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# DEDUCTIBILITY OF MANDATORY DONATIONS TO RELIGIOUS ORGANIZATIONS UNDER THE INTERNAL REVENUE CODE

## I. INTRODUCTION

Church of Scientology members discovered their “inner selves” through “auditing”<sup>1</sup> and studied Church doctrines and tenets during “training” sessions.<sup>2</sup> To participate in the auditing and training sessions, members paid mandatory or fixed fees to the Church.<sup>3</sup>

In a recent United States Supreme Court Case, the Court considered whether the mandatory donations made to the Church of Scientology constituted a charitable deduction.<sup>4</sup> The Court determined that the members made the mandatory donations with the expectation of a commensurate return benefit (i.e., a *quid pro quo*) and disallowed the charitable contribution deductions.<sup>5</sup>

Although the Court’s decision to disallow the deductions affected thousands of Church members, the Court’s decision reaffirmed longstanding precedent in the charitable contribution deduction area.

## II. STATUTORY ANALYSIS OF CHARITABLE CONTRIBUTIONS UNDER THE INTERNAL REVENUE CODE SECTION 170

### A. *Contribution or Gift under Section 170*

Section 170 of the Internal Revenue Code (Code) permits a taxpayer to deduct the amount of a charitable contribution from adjusted gross income.<sup>6</sup> The Code defines a charitable contribution as “any gift or contribution” to certain eligible entities, including entities organized and operated exclusively for religious purposes.<sup>7</sup>

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<sup>1</sup> Auditing is also known as “processing,” “counseling,” and “pastoral counseling.” *Hernandez v. Commissioner*, 109 S.Ct. 2136, 2141 (1989).

<sup>2</sup> *Id.*; *See Staples v. Commissioner*, 821 F.2d 1324, 1325 (8th Cir. 1987). The church offers group training and education through basic introductory courses in the doctrines of Scientology, auditor training courses, and general educational courses.

<sup>3</sup> *Id.*; *See Graham v. Commissioner*, 822 F.2d 844, 846-47 (9th Cir. 1987). Stating that Doctrine of Exchange requires parishioners of Church of Scientology to make mandatory payments to church in return for religious services. The Doctrine of Exchange provides the foundation for the structure of fixed donations. *Id.*

<sup>4</sup> *Id.* at 2143.

<sup>5</sup> *Id.* at 2145-46.

<sup>6</sup> *See* I.R.C. Section 170(a)(1) (1987) (stating that individuals may deduct charitable contributions); I.R.C. Section 170(c)(2)(B) (1987) (providing that charitable contributions are gifts to or contributions for use by charitable organizations).

<sup>7</sup> I.R.C. Section 170 (1987):

(c) Charitable contribution defined. For purposes of this section, the term “charitable

Congress created the contribution deduction to stimulate individuals contributions to charitable organizations.<sup>8</sup> Congress wanted to reduce the government's financial burden of supporting charitable organizations by increasing donated funds from private individuals.<sup>9</sup>

In addition to reducing governmental funding, Congress expected that the contributions would enhance the charitable organization's ability to support educational, cultural, and religious activities for the public.<sup>10</sup>

Although Congress stated the aforementioned policy reasons for enacting section 170, Congress has provided little guidance for regulation of the charitable contribution deduction or the definition of what constitutes a "gift or contribution."<sup>11</sup>

Accordingly, courts have applied a variety of tests for determining what comprises a contribution or gift for purposes of section 170.

## B. Directness of the Benefit Analysis

### 1. Subjective Intention Test: "Detached and Disinterested" Gift

In *Duberstein*, the Supreme Court established a subjective test which considers the donor's intent at the time of the gift.<sup>12</sup> Under the subjective test, a gift must "proceed from a detached and disinterested generosity: out of affection, respect, admiration, charity or like impulses," not from a legal or moral duty or anticipation of a return of economic benefit.<sup>13</sup>

### 2. Objective Test: *Quid Pro Quo*

Some courts have rejected the subjective test and have adopted an objective

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contribution" means a contribution or gift to or for the use of...

(2) A corporation, trust or community chest, fund, or foundation...

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;

<sup>8</sup> See H.R. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1938) (stating that Congress enacted charitable contribution deduction to encourage taxpayers to make charitable contributions).

