Florida Law Review

Volume 37 | Issue 3 Article 3

July 1985

Constitutional Issues in Revoking Religious Tax Exemptions: Church of Scientology of California v. Commissioner

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CONSTITUTIONAL ISSUES IN REVOKING RELIGIOUS TAX EXEMPTIONS: *CHURCH OF SCIENTOLOGY OF CALIFORNIA V. COMMISSIONER*

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I. INTRODUCTION

Churches and other religious organizations are exempt from taxation under section 501(c)(3) of the Internal Revenue Code. Given such an advantage, it is not surprising that many tax avoidance schemes have clothed themselves in clerical garb.[1] Unlike other tax-shelter devices, which generally present only technical issues of statutory interpretation, tax controversies involving religious organizations often raise sensitive and difficult constitutional questions. While the government strives to protect its revenue from cynical parodies of religion, the Constitution requires that unorthodox and unconventional beliefs be protected from overzealous tax collectors.

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1. Organizations that are exempt from taxation under I.R.C. § 501(c)(3) of the Internal Revenue Code (IRC) are generally also classified as organizations to which tax deductible contributions may be made under I.R.C. § 170. Under § 107, it is also possible for a minister to exclude the fair market rental value of a home that is provided by a congregation. See Note, *Mail Order Ministries, The Religious Purpose Exemption and the Constitution*, 33 TAX LAW. 959 (1980) for a discussion of how many organizations are achieving these benefits as well as the IRS' response.

The difficulty in balancing these interests is illustrated in *Church of Scientology v. Commissioner*.[2] In *Church of Scientology*, the IRS revoked the church's tax-exempt status after years of investigation, litigation and audits. The revocation was based on the church's failure to satisfy the express and implied requirements of section 501(c)(3).[3] The church countered that the religion clauses of the first amendment bar the IRS action since it was motivated by a hostility to particular religious practices. Additionally, the church contended that the statute's criteria are unconstitutional when applied to churches.

The *Church of Scientology* decision did not question the validity or sincerity of the church's beliefs and practices; the Tax Court conceded their religiosity.[4] Although many ancillary questions were involved,[5] the basic issues concerned

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2. 83 T.C. 381 (1984).

3. Organizations that are exempt from taxation under I.R.C. § 501(a) are described in I.R.C. § 501(c)(3). Although these organizations are ordinarily referred to as "charitable," I.R.C. § 501(c)(3) defines them as follows:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition. . .or for the prevention of cruelty to animals. . . .

Some of the flavor of the case as well as the positions of the parties can be gotten from a review of their pretrial statements. L. Ron Hubbard, the founder and leader of worldwide Scientology, provided his adherents with the following advice on tax matters:

> Now as to TAX, why this is mainly anybody's game of what is PROFIT. The thing to do is to assign a significance to the figures before the government can. The whole thing is a mess only because arithmetic figures are symbols open to ANY significance. So I normally think of a better significance than the government can. I always put enough errors on a return to satisfy their blood-sucking appetite and STILL come out zero. The game of accounting is just a game of assigning significances to figures. The man with the most imagination wins. . . .
>
> Income tax is a suppressive effort to crush individuals and businesses and deprive the state of gross national produce (since none can expand). The thing which baffles any suppressive is truth. It's the only thing that works. . . .
>
> *Income* does not mean profit. One can and should make all the INCOME one possibly can. Always. The only crime really is to be broke. But when one makes INCOME be sure it is accounted for as to its source *and* that one covers it with expenses and debts. Handling taxation is as simple as that.

83 T.C. at 430 n.30 (emphasis in original).

On the other side, evidence of the IRS' feelings may be found in a number of derogatory statements about Scientology appearing in IRS memoranda and correspondence. Among these were comments denouncing Scientology as "a threat to the community, medically, morally and socially," and as a "grabbag of philosophical voodooism." *Id.* at 405. The government's trial memorandum maintained that the church's practice of auditing inflicted psychic harm through "brainwashing," *id.* at 449, and dissolution of marriage and family ties.

4. 83 T.C. at 462. The IRS had inquired into the religiosity of certain practices, but the issue was not raised at trial. The court concluded that a threshold inquiry did not interfere with the church's beliefs because the inquiry was dropped when witnesses asserted the practices did have a religious purpose.

5. *Id.* at 444. These issues involved technical questions about the IRS' notice of deficiency; constitutional questions regarding the burden of proof; retroactive application of statutory constructions; numerous fact questions as to whether church activities included a substantial commercial purpose and whether its net earning inured to the benefit of private individuals.

the government's statutory and constitutional power to tax churches. These issues may be framed as follows:

1. Was the IRS' action constitutionally impermissible because it was motivated by hostility to the religious practices and beliefs of Scientology?

2. Does the First Amendment prohibit the taxation of income derived from and used for religious purposes?

3. Is section 501(c)(3) unconstitutional to the extent that it disallows tax exemptions for churches whose religious activities generate substantial profits?

4. Is it constitutionally permissible to read into section 501(c)(3) an implied requirement that tax-exempt churches conform to fundamental public policies?

This article will discuss these questions.

II. Background

Scientology maintains that part of the unconscious mind, called the "reactive mind," is the source of irrational behavior. An individual seeking spiritual competence can eliminate the "engrams" of the reactive mind through the process of "auditing" which is administered by trained Scientologists called "auditors." The auditor identifies specific areas of spiritual difficulty through an electronic device called an "E-meter." This instrument measures the individual's skin responses during question and answer sessions.[6]

As auditing progresses, the individual obtains higher levels of spiritual awareness. Each level of awareness requires auditors with higher levels of training. However, a major tenet of Scientology is the "doctrine of exchange" which holds that persons must pay for what they receive. Consequently, the church requires payment of a "fixed donation" in return for all auditing and training.[7] These donations generate substantial earnings for the church and its sister organizations.

The Church of Scientology of California is only one part of the worldwide Scientology organization. Nevertheless, it is the largest and most important part and often was referred to as the "mother church."[8] Initially L. Ron Hubbard and a number of close associates controlled church affairs from headquarters aboard a ship. Hubbard, his family, staff and the ship's crew lived aboard the

6. *Id.* at 385. The earliest litigation involving Scientology was an action by the Food and Drug Administration seeking to regulate the E-meters (actually skin galvonometers which are used to measure emotional responses) as medical devices. It appears probable that Scientology was reorganized into a church partially to avoid these problems by characterizing the E-meters as religious devices and auditing as a religious practice. Founding Church of Scientology v. United States, 409 F.2d 1146 (D.C. Cir. 1964).

7. 83 T.C. at 386.

8. *Id.* at 385.

ship. Although Hubbard officially resigned from his official church positions in 1966, the Tax Court found that he still controlled church policy and operations. This control was particularly evident in church financial affairs. Hubbard's approval was required for all financial planning and he remained a signatory on church bank accounts.[9]

In 1972, following several unfavorable rulings by the IRS, high church officers carried out a number of obstructionist and illegal actions designed to thwart further financial audits and investigations.[10] These actions included burglaries of government offices and planting a Scientology official as a secretary in an IRS office. Several persons were convicted and imprisoned as a result of these activities.[11]

During this period, the IRS actively investigated the church. The church was rigorously scrutinized by three special intelligence units.[12] The intelligence units classified the Church of Scientology as a "tax resister" and placed materials about Scientology in a file labeled "Subversives."[13]

III. Selective Enforcement Based Upon Hostility to Religion

A. *Denial of Equal Protection*[14]

Upon the revocation of its tax exempt status, the church claimed that the IRS was motivated by hostility to Scientology,[15] violating both the equal pro-

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9. *Id.* at 389.

10. *Id.* at 434.

11. *Id.* at 435.

12. *Id.* at 449. These units often selected taxpayers for special scrutiny based on political criteria. Many dissident and politically active groups were monitored. *Id.* at 411-12.

13. *Id.* at 450.

14. Although the equal protection clause is found in the fourteenth amendment, the Supreme Court has made it expressly applicable to actions of the Federal government through the due process clause of the fifth amendment. United States v. Kras, 409 U.S. 434 (1973); Bolling v. Sharpe, 347 U.S 497 (1954).

15. Some of the history of the continuous controversy between the IRS and the Church of Scientology is reviewed in Schwartz, *Limiting Religious Tax Exemptions: When Should the Church Render Unto Caesar,* 29 U. Fla. L. Rev. 50, 103 (1976).

It may be interesting to note that Scientology has been involved in similar disputes in other parts of the world. In Australia, a Board of Enquiry appointed by the government condemned the psychological techniques used by Scientologists. Based on this report, Victoria enacted a Psychological Practices Act in 1965, prohibiting the use of E-meters by unregistered persons and prohibiting the practice or teaching of Scientology for payment (Scientology has not been illegal in Victoria since the Act was amended in 1982).

Prior to the Act, Scientology operated as the Hubbard Association of Scientologists. In order to avoid its provisions, the organization changed its name to the Church of the New Faith. Holding themselves out as a church, the Scientologists contended that they were not within the provisions of the Psychological Practices Act and that they were exempt from Victoria's payroll taxes as a religious institution.

