Deductibility of Contributions to Religious Institutions

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In Hernandez v. Commissioner*, 490 U.S. 680 (1989), the Supreme Court held that payments by Scientologists to their local churches for auditing and training, which are required religious practices, were not deductible as charitable contributions because they were made in exchange for specific services. Four years later the Internal Revenue Service "walked away" from its victory. Since 1993 the IRS has allowed a deduction for payments that are identical to those the Supreme Court held to be nondeductible in* Hernandez*, but has never explained its rationale. As* Sklar v. Commissioner*, 282 F.3d 610 (9th Cir. 2002), has shown, adherents of mainstream religions are now claiming that they are being treated unfairly compared to the Scientologists.*

The law concerning deductibility of charitable contributions to religious institutions is unclear. This article explores the issues raised by Hernandez *and provides a framework for determining deductibility of "quid pro quo contributions." It recommends that payments for auditing should be deductible, but payments for training should not be. The failure by all those involved in the* Hernandez *litigation to distinguish between auditing and training may be one of the reasons that the Supreme Court decision has been so unsatisfactory.*

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I. Introduction

This article examines the deductibility of contributions to religious institutions. The law is now quite confused. To a very large extent, the confusion (or at least our awareness of it) is due to the unceasing efforts of the Church of Scientology, a religion founded by L. Ron Hubbard in the early 1950's.[1] Its adherents make payments to the local Scientology churches for what they call "auditing" and "training," which are required religious practices. Briefly, auditing involves one-on-one sessions with an auditor who helps the individual "erase his reactive mind and gain spiritual

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[1] *See* Church of Scientology International, *Scientology: Theology & Practice of a Contemporary Religion* 17 (1998) [hereinafter, *Scientology*]. The first Church of Scientology was established in 1954. *Id.* at x. As stated in the authorized book describing the religion, its basic beliefs are as follows:

> Scientology religious doctrine includes certain fundamental truths. Prime among them are that man is a spiritual being whose existence spans more than one life and who is endowed with abilities well beyond those which he normally considers he possesses. He is not only able to solve his own problems, accomplish his goals and gain lasting happiness, but also to achieve new states of spirtitual awareness he many never have dreamed possible.
>
> Scientology holds that man is basically good, and that his spiritual salvation depends upon himself, his relationships with his fellows and his attainment of brotherhood with the universe.

Id. at 15-16.

competence."[2] Training involves "courses of instruction in the tenets of Scientology."[3] Not surprisingly, the Scientologists want to deduct the payments for auditing and training.

In a 1989 decision, *Hernandez v. Commissioner*, a divided Supreme Court held that payments for auditing and training were not deductible as charitable contributions because they were made in exchange for specific services.[4] Supreme Court decisions should settle disputes, but that definitely did not happen this time. Litigation continued,[5] and in 1993 the IRS and various Scientology churches entered into a sixty-one page closing agreement that allows the deduction of exactly the same type of payments held to be nondeductible in *Hernandez*.[6] In the words of a former Commissioner of the Internal Revenue Service, the IRS "appear[ed] to . . . walk away" from its judicial victory.[7] Why did the IRS enter into this agreement, basically conceding the issue it had won

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[2] Neher v. Commissioner, 852 F.2d 848, 849 (6th Cir. 1988), *vacated* 882 F.2d 217 (6th Cir. 1989). For more general description of auditing, see *Scientology, supra* note 1, at 33-37. *See also infra* notes 90 - 91 & accompanying text.

[3] *Id.* For more general description of training, see *Scientology, supra* note ,1 at 38-41. *See also infra* notes 92 - 95 & accompanying text.

[4] 490 U.S. 680 (1989).

[5] *See infra* notes 134 - 140 & accompanying text.

[6] *See* The Exempt Organization Tax Review, February 1998, p. 227, Doc. 98-383, 97 TNT 251-24 (reprinting purported text); Burgess J.W. Raby & William L. Raby, *Religious Tuition as Charitable Contribution,* 88 Tax Notes 215, 216 (2000), 2000 TNT 132-83 ("[T]hat agreement apparently committed the IRS to allowing charitable contribution deductions for the same auditing and training payments that the Supreme Court had ruled to be nondeductible in Hernandez."); Paul Streckfus, *Scientology Case Redux -- The Appeal*, 94 Tax Notes 921 (2002), 2002 TNT 34-58 ("A number of us were shocked that the IRS could so cavalierly dismiss a Supreme Court decision."); Paul Streckfus, *Scientology Case Redux*, 87 Tax Notes 1414 (2000), 2000 TNT 108-73 [hereinafter *Redux*]. *See also* Rev. Rul. 93-73, 1993-2 C.B. 75 (declaring obsolete Rev. Rul. 78-189, 1978-1 C.B. 68, which had prohibited deductions for auditing and training).

[7] Letter from Jerome Kurtz to IRS Commissioner Margaret Richardson, dated June 27, 1994, on behalf of Committee on Taxation of the Association of the Bar of the City of New York, published in 94 TNT 128-40 [hereinafter, Kurtz].

only four years earlier, [8] and what is the status of *Hernandez*, which after all is a decision that neither the Supreme Court itself nor a lower court has ever questioned?[9] These are reasonable questions, which the IRS. has never addressed,[10] but one can make some reasonable conjectures.

Almost immediately after the Supreme Court decision in *Hernandez,* Scientologists initiated two cases that contested the nondeductibility of payments for auditing and training. In *Powell v. Commissioner*, Scientologists argued that they were being unfairly treated because the IRS routinely allows adherents of other religions to deduct payments made in return for intangible religious benefits.[11] The taxpayers had tried to raise this issue before the Supreme Court in *Hernandez*, but the majority held that the record was insufficient for it to be considered.[12] In *Powell*, the Eleventh Circuit held that, if the taxpayers' allegations were true, they had stated a claim upon which relief could be granted, and remanded the case to the district court for further proceedings. In another case, *Garrison v. Commissioner*, Scientologists had presented evidence to the Tax Court, attempting to show that the IRS routinely allowed adherents of other religions to deduct payments that were indistinguishable from contributions that the Scientologists were not allowed to deduct.[13] The 1993

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[8]The IRS also conceded that various Scientology Churches were qualified to receive deductible contributions. In *Church of Scientology of California v. Commissioner*, 823 F.2d 1310 (9th Cir. 1987), the Ninth Circuit had held that the mother church was not a qualifying organization.

