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Taxation-Federal Income Tax-Religious Order Not Exempt from Supplement U Tax as a Church

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TAXATION—FEDERAL INCOME TAX—RELIGIOUS ORDER NOT EXEMPT FROM SUPPLEMENT U TAX AS A CHURCH—Plaintiff, a non-profit, membership corporation consists of members of the Christian Brothers Order,¹ and was established to furnish religious and secular education to youth. The Catholic Church considers religious instruction to be the performance of a church function, and property of the Christian Brothers Order is church property according to Roman Catholic canon law. During the taxable years in question plaintiff owned and operated a novitiate, Catholic schools, homes for the Brothers, and a winery and distillery.² Plaintiff was assessed and paid \$489,800.83 as a Supplement U tax on its unrelated business income realized from the winery and distillery operation. Plaintiff claimed that it was exempt from the tax as a “church”³ since, under the regulations governing section 511 of the Internal Revenue Code of 1954,⁴ a religious order qualifies as a church for the purposes of the exemption if it is an integral part of a church and engaged in carrying out church functions. In a refund proceeding before the district court, *held*, judgment for defendant. The term “church” as used in section 511 does not include

¹ The San Francisco Province of the Institute of the Brothers of the Christian Schools, a Religious Institute of Pontifical Right of the Roman Catholic Apostolic Church, founded in 1680 by St. Jean Baptiste de la Salle and established by a papal bull issued by Pope Benedict XIII in 1725.

² The latter activity was carried out principally by laymen.

³ INT. REV. CODE OF 1954, § 511 (a) (2). A tax is imposed on the unrelated business income of tax-exempt organizations “other than a church . . .”

⁴ Treas. Reg. § 1.511-2 (a) (3) (ii) (1958). “The term ‘church’ includes a religious order . . . if . . . (a) it is an integral part of a church, and (b) is engaged in carrying out the functions of a church.” The Government argued that plaintiff did not qualify as a church under the regulation. However, if it did so qualify, the Government would have been in the unusual position of attacking the validity of its own regulation.

religious orders, and the treasury regulation to the contrary is invalid. *De La Salle Institute v. United States*, 195 F. Supp. 891 (N.D. Cal. 1961).

The federal government has long adhered to a policy of indirectly subsidizing certain private organizations engaged in eleemosynary activities.⁵ Congress has given such organizations special recognition by exempting them from the federal income taxes⁶ and by encouraging gifts to them through allowing a deduction of the amounts contributed, within specified limits, from the taxable gross income of the donor.⁷ Realizing that this tax exemption privilege was being used to avoid taxes as well as to promote what it felt to be worthwhile activities, Congress enacted legislation levying a tax—the Supplement U tax—on the unrelated business income of certain tax-exempt organizations.⁸ This tax was enacted to prevent the unfair competition which had resulted when tax-exempt organizations entered into commercial activities in competition with private enterprise,⁹ but it did not impair the tax-exempt status which these organizations enjoyed in regard to their eleemosynary activities. Congress merely intended to assess a tax against the unrelated business income of these organizations which, in all fairness to their business competitors, should properly be levied.¹⁰

Churches and associations or conventions of churches were expressly excluded from the Supplement U tax.¹¹ However, Congress at the time of

⁵ Wolkstein, *Criteria for Tax Exemption as a Religious, Educational, or Philanthropic Organization*, 89 J. Accountancy 404 (1950). The theory is "that the government is compensated for the loss of revenue by its relief from the financial burden which would otherwise have to be met by appropriations from public funds and by the benefits resulting from the promotion of the general welfare." H.R. REP. No. 1860, 75th Cong., 3d Sess. 19, 20 (1938).

⁶ INT. REV. CODE OF 1954, § 501. Provisions exempting religious, charitable, and educational organizations have been a part of our tax laws since the Act of Aug. 27, 1894, ch. 349, § 32, 28 Stat. 556.

⁷ INT. REV. CODE OF 1954, § 170.

