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CHURCH TAX EXEMPTIONS

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CHURCHES AND OTHER religious organizations do not stand on exactly the same constitutional and public policy footing as other exempt organizations. Religion has been given special treatment by the Federal Constitution and by the legislative policies of Congress. The fundamental reason justifying and necessitating this special treatment is the separation of Church and State.

The history of our country shows that fiscal separation has always been considered one of the most fundamental aspects of Church-State separation. Government does not finance the churches, and churches do not finance the government. The separation of Church and State does not, of course, preclude the government from cooperating with the secular services of church-related institutions in such fields as education, health and housing on the same basis as the government cooperates with other exempt organizations. Nevertheless, it is fundamental in our system that government cannot finance or tax religious activities, nor may government become intimately involved in the internal affairs of

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churches.[1]

Not all existing church tax exemptions are matters of constitutional right. Where the tax is imposed on property and not directly on religious activities, government has wide discretion under our Constitution to impose or not to impose the tax. As a matter of sound public policy, this discretion should be exercised in such a way as to preserve the historic fiscal separation of Church and State.

In the past, churches have not been required to make annual income reports to the government.[2] It is desirable to maintain this freedom of the churches from intimate governmental financial scrutiny. The reports that churches make voluntarily to their members and to the general public are one thing; compulsory reports to the government are quite a different matter. Any tax reforms that require financial reporting by the churches should be narrowly limited to specific situations. For example, if Congress decides to abolish the exemption of churches from the tax on unrelated business income, only those churches that engage in unrelated business activities should be required to make reports, and the reports should be limited to the unrelated business activities.

Another aspect of fiscal separation of Church and State is the matter of the Federal Government's definition of religion and of religious activities. It is true, of course, that the grant of tax exemptions to churches and to religious organizations inevitably involves the Treasury in determining what is a church and what are religious activities.[3] Up to the present, however, the Treasury has shown admirable self-restraint and liberality in the interpretation of what constitutes a church and which activities are religious or related to religion. Continuation of this self-restraint and liberality is essential if government is not to get into the business of defining religion with minute exactness, thus involving itself intimately with the internal affairs of churches.

Governmental Neutrality

It has been argued by some opponents of tax exemptions for churches and other religious organizations that such exemptions are governmental subsidies, forbidden by the first amendment.

To the contrary, such exemptions are expressions of governmental neutrality, not of governmental favoritism. With respect to exempt organizations not dedicated to religious purposes, it is at least generally true that the exemptions given them by Congress are expressions of governmental approval and favor for their exempt purposes. With respect, however, to churches and religious organizations, the government is committed by the Fed-

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[1] Board of Educ. v. Allen, 392 U.S. 236 (1968); School Dist. of Abington v. Schempp, 374 U.S. 203, 222, 229 (1963); Zorach v. Clauson, 343 U.S. 306, 312, 314 (1952); People *ex rel* McCollum v. Board of Educ., 333 U.S. 203, 210-11 (1947); Everson v. Board of Educ., 330 U.S. 1, 15-16 (1946); Murdock v. Pennsylvania, 319 U.S. 105 (1943).

[2] INT. REV. CODE of 1954, § 6033.

[3] De La Salle Inst. v. United States, 195 F. Supp. 891 (N.D. Cal. 1961); INT. REV. CODE of 1954, § 511; Treas. Reg. § 1.511—2 (a) (3) (ii) (1958).

eral Constitution to a policy of neutrality.

In the field of taxation, it might be argued that neutrality is impossible. Taxation hurts; exemption helps. This argument, however, confuses abstention with aid. In itself, the exemption is worthless. You cannot buy a chalice or build a church with an exemption. You cannot maintain a synagogue or support a minister with an exemption. The exemption becomes valuable only after voluntary contributions by church members have made possible the acquisition of property and services necessary for religious purposes. Without periodic voluntary contributions from their members and the general public, and without prudent management of those contributions, the churches would be penniless.

