accompanying text.

240. *See* B. HOPKINS, *supra* note 2, at 144 (discussing the public policy test of Bob Jones Univ. v. United States, 461 U.S. 574 (1983)).

241. *See generally* Simon, *Applying the Bob Jones Public-Policy Test*, *supra* note 57.

when their services further the religious purposes of the order. Under these circumstances, a member of a religious order is entitled to tax exemption under Revenue Ruling 77-290.

The IRS can prevent taxpayers from using church scams to evade taxes without distorting agency law. If a taxpayer can devise a church scheme that meets all of the requirements of agency, then the IRS can deny tax-exempt status to the church the taxpayer has created. The operational test of section 501 of the Internal Revenue Code provides the IRS with a means of separating bona fide churches and religious orders, which are entitled to tax exemption, from fraudulent tax evasion schemes, which should be exposed and taxed. The use of the operational test will enable the IRS to detect church scams without challenging the validity of the religion, which would raise serious first amendment problems. Churches and their auxiliary organizations are tax exempt because they provide valuable benefits to society. Under section 501, they are not entitled to tax exemption if they increase the wealth of private individuals or if their actions are contrary to public policy. Bogus church schemes, by definition, are created to frustrate the policy of our income tax collection system and thereby increase the wealth of their creator. As such, bogus churches will not pass the operational test. Thus, the operational test of section 501 provides the IRS with a weapon to detect frauds without formulating dubious agency principles that "extract taxes from a poverty-pledged nun doing corporal works of mercy on behalf of a religious community."[242]

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242. Schuster v. Commissioner, 800 F.2d 672, 679 (7th Cir. 1986) (Cudahy, J., dissenting).