University of Dayton Law Review

Volume 6 | Number 1 Article 4

1981

The Taxation of Family Religious Orders

Albert Feuer

THE TAXATION OF FAMILY RELIGIOUS ORDERS

*Albert Feuer**

Some promoters have reportedly claimed that individuals may avoid income taxes without changing their life styles in any manner by using a kit available at a substantial price to form and utilize a "family religious order," i.e. a religious order consisting of an individual and his immediate family; the individual directs the order as its minister. In accord with a "vow of poverty" the family members assign all their assets, income, and the use of their personal services to the family religious order. In return, the family religious order provides the family members with all their former living expenses, including the rent-free use of their former home and possible "spiritual retreats" to traditional vacation areas. The only creed that members of the religious order must adhere to is the U.S. Constitution; moreover, the members of the order may continue to belong to and exercise the precepts of any traditional religion.[1] The success of this scheme presupposes the validity of three propositions: first, the income payed by third parties for the use of the individual's services and property will be considered earnings of the religious order rather than the individual; second, the family religious order, a religious organization, is not subject to income taxes; and third, any payments that the religious order makes to its members, particularly its minister, will not be subject to income taxes. Each of these propositions is, to say the least, quite dubious.

Aside from a religious veneer for the purported recipient of the individual's income, family religious orders are very similar to family estate trusts. Individuals also assign all their assets, income and the use of their services to a controlled entity, a trust whose trustees and beneficiaries are the individual and his immediate family. The trust

* B.S. Polytechnic Institute of New York, 1970; Ph.D. Columbia University, 1974; J.D. Yale Law School, 1978. Member of N.Y., N.J., and Ohio Bar.

1. *See, e.g.*, Transcript of "God and the IRS, "WNBC-Newscenter 4, May 19, 1980-May 21, 1980; Internal Revenue Manual—Audit 7405, Manual Supplement Apr. 5, 1977. *See also* New York Times, July 20, 1980, § Week in Review at 22 (discussion of the control which states do and should exercise over 'sham' religious sects); New York Times, June 11, 1980, at A9 (a White House military aide sought to avoid income taxes by virtue of his membership in a non-sectarian religious group); New York Times, Aug. 7, 1980 at B3 (state court bars additional sales of kits described in the above broadcast within New York State).

purportedly compensates the individual for the use of his services by permitting him and his family to continue to enjoy their prior life style, but this compensation is a tax-free benefit for the individual and deductible by the trust.[2] Although the Internal Revenue Service (hereinafter designated as the "IRS") has become so concerned about the tax evasion possibilities of family religious orders, that it recently added an audit procedure for examining returns associated with such organizations,[3] it has not issued a single ruling targeted specifically at family religious orders.[4] By contrast, the IRS has issued numerous rulings targeted at family estate trusts.[5] The IRS has, however, recently issued many rulings to the effect that compensation paid by third parties for the use of services of a member of a religious order, whether or not the order is a family religious order, is usually includable in the member's gross income, if an employer-employee relationship exists between a third party and the member.[6] This policy is contrary to

2. *See generally* "Report on Family Estate Trusts," Commissioner's Advisory Group Meeting of April 24-25, 1980 (BNA Daily Tax Reports, J-4, April 28, 1980); Comment, *The Family Estate Trust: Tax Myths and Realities*, 1978 B.Y.U.L. REV. 706 (1978) [hereinafter designated as *Family Estate Trusts*].

3. *See* Internal Revenue Manual 426(28), MT-4200-365; Sept. 14, 1979.

4. *But see* Rev. Rul. 78-232, 1978-1 C.B. 69 (a taxpayer who forms a church, not a religious order, with his immediate family and friends, which he controls may not deduct as charitable deductions his salary checks which he deposits in the church account because the taxpayer retain complete control and enjoyment of the funds).

5. Rev. Rul. 75-257, 1975-2 C.B. 251 [hereinafter cited as Rev. Rul. 75-257] (the grantor is treated as the earner of the trust's income and assignment of the grantor's lifetime services does not shift income); Rev. Rul. 75-258, 1975-2 C.B. 503 (the trust will be taxed as a corporation under some circumstance); Rev. Rul 75-259, 1975-2 C.B. 361 (the trust does not remove an individual's assets from his estate); Rev. Rul. 75-260, 1975-2 C.B. 376 (the grantor incurs no gift tax liability on the transfer of assets to the trust); Rev. Rul. 80-321, 1980—48 I.R.B. at 6 (the presence of a "services contract" between the trust and the user of the taxpayer's services will not cause income to be shifted).

6. Rev. Rul. 79-132, 1979-1 C.B. 62; Letter Ruling 8014017, CCH IRS Letter Rulings Report No. 163, Apr. 16, 1980; Letter Ruling 7937012, CCH IRS Letter Rulings Reports No. 133, Sept. 18, 1979; Letter Ruling 7931004, CCH IRS Letter Rulings Reports No. 127, Aug. 7, 1979; and Letter Ruling 7917007, CCH IRS Letter Rulings Reports No. 113, May 3, 1979. Although private letter rulings are stamped: "this document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code." IRS District Offices can and do use them to establish audit policy. *See*, Internal Revenue Manual 424.3, MT 4200-353, Apr. 27, 1979. Moreover, such rulings will take on increased significance in view of the new IRS policies to reduce the number of published rulings which it will issue (*Remarks of the Commissioner of the Internal Revenue Service on May 18, 1980*, U.S. Tax Week, May 24, 1980). The large number of private rulings which resolve "ambiguities" in the published rulings dealing with this issue would seem to illustrate this phenomenon. *But see* Excerpts from the Remarks of IRS Ass't Comm'r (Techical), Gerald C. Porty, before the Federal Bar Ass'n, Oct. 29, 1980, BNA Daily Tax Reports, Oct. 30, 1980, at J-1 (such reliance is not advisable, instead each taxpayer should seek his own individual ruling, despite the

traditional tax principles, and it is causing many members of traditional religious orders, who are assigned to positions outside their order's church, such as military or prison chaplains, to face improper challenges of their tax returns. Moreover, such policies provide IRS examiners with no guidance regarding the treatment of the self-employed who try to evade taxes by means of family religious orders.

BASIC PRINCIPLES

A tax principle of long standing is that income is taxed to the party who earns the income.[7] Many recent cases have held that the party who earns income derived from the use of personal services is the party that controls the production of the compensation.[8] The critical question in determining which party should include the third party's compensation in gross income is not who performs the services in question, but who controls the production of the compensation,[9] i.e. the availability of the performer's services. The control referred to is general direction and control rather than day-to-day control, as is the case in determining the earner of compensation paid for the use of property. For example, the earner of car rental payments would be the rental company, which controls the availability of the property, rather than the renter who has day-to-day control of the car.

Anticipatory assignments of income do not affect the identity of the recipient of the income for income tax purposes.[10] Consequently,

---

substantial costs to the taxpayer of making such requests). *See also* Remarks of Assistant Commissioner (Technical) of the Internal Revenue Service on July 23, 1980 (BNA Daily Tax Reports, K-3, July 25, 1980).

7. *Commissioner v. Culbertson*, 337 U.S. 733, 739-40 (1949).

8. *See* Raymond A. Vercio, 73 Tax Ct. Rep. Dec. (P-H) 687 (1980); *Nittler v. Commissioner*, 39 T.C.M. 422 (1979); *Wesenberg v. Commissioner*, 69 T.C. 1005, 1011 (1978); *Damm v. Commissioner*, 36 T.C.M. 793, 796 (1977); *Ronan State Bank v. Commissioner*, 62 T.C. 27, 35 (1974); and *American Savings Bank v. Commissioner*, 56 T.C. 828, 839 (1971).