Continuation of most of the existing exemptions for churches and religious organizations is one of the best possible expressions of governmental neutrality towards religion. The aid that results to churches from such exemptions is a by-product of a policy of abstention, not the fruit of federal favoritism. As the Supreme Court has indicated in its most recent Church-State decisions, indirect and collateral help or hurt to religion does not destroy the constitutionality of otherwise valid secular governmental programs.[4] It may seem paradoxical, but tax exemptions of churches have served the highest secular purpose: to keep the government itself secular, neutral, and uninvolved with the internal affairs of churches.

[4] Board of Educ. v. Allen, 392 U.S. 236 (1968); School Dist. of Abington v. Schempp, 374 U.S. 203, 222 (1963); McGowan v. Maryland, 366 U.S. 420, 442 (1961).

Objectives of Tax Reform Legislation

The objective of tax reform legislation should be the elimination of inequities and abuses, not the reduction of the income of exempt organizations, much less the reduction of the income of churches.

Exempt organizations, including churches, have not been paying taxes, but they have been saving the American people hundreds of millions of tax dollars every year. In the educational, medical, welfare, housing and social services they perform, churches and other exempt organizations make contributions to the general welfare that would cost billions of tax dollars to replace. Since many exempt organizations, and especially churches, have dedicated personnel working at well below the market value of their services, a dollar in the hands of these organizations can and does produce much more benefit to the public than a dollar in the hands of a government compelled to purchase everything in the marketplace. It follows that any substantial diversion of exempt income used for governmental purposes represents a loss to the general welfare, not a gain.

Some reduction of income, however, may well occur as a by-product of reforms aimed at other objectives, such as (1) eliminating opportunities for personal profit, as distinguished from opportunities for charitable giving; (2) treating all organizations engaged in the active conduct of certain types of competitive commercial businesses on the

same tax basis; and (3) eliminating the necessity for time-consuming and unprofitable auditing by the Internal Revenue Service.

Tax reform aimed at these objectives would necessarily tend to reduce the amount of charitable giving and the total amount of exempt income, including the income of churches. No organization is going to view reduction of its income with pleasure, but it can recognize the need for fairness and simplicity in the text and administration of the tax laws. Accordingly, as long as the legislation is not aimed primarily at the reduction of the income of exempt organizations, and does not substantially reduce that income, there should be no objection in principle to the legislation.

Most of the present Treasury proposals for tax reform are not aimed directly at reduction of the income of exempt organizations. There are two, however, that would have that effect. The first is the proposal to impose a 3% threshold on the deductibility of charitable contributions even for those taxpayers who do not claim the standard deduction but itemize their deductions.[5] The second proposal which would result in a reduction of exempt income proposes a tax on *all* debt-financed income produced by activities not directly related to the organization's exempt purposes. Innocent as this proposal might appear on its face, it goes to the heart of an exempt organization's freedom to increase its income from passive investments through the skill of its management of assets and without any involvement in unfair competitive business practices. The Treasury's proposal is based on the erroneous concept that exempt organizations should be kept dependent for income on annual contributions and the management of debt-free resources that they already possess.[6]

Government should favor the growth of exempt organizations generally and certainly should not interfere unnecessarily with the growth of churches. Credit is an essential part of American economic life, and the Treasury proposal, especially by the "but for" test that it contains, would severely restrict exempt organizations in their proper use of credit.[7] The abuses inherent in the *Clay-Brown*[8] type of situation can and indeed should be cured. The pending proposal, however, goes far beyond a solution of those abuses and unnecessarily intrudes on internal affairs of churches.

General Welfare Contributions

In order to illustrate the magnitude and importance of the contributions by American churches to the general welfare, we would like to give a brief survey of the work of the Catholic Church in the United States.

At the present time the Catholic Church is operating 834 hospitals in the United States which contain 156,838 beds (approximately 30% of the bed capacity for general hospitals in the country).

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[5] Tax Reform Studies and Proposals, U.S. Treasury Dep't, Committee Print, Part I, at 19 (B-2).