<sup>9</sup> *Id.* By enacting the charitable contribution deduction under section 170, Congress desired to increase private sector support and thus relieve the government of the burden of supporting charities.

<sup>10</sup> *Id.* (stating that Congress enacted charitable contribution deduction to assist charities in providing public benefit).

<sup>11</sup> *Miller v. I.R.S.*, 829 F.2d 500, 502 (4th Cir. 1987) (stating that despite the importance to the Code of the abstract phrase "contribution or gift," neither Congress nor the courts have [sic] offered any very satisfactory definition).

<sup>12</sup> *Commissioner v. Duberstein*, 363 U.S. 278, 285-86 (1960).

<sup>13</sup> *Id.* at 285.

test which considers whether the taxpayer actually received a return benefit (i.e., quid pro quo) for the gift.<sup>14</sup> In *Oppewal v. Comm*, the Court determined that the proper test for determining whether a gift constituted a contribution was whether the payment was substantially offset by the services rendered to the taxpayer.<sup>15</sup>

### 3. American Bar Market Test

In *U.S. v. American Bar Endowment*,<sup>16</sup> the United States Supreme Court adopted a fair market value test which utilized both objective and subjective criteria. The Court determined that a contribution is deductible if the taxpayer transfers money or property to a charitable organization without receiving adequate consideration in return for the contribution.<sup>17</sup>

Recognizing that a payment may possess the dual characteristics of a contribution and a purchase, the court determined the payment would be deductible to the extent that the payment exceeded the fair market value of the benefit received.<sup>18</sup>

### 4. Direct Benefit v. Indirect Benefit

Regardless of characterization, the various approaches are analogous. Each method assesses whether the taxpayer received a direct benefit, rather than an indirect benefit, in return for a donation.

The Internal Revenue Service distinguishes direct and indirect benefits based on who receives the benefit of the donation.<sup>19</sup> Direct benefits enhance the donor in some immediate way.<sup>20</sup> Indirect benefits enhance the recipient organization; society receives the primary benefit from the donation.<sup>21</sup>

For example, assume a taxpayer makes a contribution to a tax-exempt museum and he receives no individual profit for making the contribution. However, the taxpayer derives an inner satisfaction from the gifting and shares in the enhancement of the museum, along with the rest of the community. The Internal Revenue Service construes these benefits as indirect rather than direct because inner satisfaction and

<sup>14</sup> See *Oppewal v. Commissioner*, 468 F.2d 1000, 1002 (1st Cir. 1972) (subjective test rejected in favor of fundamental objective test).

<sup>15</sup> *Id.* First Circuit specifically rejected the application of subjective standards to determine whether parents could deduct the amount of payments to a Christian educational society. The court disallowed the deduction based on the objective criterion that the payment was substantially offset by the cost of services rendered to the taxpayer.

<sup>16</sup> 477 U.S. 105 (1986).

<sup>17</sup> *Hernandez*, 109 S.Ct. at 2138-39.

<sup>18</sup> *Id.* (stating that the insurance policy that the taxpayer received in return for his payment to an endowment fund had a value equal in amount to the fair market value of a comparable insurance policy).

<sup>19</sup> See Rev. Rul. 71-580, 1971-2 C.B. 235, 236 (recognizing that religious observances benefit general public). Congress found that certain charitable activities benefit society and thus are desirable.

<sup>20</sup> See *Miller*, 829 F.2d at 502-03.

<sup>21</sup> *Id.* at 504-05.

shared communal benefits do not outweigh the greater benefit the recipient organization or society receives.<sup>22</sup>

However, should the taxpayer receive a gratuitous membership privilege in return for the donation,<sup>23</sup> the court may interpret this as a nondeductible, direct benefit contribution. Utilizing the market value test, the court may construe a gratuitous membership privilege as a partial deduction if the fair market value of the donation exceeds the value of the membership privilege. To take a partial deduction, the taxpayer receiving the "nominal" direct benefit must prove:

- (1) an intent to make a gift,<sup>24</sup> and
- (2) the donation exceeded the value of the benefit received.<sup>25</sup>

### III. CHURCH OF SCIENTOLOGY

Scientology was founded in the 1950's by L. Ron Hubbard.<sup>26</sup> The Church of Scientology promulgates its religion through a "mother church" in California and numerous worldwide Branch "franchises or missions."<sup>27</sup>