The claimed tax exemption resulted in litigation which examined two issues: first was Scientology in fact a religion; and second, may the exemption be denied because the church was organized for the illegal purpose of avoiding the Psychological Practices statute. Both issues were resolved against the Scientologists. *See* Note, Church of the New Faith v. Commissioner for Payroll Tax, 14 Melb. U.L. Rev. 318 (1983).

tection clause of the fifth amendment and the free exercise clause of the first amendment.[16] The hostility was evidenced by the special scrutiny it received from IRS intelligence units. It was also exhibited in the IRS agents' derogatory statements about Scientology during investigation of the church and by government counsels' statements during trial.

The Tax Court concluded that these facts did not establish that the IRS' revocation of the church's exemption violated its right to equal protection.[17] Applying the standards used in criminal cases,[18] the court maintained that a selective prosecution is unconstitutional only if (1) the decision to prosecute was based on impermissible grounds such as race, religion or the exercise of constitutional rights, and (2) similarly situated persons are not generally prosecuted. The court held that the church's argument failed both prongs of this test.[19]

Notwithstanding evidence indicating IRS hostility to Scientology, the court concluded the revocation was not motivated by religious or political animus but

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16. 83 T.C. at 447. The denial of equal protection resulted from the selective enforcement of the tax laws against an organization with unpopular religious views and practices. Free exercise of religion was impaired because the revocation was motivated by the governmental officials' dislike for the church's unorthodoxy. *Id.* at 448.

The church also maintained that matters concerning its exempt status were handled in an arbitrary and capricious manner, being rushed through in a wholesale effort to eliminate the exempt status of all Scientology churches. Shortly before the formal letter of revocation was issued, the Justice Department requested an IRS review of the exempt status of several Scientology churches including the Church of Scientology of California. The Justice Department was at that time preparing its defense in a refund litigation case in the Court of Claims against the Founding Church of Scientology. Believing that the IRS' recognition of the exempt status of other Scientology churches was inconsistent with its position in that case, the Justice Department asked the IRS to revoke the exemptions of similar Scientology churches before the beginning of the trial.

The Tax Court held that the revocation was based upon the facts learned during an extensive audit and not as part of a governmental plan to rush through revocations. Evidence for this was found in the good faith negotiations with the church that preceded issuance of the revocation and the fact that no other Scientology churches lost their exemptions during the period between Justice's request and the trial. *Id.* at 451.

17. *Id.* at 452. Noting that selective enforcement is not in itself unconstitutional, the court maintained that in some instances, particularly in tax cases, it may be a necessity. *Id.* at 448.

18. *Id.* However, in applying this standard the court noted: "Like the Ninth Circuit, which has appellate jurisdiction of this case, we express our concern that examining the IRS' actions here under the standard applied in criminal cases may be too stringent a test." *Id.* at 448. In Karme v. Commissioner, 673 F.2d 1062 (9th Cir. 1982), the Ninth Circuit did not decide whether a more lenient standard applied in civil cases because the taxpayers had failed to satisfy the more stringent criminal standard.

19. 83 T.C. at 456. A similar two-part test is applied to selective enforcement claims in nearly all circuits. It is based upon the Supreme Court's holding in Oyler v. Boles, 368 U.S. 448, 456 (1962), that equal protection is violated where a selection for prosecution is "deliberately based upon an unjustifiable standard such as race, religion or other arbitrary classification." Because of the deference that the courts generally accord prosecutorial discretion, defendants have rarely been successful in asserting this defense. *See* Note, *Rethinking Selective Enforcement in the First Amendment Context*, 84 COLUM. L. REV. 144 (1984) [hereinafter cited as Columbia Note]; Note, United States v. Wayte: *Selective Prosecution and the Right to Dissent*, 14 GOLDEN GATE L. REV. 58 (1984); *see also* Note, *Passive Enforcement of Draft Registration: Does It Constitute Selective Prosecution in Violation of Equal Protection Because It Discriminates Against Persons Based on Their Exercise of First Amendment Rights?*, 57 TEMPLE L.Q. 671 (1984).

by "legitimate agency concerns."[20] Characterizing the government's denigration of Scientology's religious practices as "trial lawyer's hyperbole," the court noted that some of the IRS' animosity toward the church may be attributed to the church's efforts to "thwart [its] duty to administer the tax laws."[21] The church also failed to demonstrate that the IRS had not revoked the exemptions of similarly situated churches.[22] Citing to a list of revocation cases, the court maintained that there was ample evidence of the IRS' vigorous enforcement policy in this area.[23]

The court's emphasis on the IRS' motive appears unduly narrow. The government's motive for classifying an organization as a subversive or tax resister is not determinitive of whether the classification affords equal protection. Equal protection means that the government may not treat similarly situated persons in different ways.[24] Although the government may draw lines to determine which persons are in fact dissimilar, these classifications may not be based upon arbitrary or constitutionally impermissible criteria.[25] The legislature may not place such criteria in the laws nor may an administrative agency use them in the application of otherwise valid laws.[26]

In most cases, the courts will defer to a legislative or administrative classification if there is a rational relationship between the line drawn and a legitimate governmental end. However, if the classification is based upon the exercise of a fundamental right protected by the first amendment, the courts will review it under a "strict scrutiny" standard.[27] This standard requires that the government show that its interest is so overriding as to justify restricting the right in question.[28]

In the *Church of Scientology* decision, the alleged equal protection violation was that the IRS mandated special treatment and scrutiny for unorthodox churches. If such a policy had the effect of inhibiting unorthodox beliefs, then

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20. 83 T.C. at 450. The court considered the IRS' actual treatment of the church's tax status to be "flawless." The IRS' decision to revoke was found to be made after intensive audits of the church's information returns and following good faith negotiations. *Id.* at 452.

21. *Id.* at 453 (It would appear that a governmental action based upon an IRS desire to "get even" would violate the improper motive prong of the selective enforcement test cited by the court.).

22. *Id.* The court appears to have given little weight to the fact that the Church of Scientology was selected for intensive investigation by IRS intelligence agents for political reasons. Thus, it was targeted in a different manner and for different reasons than other churches noted by the court. *Id.*

23. *Id.* at 453. The church sought to distinguish itself from these cases by characterizing itself as the only "hierarchical church" to be selected. The court refused to make this distinction, holding that the operative class is churches or religious organizations. The court noted that even if the church could distinguish itself in this manner, an IRS decision to mount a test case would not constitute discriminatory enforcement. *Id.*

24. *See* J. NOWAK, R. ROTUNDA, & N. YOUNG, CONSTITUTIONAL LAW 582 (1978).

25. *Id.*

26. Yick Wo v. Hopkins, 118 U.S. 356 (1886).

27. Carey v. Brown, 447 U.S. 455 (1980); *e.g.*, Police Dep't v. Mosely, 408 U.S. 92 (1972).

28. *See infra* text and accompanying notes 32-48.

the classification is certainly suspect.[29] This follows whether the policy is motivated by "legitimate agency concerns" or by hostility to unorthodox beliefs.[30] The government should be required to show that its monitoring of religious organizations such as the Church of Scientology is justified. In effect, no real distinction can be made between the first amendment and fifth amendment protections in cases where a classification is based upon religious activities.[31]

B. *Violative of Free Exercise Clause*

The Tax Court also reviewed the church's hostility argument under a direct first amendment analysis.[32] However, it framed the issue in terms of equal protection stating that "[t]he First Amendment, however, offers petitioner no more protection than the Fifth Amendment.'"[33] Thus, the court minimized the impact of an IRS policy that selected a church for intensive scrutiny on the basis of its unpopular religious beliefs and practices. Additionally, even if the IRS' actions were substantially motivated by unconstitutional conduct, the court maintained the government may prevail by showing by a preponderance of the evidence that the same determination would have been made without resorting to impermissible considerations.[34]

This holding relied on the Supreme Court's decision in *Mt. Healthy City Board of Education v. Doyle*.[35] In *Mt. Healthy*, an untenured teacher's revelation of a school memorandum to a local radio station was found to be a "substantial factor"[36] behind the school board's decision not to rehire him. The Court held that such a showing did not automatically require the teacher to be rehired. Rather, it shifted the burden to the employer to establish, by a preponderance of the evidence, that the instructor would not have been rehired notwithstanding consideration of the protected speech.[37] The Court reasoned that this test would

29. The executive branch may not adopt a policy that would be unconstitutional if enacted into a statute. In United States v. Schmucker, 721 F.2d 1046 (6th Cir. 1983), the court held that the government's policy of passively enforcing the draft registration requirements was an impermissible selective enforcement because it punished only those persons who spoke out against registration. *But see* United States v. Wayte, 710 F.2d 1385 (9th Cir. 1983), *vacated and remanded*, 105 S. Ct. 1524 (1985).