[6] *Id.* at 26.

[7] H.R. REP. No. 12663, 90th Cong., 1st Sess. (1967).

[8] Commissioner v. Clay-Brown, 380 U.S. 563 (1965).

In 1967 these hospitals had 5,446,675 admissions. The school system is of comparable size. In 1967 there were 10,603 parochial schools enrolling 4,143, 150 students and 2,356 secondary schools enrolling 1,098,756 students. Additionally, there are 308 colleges sponsored by the Catholic Church with an enrollment of 433,960 students.

The institutional system in the welfare field is likewise substantial. For example, in 1968 there were 103 protective institutions with 8,110 students; 142 special hospitals and sanitoria with a bed capacity of 11,578; 239 orphanages with 21,237 resident children. Additionally, there were 25,188 foster homes operated in connection with Catholic Charities. The Catholic Church maintains 420 homes for the aged with 37,966 residents.

Today, this institutional system is confronted with challenges in the fields of health, welfare, education, urban housing and civil rights—challenges which must be met. It will take a substantial amount of money in addition to contributed services of many volunteers and religious personnel adequately to respond to the increasing tempo of the social challenge.

The money to support the activities of this institutional system must come from a cross-section of the people. Certain types of institutions rely on gifts from taxpayers in relatively high brackets (colleges and hospitals). On the whole, however, the Catholic Church in this country and its institutional system relies primarily on contributions of people with relatively small incomes. This has been the principal financial support of the Catholic Church in this country and will continue to be unless it is dried up at its source by an adverse tax policy. In this connection we wish to emphasize the importance of patterns of giving. Long-range financing of church projects for the institutional system of the Catholic Church takes into consideration established patterns of contributions. The experience of the Catholic Church indicates that the small giver follows a pattern which gradually results in substantial contributions after a period of time.

The provisions in the tax laws for the deductibility of charitable contributions have proven of great assistance to the fund appeals of all exempt organizations, including the churches. Tax deductibility has become an important part of the psychology of giving. As a result, churches and non-profit organizations should be greatly concerned with the Treasury proposals that would alter existing deductibility provisions.

Regular Standard Deduction

Current Congressional hearings involve the question of increasing the regular standard deduction from 10 to 14% of the adjusted gross income of a taxpayer, with a ceiling of $1800. The charitable contribution deduction would be taken out of the area of the regular standard deduction and treated as a separate deductible item with a 2% or 3% minimum amount above which deductions would be available. Any contributions below this threshold would not qualify as deductible items. The threshold limitation would apply also to taxpayers who itemize their returns.

The Treasury Department at these

hearings indicates that at present 53% of the taxpayers use the regular standard deduction and that if the standard deduction is increased to 14% of the adjusted gross income, 80% of the taxpayers will use this method.[9]

Thus, the group of taxpayers upon whom the Catholic Church invariably relies for contributions, would be utilizing the standard deduction in the event that the proposal is enacted into law. Such a development would obviously interfere with the established psychology of giving. However, the Treasury argues that the allowance of a deduction for charitable gifts in excess of 3% of adjusted gross income would tend to offset the reduction of the incentive inherent in the use of the expanded standard deduction. We do not agree. For example, of the 27 million taxpayers who itemized their returns in 1966, 52.7% deducted less than 3% of their adjusted gross income.[10] If this be true of itemizing, then a fortiori it would apply to those who use the standard deduction and there is little reason to believe the Treasury Report's statement that the proposal for a charitable deduction in excess of 3% would provide a substantial incentive for giving.[11] Certainly it would not offset the impact of the shift of 27% of the itemizers to the practice of relying on the standard deduction.