9. The determination of the earner of compensation paid for the use of party's services is thus a two step process; (1) identify the performer of the services; (2) identify the party who controls the availability of the performer's services to the user. It is, of course, reasonable to presume that absent strong evidence to the contrary that the performer is the earner of the compensation that a third party pays for the use of the performer's services. In particular, if the reputed principal is a mere sham, then it is not the earner of the compensation. *See, e.g., Markosian v. Commissioner*, 73 Tax Ct. Rep. Dec. (P-H) 681, (1980). *Roubik v. Commissioner*, 53 T.C. 365, 379 (1969). Similarly if the reputed principal is incapable of performing the services or controlling the performer, then it is not the earner of the compensation. *See, e.g., Millette & Assoc.*, 37 T.C.M. 774 (1978).

10. United States v. Basye, 410 U.S. 441 (1973); Lucas v. Earl, 281 U.S. 111 (1930).

the identity of the party that physically receives the compensation does not affect the identity of the earner.[11] In particular, the includability of the third party's compensation for the use of the member's services will not be affected by whether the member or the order receives the payments.

The taxability of compensation paid by third parties to members of religious orders by the characterization of such cases as "vow of poverty" cases has generated much confusion.[12] A vow of poverty only provides that the votary renounces either the ownership or the unrestricted use of material objects.[13] The vow need not be made to a religious order but may be made to a secular entity, such as the family estate trust. Such vows, whether genuine or not, do not directly affect the taxability of the third party's compensation because they refer to the control of the proceeds rather than the source of the income. It is the latter which determines whether the proceeds are includable within the member's gross income.[14] If the taxpayer is, in fact, dependent upon the order or a secular entity for his sustenance, then the vow of poverty will provide the entity with the *ability* to control the taxpayer's *personal* services if the taxpayer does not control the entity. The vow does not by itself demonstrate that sufficient control is, in fact, being exercised by the order so as to shift the third party's compensation to the order.

TRADITIONAL RULINGS

In 1968, the IRS provided for the first time in a published ruling, Revenue Ruling 68-123,[15] a set of sufficient conditions under which

11. *But see* Commissioner v. First Security Bank of Utah, 405 U.S. 394 (1972) (income will not be attributed to taxpayer who had not received income and was prohibited by law from receiving such income for performing the services that its reputed agent performed). *Cf.* James v. United States, 366 U.S. 213 (1961) (illegal income which a taxpayer earns and receives will be includable in the taxpayer's gross income).

12. The IRS characterizes cases involving the taxability of the compensation of member of religious orders as "vow of poverty" cases for its own internal purposes. *See also* Myers, *Vow of Poverty Ruling*, 24 CATH. LAW. 221 (1979); Comment, *Income Tax Aspects of the Vow of Poverty*, 4 U. DAY. L. REV., 383 (1979) [hereinafter cited as Income Tax Aspects of the Vow of Poverty].

13. *See, e.g.*, 9 *The Catholic Encyclopedia for School and Home*, 227-28 (1965). For a more detailed discussion of the legal aspects of the three vows, obedience, poverty, and chastity, that all members of Catholic religious orders profess, *see* F. D. Rocca, *Manual of Cannon Lawyer*, at 146 (Rev. A Thacher, trans. 1959).

In the case of family religious orders, by contrast some promoters have reportedly suggested that the vow of poverty has so little substance that it can be used to make a person rich. *See* Internal Revenue Manual-Audit 7405, Mar. 10, 1977.

14. Shaw v. Commissioner, 59 T.C. 375, 383 (1972).

15. Rev. Rul. 68-123, 1968-1 C.B. 35 [hereinafter cited as Rev. Rul. 68-123]. The IRS did provide in O.D. 119, 1 C.B. 82 (1919), that sums received by members of

compensation paid by a third party for the use of the services of a member of a religious order is not includable in her gross income. In that case, there was no question that the religious order was a traditional religious order rather than a family religious order. A purpose of the order was to provide personnel to missions, hospitals, schools and social work agencies. The taxpayer was a registered nurse who was assigned by the order to work as an employee at a hospital not affiliated with the taxpayer's order.[16] The hospital paid the taxpayer directly for the use of her services, and she immediately endorsed all the salary checks over to the order. The Ruling stated "[i]t is apparent that the taxpayer was performing services for the hospital as agent of the Society [i.e. the religious order] *since* at all times she remained under its general direction and control."[17] The Ruling also specifically distinguished such control from the supervision of the taxpayer's daily activities which the hospital rather than the order, exercised.

In 1974, the courts for the first and only time confronted the issue of the includability of compensation paid by a third party for the use of the personal services of a member of a religious order in the member's gross income. In *Frances E. Kelley*,[18] the taxpayers worked as a securities salesman and a philosophy teacher at a public college while living outside the order as a layman in order to determine whether he wished to remain a priest. The order was a traditional religious order, the Dominicans, who are a part of the Roman Catholic Church. The Tax Court had no difficulty in deciding that the member had not performed the services in question under the direction and control of his Order; he had not been acting as the Order's agent. The taxpayer neither received instructions from his Order during the period in question, nor did he even inform the Order of either his income or his jobs. The court thus properly disregarded his written vow of obedience to the Order. There was no evidence that the taxpayer was a

---

religious orders as individuals were includable in their taxable income while those sums received as agents of their order were excludable. The ruling, however, provided no criteria for distinguishing the two situations.

16. Although the Ruling does not explicitly state that she was an employee of the hospital, it did state that the details of her daily activities while working there were under the supervision of the hospital. Consequently, the member was an employee of the hospital within the meaning of Treas. Reg. § 31.3401(c)-1 (1970). The ruling does not expressly describe the character of the hospital. It is quite clear, however, that the hospital was not affiliated with the order. Otherwise, why would the ruling so carefully distinguish the different kinds of control exercised over the member's services by her order and the hospital? Moreover, why would the hospital have refused to have paid all of its compensation for the use of the member's directly to the order as requested?

17. Rev. Rul. 68-123, *supra* note 15, at 36 (emphasis added).

18. 62 T.C. 131 (1974).

member in good standing of the Order and thus acting in accord with the vow during the time in question.

TRANSITIONAL RULINGS

In 1975 the IRS issued its first published ruling in a secular vow of poverty case involving a family estate trust and found that the transfer did not shift the taxpayer's personal compensation to the entity.[19] The taxpayer had transferred his personal residence, rental property and income producing property to a trust in exchange for all the trust's units of beneficial interest. The taxpayer, his spouse, and a non-adverse third party were appointed trustees. The taxpayer also "assigned" to the trust "exclusive use of his lifetime services including all remuneration earned by him regardless of its source" (emphasis added).[20] the trust designated the taxpayer as the executive manager of the trust and his wife as the secretary. They were entitled to continue living in their prior residence and to have their family's living and medical expenses paid by the trust.