[9]*See generally* Sklar v. Commissioner, 282 F.3d 610, 614 n.3 (9th Cir. 2002) (dictum that Hernandez is still controlling law).

[10]*See* Kurtz, *supra* note 7 (asking for the IRS or Congress to provide clarification about the settlement with the Scientologists and guidance about deductibility of gifts).

[11]945 F.2d 374 (11th Cir. 1991).

[12]490 U.S. at 701-03.

[13]Tax Ct Dkt. No. 18956-88, Petitioner's Brief on the Merits, 93 TNT 42-28. In *Garrison* the taxpayers were also presenting other grounds for a full or partial deduction of their auditing and training payments.

agreement between the Scientologists and IRS effectively settled both cases.[14] It certainly appears that the IRS surrendered to the Scientologists because it could not justify treating payments for auditing and training differently from payments made to mainstream religions. But this answer only raises other questions. If payments made by Scientologists are not distinguishable from those made by adherents of other religions and if the Supreme Court has held the payments by Scientologists are not deductible, are not many of the payments made by members of other religions also not deductible? Should the IRS be ignoring the Supreme Court's interpretation of the Internal Revenue Code?[15]

Of course, Scientologists are not the only ones who can argue that they are not being treated fairly. Michael and Marla Sklar are Orthodox Jews who have attempted to deduct the portion of their children's tuition for day schools that is allocable to religious education.[16] The Sklars argued, not unreasonably in this author's opinion, that payments for their children's religious education are similar to payments the IRS is allowing the Scientologists to deduct.[17] The Ninth Circuit was not

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[14]*See supra* note 6.

[15]Because the IRS is acting in a way that benefits a particular taxpayer, it does not appear that any person would have standing to challenge directly the allowance of the deductions. *See* Frothingham v. Mellon, 262 U.S. 447 (1923). However, the constitutionality of the allowance might be considered if a taxpayer could claim that the Establishment Clause was violated because she was not able to deduct a similar contribution to another church and thus she was being treated unfairly compared to the Scientologists. *See generally* Eric Rakowski, *Are Federal Income Tax Preferences for Ministers' Housing Constitutional?, 95* Tax Notes 775, 781-782 (2002) (discussing standing to challenge exclusion from income of housing allowances for clergy).

[16]See Sklar v. Commissioner, 282 F.3d 610 (9th Cir. 2002), *aff'g* 79 T.C.M (CCH) 1818 (2000).

[17]The majority opinion in Hernandez noted the similarity between the payments that taxpayers in that case were attempting to deduct and "tuition payments to parochial schools," as well as payments to "church-sponsored counseling sessions," and payments to "medical care at church-affiliated hospitals." Hernandez at 693. *See also* Foley v. Commissioner, 844 F.2d 94, 98 (2nd Cir. 1988), *vacated* 490 U.S. 1103 (1989) (discussing possibility that education in church-run schools is a "religious practice" and thus possibly similar to payments by

receptive to the Sklars' case, but it also made clear that it considered the IRS's refusal to enforce the *Hernandez* decision improper and would not extend an unwarranted deduction by the Scientologists to other taxpayers.[18] Although the Ninth Circuit held against the Sklars on the narrow ground that they could not demonstrate that their payments to the schools exceeded the value of the secular education their children received, the case raises the question of what consequences would follow if the Supreme Court were to overrule the *Hernandez* opinion or if Congress enacted a statute changing the result. Probably, most tax experts have always assumed that tuition for religious education is not deductible,[19] and a change in this result would undoubtedly be troubling to many.

As explained below,[20] the basic problem is that the majority's decision in *Hernandez* is not viable. Justice Marshall, who wrote the Court's decision,[21] reasoned that the external arrangements indicated a quid pro quo and that payments made as part of quid pro quo transactions are generally

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scientologists for auditing and training).

[18]282 F.3d at 620 ("[W]e would not hold that the *unlawful* policy set forth in the closing agreement [between the IRS and Church of Scientology] must be extended to all religious organizations.") (emphasis added).

[19]Raby, *supra* note 6, at 215 ("[P]ast practice has been for the IRS to disallow payments made in exchange for educational benefits."); Sklar v. Commissioner, 79 T.C.M. (CCH) 1818(2000), *aff'd* 282 F.3d 610 (1992) ("The law is well settled that tuition paid for the education of the children of the taxpayer is a family expense, not a charitable contribution to the educating institution); *Redux*, *supra note 6*. *See also* 1997 WL 33313757 (IRS FSA) (July 11, 1997) (tuition payments for religious and secular education are not deductible).

[20]*See infra* notes 121 - 124 & accompanying text

[21]Five Justices joined the majority decision. Justices Brennan and Kennedy recused themselves and took no part in consideration or decision of the case. Justice Brennan typically has not taken part in cases involving the Church of Scientology. *See e.g.,* Church of Scientology of California v. Internal Revenue Service, 484 U.S. 9 (1987). Justice Kennedy wrote the decision in *Graham v. Commissioner*, one of the two consolidated cases affirmed in *Hernandez v. Commissioner,* when he was on the Ninth Circuit. Graham v. Commissioner 822 F.2d 844 (9th Cir. 1987), *aff'd* 490 U.S. 680 (1989).

not deductible.[22] But that position is inconsistent with accepted results in other contexts, involving contributions to both religious institutions and other charitable organizations. Justice Marshall wanted to ignore the fact that at least some of the consideration received by the taxpayers in Hernandez was religious benefits, but the type of consideration is relevant and cannot be ignored.