By imposing a 3% threshold on the deductibility of charitable contributions by those who use the standard deduction, the Treasury proposal takes away with one hand what it says it is giving with another. It should be recognized, however, that the basic motive for raising the standard deduction is to reduce the amount of auditing necessary by the Internal Revenue Service. Accordingly, it is suggested that, in order to reduce the auditing without such a serious interference with charitable giving, that a floor of 1½% of adjusted gross income or $125, whichever is greater, be established as the threshold for the deductibility of charitable contributions by those who use the standard deduction. Further simplification of auditing procedures should be pursued by the increased utilization of computers and the development of new types of tax information returns, not by raising deductibility thresholds to the point where they would seriously interfere with contributions to charity.

3% Threshold on Deductibility of Charitable Contributions by Those Who Itemize All Deductions

The proposed increase in the regular standard deduction would result in a substantial loss of revenue by the Federal Government. To offset this loss, the Treasury Report proposes to impose a 3% threshold on the deductibility of charitable contributions even by those taxpayers who do not use either of the standard deductions but itemize all deductions. Imposition of this threshold would result in a $1.4 billion gain of revenue to the Federal Government.

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[9] Tax Reform Studies and Proposals, *supra* note 5, at 64, table 13.

[10] Statistics of Income, Individual Tax Returns, 1966.

[11] Tax Reform Studies and Proposals, *supra* note 5, at 19.

Thus, in effect, the Treasury Report proposes that the churches and other charitable organizations of the country finance the increase in the regular standard deduction. This is unfair and unwise. A wide variety of tax measures could produce the income needed to offset the loss from increasing the regular standard deduction. In the pursuit of more revenue for the general welfare, it would be absurd for government to divert dollars already voluntarily donated to exempt purposes. What is needed is not merely more money for the government, but more money spent for the general welfare.

Moreover, the argument of Treasury predicated on simplification of tax returns and the elimination of audits has no force as applied to taxpayers who itemize all their deductions. Their returns must be audited, at least on a sample basis, not merely for charitable contributions but for all their deductions. To single out charitable contributions as the basis for simplification, leaving the deductions, for example, of interest and state taxes intact, does not harmonize with the Treasury position on equity.

There is a sound basis for allowing a charitable deduction above a specified threshold for taxpayers who use the standard deduction, for presumably the said deduction represents, in part, their charitable giving. But for those who itemize their returns, no such indirect credit is received. Therefore, there is no justification for advocating this deterrent to charitable giving.

Additionally, a burden would be placed upon the effort of the Church in maintaining its parochial school system. It is a well-documented fact that one out of every seven elementary school children is in a nonpublic school and that 90% of the children in these schools are in Catholic parochial schools.

It is also a well-known fact that due to the increased costs, teachers' salaries and other related items, it is becoming more difficult to maintain these schools, for they are supported primarily by contributions. The level of the contributions must be increased in order to provide the best possible education for those attending the parochial schools, otherwise a large number will be enrolling in the public schools and will therefore substantially increase the local tax burden. For example, from the school year 1967-68 to the school year 1968-69 there was a decrease of 4.6% enrollment in Catholic high schools and a decrease of 2.5% in elementary schools. Most of the children transferring from the parochial schools are enrolled in the public schools with a consequent increase in the tax burden. This situation will continue because of the increasing cost of operating a parochial school. During the current school year 44.4% of the total teaching staff in parochial and elementary schools consisted of lay teachers. In high schools 40.9% of the teaching staff were laymen. Additionally, the lay teachers in our school systems are now getting substantially the same amount of money which their counterparts receive in the public school system. Accordingly, any change in the tax structure which discourages contributions certainly will make it extremely difficult to support the parochial school system at its current level.

Finally, it is a fact that throughout the Nation there have been various fund drives to support projects sponsored by the Catholic Church. Many people have pledged to give certain amounts. The fulfillment of these pledges is conditioned on the assumption that the tax laws with respect to contributions will remain relatively stable. The imposition of the 3% threshold on taxpayers who itemize would undoubtedly have a financially disruptive impact upon completed drives; and where there are outstanding pledges one would no longer be able to operate on the assumption that these pledges would be fulfilled.

Tax Treatment of Charitable Contributions (II-5.)