The IRS provided an obscure explanation for its holding. As in *Kelley*, there had been a purported surrender of control over the taxpayer's personal services in a written document, albeit a trust agreement rather than a profession of solemn vows to a religious order. The courts have, however, never regarded the "simple expedient of drawing up papers"[21] as controlling for tax purposes when the objective economic realities are to the contrary.[22] This is particularly true when the agreement on its own terms seemed to merely convey his earnings rather than the use of his services. Moreover, as in *Kelley*, there was no evidence that the purported prinicipal exercised any control over the taxpayer. A lack of control is supported by the fact that the taxpayer continued to make his services available in precisely the same manner as he did prior to forming the trust. Thus, the taxpayer, rather than the trust, earned the taxpayer's compensation. The IRS did not, however, say this. Instead it merely noted that the employer-employee relationship continued to exist. It concluded that the taxpayer earned the income as an employee of X, his employer.[23] This brief explanation unnecessarily focuses on an irrelevance—the character of his employment. The trust's lack of control over the taxpayer's personal services,

---

19. Rev. Rul. 75-257, *supra* note 5.
20. *Id.* at 252.
21. Commissioner v. Tower, 327 U.S. 280, 291 (1946).
22. Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978); Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 266-67 (1958).
23. Rev. Rul. 75-257, *supra* note 5, at 253.

and thus its inability to shift the taxpayer's compensation to it would not have changed if the taxpayer had not been an employee but self-employed, for example as a securities salesman, as in *Kelley*.

In 1976, the IRS published its first ruling describing a fact pattern in which members of religious orders purportedly received compensation in their capacity as individuals rather than as agents of their order.[24] In particular, members of a religious order who, on their order's instructions, sought and obtained employment *on their own* at a construction company and a plumbing company were required to include in their gross income the companies' compensation even though they gave their order all their compensation minus their living expenses. No mention was made of any kind of control being exercised by the order over the members while they performed the services in question. On the other hand, the final paragraph of the Ruling contrasted its fact pattern with that of Revenue Ruling 68-123, where an agency relationship was found because the order exercised general direction and control over its member while she performed the services in question. In fact, the Ruling's fact pattern described nothing more than an assignment relationship rather than an agency relationship; thus little question should have arisen regarding the includability of the companies' compensation in their gross income.

Revenue Ruling 76-323 improperly concluded that as a result of the employer-employee relationship between the members of the order and the third parties, the members' compensation was subject to withholding. Section 3401(a)(9) specifically provides that remuneration for services performed by a member of a religious order "in the exercise of duties required by such order are not subject to withholding."[25] In this Ruling, the IRS restricted this exception to duties that are not only *ordinarily* the duties of the members of the order but also those which are performed by the member as an agent of the order, where agency is defined in a very restrictive manner.[26] The first criterion flatly con-

24. Rev. Rul. 76-323, 1976-2 C.B. 18 [hereinafter cited as Rev. Rul. 76-323].

25. I.R.C. § 3401(a)(9). Unless otherwise indicated, references to section numbers are to the Internal Revenue Code of 1954 as amended [hereinafter designated as the Code].

26. The Social Security Administration has not imposed either restriction on identical provisions with regard to which wages are not subject to Social Security taxation (§ 3121(b)(8)) or coverage (42 U.S.C. § 410 (1976)). Letter from Acting Associate Commissioner for Operational Policy and Procedures, Social Security Administration to Chicago Regional Commissioner of Social Security Administration (May 25, 1979). Moreover, as part of Operation Common Sense, the Department of Health Education and Welfare recently issued regulations describing which wages of members of religious orders are exempt from Social Security coverage, which specifically refer to work "done for the order *or* for another employer." 45 Fed. Reg. 20081 (1980) (to be codified in 42 C.F.R. § 404.1023(a)) (emphasis added).

tradicts the regulation associated with section 3401 (a)(9) which provides that the nature or extent of the service is immaterial.[27] The second criterion presumes non-agency if the "legal relationship of employee and employer exists between the member and the third party with respect to the performance of such services."[28] This presumption betrays remarkable confusion. Withholding exemptions are only applicable to employer-employee relationships; the existence of such relationship may not preclude the existence of such an exemption.

Revenue Ruling 77-290[29] implicitly presented the principle that members of religious orders who are employed by institutions not associated with their order's church must ordinarily include the institution's compensation in their gross income, whereas those employed by institutions associated with their order's church should exclude it. In particular, a lawyer, a member of a religious order, who had taken a vow of poverty and, in accord with the instructions of his order, obtained employment with a private law firm, was an agent of the firm rather than the religious order; he therefore had to include the law firm's compensation in his gross income even though the firm paid the order directly. On the other hand, a member of the same order, who had also taken a vow of poverty, and was instructed to work as a secretary in the business office of the church that supervised her order, was considered as agent of the order, and the church's compensation was excludable from her gross income.

Revenue Ruling 77-290 is consistent with both Revenue Ruling 76-232, which it specifically clarified, and Revenue Ruling 68-123, which it did not mention. Like Revenue Ruling 76-323, it provides an exception to the general rule that *ordinarily* a religious order is not engaged in the performance of services as a principal if the legal relationship of employee and employer exists between the member and a third party for the performance of such services. Its exception applies if the employer is associated with the order's church. The exception of Revenue Ruling 76-323 applied if the condition in Revenue Ruling 68-123 was satisfied—the order exercised general direction and control over the member. The concluding paragraph of Revenue Ruling 76-323 provided the first exception, the order exercised general direction and control over the member while he performed the services.[30]

The principle that the character of the employer of the religious

27. Treas. Reg. § 31.3401(a)(9)-1(d) (1960).
28. Rev. Rul. 76-323, *supra* note 24, at 19.
29. Rev. Rul. 77-290, 1977-2 C.B. 26.
30. The satisfaction of the condition in Rev. Rul. 68-123, 1968-1 C.B. 35, is the same exception.

member ordinarily determines whether the member should include the third party's compensation in his taxable income[31] is similar to the principle of Revenue Ruling 76-323 that the character of the member's employer ordinarily determines whether his compensation is subject to withholding. Both rest upon the presumption that a member of a religious order who is an employee of a third party is an agent of the third party and therefore, cannot ordinarily be an agent of his order for federal income tax purposes. This proposition shows remarkable confusion. The proposition presupposes that the only question is the identity of the principal; it presumes an agency relationship. If this were the case, then the member should clearly not include the compensation for the use of his services in his gross income. The principal, whether it is the employer or the order, should instead include it in gross income.

In 1977 and 1980, the Tax Court found that two purported secular vows of poverty did not shift income because the recipients, family estate trusts in both cases, were not viable taxable entities. *Louis Markosian v. Commissioner*[32] was a rather blatant example. The taxpayer and his wife transferred all their business and personal assets including the "exclusive use of the taxpayer's lifetime services and all his earned remuneration accruing thereof,"[33] to a family estate trust similar to the one described in Revenue Ruling 75-257. The relationship of the grantors to the property transferred, however, did not differ in any material aspect before or after the creation of the trusts. Moreover, the taxpayers who were the trustees did not recognize any fiduciary responsibilities; the taxpayers admitted that the trust imposed no substantial restrictions on the use of the transferred property. In an earlier and less blatant case, *George T. Horvat v. Commissioner*[34] the taxpayer attempted to convey to a family estate trust "the exclusive use of my lifetime services and all resultant earned remuneration from all

---

31. It has been suggested that the includability of the compensation paid for the use of a member's services in the member's gross income should be determined by whether the employer is a charitable entity. *See* Witbach, *Remuneration Earned by Members of Religious Orders—Is it Taxable?*, 57 TAXES 553, 555 (1979) [hereinafter cited as *Remuneration Earned*]. There is no basis in either the statutes or the case law for such a proposition. *See* Income Tax Aspects of the Vow of Poverty, *supra* note 12, at 398.

On the other hand, it is reasonable to presume that a traditional religious order which has a narrow focus, such as a teaching order or a preaching order or a nursing order would be particularly adept at exercising general direction an control over those of its members who pursue traditional professions within the order's narrow focus, such as a teacher within a teaching order.