"Scientists believe that an immortal spiritual being exists in every person."<sup>28</sup> An individual becomes aware of this spiritual dimension through a process called "auditing."<sup>29</sup> A trained Scientologist (i.e., "auditor"),<sup>30</sup> with the aid of an electronic device (i.e., E-meter),<sup>31</sup> measures the participant's skin responses during a question and answer session. The participant (i.e., "preclear") gains spiritual awareness by progressing through consecutive levels of auditing.<sup>32</sup>

In addition to auditing sessions, the Church provides "training" sessions for its members.<sup>33</sup> Participants of the training sessions study the tenets of Scientology and seek to procure the necessary qualifications to become an auditor.<sup>34</sup> Scientologists learn that spiritual gains result from participation in the auditing and training sessions.<sup>35</sup>

<sup>22</sup> See Rev. Rul. 68-432, 1968-2 C.B. 104.

<sup>23</sup> *Id.* at 104-05 (discussing availability of charitable deductions for donations to museums).

<sup>24</sup> *U.S. v. American Bar Endowment*, 477 U.S. at 117. (noting that courts have questioned the relevancy of the donor's subjective intent or motive when attempting to define "contribution or gift").

<sup>25</sup> *Id.*

<sup>26</sup> *Hernandez*, 109 S.Ct. at 2141.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* (noting that "auditing" involves a one-to-one encounter between a participant and a Church official).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.* The E-meter is an electronic device invented by L. Ron Hubbard and used to identify areas of spiritual difficulty by measuring an individual's response during auditing sessions.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

To participate in these sessions, the individual pays a "fixed donation" to the Church.<sup>36</sup> The charges are summarized in schedules and prices vary with the session's length and level of sophistication.<sup>37</sup> The Church of Scientology bases the fixed charge system on a central tenet of Scientology known as the "doctrine of exchange."<sup>38</sup> Under the "doctrine of exchange," individuals must pay something back each time they receive something.<sup>39</sup> Individuals who avail themselves of this doctrine avoid spiritual decline because they maintain "inflow" and "outflow."<sup>40</sup>

The Church is primarily sustained by proceeds generated from the auditing and training sessions.<sup>41</sup> The Church rewards advance payment for these sessions with a 5% discount and refunds unused portions of prepaid fees, less an administrative charge.<sup>42</sup>

#### IV. DEDUCTIBILITY OF MANDATORY DONATIONS MADE TO THE CHURCH OF SCIENTOLOGY

Section 170 of the Internal Revenue Code does not differentiate between religious and nonreligious organizations.<sup>43</sup> Traditionally, courts have determined whether a donation to a religious organization constitutes a contribution or gift by applying the directness of the benefit test. Revenue Ruling 70-47 sets forth specific situations where a taxpayer may take a charitable deduction for a contribution to a religious organization.<sup>44</sup> Delineated in Revenue Ruling 70-47 are payments for pew rents, periodic church dues, and building fund assessments.<sup>45</sup>

In *Staples v. Commissioner*,<sup>46</sup> the court allowed a charitable deduction to a church because the taxpayer's receipt of an indirect benefit was shared by all members of the congregation. The court suggested that the actual use of the donation was incidental because the benefit from the donation was distributed to the entire church community.<sup>47</sup>

Apart from the directness of the benefit issue, courts must face the delicate task

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<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* (noting that the Church charges a "fixed donation" for participants to gain access to auditing and training sessions). The charges are set forth in schedules and prices vary with session length. For instance, in 1972, the general rates for auditing ranged from \$625 for a twelve and a half hour auditing intensive to \$4,250 for a one hundred hour auditing intensive.*Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> See I.R.C. Section 170 (West Supp. 1988) (providing qualifications for tax-exempt status).

<sup>44</sup> Rev. Rul. 70-47, 1970-1 C.B. 49.

<sup>45</sup> *Id.*

<sup>46</sup> 821 F.2d 1324, 1325 (1987).