30. *But see* Board of Educ., Island Trees Union Free School Dist. v. Pico, 457 U.S. 853 (1982) (question of whether removal of books from school library violated students' first amendment rights depended on motivation behind school board's action). *See generally* Columbia Note, *supra* note 19.

31. In first amendment cases the courts must determine whether a compelling state interest justifies an infringement of religious liberty. *See e.g.*, Larson v. Valente, 456 U.S. 228 (1982); United States v. Lee, 455 U.S. 252 (1982); Wisconsin v. Yoder, 406 U.S. 205 (1972).

32. 83 T.C. at 454.

33. *Id.*

34. *Id.* The court concluded that a preponderance of the evidence showed that there were valid statutory grounds for the revocation. Thus, any taint arising from IRS hostility was overcome.

35. 429 U.S. 274 (1977). *See also* Lee v. Russell County Bd. of Educ., 684 F.2d 769 (11th Cir. 1982); Givhan v. Western Line Consol. School Dist., 439 U.S. 410 (1979).

36. *Mt. Healthy*, 429 U.S. 274 at 283.

37. *Id.* at 287. In a subsequent case, Givhan v. Western Line Consol. School Dist., 439

protect the employee's first amendment right to speak freely without placing him in a better position than he would have occupied if he had not exercised this right.[38]

The Court's goal in *Mt. Healthy* was to protect the teacher's rights without unnecessarily interfering in the school board's exercise of discretion in selecting its teaching staff.[39] Absent constitutional considerations, a school board need not show a substantial reason for refusing to rehire an untenured teacher; such teachers are not afforded most procedural due process protections.[40] The Supreme Court was concerned that a "borderline or marginal" teacher might prevent the board from assessing his performance by engaging in dramatic or abrasive, yet constitutionally protected, conduct;[41] a particularly important consideration if the decision to rehire would accord tenure.[42] The "but for" test adopted in *Mt. Healthy* was intended to protect the interests of the school board by allowing the board to show that the injury to the teacher, that is, the decision not to rehire, was not caused by constitutionally impermissible considerations.[43]

Assuming the *Mt. Healthy* criteria apply to the *Church of Scientology* situation,[44] the government must establish by a preponderance of the evidence that the church's tax exemption would have been revoked even if the IRS was not motivated by hostility to its religious practices.[45] In concluding that the IRS

U.S. 410 (1979), the Court indicated that the lower courts must find that the employee would have been rehired "but for" the protected conduct. *Id.* at 417. A somewhat different definition is found in Board of Educ., Island Trees Union Free School Dist. v. Pico, 457 U.S. 853 (1982), where the Court held that a school board could not remove books from a school library if a constitutionally impermissible intent was a "decisive factor" behind its decision. The Court defined a "decisive factor" as "a 'substantial factor' in the absence of which the opposite decision would have been reached." *Id.* at 871 n.22.

38. *Mt. Healthy*, 429 U.S. at 285.

39. *Id.* at 287.

40. Board of Regents v. Roth, 408 U.S. 564 (1972); Megill v. Board of Regents, 541 F.2d 1073 (1976). *See also* Eagle, *First Amendment Protection For Teachers Who Criticize Academic Policy: Biting the Hand That Feeds You*, 60 CHI.-KENT L. REV. 229, 235 (1984).

41. *Mt. Healthy*, 429 U.S. at 285.

42. *Id.* at 286. The court noted that:

> The long-term consequences of an award of tenure are of great moment both to the employee and the employer. They are too significant for us to hold that the Board in this case would be precluded, because it considered constitutionally protected conduct in deciding not to rehire Doyle, from attempting to prove to the trier of fact that quite apart from such conduct Doyle's record was such that he would not have been rehired in any event.

Id.

43. *See* Wolly, *What Hath* Mt. Healthy *Wrought*, 41 OHIO ST. L.J. 385 (1980).

44. It is, of course, questionable whether the two situations are sufficiently similar for the *Mt. Healthy* test to apply at all. The relative weights of the interests of the government and the parties are quite different. In *Mt. Healthy*, the school board's interest in controlling the selection of its teachers was balanced against the rights of an untenured teacher, who, absent unconstitutional conduct, had no claim to his position. In the *Church of Scientology* case, the government's stake is protection of the tax system and the revenue base. However, the church's right of free exercise does not first pass through any tenure period, during which the IRS is given broad discretion to grant or not grant tax exemptions.

45. Church of Scientology v. Commissioner, 83 T.C. 381, 448 (1984). Under the *Mt. Healthy* test, the burden of proof shifts to the government only after it is established that unconstitutional

had carried this burden of proof, the Tax Court relied upon the government's showing that the church did not satisfy the statutory requirements for exemption under section 501(c)(3).[46] This proved that the result of the church's audit would have been the same absent any IRS hostility towards its religion.

However, the church contended that unconstitutional conduct had motivated the government's selection of the church for special scrutiny and audit. Thus, the "but for" test of *Mt. Healthy* should require the IRS to show that its policies would have resulted in that investigation in any event. The selection of a taxpayer for audit involves different considerations than the review of a candidate for retention in a teaching position. Since the teacher's contract is subject to renewal, the school board must annually review the records of all untenured teachers. Although unconstitutional considerations may play a part in the retention decision, generally they are not involved in selecting who shall be reviewed.

Conversely, most taxpayers are not audited and most exempt organizations are not subjected to rigorous examination of their financial affairs. This does not mean that the selection of a taxpayer for audit must be random. It may be based upon factors such as notoriety, deterrent effect on other taxpayers, cost of prosecution and ease of identification.[47] Had the IRS shown that these factors were present in the *Church of Scientology* case, and that the audit and investigation were likely in any event, the *Mt. Healthy* test would have been satisfied.[48]

IV. Constitutionality of Section 501(c)(3)

A number of issues in *Church of Scientology* arise from the church's assertion that the Internal Revenue Code provides unconstitutional criteria for determining the tax-exempt status of churches. Section 501(c)(3) of the Code describes an exempt religious entity as being "organized and operated exclusively for religious . . . purposes, . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual."[49] In addition to these

considerations were a substantial factor motivating the government's actions. The Tax Court determined that the church had produced evidence to raise sufficient doubts about the constitutionality of the IRS' conduct.

46. *Id.* at 454.

47. *See* Columbia Note, *supra* note 19, at 144.

48. An important case on selective enforcement in the tax exemption area predates *Mt. Healthy*. In Center for Corporate Responsibility Inc. v. Shultz, 368 F. Supp. 863 (D.D.C. 1973), a district court enjoined the IRS from denying an exemption to the plaintiff. The court found that the organization in question met all the requirements for exemption but that it had been denied because of direct political intervention by the White House and by political appointees in the IRS. The District of Columbia Circuit Court of Appeals reviewed a number of White House files in camera with respect to a claim of executive privilege. In denying that the documents were protected, the court stated that they involved use of the IRS in a "selective and discriminatory fashion." *Id.*

49. I.R.C. § 501 (West 1985). Organizations that are exempt from taxation under I.R.C. § 501(a) of the Internal Revenue Code are described in § 501(c)(3) of the Code. Although these organizations are ordinarily referred to as "charitable," § 501(c)(3) describes the following as qualified purposes: "religious, charitable, scientific, testing for public safety, literary, or educational

express conditions for exemption, the Tax Court reads an implied "public policy" condition into the statute requiring compliance with fundamental public policy standards derived from the law of charitable trusts.[50] The church maintained that both the express and implied conditions for exemption violate the free exercise and establishment clauses of the first amendment.

A. *Taxation of "Religious Income"*

The church contended that these statutory conditions were invalid because the Constitution compels tax-exemption for income derived from and applied to religious activities.[51] The exemption of "religious income" is mandated by both first amendment religion clauses in order to maintain governmental "neutrality" toward religion.[52] Although the Supreme Court has ruled that the Constitution does not prohibit tax exemptions for churches,[53] there is no direct authority that such exemptions are required.[54]

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purposes, or to foster national or international amateur sports competition. . .or for the prevention of cruelty to animals." See *supra* note 3 for definition of qualified purposes. Contributions to organizations described in I.R.C. § 501(c)(3) may also be deductible by donors under I.R.C. § 170.

50. Bob Jones Univ. v. United States, 103 S. Ct. 2017 (1983). Although the *Bob Jones* decision applied this public policy standard, it is questionable whether it is applicable to churches. The Court stated in a footnote: "We deal here only with religious *schools*, — not with churches or other purely religious institutions; here, the governmental interest is in denying public support to racial discrimination in education." *Id.* at 2035 n.29 (emphasis in original). *See infra* text accompanying notes 125-41.

51. *Church of Scientology*. 83 T.C. at 456. Income derived from commercial activities unrelated to a charitable organization's exempt purpose is taxable under the "unrelated business income" provisions of I.R.C. §§ 511-513. The regulations state that a business is related, and therefore not subject to tax, if "the conduct of the business activities has a causal relationship to the achievement of exempt purposes." Treas. Reg. § 1.513-1(d)(2) (West 1985). To be substantially related, the business activities must "contribute importantly" to the accomplishment of these exempt purposes. *Id.* The constitutional issue raised here concerns only such of the church's income that is earned through activities substantially related to its religious purpose. Of course, one of the major issues in this case is whether the church had a substantial commercial rather than religious purpose for engaging in its profit-making activities. *See infra* text accompanying notes 103-13.