⁸ Int. Rev. Code of 1939, § 421 added by ch. 521, 65 Stat. 452 (1951) [now INT. REV. CODE OF 1954, § 511]. The tax avoidance problem resulted largely from the Supreme Court's view that the destination rather than the source of the income determined whether or not an organization was tax-exempt. For example, in the principal case, although the source of plaintiff's income was its winery and distillery, its destination was plaintiff's religious activities. Thus, the plaintiff would ostensibly maintain a tax-exempt status. *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924). For cases applying this test, see, e.g., *Gymnastic Ass'n v. Higgins*, 147 F.2d 774 (2d Cir. 1945); *Roches Beach v. Commissioner*, 96 F.2d 776 (2d Cir. 1938). *But cf.* *Universal Oil Prods. Co. v. Campbell*, 181 F.2d 451 (7th Cir. 1950); *Mueller Co. v. Commissioner*, 14 T.C. 922 (1950). The *Universal* and *Mueller* cases immediately preceded the enactment of the Supplement U tax and called Congress' attention to the abuse of the tax exemption privilege. The *Mueller* case was highly publicized. New York University Law School had purchased a controlling interest in the *Mueller Macaroni Co.* and was using the profits for the exclusive benefit of the Law School. In that instance the Tax Court held the income taxable, limiting severely the ultimate destination test of *Sagrada*.

⁹ H.R. REP. No. 2319, 81st Cong., 2d Sess. 36, 37 (1950).

¹⁰ *Ibid.*

¹¹ INT. REV. CODE OF 1954, § 511.

the enactment of the statute clearly stated that religious organizations, including religious orders, were within the purview of the tax.¹² The exclusion of churches from the Supplement U tax was re-enacted in the Internal Revenue Code of 1954 without substantial change.¹³ Had the impact of that section truly remained unchanged there could be no question that plaintiff in the principal case would have fallen within the category of organizations at which the Supplement U tax was directed. But, in 1954, during the re-enactment of section 170,¹⁴ dealing with deductions for charitable contributions to exempt institutions, significant discussions conducted during the Senate Finance Committee hearings induced the Treasury Department to issue a new regulation redefining the word "church" as used in section 511.¹⁵ The House Bill on charitable deductions had granted an extra ten percent deduction to taxpayers making contributions to "a church, a convention, or association of churches, or a religious order."¹⁶ Notwithstanding the existing Treasury Regulation to the contrary,¹⁷ the Committee accepted the premise of a representative of the Catholic Church that the term "church," as then appearing in section 511, included religious orders, and that explicit reference to religious orders in section 170 would necessarily imply a more restricted meaning of the word "church" in the former section.¹⁸ The Committee, induced by the desire for the uniform interpretation of the phrase, "a church, a convention or association of churches," as it would appear in both sections 170 and 511, deleted the words "or a religious order" from the bill as originally drafted.¹⁹ This action prompted the Treasury to issue the present regulation²⁰ which broadened the pre-1954 definition of "churches" to include religious orders if (a) they were an integral part of a church, and (b) they performed a church function. Since the Christian Brothers Order was established by papal bull to teach religion, which the Catholic Church considers an essential church function,²¹ plaintiff in the principal case would appear to meet the qualifications required by the regulation in order to obtain

¹² H.R. REP. NO. 2319, 81st Cong., 2d Sess. 108 (1950).

¹³ H.R. REP. NO. 1337, 83d Cong., 2d Sess. A170 (1954); [1954] 3 U.S. CODE CONG. & AD. NEWS 4304.

¹⁴ INT. REV. CODE OF 1954, § 170.

¹⁵ Treas. Reg. § 1.511-2(a)(3) (1958). The same definition is applied to § 170. Treas. Reg. § 1.170-2(b)(2) (1958).

¹⁶ S. REP. NO. 1622, 83d Cong., 2d Sess. 30 (1954); [1954] 3 U.S. CODE CONG. & AD. NEWS 4660-61.

¹⁷ Treas. Reg. § 39-421(2)(a)(3) (1950).

¹⁸ *Hearings Before the Senate Finance Committee*, 83d Cong., 2d Sess. 1029 (1954).

¹⁹ S. REP. NO. 1622, 83d Cong., 2d Sess. 30 (1954); [1954] 3 U.S. CODE CONG. & AD. NEWS 4660-61.

²⁰ Treas. Reg. § 1.511-2(a)(3) (1958).

²¹ See Garland & Cahill, *The Concept of Church in the 1954 Internal Revenue Code*, 1 CATHOLIC LAW. 27 (1955), for the Catholic view of what constitutes a church for tax exemption purposes.

the claimed exemption of its unrelated business income.²² The validity of the Treasury regulation was therefore brought squarely into issue.