<sup>47</sup> *Id.*

of protecting First Amendment rights without favoring one religion over another.<sup>48</sup> Under the Establishment Clause,<sup>49</sup> the government may not advance a religion to the detriment of others or inhibit a religion to the benefit of others.<sup>50</sup> Under the Free Exercise Clause, the government may not prevent followers of a religion from engaging in conduct which their faith mandates or pressure them to commit acts forbidden by their religion.<sup>51</sup>

The First Amendment does not require the government to provide charitable deductions<sup>52</sup> nor does it prevent the government from limiting the amount of the deduction once the deduction is established. Instead, the First Amendment provides a framework which the courts must be aware of when determining the "contribution or gift" limitation to religious organizations.

#### A. *USSC Adoption of Structural Analysis Test*

Members of the Church of Scientology challenged the Tax Court's holding that fixed donations were not deductible as charitable contributions in all Federal Courts of Appeals except the Federal Circuit.<sup>53</sup>

The First, Fourth, Ninth, and Tenth Circuit Courts held that mandatory donations paid to the Church for auditing and training sessions were not deductible.<sup>54</sup>

The Second, Sixth, and Eighth Circuit Appellate Courts held that mandatory donations paid to the Church for auditing and training sessions were deductible.<sup>55</sup>

The United States Supreme Court granted certiorari to resolve the Circuit conflict over the validity of charitable deductions for auditing and training payments.<sup>56</sup>

The Court addressed three main issues in *Hernandez v. Comm.*:

1. Whether taxpayers may deduct, as charitable contributions, payments made to the Church of Scientology for auditing and training sessions

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<sup>48</sup> The First Amendment provides that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof." U.S. CONST. Amend 1. The first amendment does not require the government to provide tax deductions for gifts to religious organizations. See *Regan v. Taxation with Representation*, 461 U.S. 540, 546 (1983).

<sup>49</sup> *Hernandez*, 109 S.Ct. at 2140-42.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Regan*, 461 U.S. 540, 549.

<sup>53</sup> *Hernandez*, 109 S.Ct. at 2137.

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

2. Whether denial of a Scientology taxpayer's deduction violates the Establishment Clause of the First Amendment
3. Whether the denial of a Scientology taxpayer's deduction violates the Free Exercise Clause of the First Amendment.<sup>57</sup>

In analyzing the Scientologist's donations, the Court considered whether the payments were part of a quid pro quo transaction.<sup>58</sup> The court based its adoption of the quid pro quo test on the legislative history of section 170, the Internal Revenue Service's customary practice, and the United States Supreme Court's decision in *U.S. v. American Bar Endowment*.

The Court noted that the legislative history of the "contribution or gift" limitation revealed that Congress intended to differentiate between unrequited payments to qualified recipients and payments made to such recipients in return for goods or services.<sup>59</sup> Only unrequited payments to qualified recipients were deductible.<sup>60</sup>

In ascertaining whether the Scientologists' payments were made with the expectation of a quid pro quo, the Court concentrated on the Internal Revenue Service's customary examination of the external features of the transaction.<sup>61</sup> The Court adopted this structural approach to examine the external features of the transaction because it alleviates the need to conduct imprecise inquiries into the intent of individual taxpayers.<sup>62</sup>

The Court's decision to adopt a structural approach confirms its prior decision in *U.S. v. American Bar Endowment*.<sup>63</sup> The Court stressed that the "sine quo non of a charitable contribution is a transfer of money or property without adequate consideration."<sup>64</sup> The Court agreed with the conclusions of the Fourth and Ninth Circuits; the structure of the transaction determined whether a quid pro quo was created.<sup>65</sup>

The Court elucidated several reasons why the Scientologists' mandatory payments resulted in a quid pro quo:

1. The Church established fixed price schedules for auditing and training sessions in each branch church;<sup>66</sup>

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<sup>57</sup> *Id.*

<sup>58</sup> *Id.* at 2138.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 2138-39.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* at 2139.



2. The Church elevated particular prices for auditing and training sessions because of particular length and levels of sophistication;<sup>67</sup>
3. The Church returned a refund if auditing and training services went unperformed;<sup>68</sup> and
4. The Church categorically barred provision of auditing and training services for free.<sup>69</sup>

The Court stated that these external factors revealed the inherently reciprocal nature of the exchange.<sup>70</sup>

Scientists admitted that under a section 170 structural analysis the Court may conclude that a quid pro quo exchange existed. However, the Scientists claimed that a quid pro quo analysis was inappropriate under section 170 when the taxpayer received a purely religious benefit; section 170 should automatically allow deductions for the right to participate in a religious service.<sup>71</sup>

The Court rejected the Scientists statutory argument for several reasons.