52. In Walz v. Tax Comm'n, 397 U.S. 664 (1970), Chief Justice Burger used the term "benevolent neutrality" to describe the course that the courts must steer "between the two Religion Clauses, both of which are cast in absolute terms, and either of which, if expanded to a logical extreme, would tend to clash with the other." *Id.* at 668-69. The term "neutrality" is again referred to in the opinion as meaning that the government must adhere to a "policy of neutrality that derives from an accommodation of the Establishment and Free Exercise Clauses [that] has prevented the kind of involvement that would tip the balance toward government control of churches or governmental restraint on religious practice." *Id.* at 669-70.

53. Walz v. Tax Comm'n, 397 U.S. 664 (1970). The Court held that the benefit conferred on religion through the exemption of churches from property taxation does not violate the establishment clause. *But cf.* Committee for Pub. Educ. & Religious Liberty v. Nyquist, 413 U.S. 756 (1973) (distinguishing *Walz* and invalidating a program which provided tax benefits to parents of children attending parochial schools).

54. 397 U.S. 664. The decision in *Walz* does not directly address this question. However, the Chief Justice's majority opinion does give some indication of his view:

> Either course, taxation of churches or exemption, occasions some degree of involvement

The Tax Court rejected the church's contention that the first amendment requires a tax exemption for religious income.[55] In the court's view, the Constitution does not compel exemption of such income any more than it prohibits the general economic regulation of the press.[56] Indeed, the court maintained that a compulsory exemption for religious income would violate the establishment clause in two ways. First, it would be a compulsory subsidy that advanced religion. Second, it would necessitate an excessive government entanglement in church affairs because the government would have to examine the religious or secular nature of each item of income and expenditure.[57]

Although the Tax Court concluded an exemption for religious income would impermissibly subsidize religion, the Supreme Court has never directly addressed this question. The Court has determined that the establishment clause does not prohibit churches from being included in a broad class of tax-exempt organizations.[58] Thus, the inquiry is limited to exemptions that are specifically applicable to religions. There are two basic issues involved: first, whether religious tax exemptions are in fact subsidies; and second, whether this kind of support for religious activities is constitutionally impermissible.

The most relevant case for analyzing these issues is *Walz v. Tax Commission*[59] where the Supreme Court upheld a New York statute exempting houses of religious worship from taxation. In determining whether the statute violated the establishment clause, the Court applied a three part test.[60] To be valid, a statute (1) must have a secular purpose, (2) must not have a primary effect of advancing or inhibiting religion and (3) must not result in excessive entanglement of

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with religion. Elimination of exemption would tend to expand the involvement of government by giving rise to tax valuation of church property, tax liens, tax foreclosures, and the direct confrontations and conflicts that follow in the train of those legal processes.

Granting tax exemptions to churches necessarily operates to afford an indirect economic benefit and also gives rise to some, but yet a lesser, involvement than taxing them.

Id. at 674-75.

55. 83 T.C. at 458. Before addressing the constitutional questions, the court discussed the appropriate standard of review to be applied to issues involving the taxability of activities protected by the first amendment. The court stated that a strict scrutiny standard applies only where the church can show that the statute in question endangers one of its "fundamental rights" under the free exercise clause. Where this is not shown, the court will apply a lesser standard, measuring the statute by its "reasonableness." Concluding that there is no fundamental constitutional right to tax-exempt religious income, the court applied the reasonableness standard. *Id.* at 456.

56. *Id.* at 458.

57. *Id.*

58. *E.g.*, Mueller v. Allen, 463 U.S. 388 (1983) (state tax deduction for public and private school expenses); Walz v. Tax Comm'n, 397 U.S. 664 (1970) (property tax exemptions provided for a broad class of charitable orgainzations included houses of religious worship); Board of Educ. v. Allen, 392 U.S. 236 (1968) (state loan of secular textbooks to all children); Everson v. Board of Educ., 330 U.S. 1 (1947) (state reimbursement to all parents for expenses incurred in transportating children to school).

59. 397 U.S. 664.

60. Although this three prong test was more clearly enunciated in the subsequent case of Lemon v. Kurzman, 403 U.S. 602 (1971), it had in fact completely evolved first in *Walz*. *See* Cornelius, *Church and State — The Mandate of the Establishment Clause: Wall of Separation or Benign Neutrality?*, 16 ST. MARY'S L.J. 1 (1984).

government in religion. Because the statute exempted a broad range of organizations, it was found to have a secular purpose.[61] After examining the long history of federal and state tax exemptions for religious organizations, the Court concluded that their effect was a "kind of benevolent neutrality" to churches rather than an impermissible aid to religion.[62]

In analyzing the third part of the test, the Court maintained that both taxing and exempting churches involves government "entanglement" in religious affairs.[63] However, eliminating the exemption increases involvement by requiring valuation of church property and a variety of legal proceedings such as tax liens and foreclosures.[64] Allowing the exemption gives religion an "indirect economic benefit" but results in fewer other forms of involvement.[65] The proper analysis, the Court indicated, is to determine which alternative results in a lesser degree of entanglement.[66]

The Court was unequivocal in holding that a church tax exemption does not create an impermissible entanglement with religion, nor does it constitute a subsidy for religion. The opinion indicates that a "direct money subsidy" is the kind of relationship likely to result in excessive government involvement because a close administrative relationship is required to enforce statutory and administrative standards.[67] However, the grant of a tax exemption is not sponsorship of religion because "the government does not transfer part of its revenue to churches but simply abstains from demanding that the church support the state."[68]

Despite this language, a recent Supreme Court decision has raised the question of whether the Court will continue to distinguish religious tax exemptions

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61. 397 U.S. at 672-73.

62. *Id.* at 676-80.

63. *Id.* at 674.

64. *Id.*

65. *Id.*

66. *Id.* at 675, where the Court stated: "In analyzing either alternative the questions are whether the involvement is excessive, and whether it is a continuing one calling for official and continuing surveillance leading to an impermissible degree of entanglement."

67. *Id.* An interesting comment on the question of what constitutes an administrative entanglement is found in Schachner, *Religion and the Public Treasury After* Taxation With Representation of Washington, Mueller *and* Bob Jones, 1984 UTAH L. REV. 275, 287-90 (author discusses the considerable administrative supervision required under I.R.C. § 107 with respect to the clergy's income tax exemption for the rental value of residences provided as compensation).

68. 397 U.S. at 675. Similar language appears in Justice Brennan's concurring opinion:

> Tax exemptions and general subsidies. . .are qualitatively different. Though both provide economic assistance, they do so in fundamentally different ways. A subsidy involves the direct transfer of public monies to the subsidized enterprise and uses resources exacted from taxpayers as a whole. An exemption, on the other hand, involves no such transfer.

Id. at 690 (citation omitted). This language and Chief Justice Burger's majority opinion appear to have been influenced by the economic analysis of church tax exemptions in Professor Bittker's article, Bittker, *Churches, Taxes and the Constitution*, 78 YALE L.J. 1285 (1969).

Justice Harlan's concurring opinion does not adopt the idea that exemptions are economically different from subsidies. However, he agrees that subsidies necessitate more governmental involvement in religion. He leaves open the question of whether direct subsidies would violate the establishment clause. 397 U.S. at 699.

from direct subsidies. In *Regan v. Taxation With Representation*[69] a public interest group challenged the constitutionality of the portion of section 501(c)(3) that denies tax exemptions to organizations engaged in lobbying.[70] The court held that the first amendment does not require that Congress subsidize lobbying activities. The rationale underlying its conclusion was that a tax exemption is equivalent to a subsidy.[71]

The Court tempered this conclusion somewhat by a footnote which maintained that although exemptions and cash subsidies are similar, they are not identical in all respects.[72] The footnote refers to portions of the majority and concurring opinions in *Walz* which maintain that church tax exemptions are not subsidies for religion and that exempting churches from taxation results in less government entanglement with religion than would taxation.[73] However, the Court apparently no longer accepts the economic distinction between exemptions and subsidies made in *Walz*.[74] Since it is unlikely the Court intends

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69. 461 U.S. 540 (1983).

70. I.R.C. § 501(c)(3) (West 1985). In pertinent part § 501(c)(3) provides exemptions for described organizations "no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation. . . ." The group in question claimed that this prohibition on lobbying violated the first amendment by imposing an "unconstitutional condition" on its receiving tax exempt and tax deductible status.

71. 461 U.S. at 544.

> Both tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system. A tax exemption has much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income. Deductible contributions are similar to cash grants of the amount of a portion of the individual's contribution.