Justices O'Connor and Scalia would have allowed the deduction because they believed that the taxpayers in *Hernandez* were treated unfairly compared to adherents of other religions. Their position was that the taxpayers were only receiving intangible religious benefits and that the IRS properly allows adherents of other religions to deduct payments for such benefits. This approach, however, gives too much weight to the label "religious benefits." The Scientologists in *Hernandez* were receiving specific services for their contributions. More than a label is needed to justify allowing them to deduct the purchase of services. Allowance of the deduction would seem unfair to those who purchase similar services, such as counseling or specialized education, and are not entitled to a deduction. Furthermore, the label "religious benefits" can be attached to many activities that we had not previously considered to be deductible. The religious education of the Sklars's children is only one example. The label "religious benefit" should have some significance, but not as much as the dissent claims.

The taxpayers in *Hernandez* maintained that all of their contributions were deductible and did not argue that a partial deduction was appropriate. Similarly, the government only argued that no portion of the contributions was deductible. There is, however, an appealing argument that the taxpayers should have been allowed a deduction equal to the excess of their payment over the fair

[22]Taxpayers had not argued that the value of the auditing and training services they received was less than their payment and that consequently they should be able to deduct a portion of their contribution.

market value of what they received. This approach is used when a charity sponsors a special event, such as a lavish banquet, and requires attendees to purchase tickets that admittedly cost more than the food and entertainment are worth. If the tickets cost $500 and the meal and entertainment are worth $100, a purchaser can deduct the excess or $400. The problem in *Hernandez*, however, is estimating the value of the services that the taxpayers received in exchange for their contributions. Justice Marshall took note of the possibility of a partial deduction, but was able to avoid confronting the difficulties that it poses because the taxpayers had not presented any evidence on the value of the auditing and training services.[23]

This article concludes that the taxpayers in *Hernandez* should have been allowed to deduct their payments for auditing, but not for training.[24] Because there is no principled way to value the auditing services that the taxpayers received, the two practical choices are either to value the service at whatever the taxpayers pay for it and thus allow no deduction or to value the service at zero and allow a full deduction. As the surrender of the IRS after its *Hernandez* victory demonstrates, the first choice – allowing no deduction – requires that settled practices concerning treatment of contributions to religious institutions be rethought. Neither the IRS nor Congress appear eager for the dramatic changes that may follow.[25] On the other hand, allowing a full deduction for auditing on the suggested rationale is consistent with the current practice of the IRS with respect to other religions. In addition, provisions enacted by Congress in 1993, although dealing only with procedural

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[23]490 U.S. at 694 n.10. Scientologists presented this type of evidence to the Tax Court in *Garrison v. Commissioner*, Tax Ct Dkt. No. 18956-88., but the settlement between the Church of Scientology and the IRS mooted the case before it was decided.

[24]Payments by the taxpayers were designated as either for auditing or training.

[25]*See infra* notes 45 - 48 & accompanying text.

requirements, strongly indicate that Congress is comfortable with lenient treatment for contributions in exchange for intangible religious benefits. Finally, there is precedent for the proposed solution. Courts have often resolved a factual issue in a way that is most favorable to the taxpayer when a conceptually correct result is impractical.

A different result is appropriate for training, which is instruction in the tenets of Scientology. Persons of all religions and beliefs, including those who adhere to no religion, value education, and therefore education services generally have a value that can be estimated by observation of similar courses of study. Although the training offered by Scientologists may not be of value to those who are not adherents, it is similar enough to other classes that estimation of value is possible. The failure by all those involved in *Hernandez* and related litigation to distinguish between auditing and training may be one of the reasons that the Supreme Court decision has been so unsatisfactory.[26] The different recommendations for auditing and training may appear anomalous. Perhaps, auditing can be analogized to personal counseling and a value estimated in that way. The crucial difference is one of categorization. Auditing is properly categorized as a religious ritual, and religious rituals generally do not have value to those who are not believers. Training, on the other hand, can easily be categorized as education.

My proposal for auditing appears inconsistent with the holding in *Hernandez,* but compatible

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[26] *See infra* notes 96 - 99 & accompanying text. Failure to distinguish between auditing and training continues to cause problems. For example, one recent article purports to describe both auditing and training when it is only portraying auditing. *See* Douglas A. Kahn & Jeffrey H. Kahn, *"Gifts, Gafts, and Gefts" -- The Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income*, 78 Notre Dame L. Rev. 441, 506 (2003). Similarly, in *Sklar v. Commissioner*, 282 F.3d 610 (9th Cir. 2002) *aff'g* 79 T.C.M. (CCH) 1818 (2000). the Tax Court stated: "[P]etitioners have not established that they are similarly situated with the members of the Church of Scientology who make payments for auditing." Petitioners' argument in *Sklar* that they were similarly situated with members of the Church of Scientology was stronger with respect to the latter's payments for training, rather than auditing, but the Tax Court ignored training.

with current IRS practice. In contrast, my proposal for training is inconsistent with IRS practice, but conforms with the *Hernandez* holding. The IRS could, however, announce that it is adopting these approaches. Scientologists would undoubtedly challenge the disallowance of a deduction for the amounts paid for training, but classifying training as education provides a firm ground for differentiating the payment from contributions to mainstream religions that are routinely deductible.[27] If these recommendations were followed, the law concerning deductibility of contributions to religious institutions would no longer be so confused.