32. 73 T.C. 681 (1980).

33. *Id.* at 685.

34. 36 T.C.M. 476 (1977), *aff'd* per order (7th Cir., June 7, 1978), *cert. denied*, 440 U.S. 959 (1979).

and any outside source."[35] The court quickly disposed of the case because there was no evidence that the agreement was anything other than an assignment or that the trust was anything other than "a vehicle designed to lessen the petitioner's tax burden."[36] The trust was not a viable tax entity. The agreement also conveyed the taxpayer's "earned remuneration" which he is required to include in his income.

In 1977 the Tax Court recognized the tax viability of a family estate trust, but nevertheless found that income was not shifted. In *Douglas H. Damm*,[37] the taxpayer purported to convey his future services to the family estate trust in a manner similar to *Horvat*. The *Damm* court did not base its decision on the absence or presence of an employment relationship between the taxpayer and the third party which used his services. Instead it asked who controlled the use of the taxpayer's services and concluded that the taxpayer did: (1) the trust lacked the right to control the amount of income that the taxpayer would generate for the trust; (2) the trust lacked the right to control the manner by which the taxpayer was to generate income for the trust; and (3) the taxpayer was not legally obligated to earn income for the trust. Note that each and every factor refers to the lack of a legal obligation between the taxpayer and the family estate trust, rather than the presence of actual control by the controlled entity of the taxpayer's services. The court also mentioned a lack of "privity" between the purported earner and the user of the taxpayer's services - the trust was not a party to either the taxpayer's employment contract or his distributorship agreement.[38]

In 1978, the Tax Court for the first time as a body decided a family estate trust case and found that the arrangement did not shift income.[39] In *Wesenberg v. Commissioner*, the fact pattern was similar to Revenue Ruling 75-257, although the only trustees were the taxpayer and his wife, and the taxpayer's employer, a school, paid his compensation to the trust. The court concluded that the ultimate direction and control of the earning of the compensation rested with the taxpayer not with the trust.[40] Rather than simply stating that the taxpayer failed

35. *Id.* at 477.
36. *Id.* at 479.
37. 36 T.C.M. 793 (1977).
38. The taxpayer failed to transfer his distributorship rights to the trust, but merely transferred the right to his remuneration from the distributorship. Thus the proceeds rather than the source of the income was transferred. *See also* Realty Settlement Co., 40 T.C.M. 569, 573 (1980) (income was not shifted by "transfers solely of the right to receive income without assignment of the duties or property which created the right to receive it.") In Frederick H. Foglesong, 80-1 USTC ¶ 9399 (7th Cir.) the transfer of distributorship rights to a one-person corporation did shift income.
39. Wesenberg v. Commissioner, 69 T.C. 1005 (1978).
40. *Id.* at 1011.

to show that the trust did, in fact, control or have the power to control the use of the taxpayer's services, the court also described evidence of the lack of such control. In particular, the school, rather than the trust, determined the taxpayer's salary and supervised his employment. Such a reference shows confusion on the court's part with respect to the kind of control that determines taxability. Does the fact that the school, rather than the taxpayer, determined the taxpayer's salary and supervised his employment, demonstrate that the school should include the taxpayer's compensation in its income? Control over the trust's income is, of course, relevant, but it does not refer to the ability to force a particular party to pay the desired compensation or to treat the taxpayer in a particular manner. Instead, it refers to the ability to decide for whom and under what conditions the taxpayer's services will be made available. The *Wesenberg* court mentioned the fact that, as in *Damm*, the employment agreement with the school was not made by the trust but by the taxpayer.

In 1980, the Tax Court as a body found that the existence of a privity relation between the family estate trust and the user of the taxpayer's services did not affect the identity of the earner of the user's compensation.[41] In the previous year in *Vnuk v. Commissioner*[42] the court, in a memo decision, found that having the trust, rather than the taxpayer, enter into a partnership which utilized the taxpayer's services also did not affect the identity of the earner of user's compensation. In *Vercio*, the court declared that "[a]lthough this contractual relation [an employment contract] may have given the trust the legal right to receive the income *earned*, it did not alter the fact that Hailey [the taxpayer] was in control of the earnings and as stated previously, the choice of taxable person turns on who in fact controls the income." (emphasis added).[43] In particular, the court found that the taxpayer was in control because there was no binding contract creating enforceable rights and duties between the taxpayer and the trust. Note

41. Raymond A. Vercio, 73 T.C. No. 99 (Mar. 31, 1980). *On appeal* (10th Cir., June 2, 1980). Trying to determine whether a performer is taxable on the compensation paid by a third party for the use of his services by focusing on whether there is a contractual relation between the user and the punative principal would confuse the basic issue. The basic issue is whether the obligor acts as a principal or an agent in the particular transaction. Similiarly, taxation should not be based on the income from the use of property, but rather in what capacity the title holder was acting. *See* note 47 and accompanying text *infra*. *But see* Rev. Rul. 80-321, 1980—48 I.R.B. at 6 (the IRS also concluded that a privity relation between the user and the trust was irrelevant, but for a different reason, namely because such a relation did not affect the employment relationship between the user and taxpayer).

42. 38 T.C.M. 710 (1979). *Aff'd* (8th Cir. July 11, 1980).

43. *Id.*

the emphasis, as in *Damm*, on enforceable legal obligations between the taxpayer and the controlled entity. Thus, the court was able to distinguish *Vercio* from *Rubin v. Commissioner*[44] and *Laughton v. Commissioner*[45] where there were such contracts.

The courts are beginning to treat attempt to shift income for the use of personal services from the performer to a family estate trust in the same manner that they treat attempts to shift income to family corporations. In both cases, the taxpayer generated income by the use of his services. It would be foolish in either case to try to determine if the entity is taxable on the income by merely asking whether the entity controlled the taxpayer in fact. Such an approach would prevent controlled corporations from ever being regarded as viable taxable entities, and the United States Supreme Court rejected that position in *Moline Properties, Inc. v. Commissioner.*[46] Moreover, the courts have even gone so far as to recognize one-person corporations.[47] The basic question is when will the legal fiction that the entity controls the use of the taxpayer's services be adopted. The answer for controlled corporations appears to be if the entity acts as if it is an independent user of the taxpayer's services. To be more precise, a controlled corporation will be treated as the earner of the compensation paid by a third party for the use of the controlling taxpayer's services if the taxpayer is legally obligated to the corporation to perform the services *and* the corporation is a viable tax entity, (i.e. there is a non-tax avoidance reason for existing and it observes the customary formalities).[48] Section 482 may be used to reallocate the corporation's income to the taxpayer's com-

44. 429 F.2d 650 (2d Cir. 1970).

45. 40 B.T.A. 101 (1939).

46. 319 U.S. 436, 441 (1943).

47. *See, e.g.*, Riemer, *Professional Corporations*, 62 MASS. L.Q. 151 (1977); *But see* Alan Nittler, 39 T.C.M. 422, 429 (1979) (even though the taxpayer transferred his medical practice to a controlled trust in return for an employment contract, income was not shifted because the trust did not operate Dr. Nittler's medical practice, he did, in that the rendering of medical care was under his sole control). *See also Ronald E. Morgan*, 37 T.C.M. 1661, 1665 (1978) in which it is stated: [E]ven if the [family estate] Trust had specified duties and remuneration [for the taxpayer], we agree with the statement in *Wesenberg* that it is questionable whether the Trust could obligate Ronald to perform services which are inherently personal in nature." *Id.* Could not the same comments be made about any personal services corporation regardless of whether the performer controls the corporation? Note both *Nittler* and *Morgan* involved grantor trusts, whose income would be reattributed to the performer in any case.