Id. In Committee for Pub. Educ. & Religious Liberty v. Nyquist, 413 U.S. 756 (1973), the Court found a similar equivalence between tax deductions and subsidies. *Id.* at 793. The Court struck down a New York statute that provided tax deductions for parents of children in private schools. The Court stated: "The only difference [between parents receiving a tax deduction and those receiving a tuition grant] is that one parent receives an actual cash payment while the other is allowed to reduce. . .the sum he would otherwise be obliged to pay over to the State." *Id.* at 791.

But see Mueller v. Allen, 103 S. Ct. 3062 (1983), where the Court suggested that tax deductions may be a form of quid pro quo, whereby the state foregoes taxation in return for some of the benefits and lower costs attributable to the services performed by charitable organizations. *Id.* at 3070.

72. Regan v. Taxation with Representation, 103 S.Ct 1997, 2000 n.5 (1983). In stating that exemptions and deductions, on the one hand, are like cash subsidies, on the other, we of course do not mean to assert that they are in all respects identical. 461 U.S. 544.

73. The footnote gives the following citation to *Walz*: Walz v. Tax Comm'n, 397 U:S. 664, 674-676 (1970); *id.* at 690-91 (Brennan J., concurring); *id.*, at 699 (opinion of Harlan, J.).

74. No clear economic rationale for not taxing churches has been articulated. One view is that the exemption is necessary because it is not possible to define the taxable income of nonprofit organizations in a meaningful way. Donations are not really equivalent to income, but are more in the nature of gifts. Expenditures for charitable purposes are not really equivalent to business expenses. *See* Bittker & Radhert, *The Exemption of Nonprofit Organizations From Federal Income Taxation*, 85 YALE L.J. 299 (1976); Bittker, *supra* note 68. Another position is that it is economically efficient to allow the exemption for organizations whose services are not more efficiently provided by profit-oriented entities. Under this approach, the cases that have denied exemptions to organizations because of "commercial purposes" are justified where the charity engaged in commercial activity that produced, distributed or sold goods and services that are also provided by profit-seeking businesses. Since the profit-seeking business will generally operate more efficiently, there is no

to overrule *Walz* and begin taxing the churches, eliminating the distinction between exemptions and subsidies may make it possible for the government to provide more direct forms of economic assistance to religious organizations.[75] A direct subsidy could be permissible if it would not result in more governmental administrative and supervisory entanglement than would a tax exemption.[76]

B. *Free Exercise Issues*

1. Background — The "Purposes" Test

The issues concerning the free exercise clause involve the Tax Court's application of the "religious purposes" test in section 501(c)(3). The statute requires that an exempt entity be organized and operated exclusively for exempt purposes. This has been construed to mean that an exempt organization's activities may not be motivated by a substantial commercial purpose.[77] Where a nonexempt purpose is not one of the organization's stated goals, it has been inferred from the nature of its activities.[78] In a number of cases, a commercial purpose has been inferred from the business-like manner in which the charity operated.[79]

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economic reason to grant tax exemptions. This would not apply then, to churches, whose religious services are not competitive with business. *See* Hansmann, *The Rationale For Exempting Nonprofit Organizations From Corporate Income Taxation*, 91 YALE L.J. 54 (1981).

75. Possibly the Court will use the entanglement test in a more restrictive manner, allowing an exemption only if it results in a lesser degree of entanglement than would taxation of the religious organization. *See* Schachner, *supra* note 67, at 285.

76. Justice Harlan's concurring opinion in *Walz* may presage this approach. Harlan maintained that exemptions and subsidies do not differ as an economic matter. However, he went on to state:

> Whether direct aid or subsidies entail that degree of involvement that is prohibited by the Constitution is a question that must be reserved for a later case upon a record that fully develops all the pertinent considerations such as the significance and character of subsidies in our political system and the role of the government in administering the subsidy in relation to the particular program aided. It may be that the States, while bound to observe strict neutrality, should be freer to experiment with involvement — on a neutral basis — than the Federal Government.

397 U.S. at 699 (citation omitted).

77. Better Bus. Bureau v. United States, 326 U.S. 279 (1945). The Court held that one of the organization's stated purposes, the improvement of business methods among merchants, was not an exempt purpose. Since this purpose was substantial, no exemption from Social Security taxes was allowed. *Id.*

78. Fides Pub. Assn. v. United States, 263 F. Supp. 924 (N.D. Ind. 1967); Scripture Press Found. v. United States, 285 F.2d 800 (Ct. Cl. 1961); B.S.W. Group v. Commissioner, 70 T.C. 352 (1978); Presbyterian & Reformed Pub. Co. v. Commissioner, 79 T.C. 1070 (1982), *rev'd*, 84-2 U.S. Tax Cas. (CCH) ¶ 9764.

79. The test was stated by the Tax Court in B.S.W. Group v. Commissioner, 70 T.C. 352 (1978) as follows:

> The fact that [an] activity may constitute a trade or business does not, of itself, disqualify it from classification under Section 501(c)(3), provided the activity furthers or accomplishes an exempt purpose. Rather, the critical inquiry is whether [the] primary purpose. . .is an exempt purpose, or whether [the] primary purpose is the nonexempt one of operating a commercial business producing net profits. This is a question of fact to be resolved on

The IRS originally defined the statutory requirement that an organization be organized and operated for exclusively charitable purposes to mean that exempt organizations could not engage in any business activities.[80] The Supreme Court rejected this narrow construction, holding that the conduct of profitable business activities does not constitute a nonexempt purpose where the business income is used to further exempt purposes.[81] The "destination" rather than the source of income was held to be the proper test because Congress had not intended to prevent tax-exempt organizations from generating income to support their charitable activities.[82]

This "destination" test was criticized as allowing an unfair competitive advantage to businesses owned by exempt organizations.[83] To prevent commercial

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the basis of all the evidence. . . . Factors such as the particular manner in which the organizations' activities are conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits are relevant evidence of a forbidden predominant purpose.

Id. at 357 (citations omitted).

Although this case refers to the organization's primary purpose, subsequent cases have held that the exemption is lost where the organization's commercial purpose is "substantial." Fides Pub. Ass'n v. United States, 263 F. Supp. 924, 935 (N.D. Ind. 1967).

80. *See* O.D. 953, 1921-4 C.B. 261-62. This definition is not in accord with the legislative history of § 501(c)(3). Senator Bacon, the sponsor in 1909 of the bill containing the statute's present wording, clearly indicated his intention that profit-making activities would be permitted: "The corporation which I had particularly in mind. . .is a large printing establishment. . .in which there must necessarily be profit made, and there is a profit made exclusively for religious, benevolent, charitable, and educational purposes. . . ." 44 CONG. REC., pt. 4. at 4151 (1909).

81. Trinidad v. Sagrada Orden, 263 U.S. 578 (1924). This view is reflected in the Treasury Regulations adopted in 1960, which state:

> An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513.

Treas. Reg. § 1.501(c)(3)-1(e)(1) (1960).

82. *Id.* at 581. *See* Note, *Profitable Related Business Activities and Charitable Exemption Under Section 501(c)(3)*, 44 GEO. WASH. L. REV. 270 (1976).

83. The House Ways and Means Committee Report on the Revenue Act of 1950, H.R. REP. No. 2319, 81st Cong. 2d Sess. (1950) states:

> The tax-free status of. . .[section 501(c)(3)] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes. Also, a number of examples have arisen where these organizations have, in effect, used their tax exemption to buy an ordinary business. That is, they have acquired the business with no investment on their own part and paid for it in installments out of subsequent earnings — a procedure which usually could not be followed if the business were taxable.

Id. at 36-37. This concern was reiterated during congressional consideration of the Tax Reform Act of 1976. The Senate Finance Committee stated that the major purpose for the taxation of unrelated business income is "to make certain that an exempt organization does not commercially exploit its exempt status for the purpose of unfairly competing with taxpaying organizations." S. REP. No. 938, 94th Cong., 2d Sess. 601 (1976).

One case that achieved a great deal of notoriety involved a macaroni company owned by an

exploitation of tax-exempt status, the Revenue Act of 1950 imposed a tax on an exempt organization's "unrelated business income."[84] This is defined as income derived from the conduct of a trade or business that is not substantially related to the exercise or performance of an organization's exempt purpose or function.[85] The legislative history indicates, however, that the unrelated business income tax was not intended to restrict an organization's ability to make profits through its charitable activities even when earned in direct competition with taxable businesses.[86] Nor was the tax intended to affect in any way the exempt status of an otherwise qualified organization.[87]

Notwithstanding this legislative history, a number of otherwise qualified organizations have lost their tax exemptions because their exempt activities generated profits.[88] In these situations, the presence of a substantial commercial purpose was inferred from the business-like manner in which the charity operated.[89] As the Tax Court described the analysis: "If . . . an organization's management decisions replicate those of commercial enterprises, it is a fair inference that at least one purpose is commercial, and hence nonexempt."[90] The factor most likely to indicate a commercial purpose appears to be the presence of substantial profits.[91]

Determining the existence of an unstated commercial purpose by scrutinizing business-like practices and profitability favors poorly managed and less efficient religious organizations. In *Golden Rule Church Association v. Commissioner*,[92] the Tax Court upheld the exempt status of a religious group that operated sawmills, a chain of laundries, a hotel and a tree nursery in order to illustrate to the

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exempt university. C.F. Mueller v. Commissioner, 190 F. 2d 120 (3rd Cir. 1951). *See* Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 HARV. L. REV. 1280 (1968).