Section II of this article discusses theoretical justifications for the charitable contribution deduction and their implications for contributions to religious institutions. Section III explores how the caselaw prior to *Hernandez* dealt with contributions (or purported contributions) to religious and charitable organizations when benefits related to the contribution are received by the donor. Section IV critically analyzes *Hernandez v. Commissioner*[28] and then explores the implications of *Sklar v. Commissioner*.[29] It demonstrates that neither the majority nor dissenting opinion in *Hernandez* provides an acceptable solution for the problem exemplified by that case. Section V describes the 1993 amendments to the Internal Revenue Code, which have provided for new substantiation and reporting requirements for charitable contributions, and shows that enactment of these amendments support the conclusion that Congress was either not aware of or did not approve the majority holding in *Hernandez*. The recommended approach is presented in Section VI and its applicability to similar issues is explored. The conclusion is given in Section VII.

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[27]Any persons who objected to the allowance of a deduction for auditing would not have standing to bring a lawsuit. *See supra* note 15.

[28]490 U.S. 680 (1989).

[29]282 F.3d 610 (9th Cir. 2002).

II. Tax Policy and Deductibility of Contributions to Religious Institutions

Concepts of fairness and proper measurement of income may justify deductibility of charitable contributions. In a deservedly famous 1973 article, Professor William Andrews theorized that ability to pay taxes is properly determined after charitable contributions had been deducted.[30] His basic rationale was that ability to pay taxes should be measured according to one's "private consumption of divisible goods and services whose consumption by one household precludes their direct enjoyment by others," or accretion for that purpose, and the donor of a charitable contribution usually surrenders control of the economic goods.[31] Professor Andrews argued that apportioning tax liability according to this refined ability to pay results in a fair tax. Although interesting and insightful in many ways, Professor Andrews' defense of the charitable contribution deduction has not received much support.[32] The notion of preclusive appropriation can be hard to pin down, and in any event the prevailing view is that the donor's exercised control over economic resources is

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[30]William D. Andrews, *Personal Deduction in an Ideal Income Tax*, 86 Harv. L. Rev. 309 (1972).

[31]*Id*. at 346. A related argument is that persons who give to charity are less well off because they are not providing for their personal needs and therefore should pay less tax. Mark P. Gergen, *The Case for a Charitable Contributions Deduction,* 74 Virg. L. Rev. 1393, 1426-33 (1988); Professor Boris Bittker has made the argument that a deduction is appropriate because they "represent a claim of such a high priority" that they might be considered not to be "at the voluntary disposal of the taxpayer." Boris I. Bittker, *Charitable Contributions: Tax Deductions or matching Grants?,* 28 Tax L. Rev. 37, 59 (1972). *See also* John K. McNulty, *Public Policy and Private Charity: A Tax Policy Perspective,* 3 Virg. Tax Rev. 229, 237-38 (1984) (comparing charitable contributions to taxes or casualty losses).

[32]For challenges to Andrews' position, see Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax Why They Fit Worse in a Far from Ideal World*, 31 Stanf L. Rev. 831 (1979); Gergen, *supra* note 31, at 1414-26; Peter J. Weidenbeck, *Charitable Contributions: A Policy Perspective*, 50 Missouri L. Rev. 84 (1985).

sufficient to make a deduction inappropriate.[33]

A different rationale for the charitable contribution deduction concentrates on the charitable donee, rather than the donor. The argument is that subsidization of charitable organizations and of the services they provide is good economic and social policy. The central idea is that charitable organizations are worthy of support and that their services should be encouraged.[34] Probably most modern commentators accept that the best justification for charitable contribution deductions is the benefit to charitable donees.[35] The question then becomes why the particular donees that the statute designates are the ones that should be assisted.[36] The answer that seems most reasonable is that a deduction is appropriate when the charitable donees are carrying on useful work that would be undersupplied without any government subsidy. These are public goods or quasi-public goods that provide benefits to more than a single consumer or a small group. More precisely, a public good provides benefits to many persons who cannot practically be excluded from enjoying that good. Clean air is a good example of a public good, and education is an example of quasi-public good. The benefits of clean or nonpolluted air are necessarily available to all who live in the relevant geographical area; practically no one can be excluded from enjoying it. Similarly, the benefit of education extends beyond a particular student in a classroom; we expect that society in general will

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[33]*See* Kelman, *supra* note 32, at 834; Weidenbeck, *supra* note 32, at 90.

[34]For development of this idea, including a justification for the superiority of a deduction or credit over direct government supply of the good or service, see Gergen *supra* note 31, at 1396-1414.

[35]*See* Kahn, *supra* note 26, at 514; Gergen, *supra* note 31; Todd Izzo, *A Full Spectrum of Light: Rethinking the Charitable Contribution Deduction*, 141 U. Pa. L. Rev. 2371 (1993); Joseph M. Kuznicki, Section 170, *Tax Expenditures, and the First Amendment: The Failure of Charitable Religious Contributions for the Return of a Religious Benefit*, 61 Temple L. Rev. 443 (1988).

[36]Qualifying charitable donees are designated in I.R.C. §170(c)(2).

benefit from educated citizens who can make scientific advances, organize new businesses, and contribute to political discourse. Furthermore, economic theory can be used to support the need for subsidization. If those who benefit from a good do not need to pay for it, it will not, absent some form of subsidization, be produced in adequate amounts.[37]

Although the deduction for charitable contributions has been part of the tax laws since 1917, legislative history is quite sparse. It does appear, however, that when Congress enacted the contribution it was concerned about the effect of taxes on the donee charities. Senator Hollis, who was the sponsor of the amendment creating the charitable contribution, stated that "if we impose these very heavy taxes on incomes . . . the first place where the wealthy men will be tempted to economize . . . [will be] donations to charity."[38]

In practice, of course, concentration on the donor and concentration on the donee are not mutually exclusive. For example, the Sixth Circuit in *Neher v. Commissioner* held that payments for auditing and training were deductible because they "furthered the charitable purposes of the Church."[39] However, to determine that the payments did this, it was necessary to "distinguish those transactions which are in reality an exchange of cash for specific services from those transactions which are transfers for facilitation of the general charitable purpose of the organization."[40] Only the latter indicate and, measure the extent to which, the donee should be subsidized.[41] Classification was

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[37]Harvey Rosen, PUBLIC FINANCE _____

[38]55 Cong. Rec. 6728 (1917) [check]

[39]852 F.2d 848, 853 (6th Cir. 1988), *vacated* 882 F.2d 217 (6th Cir. 1989).