The Treasury Department in its proposal respecting charitable contributions suggests a severe limitation in the area of the split interest trust. Here it would restrict charitable deduction allowance to the annuity and the Unitrust alone. All other donations in trust with life interest or remainder to a charity would not so qualify. We believe that where the Charity is entitled to the remainder interest there is little reason for such an extreme approach. Certainly the ordinary responsibilities imposed by law upon trustees would serve as sufficient assurance that the Corpus would be adequately conserved for the Charity and a valid charitable interest is served by permitting this type of gift.

Contributions of Appreciated Property

Churches and non-profit organizations should be quite concerned with the question whether the deduction for charitable contributions should be limited to the amount of the cost or other basis of the taxpayer in the property contributed or, conversely, whether if there is appreciation in value, such appreciation at the time of the contribution should be included in income at that time. If either alternative were adopted, Congress would be abrogating a policy and a pattern of giving that has been in effect since 1919.[12]

A general survey of gifts to higher education during 1963 discloses that this form of giving amounted to 24% of total giving to such institutions.[13] Additionally, churches receive a substantial number of gifts of appreciated property. One of the Church witnesses before the current Congressional hearings indicated that almost all of the gifts received by it are in the form of real estate or securities.[14] Certainly an important social function is served by these gifts to education as well as to other charities. The tax dollar secured by the imposition of a capital gains tax would not produce the same educational benefit, for example, that it would when given directly to a collegiate institution. Moreover, most Federal aid programs involving grants and loans to educational and charitable institutions must be matched by money from the institution. A significant amount of that money is derived from gifts which

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[12] Tax and War Proceeds Tax Under the Revised Act of 1918, Art. 251 (1919). *See also* Treas. Reg. 33 (1916).

[13] LEVI, PATTERNS OF GIVING TO HIGHER EDUCATION (Am. Council on Educ.).

[14] Testimony of George Shearin, Assoc. Sec., Baptist Foundation of Texas, Hearings on the Subject of Tax Reform, Feb. 26, 1969.

involve appropriate property and charitable remainder trusts. Tax equality is indeed a desirable goal but the progressive achievement of this goal must be related to and integrated with a social policy of encouraging voluntary effort, otherwise government would have to move into the vacuum resulting from the inability of the private institutional system to meet the social demands. To a certain extent, Government has already done this and this is desirable, for an effective partnership has been established between the Government and the voluntary system for the benefit of society. This cooperative effort can only be maintained if there is enough money for the private institution to participate as an active partner.

Increase in Maximum Deduction for Contributions (II-1)

The proposal to raise the maximum deduction from 30% to 50% of adjusted gross income with carryover privileges should encourage an expanded program of giving in a small but significant group. In 1966 approximately 41,000 taxpayers made contributions in excess of 30% of their adjusted income. The Treasury estimates that the revision in the contributions ceiling would effect 48,000 taxpayers in 1969 and would result in a loss of $20 million in revenue.[15] But this revenue loss would be more than offset by the imposition of a minimum individual tax which would produce $420 million in increased revenue.[16]

[15] Tax Reform Studies and Proposals, *supra* note 5, at Tables 1, 12.
[16] *Id.* at Table 1.

Minimum Standard Deduction (IV-2)

At the other end of the deduction spectrum, the Treasury has made recommendations with respect to the minimum standard deduction. It would be increased from $200 to $600 with an exemption of $100 for each dependent subject to an overall limitation of $1,000. A married couple with 2 children would get the maximum of $1,000, while a married couple with 3 or more would also be limited to $1,000. To the extent that this proposal would reduce or eliminate taxes for low income families, it is to be warmly supported. Certainly, it is encouraging to note that this proposal would remove from the tax rolls approximately 1.4 million people in the poverty range. This assistance, however, is limited primarily to small families. We suggest, therefore, that the exemption for each child be raised and the ceiling be removed. The proposal would then achieve equitable relief. All poor families regardless of size would receive assistance.