84. The Revenue Act of 1950, ch. 994, §§ 421-422, 64 Stat. 909, 948-50 (1950) enacted the predecessors of what are now I.R.C. §§ 511-513. Section 511(a)(1) imposes the tax at corporate rates under I.R.C. § 11, except that charitable trusts are taxable at the estates and trusts rates under I.R.C. § 1(e). I.R.C. § 511(b)(1).

85. I.R.C. § 513.

86. *See* Desiderio, *The Profitable Nonprofit Corporation: Business Activity and Tax Exemption Under Section 501(c)(3) of I.R.C.*, 1 N.M.L. REV. 563, 570 (1971); B. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 40.1 (4th ed. 1983).

87. The Senate Report makes this clear:

> The bill does not deny the exemption where the organizations are carrying on unrelated active business enterprises, nor require that they dispose of such businesses. . . . [These] provisions merely impose the same tax on income derived from an unrelated trade or business as is borne by their competitors. In fact it is not intended that the tax imposed on unrelated business income will have any effect on the tax-exempt status of any organization.

S. REP. No.. 2375, 81st Cong., 2d Sess. 29 (1950).

88. A number of cases and IRS rulings have revoked the tax-exempt status of otherwise qualified organizations whose exempt activities have generated profits. *See Zelenak, Serving Two Masters: Commercial Hues and Tax Exempt Organizations*, 8 PUGET SOUND L. REV. 1 (1984).

89. *See supra* note 79.

90. Presbyterian & Reformed Pub. Co. v. Commissioner, 79 T.C. 1070 (1982), *rev'd*, 743 F.2d 148 (3rd Cir. 1984).

91. *Id.* at 155.

92. 41 T.C. 719 (1964).

public that the "golden rule" is not incompatible with business. In reaching its conclusion, the court maintained that the organization's "consistent nonprofitability" evidenced the absence of a commercial purpose for its business activities.[93] Because of this holding, the court did not address the contention that the first amendment barred treating business activities as a nonreligious purpose when they are engaged in to conform with a religious doctrine.[94]

The view that an organization's profitability indicates a nonexempt commercial purpose was recently rejected by the Third Circuit Court of Appeals in *Presbyterian & Reformed Publishing Co. v. Commissioner*.[95] In reversing the Tax Court, the appellate court noted that neither section 501(c)(3) nor its legislative history define an organization's purpose as a derivitive of the volume of its business activities.[96] The court maintained that since the regulations and case law do not provide a clear definition of "purpose," determining it by reference to accumulation of profits results in arbitrary and ad hoc decisionmaking.[97] The proper inquiry, according to the court, is to determine the purpose to which an organization's business activity is directed.[98]

A similar approach was adopted by the Seventh Circuit in *Bethel Conservative Mennonite Church v. Commissioner*.[99] The court maintained that the crucial inquiry is not into the nature of an organization's activity, but into the purpose the activity accomplishes.[100] The Tax Court revoked the church's exemption because a large portion of its disbursements and receipts were for the payment of medical expenses under a church-sponsored medical plan. The Tax Court held the operation of the plan constituted a substantial nonexempt purpose.[101] The appellate court reversed, determining that the medical plan served the church's exempt purpose by furthering the belief that church members should pool their resources and bear each other's burdens.[102]

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93. *Id.* at 731.

94. *Id.* at 729-30.

95. Presbyterian & Reformed Pub. Co. v. Commissioner, 743 F.2d 148 (3rd Cir. 1984), *rev'g* 79 T.C. 1070 (1982). The Tax Court had upheld the IRS' revocation of the exemption of a publisher of religious books. The Tax Court maintained that the publisher's substantial profits and accumulated earnings in recent years had changed the corporation's purpose from charitable to commercial.

96. *Id.* at 156.

97. *Id.*

98. *Id.*

99. 746 F.2d 388 (7th Cir. 1984), *rev'g* 80 T.C. 352 (1983).

100. *Id.* at 391.

101. 80 T.C. 352 (1983).

102. 746 F.3d at 391-92. The Tax Court had concluded that a plan which benefits all contributing members of a religious congregation rather than only "needy" members does not further a religious or other exempt purpose. 80 T.C. at 360 (1983). The appellate court maintained it was an error for a court to define "needy" in strictly financial terms when the Mennonite faith considers all of its members to be needy and deserving of assistance regardless of financial status. The court pointed out that: "Religions by their very nature provide many services that benefit only the members of the individual congregation, and to say that any church which so provides these benefits must be denied tax exemptions would disrupt many organized churches as we know them." 746 F.2d at 391.

2. The Right to Earn Profits

The Tax Court's inference that the Church of Scientology was animated by a substantial commercial purpose was based on two factors: (1) the profit-oriented manner in which the church promoted, priced and sold its religious services and products,[103] and (2) the church's substantial cash reserves and annual profits.[104] The church contended that this application of the section 501(c)(3) purposes test unconstitutionally restricted profit-making activities that furthered religious beliefs.[105] The limitation directly conflicted with the church's practice of its belief in the doctrine of "exchange," which requires the church to charge fees for religious services and literature.[106]

The court conceded that the commercial purpose test of section 501(c)(3) conflicted with this religious practice, thereby restricting a fundamental right protected by the free exercise clause.[107] Such restrictions are subject to strict judicial scrutiny, requiring the government to justify them as being "essential to accomplish an overriding governmental interest."[108] However, citing the Supreme Court's decision in *United States v. Lee*[109] as controlling, the court concluded that the Treasury has such an overriding interest in maintaining its revenue base. In *Lee*, the Court held that an employer's religious beliefs did not exempt him from paying social security taxes on behalf of his employees.[110] Although payment of the tax conflicts with the Amish belief that participation in insurance programs is sinful, the Court concluded that the employer's free exercise right could not be accommodated without opening the door to a variety of beliefs seeking similar exemptions.[111]

It is difficult to understand the Tax Court's conclusion that the holding in *Lee* controlled in the *Church of Scientology* case since the government's interest

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103. Church of Scientology v. Commissioner, 83 T.C. 381, at 477 (1985) (the court was particularly impressed by the commercial manner in which these religious services and products were promoted, priced and contracted for).

104. *Id.* at 480.

105. *Id.* at 456.

106. *Id.* at 459. The church also asserted that it was necessary for it to engage in commercial activities in order to sell its literature, advertise, accumulate earnings for future needs and to remunerate its founder. The court rejected this contention, holding that the first amendment only applies to church-sponsored activities that further a religious mission or purpose. Since purely commercial ventures are not covered, an exemption may be revoked where commercial activities take on a life of their own and assume "an independent importance and purpose." *Id.*

107. *Id.* at 460. The court stated that the fact that five of the Church of Scientology's branches earned between 73 and 100 percent of their incomes from the sale of religious items and services measurably contributed to its conclusion that the church had a substantial commercial purpose. Id.

108. *Id.* The court quotes this language from the Supreme Court's holding in Bob Jones Univ. v. United States, 461 U.S. 574, 603 (1983), which in turn was quoting its language in United States v. Lee, 455 U.S. 252, 257-58 (1982).

109. 455 U.S. 252 (1982).

110. Under I.R.C. § 1402(g) (1982), self-employed persons may claim a religious exemption from participation in the social security and unemployment insurance systems. However, this exemption does not apply to persons who employ others.

111. 455 U.S. at 260. The Court's decision was motivated by its concern for the income tax system rather than the social security system. It noted, however, that "[t]here is no principled way. . .to distinguish between general taxes and those imposed under the Social Security Act." *Id.*

in the two situations is clearly different. In *Lee*, the Supreme Court declined to exempt an individual from a broadly applied tax because the exemption would compromise the integrity of the entire tax system. The Court's concern is clearly stated: "The tax system could not function if denominations were allowed to challenge the tax system because tax payments were spent in a manner that violates their religious belief."[112] The Church of Scientology, however, was not seeking an exemption because of a religious concern about the government's use of tax dollars. It was the government, rather, that revoked the exempt status of an organization because of the nature of its activities. The government's narrow interest here is limited to the taxability of profits derived from religious activities.[113]

V. Establishment Clause

The Church of Scientology contended that construing section 501(c)(3) to restrict commercial activities which further a religious purpose was a limitation which violated the first amendment establishment clause.[114] To satisfy the requirements of this clause, a statute (1) must have a secular purpose, (2) must neither advance nor inhibit religion and (3) must not foster excessive government entanglement with religion.[115] The church claimed that such a limitation inhibited newer religions that must rely on commercial techniques to gain adherents and propagate their faiths, while advancing older, more established religions. Additionally the limitation results in excessive government entanglement with religion by necessitating intensive investigations and audits that question the religiosity of church policies and practices.