48. Battle, *The Use of Corporations by People Who Perform Services to Gain Tax Advantages*, 57 TAXES 797, 805 (1979); *Cf.* Foglesong v. Commissioner, 80-1 USTC ¶ 9399 (7th Cir.) (tax viability suffices in all but extreme cases; § 482 may always be used to prevent tax evasion); Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970).

pensation from the corporation to prevent the evasion of taxes.[49] If the entity is not controlled by the performer one should not rely on legal fictions, but instead ask whether the entity, which is presumably a viable tax entity, actually controlled the taxpayer's services. A binding legal obligation is not necessary if control can be shown without such an obligation as is often the case when services are provided for the use of a not-for-profit organization[50] or a political organization.[51]

It is interesting to note that the courts treat attempts by taxpayers to shift income for the use of their personal servcies to a controlled corporation in a manner similar to attempts by taxpayers to shift income from property associated with a controlled entity to themselves. In the latter case, however, taxpayers seek to have the IRS disregard their controlled entity for the transaction in question. The courts also seem to resolve this question by asking does the controlled entity act as an independent user of the property. To be more precise, a controlled entity will be treated as the earner of property associated with the entity if the entity is the substantive legal owner of the property rather than the title owner, *and* the entity is a viable tax entity.[52] Section 482 may again be used to prevent tax evasion in such cases, although it is not often needed in these cases.

Adoption of the same approach for family estate trusts that is now being applied to controlled corporations will not result in the improper avoidance of taxes. First, it is often quite difficult to establish that a family estate trust is a viable entity, because many grantors probably do not observe the requisite formalities.[53] Second, it may be difficult to establish that the family estate trust is a viable tax entity, because it is difficult to conceive of a non-tax avoidance reason for transferring all one's current and future assets to an entity which one controls. Third, the taxpayer will only succeed in converting some of his taxable income into tax-free income, if the trust is entitled to deductions that an individual taxpayer would not be entitled to but which the taxpayer is

49. Several cases have held that § 482 applies to individuals who perform services for controlled corporations. *See* Fogelsong v. Commissioner, 80-1 USTC ¶ 9399 (7th Cir.); Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970); Pauline W. Ach, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966).

50. *See* Rev. Rul. 58-276, 1958-1 C.B. 35.

51. *See* Rev. Rul. 68-503, 1968-1 C.B. 44.

52. *See* Miller, *The Nominee Conundrum: The Dummy is Dead, but the Dead Dummy Should Live*, 34 TAX L. REV. 213 (1979), for a more complete discussion of this matter with particular emphasis on the requisite degree of ownership by the entity. *See also* McEntee, *Use of Controlled Corporations in Real Estate Development*, 58 TAXES 520 (1980).

53. *See* note 31 and accompanying text *supra*.

not required to include in his gross income as compensation from the trust. There are such deductions, pension benefits,[54] death benefits,[55] health and accident insurance,[56] educational assistance,[57] and meals and lodging furnished for the convenience of the employer.[58] Such deductions,[59] however, all presuppose that the taxpayer is an employee of the trust rather than an employee of another party or an independent contractor. However, if the taxpayer is a trust employee, the taxpayer could have obtained the same advantages from a family corporation; thus such advantages are not improper tax avoidance.[60] It is true that the family estate trust, like a family corporation, could be used to attempt to improperly shift income to a lower-bracket taxpayer. However, since all the taxpayer's assets and those of his family are transferred to the trust, it may not be a lower-bracket taxpayer. Moreover as with family corporations, section 482 could be used to reallocate the trust's income to the individual's compensation from the trust to prevent tax evasion.[61] Moreover, sections 671-77 provide that if a taxpayer and his spouse establish a trust over which they retain control of the beneficial enjoyment of the trust's assets or control of the trust's administrative powers or the trust's income may be used for their benefit, then they must include the trust's income, deductions and tax credits in their gross income.[62] Taxpayers generally retain all these powers for family estate trusts,[63] therefore, none of their income will be shifted away from them by this device unless they actually give up control of their personal services to an entity which they do not control.

54. *See, e.g.*, Stoeber, *Maximizing Qualified Retirement Benefits for Professional Corporations*, 6 J. PENSION PLANNING & COMPLIANCE 3 (1980).

55. I.R.C. § 101.

56. I.R.C. § 106.

57. I.R.C. § 120.

58. I.R.C. § 119. *See* Wesenberg v. Commissioner, 69 T.C. 1005, 1009 (1978), for the significance of such a deduction in family estate trust schemes.

59. For a more detailed discussion of these issues and the other tax implications of operating a business in the corporate form, *see Tax Choices in Operating a Business, Tax Analysis Series No. 26*, (CCH 1980).

60. *But see* Private Letter Ruling 7939003 (CCH Private Letter Rulings Report No. 135, Oct. 2, 1979) (if the principal purpose for the information of a corporation is to obtain such deductions, § 269 requires disallowance).

61. Treas. Reg. § 1.482-1(a)(1) provides that § 482 applies to trusts. Several cases have held that § 482 applies to individuals who perform services for controlled corporations, Fogelsong v. Commissioner, 80-1 USTC ¶ 9399 (7th Cir.); Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970); Pauline W. Ach, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966).

62. These sections of course mention the impact of the presence of adverse parties as trustees, but they are not usually present in family estate trusts.

63. *See Family Estate Trust, supra* note 2, at 715-19 for a more extended discussion of this matter.

RECENT RULINGS

The recent IRS rulings regarding the taxability of the compensation third parties pay for the use of the services of members of religious orders make no attempt to distinguish traditional religious orders which are not controlled by any individual's family, and family religious orders. The rulings also make no attempt to examine the degree of actual control exercised by the order over the services in question. Instead, the IRS has become preoccupied with an irrelevant issue, the existence of an employer-employee relationship between a third party and the other member.

In Private Letter Ruling 7917007,[64] the member was under a vow of poverty to a religious order whose basic purposes were teaching, sacred ministry, missionary work and charitable work. The taxpayer contracted on his own with a publicly supported university on a professional scientific basis to become a faculty member. The order subsequently approved the appointment, but exercised no direction over the content of the member's courses. Although the taxpayer requested that the university pay its compensation to the order, the university refused. Any amount that the taxpayer did not require for his own personal needs was to be used for charitable work or field research. The member maintained records of all his receipts and expenditures which were subject to the order's inspection. Although the order was not controlled by the taxpayer, no evidence of the order controlling the taxpayer's personal services other than approving the appointment which the member (taxpayer) arranged is adverted to. Such approval could have been quite mechanical.[65] Thus the approval by itself does not show that the order determined where and for whom the taxpayer worked or "the amount earned or the manner in which it was earned" as in *Damm*.[66] The IRS, however, based its decision solely upon the existence of an employment relationship between the member and any institution not associated with the order's church.

The only recent published ruling, Revenue Ruling 79-132,[67] was

64. *See* note 6 *supra*.

65. *See, e.g.*, Boyer v. Commissioner, 69 T.C. 521 (1977) (the eligibility of a Methodist minister for a parsonage allowance was in question); Rev. Rul. 78-216, 1978-1 C.B. 305 (eligibility of a minister working on an assembly line for the withholding exemption of § 3401(a)(9) was in question).

66. 36 T.C.M. 793 (1977).