[40]Id. at 853 (quoting from Haak 451 F. Supp. 1087, 1091 (D.C. Mich. 1978)).

[41]*See also* United States v. American Bar Endowment, 477 U.S. 105 (1986) (partial deduction for contribution allowable only if exceeds market value of benefit received and made with proper donative intent); Kahn *supra* note 26, at 520-21 ("The statutory deduction for

not obvious, but the court held that the payments under consideration were to facilitate the general charitable purpose.

> [T]he payments made by the appellant to the Church furthered the charitable purposes of the Church since payments for auditing and training are the Church's predominant means of rasing money to support its activities. Thus, this type of payment, in keeping with the Scientologist practice of the doctrine of exchange, is as much a furtherance of the Church's charitable purposes as an outright gift.[42]

It is not obvious, however, that religious institutions generally need subsidization. Those who participate in the church or synagogue are normally the ones who contribute.[43] Formal and informal methods of enforcing "required contributions" exist because participation in services or other activities can be noted, and others may be aware of whether participants have joined the congregation or made monetary contributions. Contributions can often be characterized as quid pro quo. The IRS has published statements stating that participation in religious service is deemed to benefit the general public and that "[a]ny private benefit . . . is regarded as merely incidental to the

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charitable gifts is for the purpose of aiding charitable functions, but it also serves to recognize that the dedication of the donor's funds for a charitable purpose is not a consumption by the donor.").

[42]852 F.2d at 853-54.

[43]*See* Gergen, *supra* note 31, at 1412, 1437-40 (suggesting that there might be optimal funding of churches without a deduction for contributions).

general public benefit."[44] Although it would not be hard to find people who vehemently disagree with the point of view that religion is good for society, probably most persons would not be offended by it. But that should not be enough for a deduction. Most would agree that education is beneficial to society, yet we do not allow persons automatically to deduct college tuition, The statement concerning private benefit is more controversial. The benefit to the individual participant seems more than "incidental." Should payments for participation in religious services or rituals be treated the same as tuition payments and thus generally not be deductible? That is the type of question that *Hernandez* raises.

Although the theoretical justification for deductibility of contributions to religious institutions can be questioned, both Congress and the Internal Revenue Service have treated contributions to religious institutions quite favorably. For example, Congress requires most charitable organizations to submit an exemption application to become eligible to receive deductible contributions.[45] Churches are exempt from this requirement.[46] Amendments to the Internal Revenue Code, which were enacted in 1993, specifically relax substantiation and reporting requirements when intangible religious benefits are provided by an organization that is "organized exclusively for religious purposes."[47] Similarly, the IRS has shown no inclination to challenge deductibility of contributions

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[44]Rev. Rul. 71-580, 1971-2 C.B. 235 (qualification of nonprofit organization as exempt under I.R.C. § 501(c)(3)). *See also* Hernandez v. Commissioner, 490 U.S. 680, 704, 708 (dissenting opinion) (citing a "question and answer guidance package" from an Assistant IRS Commissioner); Powell v. United States, 945 F.2d 374, 376 (11thCir. 1991).

[45]I.R.C. §508; Treas. Reg. §1.508-1. A charitable organization that is not a private foundation and the annual gross receipts of which "are normally not more than $5,000 is exempt from the application requirement. I.R.C. §508(c)(1)(B); Treas. Reg. §1.508-1(a)(3)(i)(b).

[46]I.R.C. §508(c)(1); Treas. Reg. §1.508-1(a)(3)(i)(a).

[47]Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §§13172, 13173, 107 Stat. 312, 455-57 (adding I.R.C. §§170(f)(8)(B), 6115). *See infra* notes 148 - 159 & accompanying text.

made to mainstream religions.[48] Therefore, despite the questions that can be raised about its underlying justification, the policy of favorable tax treatment for most payments to religious organizations seems to have strong support and is unlikely to change. Any resolution of the issues presented by the *Hernandez* opinion needs to take account of, and probably comport with, this policy.

III. Receipt of Benefits and Deductibility

A. *American Bar Endowment v. United States*

Section 170 allows a deduction for a "gift or contribution" to a qualifying organization.[49] Typically there will not be a gift or contribution if the taxpayer "expects a substantial benefit in return,"[50] but the relative size of the benefit is relevant. As the Supreme Court recognized in *American Bar Endowment v. United States*, "it would not serve the purposes of section 170" to totally deny a deduction when the benefit is much less than the payment to the charity.[51] In this event, the payment is considered to have a "'dual character' of a purchase and a contribution."[52] A taxpayer may, in appropriate cases, claim a deduction for the excess of the payment to the charity

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[48] *See* Rev. Rul. 70-47, 1970-1 C.B. 49; *infra* notes 68 - 77 & accompanying text.

[49] I.R.C. §170(c). It is generally accepted that "contribution" and "gift" are synonymous. *See* Channing v. United States, 4 F. Supp. 33 (D. Mass. 1933), *aff'd* 67 F.2d 986 (1st Cir. 1933); Miller v. Commissioner 829 F.2d 500, 502 n.2(4th Cir. 1987).

[50] United States v. American Bar Endowment, 477 U.S. 105, 116 (1986).

[51] 477 U.S. at 117.

[52] *Id.*

over the fair market value of the benefit received. A typical example is a ticket to a concert sponsored by a qualifying charity. The taxpayer can generally deduct the excess of the amount paid over the fair market value of the ticket.