1. The language of section 170 does not support the statutory argument.<sup>72</sup> Congress specified that a payment to a religious organization is deductible only if the payment is a "contribution or gift." Congress chose not to provide for automatic deduction of a payment made to a church that either generates religious benefits or guarantees access to a religious service. Neither the House and Senate Reports on section 170 or other legislative history on section 170 indicates that Congress' failure to enact an automatic deduction was an oversight;
2. The Scientists' deductibility proposal would expand charitable contribution deductions far beyond what Congress provided.<sup>73</sup> An expansion of the charitable contribution deduction could jeopardize previously settled conclusions of the court. Following the Scientists' reasoning, ceremonies such as the Bar Mitzvah, tuition payments to parochial schools, and payments for medical care at church-affiliated hospitals

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<sup>67</sup> *Id.*

<sup>68</sup> *Id.* (noting that the Church distributed "account cards" on which persons who had paid money to the Church monitor prepaid services they had not yet claimed).

<sup>69</sup> *Id.* (noting that Church tenet #9 states price cuts are forbidden under any guise). "9. Only fully contracted staff is awarded free service, and this is done by invoice and legal note which becomes due and payable if the contract is broken."

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

would become analogous to the auditing and training session payments; taxpayers could automatically deduct such payments because the payments might generate a “religious benefit” or secure access to a religious service; and

3. The Scientologists’ deductibility proposal might raise problems of excessive entanglement between church and state.<sup>74</sup> If the Court adopted the Scientologists’ proposal of automatically allowing a deduction for payments made in connection with a religious service, the lower courts and the Internal Revenue Service would be required to differentiate “religious” services from “secular” ones. Although the Court did not determine the constitutionality of a situation such as this, the Court noted that such “pervasive monitoring” could result in excessive entanglement of church and state.

#### B. *Constitutional Issues Relating to Charitable Contributions to Religious Organizations*

The Court determined that the disallowance of the deductions did not violate the First Amendment Establishment Clause because section 170 is neutral in design and purpose, does not advance nor inhibit religion, and does not threaten excessive entanglement between church and state.<sup>75</sup> The court noted that application of section 170 to religious practices does not require the Internal Revenue Services to place a monetary value on particular religious benefits. The Scientologist’s claim did not require valuation because they alleged their payments were exempt from a quid pro quo analysis and not that the portion of their payment exceeding the value of the acquired service is deductible.<sup>76</sup>

The Court suggested that had the Scientologist’s made such a claim, the need to ascertain what portion of payment was a purchase and what portion was a contribution does not create entanglement problems.<sup>77</sup>

In addition, the Court concluded that the disallowance of the deductions did not violate the Free Exercise Clause of the First Amendment. The Court concluded that any burden on the practice of Scientology (*e.g.*, having less money available for the Church because fewer persons participate in the auditing and training sessions) is no different from that imposed by any public interest in maintaining a sound tax system that is free of exceptions flowing from a variety of religious benefits.<sup>78</sup>

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<sup>74</sup> *Id.* at 2139-40.

<sup>75</sup> *Id.* at 2140-41.

<sup>76</sup> *Id.* at 2141.

<sup>77</sup> *Id.* at 2140-41.

<sup>78</sup> *Id.*

V. CONCLUSION

Fixed or mandatory donations are not charitable contributions within the meaning of section 170 because Scientologists made the payments with the expectation of receiving a commensurate return benefit. Adopting a structural analysis, the Supreme Court determined that the Church's practice of establishing fixed price schedules, elevating particular prices, refunding unused fees, and not allowing services for free, constituted a quid pro quo transaction.

Section 170, as applied to the Church of Scientology, does not violate the First Amendment's Establishment Clause or Free Exercise Clause. The societal interest in the tax system substantially outweighs any burden upon the Church.

The Supreme Court's decision regarding mandatory donations should not affect the status of payments made to other charitable organizations unless the payments are fixed, mandatory, and refundable.

By applying a quid pro quo test to determine the deductibility of mandatory payments to religious organizations, the Supreme Court has aided Congress in making tax rules clearer and more consistent for taxpayers, and has encouraged taxpayers to contribute to charitable organizations without the expectation of a commensurate return benefit.

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