The court in the principal case was faced with a choice between two conflicting declarations of congressional intent. The declared intent of the Senate Finance Committee, albeit erroneously founded, was to treat religious orders as churches. On the other hand, the effect of re-enacting section 511 without substantial change was to continue to distinguish between churches and their respective religious orders. In resolving this conflict the court adopted the latter alternative. The regulation promulgated under the predecessor to section 511²³ was construed to contain the intended meaning of the word "church."²⁴ By re-enacting that section without substantial change Congress was held to have intended to incorporate that definition into the 1954 Code. This judicial approach seems consistent with the overall purpose sought to be accomplished by Congress when the Supplement U tax was enacted. Plaintiff unquestionably is a corporation organized and operated for religious and educational purposes and in all respects qualifies for a tax exemption.²⁵ However, the manufacture and distribution of plaintiff's wine and brandy is the regular conduct of a trade or business substantially unrelated to the purpose constituting the basis for its exemption.²⁶ These business activities are illustrative of the very activity Congress sought to render taxable through passage of the Supplement U tax—the entry of otherwise tax-exempt organizations into unrelated businesses while using their preferred tax status to put their private counterparts at a competitive disadvantage. Had the court in the principal case allowed plaintiff to be excluded from the Supplement U tax it would have substantially narrowed the effect of that provision.

²² Treas. Reg. § 1.511-2(a)(3) (1958), states: "A religious order or organization shall be considered to be engaged in carrying out the functions of a church if its duties include the ministration of sacerdotal functions and the conduct of religious worship." In the principal case the court believed the functions of the order were educational and religious, not sacerdotal. Thus it was concluded that even under the regulation the order could not qualify as a "church." However, in the view of the Catholic Church the ministration of sacerdotal functions are not the sole function of a church. The teaching of religion is considered an important church function. So, unless the regulation is read to mean that only the ministration of sacerdotal functions enable an order to qualify as a "church," the plaintiff would come within the definition of the regulation.

²³ Treas. Reg. § 39.421(2)(a)(3) (1950).

²⁴ The committee reports and discussion on the floor of the House at the time of the original enactment substantiate this premise. H.R. REP. NO. 2319, 81st Cong., 2d Sess. 108 (1950). See 96 CONG. REC. 9367-68 (1950), for discussion on plaintiff's status under the Supplement U tax. The representative from plaintiff's district questioned the sponsor of the bill. The resolution of the question seemed to depend on whether or not the activity was unrelated, it being felt that if it were plaintiff would be taxed.

²⁵ INT. REV. CODE OF 1954, § 501(c)(3).

²⁶ INT. REV. CODE OF 1954, §§ 512, 513 define unrelated trade or business and unrelated business income.

Under the court's approach it would seem that the exclusion from taxation of the unrelated business activities of a church, as distinguished from a religious order, is unaffected. This is apparently consistent with the intent of Congress although no reason appears on record for the exclusion of churches from the Supplement U tax. It can only be surmised that it resulted from a compromise and from the knowledge that generally churches do not carry on any substantial unrelated business activities. Nevertheless, if plaintiff's winery and distillery were now turned over to an affiliated church, the income therefrom would escape tax under the exemption, although the same laymen who operated the business when controlled by plaintiff were to continue its operation. Yet, there seems to be no justification for not taxing any income realized if the purpose of the Supplement U tax was in fact to prevent unfair competition. Indeed, the position of the church would be analogous to that of New York University Law School in operating Mueller's Macaroni Co.²⁷—the case that crystallized the abuse of the tax exemption privilege and led to the passage of the Supplement U tax.²⁸ Unless Congress has a specific reason for excluding churches from taxation of their unrelated business income, other than those suggested, reconsideration of the exclusion granted churches in section 511 seems appropriate to prevent the reoccurrence of activities considered undesirable in 1954.

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²⁷ *Mueller Co. v. Commissioner*, 14 T.C. 922 (1950). See note 8 *supra*.

²⁸ See 96 CONG. REC. 9366 (1950). Acting Secretary of the Treasury Lynch, while speaking on the House floor, referred to the NYU-Mueller situation. He concluded: "I can see no reason in justice to permit an educational institution to operate a spaghetti factory, a department store or any other business under the cloak of tax exemption, while competitors in the same business are presently subject to a . . . tax . . ." By the same reasoning it is submitted that there is "no reason in justice" for allowing a church to operate a winery and distillery without tax consequences.