67. *See* note 6 *supra*. The authority of the IRS to publish this ruling, so that it has precedential value, is dubious. It was published on April 16, 1979, in the midst of the moratorium on the IRS publishing rulings with respect to the employment status of any individual for purposes of the employment taxes. Revenue Act of 1978, Pub. L. No. 95-600, § 503(b) 92 Stat. 2763. Moreover, even if the moratorium were not in ef-

based almost entirely on the existence of an employee-employer relationship between the member and the U.S. Armed Forces, an institution not associated with the church's order. A military chaplain who had been instructed by his order to serve in the military as a chaplain and who turned over all his remuneration to his order was found not to be acting as an agent of his order. There was no further evidence of the order exercising control over the member during the time he was in the military. The ruling does contain a conclusory statement that the military looks directly to the member rather than the order for the performance of the services. There should be no question that if the military had had such an arrangement with the order, the member would be acting as the order's agent. Less than a week later, however, the IRS ignored such an arrangement.[68] Moreover, such an arrangement is not necessary for the order to exercise sufficient control over the member's personal services to be considered the earner of compensation paid for their use by a third party. For example, in Revenue Ruling 58-515,[69] the compensation an undercover policeman received from a third party while employed on an undercover basis was found not to be taxable because the police retained such control over his services.

Revenue Ruling 79-132 is not internally consistent; it refuses to concede the existence of an agency relationship between the member and his order unless an irrelevant and unfeasible condition is fulfilled. The issue is does the taxpayer or his religious order earn the compensation that the military pays for the use of his services. The military does not want nor does it expect its members to insure that their military posts will always be filled. If for any reason a soldier is unable to fulfill his duties due to death or injury, the military wishes to have the right to select the most appropriate replacement. Thus, asking that the religious order assume such an obligation, would not only require the satisfaction of an unfeasible condition, but one that is beyond the control of either the member or his order. It should have no bearing on whether *the member or his order* has more control over the use of his services; the condition should not affect the identity of the earner of the compensation paid by the military.

---

fect, § 3122 delegates to the head of the taxpayer's department the power to decide whether the taxpayer's service constitutes employment for withholding purposes. These provisions arguably apply also to questions of the includability of the military's compensation in the taxpayer's gross income because the IRS has interpreted the questions to be identical to withholding questions.

68. *See* Private Letter Rul. 7931004 (CCH Aug. 7, 1979).

69. 1958-2 C.B. 28.

Revenue Ruling 79-132 is not consistent with the other rulings in this area, not even with Revenue Ruling 77-290, which it is supposed to clarify. A ruling clarifying Revenue Ruling 77-290 could be expected to discuss in more detail how closely associated a third party should be with the order's church in order for the member to be considered her order's agent. Alternatively, like Revenue Ruling 77-290, which in turn clarified Revenue Ruling 76-323, it could provide an exception to the general rule that members of religious orders employed by third parties are not ordinarily acting as their order's agent. Revenue Ruling 79-132 did neither. Instead, it presented a single *necessary*, rather than a sufficient condition, which is subsumed in neither the exception of Revenue Ruling 76-323 (i.e. the sufficient condition of Revenue Ruling 68-123) nor that of Revenue Ruling 77-290. Thus, it's impact is rather unclear. Should it be taken literally, so that it supersedes both of the prior rulings? Such an interpetation would seem to be unlikely. Private Letter Ruling 7937012, which was subsequently issued indicates that Revenue Ruling 68-123 (and thus by implication Revenue Ruling 76-323) is valid in the first sentence of its conclusion. It would seem most reasonable to either totally disregard the ruling, or interpret it as presenting a third exception to the general rule regarding the taxability of the compensation of members of religious orders employed by third parties.

Private Letter Ruling 7931004[70] shows the extent to which the IRS has become obsessed with the existence of an employer-employee relationship. In that case, the order responded to a request by the administrators of a youth correctional institution for a chaplain by assigning one of its ministers to the institution five days a week. The IRS conceded that "the taxpayer is under a vow of obedience and is under the control of his ecclesiastical superiors because he is a chaplain. The County does not control the content of his work."[71] The institution pays the compensation in the form of a check payable to the taxpayer, who turns it over to his order which deposits it in its account. The IRS nevertheless found that the member could not be an agent of his order because he was an employee of the institution. The manner by which the IRS concluded that the taxpayer was an employee is almost as astonishing as their conclusion that he was not an agent of his order. The taxpayer did not satisfy the minister exclusion from employment FICA tax purposes;[72] thus the IRS concluded he was an employee for purposes of determining the includability of his compensation in his income. The IRS ignored the fact that the taxpayer

70. *See* note 6 *supra.*
71. *Id.* at ____ .
72. Treas. Reg. § 31.3121(b)(8)-1(c)(3) (1954).

was not only a minister but also a member of a religious order. Thus, the taxpayer was eligible for the exclusion described in the very next paragraph of the employment tax regulations.[73]

In Private Letter Ruling 7937012, the IRS reached a conclusion opposite to that of Revenue Ruling 68-123 even though the fact patterns were virtually identical. The member (taxpayer) was under a vow of poverty to an order whose purpose was "healing in all of its many facets, including physical, mental, social, environmental, occupational and communal health care."[74] The taxpayer was a registered nurse-anesthesiologist who was assigned to Associates by her order but she remained at all times under the general supervision and control of her order. There was no formal agreement but only an implied understanding that if the order would re-assign the taxpayer, it would offer Associates the services of another member, if one was available. Associates employed nurse-anesthetists other than those from the order and provided all the anesthesia services to a local hospital. The IRS sought to distinguish Revenue Ruling 68-123, thereby conceding its continued viability, on two grounds. First, there was no formal arrangement between the order and Associates, although why an informal arrangement is not sufficient or why such an arrangement is needed to establish the order's control is not explained. Recall that Revenue Ruling 68-123 found that a sufficient condition for its member to be acting as its agent was that it exercised general direction and control over the member's services; moreover this control does not preclude the member from being an employee of the user of her services. The second distinction that the IRS relied upon was that the employer-employee relationship between Associates and the member precludes the taxpayer from acting as an agent of her order.

In Private Letter Ruling 8014017,[75] the IRS found that members of a section 501(d) organization, rather than a religious order, who in accord with their organizations, had obtained jobs completely on their own outside the organization were taxable on the compensation paid by third parties for the use of their services. This was the opinion of the IRS even though, in accord with vows of poverty, they transferred all the compensation to their organization. Aside from the organization not being a religious order, the only distinction between this fact pattern and that of Revenue Ruling 76-323 was that in this case a fundamental precept of the organization is the promotion and practice of the work ethic. Such adherence to the Protestant work ethic does not

73. Treas. Reg. § 31.3121(b)(8)-1(d) (1954).
74. *See* note 6 *supra*.
75. *Id.*

distinguish the organization from many American families. More importantly there was not a shred of evidence presented to show that the organization exercised general direction and control over the member's services as well as their compensation from the third parties. The IRS, however, took no notice of this but instead focused its entire attention on the presence of an employment relationship between the members and third parties. Its presence convinced the IRS that the members were agents of third parties rather than their organization, and thus they earned the compensation as principals as far as the IRS is concerned.