In *American Bar Endowment*, the charitable organization (ABE) raised money by providing group insurance policies to its members. It chose the insurance companies that issued the policies and negotiated rates with them. ABE had two advantages in negotiating with the insurance companies. Its size gave it bargaining power, and the members purchasing insurance through ABE had favorable mortality and morbidity rates.[53] Therefore, although rates were competitive with those of commercial policies, the policies generated large dividends. To participate in these policies, members had to agree that ABE would retain the dividends, rather than distribute them pro rata to the policyholders. One of the issues before the Supreme Court was whether the policyholders could deduct the dividends retained by ABE.[54] It held they could not.

The Supreme Court held that a two-part test is used when determining deductibility of a "dual character" payment.[55] First the payment must exceed the benefit received, with the deduction not exceeding this excess. Market price necessarily determines the value of the benefit received.[56] Second, the taxpayer must have purposely paid the excess of the contribution over the value of the

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[53]*Id*. at 107.

[54]The other issue was whether the income from offering the policies was unrelated business income for ABE.

[55]The IRS stated the two-part test in Revenue Ruling 67-246, 1967-2 C.B. 104, and the Supreme Court endorsed the ruling. 477 U.S. at 117-18.

[56]"The most logical test of the value of the insurance respondents received is the cost of similar policies." *Id*. at 118. *See* Rev. Rul. 67-246, 1967-2 C.B. 104 (payment must exceed "market value of benefit received.") (cited approvingly in United States v. American Bar Endowment, 477 U.S. at 117). *See also* Kahn, *supra* note 26, at __-__.

property or services received. Three of the four individual taxpayers in *American Bar Endowment* could not show that they could have purchased cheaper policies than they had purchased from ABE, and thus were apparently unable to satisfy the first test. The fourth individual was able to establish that he could have purchased cheaper policies, but could not show that he was aware of those policies during the years at issue. Therefore, the second test was not satisfied.

In one respect *Amercian Bar Edowment* was an easy case. The payment certainly would not have been made to ABE if the member had not wanted insurance. As the next section demonstrates, causation is not always so clear. In *Amercian Bar Edowment*, the Supreme Court stated that a contributor is allowed a charitable contribution deduction only if she "purposely contributed money or property in excess of the value of any benefit he received *in return*."[57] What must be the relationship between the payment and the benefit for the receipt of the benefit to be "in return" for the payment? The Court did not provide any guidance.

B. Tuition Cases

Several cases involving religiously-oriented secular education demonstrate that a benefit received by the taxpayer can cause a payment to a qualifying organization to be nondeductible even though the benefit would have been available without the payment. For example, in *Oppewal v. Commissioner*, the taxpayers paid $900 to the Whitinsville Society for Christian Education, which educated their two children.[58] The IRS did not allow a deduction for $640 of the $900 because it

[57]477 U.S. 105, 118 (1986) (emphasis added).

[58]468 F.2d 1000 (1st Cir. 1972).

determined that amount was the cost of educating the two children. Both the Tax Court and First Circuit held for the IRS.[59] Of the Society's membership of three hundred twenty contributing individuals and families, only ninety had children attending the school. About 60 percent of the Society's receipts were received from those who did not have children in the school, and members who had children in the school were solicited in the same manner as members without children. Attendance at the school did not depend on payments by the parents.

> [T]he fact that the taxpayers might have made the payment even had their children not been enrolled in the Society's school, or that the Society would have enrolled the children even had no payment been made . . . become irrelevant considerations.[60]

Similarly, in *Haak v. United States*, the District Court recognized the possibility that some of the taxpayers may have contributed 10 percent of their income to the church, which operated a school, regardless of whether their children were enrolled. Consequently, "their contributions may not have been motivated by the provision of educational services."[61] Nevertheless, the court did not allow a deduction for that portion of the payment that the government maintained should be treated as tuition.

Both *Oppewal* and *Haak* were distinguished from *DeJong v. Commissioner*, a case also

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[59]30 T.C.M. (CCH) 1177 (1971), *aff'd,* 468 F.2d 1000 (1st Cir. 1972).

[60]468 F.2d at 1002, N.2.

[61]451 F. Supp. 1087, 1092, n.5 (D.C. Mich. 1978).

involving the benefit of education provided to taxpayer's children.[62] In *DeJong*, the court held that the deduction was not allowed because the contribution had not proceeded from "'detached and disinterested generosity' or 'out of affection, admiration, charity, or like impulses.'"[63] The *Oppewal* and *Haak* courts found that focusing on subjective motive was not appropriate. Instead the test was whether the transfer was "to any substantial effect offset by the cost of services rendered to taxpayers."[64] Apparently, the receipt of benefits from the charitable donee is sufficient for the deduction to be disallowed even if the payment would have been made in the absence of the payments.

A deduction for charitable contributions has also been successfully challenged in other situations when the existence of an exchange is rather attenuated. For example, in *Murphy v. Commissioner*, an adoption agency, which was a qualifying charity, required adopting parents who could afford the fee to pay 10 percent of the husband's salary.[65] If a family was unable to afford anything, the agency did not require payment of a fee. The Tax Court held that the adopting parents, who paid $1,750 over two years, were not allowed a deduction. The court distinguished a contribution to a church because "the only return benefit is the satisfaction of participating in the

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[62]309 F.2d 373 (9th Cir. 1962).

[63]309 F.2d at 379, quoting from Commissioner v. Duberstein, 363 U.S. 278 (1960).

[64]Oppewal, 468 F.2d at 1002, quoted in Haak v. United States, 451 F. Supp. 1087, 1090 (D.C. Mich. 1978). In Winters v. Commissioner, 468 F.2d 778 (2nd Cir. 1972), a payment to a school in which the taxpayer's child was enrolled was held to be tuition and not a deductible contribution. The court favorably cited both Oppewal and DeJong. It held that taxpayers "both anticipated and received substantial benefits from their payments" and that payments "did not come from a 'detached and distinterested generosity [quoting Duberstein].'" *Id.* at 781.