Tax Treatment of the Elderly (VI-1)

Another socially oriented proposal involves a revision of the tax treatment of the elderly. This revision would eliminate the complex retirement income credit and the double exemption for a person over 65. Also it would subject Social Security and regular retirement benefits to taxation (currently they are excluded). An exemption of $2,500 would be given to a single person over 65 and an exemption of $4,200 would be accorded married couples. However, if only one of the spouses was over 65 the exemption

would be limited to $2,500. The Treasury report indicates that these proposals would result in a reduction of tax liabilities for 3.6 million low income elderly taxpayers. This is indeed a significant tax reform and properly relates tax policy to constructive social purposes.

There are, however, two recommendations which we wish to make. The proposed policy apparently does not contemplate the probable rise in social security benefits. If the benefits rise substantially then the exemption provided might not be adequate. We suggest that the exemption be increased in proportion to the increase in social security benefits.

Secondly, we suggest that where the husband or the head of the family is 65 and the spouse is qualified by age for social security, that the exemption of $4,200 be extended.

Head of the Household Treatment for Single Persons (IX)

There is a significant number of single persons (aside from widows and widowers) who have children under their care and custody but who may not under the terms of the current law claim head-of-the-household treatment since the children have not been adopted or do not have a close blood relationship. Nevertheless, they perform an important social function which should be recognized. An appropriate recognition would be the extension of the head-of-the-household treatment to them so that they would receive the same benefits as other taxpayers in comparable situations.

Estate and Gift Taxes (XVI)

One of the most formidable changes in basic tax policy suggested by the Treasury Report involves the imposition of a capital gains tax on appreciation of assets transferred by death or by gift, and the synthesis of estate and gift taxation into a new unified transfer tax. The Treasury plan proposes to accommodate the charitable donor or testator by tax exemption where the amount of the interest given to charity can be measured with certainty, e.g., an outright grant to charity, but limits exemption in the complex area of the split interest trust to the gift annuity and the Unitrust alone. We realize that there is often a tension between an intent to preserve a charitable exemption and a desire to simplify taxation and avoid abuses and that the problem of achieving a just equipoise in the trust field is very difficult. Nevertheless, we suggest that such a narrow definition of the type of split interest which is permitted to qualify, as a charitable deduction when income is taxed or as an exempt charitable donation under the proposed capital gains or transfer tax, somewhat overbalances the scales in favor of tax simplicity at the expense of the traditional Federal tax policy of permitting donors and testators to make gifts or devises to charities undiminished by tax exaction.

For example, it is not believed that such transfers as the charitable remainder trust are so productive of mischief that some solution within the rationale of the exemption could not be worked out short

of loss of status as a charitable gift. This, accordingly, is believed to be an area calling for greater clarification and more extensive study.

Moreover, it might be contended that a bequest to a charity as a residuary legatee cannot be measured with certainty with the consequent denial of the charitable exemption in the event of a capital gains tax imposed at death. We doubt whether this is intended by the Treasury proposals but nevertheless, we feel that any legislation in this area should specifically preserve the exemption of the residuary legatee. Not to do so may result in disparate tax treatment under the same will between a specific bequest to a charity and one provided in the residuary clauses.

Conclusion

It should be recognized that the tax structure as it currently exists contains certain areas in which absolute tax equality among the various taxpayers is not achieved. Moreover, it is obvious that the law currently authorizes certain deductions and exclusions of income from taxation which deprive the Government of revenue. Admittedly, some of these provisions are difficult to administer, but this should not be the determining factor. From the very beginning of this country our law has formulated a tax policy which has recognized the significant role which religion together with related charitable institutions plays in society.

A political and social consensus has developed, reaffirmed by law and judicial decision throughout the last two hundred years, in which Government has specifically recognized the place of religious institutions not only in the lives of the individuals but in the community.

One of the most important recognitions of this consensus is our tax policy. This policy should not be so substantially altered that it would dry up the basic sources of income which churches and non-profit organizations currently enjoy.