THE EMPLOYER-EMPLOYEE RELATIONSHIP

The existence of an employer-employee relationship between a third party and a taxpayer, such as a member of a religious order, is not relevant to the issue whether the taxpayer should include the compensation in his gross income. If a taxpayer is an employee, the control that the employer exercises over the taxpayer does *not* preclude a third party from exercising sufficient control over the taxpayer so that the compensation paid by the employer is not includable in his income. We have seen that such an implication gained wide currency in the IRS rulings on this matter largely because of a series of misinterpetations of the employment tax provisions. These provisions do not even apply to the questions of income taxability but rather to the need for withholding. Although the employer-employee relationship does imply that an agency relationship exists between the two parties, it is only in effect for certain purposes. The relationship by no means precludes the employee from simultaneously acting as the agent of another party for purposes of determining the recipient of the employee's compensation for federal income tax purposes. Finally, such a preclusion would lead to the absurd conclusion that employees are not generally required to include their compensation in their taxable income.

An employer-employee relationship does not preclude the employee from simultaneously acting as the agent of another party. Such a false dichotomy seems to be based on the idea that one cannot act as an agent for more than one party. Such a statement is absurd on its face; in any partnership, each partner is an agent for every other partner and thus an agent for more than one party if there are more than two partners.[76] It is also preposterous to claim that an employee of *A* may not be an agent of another entity *B*. It is common practice for professional service firms such as advertising firms, accounting

76. *See, e.g.*, UNIFORM PARTNERSHIP ACT § 9(1).

firms, law firms and management consulting firms to provide the services of their employees to the clients. Obviously, these employees will also then be acting as agents for their firm's clients. More to the point, it is not unusual for agents of one entity to act as employees for other entities. In fact, workers for temporary personnel agencies do this all the time. It is customary for such agencies to delegate to their clients the power to supervise the agencies' workers (agents) on a daily basis. The agency, however, always retains the ultimate control over its workers (agents). It has never been seriously contended that the workers (agents) of these agencies should include the fees paid by their temporary employers for the use of their services in their gross income. The agency relationship which causes the fees paid by a third party for the use of the services of a taxpayer not to be includable in his gross income need not be an employment relation.[77] Consequently, in *Kelley*, the only case in which a court has decided whether a member of a religious order earned the amounts which were paid by third parties for the use of his services, the wage payments were treated no differently than the sales commissions.

The control which an employer exercises over his employees is not relevant to the determination of who is taxable on the compensation which the employer pays for the use of the employee's services. If such control would, in any way, preclude a third party from exercising sufficient control to be considered the recipient of the employer's compensation, would not the same control preclude the employee from exercising sufficient control over his own services so that he would not be considered the recipient of his own compensation for federal income tax purposes. Thus, employers rather than employees would be taxable on the compensation that they pay their own employees. Such an absurd conclusion is a consequence of a failure to distinguish the control which determines the existence of an employer-employee relationship, and thus withholding liability, from the control which determines the includability of income.

The control which determines the includability of compensation in gross income is the ability to control the production and amount of the compensation,[78] in particular, for whom and under what conditions the services will be rendered. This is the kind of control that a retailer exercises over its cashiers, so that their receipts are considered to be the

77. *See* notes 45 and 46 and accompanying text *supra*. Moreover in *American Savings v. Commissioner*, 56 T.C. 828 (1971), the court rejected an attempt to shift income because of the absence of any "agency *or* employment relationship" between the performers and their purported principal. *Id.* at 842 (emphasis added).

78. *See* note 8 *supra*.

store's income rather than the cashier's income. That is also the kind of control that the cashier ordinarily exercises over herself in choosing to become and to continue to work as a cashier in that particular store (the latter implies that she does her job properly), so her wages are includable in her gross income. It is the kind of control that the corporation with independent directors exercised over the personal services of Charles Laughton when it was found to earn the fees for his acting services.[79] It is also the kind of control that legal aid societies exercise over their attorneys who do not include in their gross income the statutory fees that they are paid for representing the indigent in civil cases.[80] That is also the kind of control that traditional religious orders exercise over their members when they decide in accord with the orders' goals for whom, in what capacity and for how long each of their members will be assigned to work in particular positions (this implies that the order is exercising general direction and control over the members). It is also the kind of control that is so lacking in the cases involving family estate trusts[81] and family religious orders.

The courts may wish to treat family religious orders in the same manner that they have treated family corporation and seem to be beginning to treat family estate trusts. In short, family religious orders will not be required to actually control the utilitization of their members' services, but rather to behave as though they were independent entities controlling their members' services. One cannot, however, merely accept a vow of obedience, such as those that traditional religious orders require their members to profess. As in *Kelley*, the existence of such a vow will not be treated as decisive. Rather the courts will inquire into whether the order is actually controlling the utilization of the member's services. As with family corporations, one can instead ask that the family religious order not only be a viable tax entity, that is, where there is a non-tax avoidance reason for its existence and it observes the customary formalities, *but* the taxpayer is legally obligated to perform the services in question for the family religious order. As we have seen for family estate trusts, compliance with these

79. Charles Laughton v. Commissioner, 40 B.T.A. 101 (1939). Recently in *Vercio v. Commissioner*, 73 T.C. 1246 (1980), the Tax Court distinguished its fact pattern from that of *Laughton*, *see* note 41 *supra*.

80. Rev. Rul. 65-282, 1965-2 C.B. 21. Universities tend to maintain similar control over faculty members involved in clinical work. *See, e.g.*, Rev. Rul. 74-581, 1974-2 C.B. 25 (attorneys) and Rev. Rul. 69-274, 1969-1 C.B. 36 (physicians).

81. The lack of the requisite control is so obvious that the IRS has announced that it will vigorously enforce actions against taxpayers who use family estate trusts to understate their tax liability. IRS News Release IR-1878 Aug. 31, 1977. Moreover the IRS will not permit taxpayers to deduct the costs of establishing family estate trusts. Rev. Rul. 79-324, 1979-2 C.B. 12.

conditions is not a trivial matter. It is important to note that family religious orders need not be tax-exempt organizations. Religious organizations are not automatically tax-exempt. Only those for which "no part of the net earnings of which inures" to the benefit of any private shareholder or individual are exempt.[82] Thus shifting the income to the family religious order does not automatically change its character to tax-exempt income. Even if the organization is a tax-exempt organization, the income for the use of the services of its members would appear to be unrelated business income, that is, income derived from the carrying on of a trade or business on a regular basis not substantially related (aside from the need for the income) to the exercise or performance of the purpose or function which constituted the basis for the order's exemption,[83] such as the income that a religious organization earned by contracting out the services of some of its members as laborers for nearby forest owners in Revenue Ruling 76-341.[84] Moreover, even if the income of the order is considered tax-exempt, as in the case with family corporations the IRS may utilize section 482 to reallocate the family religious order's income to the individual taxpayer in accord with the requisite contract between the two parties, in order to prevent tax evasion.[85] Finally, no provision of the Code declares that payments that a religious organization makes to a member, whether or not he is a minister, in return for performance of services, as would be the case with payments by a family religious order to its founding taxpayer, are tax-exempt.[86]

CONCLUSION

Questions of the includability of the compensation paid by third parties for the use of the services of members of religious orders may not be resolved by determining whether an employer-employee relationship exists between the third party and the member. Obviously, if

82. I.R.C. § 501(c)(3). *See, e.g.*, Beth-El Ministries Inc. v. United States, 44 AFTR 2d 79-5190 (D.C. Cir. 1979) (church's earnings are used to provide members with food, clothing, shelter, medical care, and recreation independent of services performed for church; thus church is not a § 501(c)(3) organization).

83. *See* §§ 511-513. For a more detailed discussion of the unrelated business income of religious orders, *see Income Tax Aspects of the Vow of Poverty*, *supra* note 12, at 385-88; *Remuneration Earned*, *supra* note 30, at 557-58 (1979).

84. 1976-2 C.B. 307.