[65]54 T.C. 249 (1970). *See also* Arceneaux v. Commissioner, 36 T.C.M. (CCH) 1461 (1977) (fixed adoption fee not deductible)("expectation of a direct tangible benefit of an economic nature" not necessary for disallowance of deduction).

furtherance of its charitable or religious cause."[66] As the next section shows, however, various benefits may be available only if there has been a contribution to a church or synagogue. The Tax Court characterized these benefits as "indirect," in contrast to the "direct" benefit in *Murphy*, but this distinction is, at best, conclusory.[67]

C. Religious Benefits prior to *Hernandez*

Many contributions to religious organization are received as part of what could be described as quid pro quo contributions and still qualify for deductibility. For example, many synagogues require purchase of tickets to be able to attend High Holiday services.[68] Mormons are required to contribute 10 percent of their income to have the right to be admitted into the temple.[69] Yet the IRS has made it clear that it will not challenge the deductibility of these contributions,[70] and, in fact, there are no reported cases where such a challenge has been made.[71] The Service's position seems to be

[66]*Id.* at 253.

[67]*Id.*

[68]Annual membership dues may be more difficult to characterize. Persons may be able to attend religious services, but be ostracized by others unless they contribute or become members. If only informal methods of enforcement are used, deductibility of dues can probably be justified without special resort to special treatment for religious benefits.

[69]These and other examples are recited in Justice O'Connor's dissent. 490 U.S. at 709. *See also* Garrison v. Commissioner, Tax Ct Dkt. No. 18956-88, Petitioner's Brief on the Merits, 93 TNT 42-28 (presenting evidence about what petitioners claimed were quid pro quo payments in Judaism, Mormonism, Catholicism, Hinduism, Zen Buddhism, and The World Wide Church of God, all of which are generally deductible).

[70]*See* Rev. Rul 70-47, 1970-1 C.B. 49. *See also* Rev. 78-366, 1978-2 C.B. 241.

[71]In other contexts, however, IRS states that it will not allow deductibility of quid pro quo contributions. *See* 1997 WL 33313757 (IRS FSA) (July 11, 1997) (taking position that tuition payments for secular and religious education are not deductible). In Feistman v. Commissioner, 30 T.C.M. (CCH) 590 (1971), the taxpayer could not deduct temple dues because

that the person attending a religious observance obtains only "incidental benefits" and the primary beneficiaries are the general public and members of the faith.[72] Consequently, in an uncharacteristically short ruling containing no qualifications, the Service has stated that "pew rents, building fund assessments, and periodic dues" to churches are deductible.[73] The Service and courts are justifiably reluctant to make judgments about religious practices.[74]

In other contexts, however, a person who attends a ceremony or is admitted to an organization would not be described as receiving only an incidental benefit. For example, membership dues to a museum are not deductible to the extent that there are monetary benefits such

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he presented no evidence with respect to it. But court also stated that petitioners "have not shown "whether these were periodic payments of a charitable nature, or whether they were membership dues entitling petitioners to participate in the social activities of the temple."

[72] *See* Rev. Rul. 71-580, 1971-2 C.B. 235 (qualification of nonprofit organization as exempt under I.R.C. § 501(c)(3)); Hernandez v. Commissioner, 490 U.S. 680, 704, 708 (dissenting opinion) (citing a "question and answer guidance package" from an Assistant IRS Commissioner). *See also* Neher v. Commissioner, 852 F.2d 848, 857 (6th Cir. 1988), *vacated* 882 F.2d 217 (6th Cir. 1989) ("Donations to churches related to participation in religious worship have long been held *not* to yield specific private benefits to the donor, who is considered only an incidental beneficiary, but to render primary benefit to the members of the religion and the public at large); Staples v. Commissioner, 821 F.2d 1324, 1326 (8th Cir. 1987), *vacated* 490 U.S. 1103 (1989) (same); Foley v. Commissioner, 844 F.2d 94, 96 (2nd Cir. 1988), *vacated* 490 U.S. 1103 (1989) (same); Murphy v. Commissioner, 54 T.C. 249, 253 (distinguishing between contributions by members to churches and other charitably organizations and fees for adoptions services). *But see* Feistman v. Commissioner, 30 T.C.M. (CCH) 590 (1971) (temple dues not deductible because may have allowed taxpayers to participate in social activities of temple).

[73] Rev. Rul. 70-47, 1970-1 C.B. 49.

[74] A court's statement for not allowing a deduction of the "cost of [taxpayers'] . . . daughter's Bas Mitzvah" shows in another context the dangers when courts get involved in evaluating payments to a church or synagogue. Feistman v. Commissioner, T.C. Memo 1971-137. The court stated that a Bas Mitzvah is "primarily a social event." Certainly many Jews would object to that characterization. The court's statement was unnecessary because the payment was probably for goods or services and thus a deduction could have been disallowed for that reason.

as the right to be admitted without cost.[75] Some writers and judges have been willing to treat religious benefits differently from secular benefits,[76] but there is no statutory justification for different treatment.[77] Providing special treatment for religious benefits also requires distinguishing between religious and nonreligious benefits. That would be a very difficult task.

IV. *Hernandez v. Commissioner*

A. Introduction and Facts

The IRS's lenient position toward contributions to religious organizations was obviously stretched beyond the breaking point when it was confronted with the Scientology Church. A detailed description of the religion and of the role of its founder, L.Ron Hubbard, are beyond the scope of this article, but a few details may provide some helpful background and illustrate the reasons for the IRS's hostility. During the 1970's (the years involved for much of the litigation concerning the Church), Hubbard and other leading officials were permanently located in a cruise ship, the Apollo, that cruised the Mediterranean. Millions of dollars of church funds were kept in a locked file cabinet

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[75]Rev. Rul. 68-432, 1968-2 C.B. 104; Rev. Rul. 67-246, 1967-2 C.B. 104. *See generally* Treas. Reg. §1.170A-13(f)(8)(B) (some annual membership benefits disregarded, but only when annual payment of $75 or less).