The court maintained that the fact that the statute restrictions on commercial activity may have a harsher impact on newer religions does not, by itself, impermissibly inhibit or advance religion. A statute may have disparate effects on religious organizations if these effects result from neutral, secular criteria.[116]

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112. *Id.* It appears that the Court's concern for the integrity of the tax system arises in part from arguments made by many conscientious objectors and tax protesters. The Court illustrates the problems it foresees as follows: "If, for example, a religious adherent believes war is a sin, and if a certain percentage of the federal budget can be identified as devoted to war-related activities, such individuals would have a similarly valid claim to be exempt from paying that percentage of the income tax." *Id. See also* Note, *Supreme Court Decisions in Taxation: 1981 Term*, 36 Tax Law. 421 (1983).

113. In Wisconsin v. Yoder, 406 U.S. 205 (1972), the Court held that the free exercise clause required that Amish children be exempted from the state's compulsory education laws. In balancing the competing claims, the Court maintained that the state's interest was not of sufficient magnitude to override the first amendment right. *Id.* Applying a similar test to the claims of the government and church in the Scientology situation appears more approriate than a blanket assertion that the government's interest in the tax system is always paramount.

114. Church of Scientology v. Commissioner, 83 T.C. 381, 459 (1985).

115. Lemon v. Kurzman, 403 U.S. 602, 612-13 (1971); Walz v. Tax Comm'n, 397 U.S. 664 (1970).

116. 83 T.C. at 461. The court cites Gillette v. United States, 401 U.S. 437 (1971) as authority for this proposition. It seems more strongly supported by the Supreme Court's recent holding in Lynch v. Donnelly, 104 S Ct. 1355 (1984), which permitted the display of a nativity scene on public property. The Court indicated that the display had the proper secular aim of showing the historical origins of Christmas. 104 S. Ct. at 1363.

In the court's view, the commercial purpose test is based upon the neutral requirements of charitable trust law that charitable organizations serve public goals rather than private interests.[117]

The Tax Court's view that a statute may have a disparate impact on religions yet still be neutral is illustrated in *Graham v. Commissioner*,[118] which concerned the deductibility of contributions to the Church of Scientology. The court denied the deductions, holding that payments to the church did not qualify as charitable contributions because they were made in exchange for and in expectation of auditing services.[119] The taxpayer argued that this construction of section 170 (which allows the deduction for charitable contributions) violated the requirement for neutrality through its particular impact on activities associated with Scientology.

The taxpayer relied upon the Supreme Court's decision in *Larson v. Valente*.[120] The Court in *Larson* struck down a Minnesota statute that imposed registration and reporting requirements on religious organizations, because the law had a substantially greater impact on certain religions. The Tax Court, however, distinguished the statute at issue in *Larson* from section 170, maintaining that enactment of the Minnesota law was motivated by a legislative attempt to discriminate against particular religious organizations.[121] The legislative history of section 170, however, indicates no discriminatory motive and the statute does not classify religions in any way.

The court also maintained that section 170 differs from the statute in *Larson* because it "bears equally upon all religious organizations."[122] Of course, the gist of the taxpayer's contention in *Graham* was that denying a charitable contribution deduction because the donor receives certain types of religious services does not bear equally on all religions.[123] It is possible to read *Larson* in this vein, that is, as striking the statute because the state had not shown that the disparate treatment afforded various religious groups was justified by an overriding state interest.[124] However, the Tax Court refused to interpret *Larson* in this manner.

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117. 83 T.C. at 461.

118. 83 T.C. 575 (1984).

119. 83 T.C. at 580-81. The courts have construed the term "charitable contribution" in the Internal Revenue Code to be synonymous with the term gift. DeJong v. Commissioner, 36 T.C. 896, 899 (1961), *aff'd*, 309 F.2d 373 (1962). Since a gift is a voluntary transfer without consideration, a payment made in expectation of an anticipated benefit does not qualify. 36 T.C. at 899.

120. 456 U.S. 228 (1982).

121. 83 T.C. at 583.

122. *Id.*

123. This holding may be contrasted with the Seventh Circuit's statement in Bethel Conservative Mennonite Church v. Commissioner, 746 F.2d 388, (7th Cir. 1984), where the court pointed out that: "Religions by their very nature provide many sevices that benefit only the members of the individual congregation, and to say that any church which so provides these benefits must be denied tax exemption would disrupt many organized churches as we know them." *Id.* at 391.

124. *See* Mansfield, *The Religion Clauses of the First Amendment and the Philosophy of the Constitution*, 72 CALIF. L. REV. 847, 893 (1984).

VI. The Public Policy Issue

A significant basis for the court's decision in *Church of Scientology* was that the church violated the public policy standard implied in section 501(c)(3).[125] Based upon its reading of the Supreme Court's holding in *Bob Jones University v. United States*,[126] the court held that section 501(c)(3) incorporates the law of charitable trusts. Accordingly, the law requires that charitable organizations, including churches, may be exempted from taxation only if they "serve a valid public purpose and confer a public benefit."[127] The court concluded that the church did not satisfy this charitable trust — public policy standard because its real purpose was not to advance religious beliefs but rather to make money through a criminal conspiracy to defraud the government.[128]

In *Bob Jones*, the Supreme Court upheld the IRS' revocation of a religious school's tax exemption on the basis of its racially discriminatory admissions policy. Chief Justice Burger's majority opinion maintained that the general legislative framework and congressional intent behind section 501(c)(3) clearly demonstrates that "entitlement to tax exemption depends upon meeting certain common-law standards of charity."[129] The form and history of the exemption statute indicates that Congress intended that the common law of charitable trusts would apply.[130] Pursuant to this common law, a charitable trust may not have purposes that are illegal or "contrary to established public policy."[131]

The Court recognized that determining public policy and public benefit are difficult and sensitive tasks. Therefore, to limit administrative discretion in making these determinations, the Court stated that an organization can be considered not to be charitable only where there is "no doubt that the activity involved is contrary to a fundamental public policy."[132] Upon review of the legislation, executive orders and court decisions during the past twenty-five years, the Court concluded there is no doubt that "racial discrimination in education" violates such a fundamental policy.[133]

The Tax Court's use of this public policy test in the *Church of Scientology* context raises two important questions. First, does the *Bob Jones* decision indicate that the public policy standard for educational institutions is also applicable to churches? Second, if this issue was not addressed in *Bob Jones*, is it constitu-

125. 83 T.C. at 502. In a pretrial ruling (which preceded the Supreme Court's holding on this issue in *Bob Jones University v. United States*), the court stated that an organization seeking exemption must satisfy the statute's express religious purpose and inurement conditions and also "comply with fundamental notions of public policy." *Id.*

126. 461 U.S. 574 (1983).

127. 83 T.C. at 502.

128. *Id.* at 504.

129. 461 U.S. at 586.

130. *Id.* at 588 n.12.

131. *Id.* at 586.

132. *Id.* at 592.

133. *Id.*

tionally permissible to condition a church's tax exemption upon conformance with governmental pronouncements on public policy?[134]

A. *Applicability of* Bob Jones *to Churches*

The Church of Scientology contended that the *Bob Jones* Court had expressly reserved decision on whether the public policy standard implied in section 501(c)(3) applied to churches. This argument appears to be based upon a footnote in the opinion stating that the Court was dealing with "religious *schools* — not with churches or other purely religious institutions."[135] However, as the Tax Court pointed out,[136] this footnote refers not to the public policy test but to the portion of the decision concerning the University's claim that denying its exemption impermissibly interferes with the exercise of religious beliefs. Having concluded that the government's overriding interest in eliminating racial discrimination in education justified the first amendment infringement, the *Bob Jones* Court noted that it was not ruling that this interest would justify interference in all religious activities.

Notwithstanding this context, it is possible to read this footnote as meaning that the Court was also reserving judgment as to the applicability of the public policy test to purely religious organizations. The text of the note is:

> We deal here only with religious *schools* — not with churches or other purely religious institutions; here the government's interest is in denying public support to racial discrimination in education. As noted earlier, racially discriminatory schools "exer[t] a pervasive influence on the entire educational process," outweighing any public benefit that they might

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134. If a public policy test is permissible, the question would arise as to the appropriate criteria for determining whether a church's activities are contrary to fundamental public policy. A corollary would be who should decide these criteria. These difficulties with the public policy test animated Justice Powell to write a separate, concurring opinion in *Bob Jones*. Justice Powell stated: "I am unwilling to join any suggestion that the Internal Revenue Service is invested with authority to decide which public policies are sufficiently fundamental to require denials of tax exemptions. Its business is to administer laws designed to produce revenue for the Government, not to promote public policy." *Id.* at 611.