85. To the extend exempt organizations carry on business functions, they are subject to § 482. *See* Treas. Reg. § 1.482-1(A)(1) (1962) and Southern College of Optometry, Inc., 6 T.C.M. (CCH) 354 (1947).

86. *But see* Treas. Reg. § 1.107(A) (gross income does not include the rental value of a home or rental allowance paid to a minister of the gospel as remuneration for services which are ordinarily the duties of a minister of the gospel).

the member is working at an institution in accord with a contract between the order and the institution, as is common with part-time chaplaincies at public institutions, the compensation should not be included in the member's taxable income. If there is not such a contract, one needs to examine the relationship between the member and the order. If the order, as a practical matter, determines for whom, in what capacity and for how long the member will remain in a position (which implies that it exercises general direction and control over her services), then the compensation should also be excluded from her income. If the order does not exercise such control, the amount should be included in the member's gross income. If family religious orders, like family corporations, are not required to exercise control in fact, they will be required to be viable tax entities to which the taxpayer is legally obligated to perform services. Tax evasion could then prevented by a Section 482 realloaction of income.

The overwhelming majority of cases involving members of traditional religious orders will be easy to resolve. Most traditional religious orders order their members' lives by (1) assigning their members to tasks which further the order's goals; (2) regularly reviewing their members' performance of all their assigned duties; (3) taking steps to insure that the members satisfactorily perform their assigned duties; and (4) regularly reviewing their members assignments. In short, the orders exercise much more than general direction and control over all of their members who remain in good standing, that is obedient to the orders' direction and control. There may be, however, some questions raised about the degree of supervision of members whose professions differ from the order's traditional professions and require that the member exercise considerable initiative in pursuing the profession, such as a scientific researcher in a nursing order. In such cases, the decisive factor may be that the order provided the member with her professional training, and thus deliberately placed her in a position where she could exercise considerable professional initiative while remaining subject to the order's general direction and control.

It is important to recognize that any audit strategy that is based upon the presumption that members of religious orders employed by parties not affiliated with the order's church are not acting as their order's agents, will needlessly subject many members of traditional religious orders to long and unnecessary audits. Many members of traditional religious orders are assigned by their orders to positions outside their order. For example, many ordained members are assigned to act as chaplains for such unaffiliated institutions as the U.S military, prisons, public hospitals and public mental health facilities.

Many religious orders find that they can best achieve their secular missions by assigning their unordained members to positions outside their order's church. For example, many teachers are assigned to the public schools rather than church schools because students in public schools need more assistance than those in private schools, operated by the church, which are able to pick and choose their students. It is clear that under current IRS policies the traditional religious orders, who are not trying to evade taxes, will be forced to either pay income taxes which the government is not entitled to or to incur significant legal expenses to demonstrate their member's agency; this will be true even if the agency is as obvious as it was in Private Letter Ruling 7931004 where the member was assigned to the institution in accord with the institution's request and the order retained control of the content of the member's work.

It is important to realize that under the arguments in this article the IRS would have to make a very limited inquiry into the operations of a religious order to determine who earns the compensation third parties pay for the use of its members' services. One must determine if the religious order is a viable entity. One would expect that many family religious orders like many family estate trusts would not qualify. It is unclear what goal other than tax avoidance such entities further, since in many cases, there seems to be no change in the taxpayer's rights and obligations following the transfer of all his assets to such entities. It is important to note that even if the family religious order is a viable tax entity, this by no means establishes that it earns all the compensation of its members.[87] It would be absurd to argue that the Roman Catholic Church, which is clearly a viable tax entity, earns all the compensation that outsiders pay for the use of the services of its almost fifty million members.[88]

Moreover, one does not have to question the legitimacy of Roman

---

87. *See, e.g.*, Elvin Jones, 64 T.C. 1066, 1076 (1975). *See also* Kurtz & Kopp, *Taxability of Straw Corporations in Real Estate Transactions*, 22 *Tax Law* 647 (1969) for the proposition that:

> To put the question in perspective, the straw corporation may be compared with an individual straw. If title to real estate is put in the name of an individual straw, there is no doubt that the real owner is taxable on the income from the property and not the straw. The result has nothing to do with the question whether the straw exists—he obviously does—or whether he might be paying taxes on some other income which he has, or whether he might, in fact have income from fees which he charges for acting as a straw in this particular transaction, or whether the beneficial owner gains some tax advantage by using the straw. The only question is whether the straw is taxable on the income from the real estate, and this depends on whether the income is his.

88. *Id.* at 648-49. *Information Please Almanac* 440 (1980).

Catholicism as a "proper religion" to reach such a conclusion.[89] One merely needs to review the Roman Catholic Church's operations to the limited extent necessary to determine if the Church controls the services of the taxpayer whose income is in question. The Tax Court did precisely that in *Kelley*. It made no attempt to inquire into the precepts of Roman Catholicism, nor did it distinguish wage payments from commission payments. The Court, instead, examined the degree of control that the taxpayer's order exercised over the taxpayer's services and found that the control was insufficient for it to be considered the earner of the compensation paid by the third parties.

Finally, the First Amendment does not preclude the IRS from making the limited inquiry suggested above into the operations of religious orders. Such inquiries would not constitute an unwarranted invasion of internal church affairs thereby interfering with the taxpayer's free exercise of religion. It is well settled that the First Amendment's right to the free exercise of religion is not absolute and may be subject to incidental and indirect burdens.[90] In particular, the Court in *Bubbling Well Church Of Universal Love v. Commissioner*[91] quoted *United States v. Holmes*,[92] in rejecting a claim that a church was tax-exempt and declared that the government may make limited inquiries into the operations of religious organizations:

> Requiring plaintiff to comply with a properly narrowed summons in order to show its entitlement to tax exempt status results in only an incidental burden upon his free exercise of religion . . . Plaintiff is free to espouse his religious doctrine and to solicit support for his cause. He simply must allow the government access to information in order to determine whether the church remains within the criteria for a lighter tax burden. The church may, of course, forego the exemption and limit IRS access to church records.
>
> Balanced against the incidental burden on church religious activities is the substantial government interest in maintaining the integrity of its fiscal policies . . . This interest is sufficiently compelling to justify any incidental infringement of plaintiff's First Amendment rights.[93]

89. Even if the taxpayer is unable to shift income to the family religious order, he may try to deduct half his income as a charitable deduction as suggested in Revenue Ruling 76-323 to the order. The IRS has not hesitated to review the operations of family religious orders to the extent necessary to find that such deductions will not be allowed. Revenue Ruling 78-233, 1978-2 C.B. 69. In making such determinations, the IRS must proceed in a nondiscriminatory basis using specific and reasonable guidelines without looking into the merits of the particular religious doctrine. Parker v. Commissioner, 365 F.2d 792, 795 (8th Cir. 1966).

90. *See generally* Johnson v. Robinson, 415 U.S. 361 (1974).

91. 74 T.C. 531 (1980).

92. 614 F.2d 985, 989-90 (5th Cir. 1980).

93. 74 T.C. 531 (1980).

Religious orders would have to produce little additional data to show that they are not only tax-exempt but should also be considered as the earners of the compensation paid for the use of services of their members. We have seen that it should be relatively easy for traditional religious orders which completely order their members' lives to show that they exercise general direction and control over their members. It should be easy to determine for family religious orders whether an appropriate binding legal obligation exists, and the courts can then look into the reasonableness of the compensation paid to the member by the order.[94]

---

94. *See, e.g.*, Unitary Mission Church of Long Island, 74 T.C. 507 (1980) (court examined the reasonableness of parsonage allowances in controlled church).