The concurring opinion also expresses concern about the dangers of selective enforcement that would arise by permitting the IRS to establish public policy. Justice Powell quotes Justice Blackmun's dissent in Commissioner v. "Americans United" Inc., 416 U.S. 752, 774-75 (1974):

> [W]here the philanthropic organization is concerned, there appears to be little to circumscribe the almost unfettered power of the Commissioner. This may be very well so long as one subscribes to the particular brand of social policy the Commissioner happens to be advocating at the time. . . , but application of our tax laws should not operate in so fickle a fashion. Surely, social policy in the first instance is a matter for legislative concern.

461 U.S. at 611-12.

For cases where IRS selection was based upon the political or controversial nature of an organization, see Note, *The Revocation of Tax Exemptions, and Tax Deductions For Donations to 501(c)(3) Organizations on Statutory and Constitutional Grounds*, 30 U.C.L.A. L. REV. 156, at 172 (1982).

135. 461 U.S. at 604 n.29 (emphasis in original).

136. Church of Scientology v. Commissioner, 83 T.C. 381, 503 n.74 (1985).

otherwise provide, Norwood v. Harrison, 413 U.S. 455, 469. . . . See generally Simon 495-96.[137]

Since the reference to *Norwood* appears in connection with the public policy test, it may be seen as referring to the entire decision rather than to a part. This view is reinforced by the Court's later reference to this footnote when considering the final issue of the proper application of the public policy requirement of section 501(c)(3).[138]

More importantly, the Court refers to the Simon article, *The Tax Exempt Status of Racially Discriminatory Religious Schools*.[139] In the section cited by the court Ms. Simon discusses the application of the public purpose test to religious organizations, not the free exercise question.[140] Indeed, Ms. Simon concludes that the public benefit requirement of the charitable trust law is not applicable to organizations engaged in purely religious activities.[141] Taken as a whole, the footnote suggests the Court intended to reserve its judgment on both the public policy and first amendment issues with respect to racially discriminatory churches.

B. *Application of a Public Policy Requirement to Churches*

The Tax Court in *Church of Scientology* maintained that although *Bob Jones* did not address the issue, it is not unconstitutional to apply the public policy requirements to church tax exemptions.[142] In support of this view, the court cited a number of free exercise cases where compelling governmental interests were found to justify substantial restrictions on religious liberty.[143] From these

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137. 461 U.S. at 609 n.29.

138. 461 U.S. at 605 n.32. This note states:

> Bob Jones University also argues that the IRS policy should not apply to it because it is entitled to exemption under § 501(c)(3) as a "religious" organization, rather than as an "educational" institution. The record in this case leaves no doubt, however, that Bob Jones University is both an educational institution and a religious institution. As discussed previously, the IRS policy properly extends to all private schools, including religious schools. The IRS policy thus was properly applied to Bob Jones University.

Id. (citation omitted).

139. Simon, *The Tax Exempt Status of Racially Discriminatory Religious Schools*, 36 TAX L. REV. 477 (1981).

140. *Id.* at 495, where the article sets forth the following excerpt from a treatise on the law of trusts:

> Where the purpose of the trust is not the promotion of religion but merely the promotion of purposes which are of a character beneficial to the community, it is obvious that a distinction must be drawn between what may rationally be thought to be beneficial to the community and what is clearly absurd. Where the purpose is to promote a particular religion, however, it is almost impossible to draw such a line.

4 A. SCOTT, THE LAW OF TRUSTS § 371.4 (1939).

141. Simon, *supra* note 139, at 495. The author states: "Thus, even if a church discriminates in who may join its congregation, it is not at all clear that the church would be denied exemption as a charitable organization. Indeed, it is likely that such a church would maintain its exemption." *Id.*

142. 83 T.C. at 503 n.74. The court stated: "In any event, we believe that the application of public policy requirements to churches does not in and of itself offend the Constitution." *Id.*

143. *Id.* The court made particular reference to Late Corp. of the Church of Jesus Christ of

cases, the court reasoned: "If the government has the power to prohibit religious practices outright which interfere with fundamental public interests,. . .then, a fortiori, it has the power to deny tax benefits to churches which espouse and practice such beliefs."[144]

The court misread the cited cases. The cases did not hold that the religious practices involved were restricted because they contravened public policies. These limitations were not based on public policy but rather upon the government's showing that governmental interests were paramount and could not accommodate the religious practices.[145] For example, in *United States v. Lee*,[146] a case cited by the court, the employer was required to make social security contributions because that system must be comprehensive to be effective. The employer's request for exemption from payment of social security taxes was denied because it could not be accommodated, not because the Amish belief interfered with fundamental public interests.[147] The Court's reliance upon governmental interests rather than contravention of public policies is also evident in *Wisconsin v. Yoder*.[148] The Court concluded in *Yoder* that the government's interest in enforcing its compulsory education laws did not justify requiring Amish children to attend schools in violation of their parents' religious beliefs. Certainly such compulsory education laws represent a fundamental public policy.

The Tax Court's analysis also mistakenly equates the constitutional requirement that overriding governmental interests justify limiting first amendment freedoms, with the trust law requirement that charitable organizations provide public benefits. The different effects of these standards may be illustrated in the racial discrimination context of *Bob Jones*. There the Court clearly established the presence of a fundamental public policy to eradicate discrimination in many aspects of American life.[149] While this public policy justifies withholding tax

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Latter-Day Saints v. United States, 136 U.S. 1 (1890), where a religious corporation was dissolved because it violated the public policy favoring monogamy. Other cited cases deal with restrictions on religious freedom necessary to control smallpox, protect children from exploitative labor, conscientious objection, and contributions to the social security system. *Id.*

144. *Id.*

145. Where the government's interest is overriding, the Supreme Court will inquire as to whether accommodating the religious belief in question will unduly interfere with fulfillment of the government's interest. United States v. Lee, 455 U.S. 252, 259 (1982); *see also* Braunfeld v. Brown, 366 U.S. 599, 605 (1961). The Court has phrased this requirement in other cases as requiring the government to use the "least restrictive means" to achieve its interests. Thomas v. Review Bd. of the Indiana Employment Sec. Div., 450 U.S. 707, 718 (1981). For a discussion of possible differences between these standards, see Schachner, *supra* note 67, at 305.

146. 455 U.S. 252, (1982).

147. *See id.* at 260-61. Similarly, in Late Corp. of the Church of Jesus Christ of Latter-Day Saints v. United States, 136 U.S. 1 (1890) a case particularly relied on by the court, the government's interest was in preventing criminal behavior (polygamy) not in upholding its public policy.

148. 406 U.S. 205 (1972).

149. 461 U.S. at 594-95. The Court illustrated the presence of the policy by reference to governmental actions concerning education, voting rights, federal employment, selective service and housing. The Court indicated that there were many more examples that would show this public policy. *Id.*

exemptions from many discriminatory organizations, it by no means follows that the exemption may be denied to a racially restrictive church.[150]

VII. Conclusion

While the decision in *Church of Scientology* reaches the correct result, the Tax Court addressed too many issues in reaching it. Except for the complex facts and effective delay tactics, this case presents the same questions as do the numerous tax-motivated religions that are frequently before the courts. Ultimately the only issue in these cases is inurement; was the organization in question organized and operated for religious purposes or for the benefit of private individuals.[151] Since there was overwhelming evidence that the church was deliberately structured to allow the founder, his family and friends to reap a fortune from it, it is difficult to understand why the court also addressed difficult constitutional questions.

Although the facts support the court's holding that the IRS' actions against the church were not motivated by religious hostility, the court's conclusion that such hostility would have been irrelevant is too broad. Certainly a governmental policy which selects religious organizations for audit on the basis of their religious beliefs would taint the proceedings in some way.

The court's application of the *Bob Jones* public policy standard to churches appears unfounded. Whether a particular church or religion provides a public benefit is an unanswerable question and therefore cannot provide the basis for determining tax exempt status. Under our constitutional framework, all religions must be considered equally beneficial. This constitutional premise may be considered a public policy that prohibits the kind of inquiry into religion which was permitted with respect to educational institutions in *Bob Jones*.

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150. The different impact of these standards may also be seen in the *Church of Scientology* situation. The church contended that penalizing the entire Church of Scientology for the misconduct of its officials violated its free association and free exercise rights. 83 T.C. at 503. Since the government's interests can be protected through criminal prosectuion of the officials, revoking the church's exemption is an unwarranted restriction of first amendment rights. *Id.* Similarly, under charitable trust law, a trust formed for legitimate purposes is not invalid simply because illegal means have been used to accomplish these purposes. *Id. citing* Restatement (Second) of Trusts, § 377, comment d (1959).

Although the issue appears to be the same under the first amendment and the trust law, the considerations are quite different. The Tax Court did not show that the church's interests could not be accommodated by removal and prosecution of the offending officers, or that revocation was the least restrictive means available. Instead, it focused on the fundamental public policy behind the criminal conspiracy statutes. Under a constitutional analysis, this policy should be irrelevant if the church officials could be separated from the church itself.

151. I.R.C. § 501(c)(3) (1982) provides in pertinent part that an organization must be organized and operated so that "no part of [its] net earnings. . .inures to the benefit of any private shareholder or individual. . . ."