[76]*See, e.g.,* Daniel Rattin Mitz, *Save your Local Church or Synagogue: When Are Taxpayer Contributions to Religious Organizations Deductible under Section 170*, 63 N.Y.U.L. Rev. 840 (1988); Jacob L. Todres, *Internal Revenue Code Section 170: Does the Receipt by a Donor of an Intangible Religious Benefit Reduce the Amount of the Charitable Contribution Deduction? Only the Lord Knows for Sure*, 90 Tenn. L. Rev. 91 (1996); Hernandez v. Commissioner, 490 U.S. 680, 704 (1989) (dissenting opinion); cases in note 87 *infra*.

[77]Hernandez v. Commissioner, 490 U.S. 680, 693 (1989) ("The Code makes no special preference for payments made in the expectation of gaining religious benefits or access to a religious service.").

on the ship. Mary Sue Hubbard, L. Ron Hubbard's wife, had the only key.[78] "[M]ake money," "make more money," and "make other people produce so as to make money" were policy directives of the Church.[79] In *Church of Scientology of California v. Commissioner*,[80] the IRS successfully challenged the tax exempt status of the mother Church in California. The trial before the Tax Court consumed the equivalent of ten weeks spread out over the course of a year,[81] with the court holding that the Church was operated for a substantial commercial purpose, that its net earnings benefitted L Ron Hubbard and related persons, and that it violated well-defined standards of public policy by conspiring to prevent the IRS from assessing and collecting taxes. The Ninth Circuit affirmed on the grounds of private inurement, and did not reach the other grounds for the Tax Court's decision.[82]

Hernandez v. Commissioner started as a Tax Court case, *Graham v. Commissioner*, involving three taxpayers from the Ninth Circuit.[83] However, over 1,000 other petitioners and the IRS agreed to be bound by the Tax Court's decision, subject to a right of appeal.[84] After the Tax Court decided

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[78] Church of Scientology of California v. Commissioner, 823 F.2d 1310, 1319-20 (9th Cir. 1987), *cert denied*, 486 U.S. 1015 (1988).

[79] 83 T.C. at 422.

[80] 83 T.C. 381 (1984), aff'd 823 F.2d 1310 (9th Cir. 1987), cert denied, 486 U.S. 1015 (1988).

[81] 83 T.C. at 392.

[82] Church of Scientology of California v. Commissioner, 823 F.2d 1310, 1319-20 (9th Cir. 1987), *cert denied*, 486 U.S. 1015 (1988).

[83] 83 T.C. 575 (1984).

[84] The procedural history is stated in several of the circuit court opinions deciding appeals from the Tax Court decision. *See, e.g.,* Neher v. Commissioner, 852 F.2d 848 (6th Cir. 1988), *vacated* 882 F.2d 217 (6th Cir. 1989).

Graham in favor of the IRS, appeals were filed in every circuit except the Federal Circuit.[85] By the time the Supreme Court's opinion had been issued in *Hernandez*, there had been seven Circuit Court opinions, of which four had affirmed the Tax Court[86] and three had reversed it.[87]

At issue in *Hernandez* was the deductibility of payments made to Scientology churches for "auditing" and "training." The IRS had stipulated that the donees were qualifying charitable donees in order to expedite the proceedings.[88] Thus, the sole issue before the Supreme Court was whether the payments for auditing and training qualified as "contribution[s] or gift[s]" under section 170.[89] Auditing "is a precise form of spiritual counseling between a Scientology minister [known as a an auditor] and a parishioner [known as a preclear]"[90] and is offered in sequential levels. Scientologists believe that an immortal spiritual being exists in every person, and auditing helps the prelclear become aware of her spiritual dimension. An electropsychometer, or "E-meter," which is an electical device that measures skin responses, helps the auditor identify the preclear's areas

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[85]*Id.*

[86]Hernandez v. Commissioner, 819 F.2d 1212 (1st cir. 1987), *aff'd* 490 U.S. 680 (1989); Miller v. IRS, 829 F.2d 500 (4th Cir. 1987), *cert. denied* 490 U.S. 1113 (1989); Graham v. Commissioner 822 F.2d 844 (9th Cir. 1987), *aff'd* 490 U.S. 680 (1989); Christiansen v. Commissioner, 843 F.2d 418 (10th Cir. 1988) *cert. denied* 490 U.S. 1113 (1989).

[87]Foley v. Commissioner, 844 F.2d 94 (2nd Cir. 1988), *vacated* 490 U.S. 1103 (1989); Neher v. Commissioner, 852 F.2d 848 (6th Cir. 1988), *vacated* 882 F.2d 217 (6th Cir. 1989); Staples v. Commissioner, 821 F.2d 1324 (8th Cir. 1987), *vacated* 490 U.S. 1103 (1989). For a thorough discussion of the litigation, see Todres, *supra* note 76.

[88]Hernandez v. Commissioner, 819 F.2d 1212, 1216 n.6 (1st Cir. 1987), *aff'd* 490 U.S. 680 (1989).

[89]490 U.S. at 686. "Contribution" and "gift" have the same meaning. *See supra* note 49.

[90]*Scientology*, *supra* note 1, at 33.

of spiritual difficulty.[91] The auditing involves questions and answers, but is not individually tailored. Training "consists of the intensive study of the tenets of the religion"[92] and is apparently offered in group settings.[93] It is both "an indispensable part of an individual's personal progress"[94] and "the route by which ministers acquire the knowledge and skill to conduct auditing."[95] None of the cases distinguished between auditing and training;[96] they would have allowed deductibility for amounts paid for both or for neither.[97] Training appears very similar to religious education and the Service and courts have been uniformly hostile to deductibility of expenses for religious

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[91]Scientologists believe that certain experiences hold minute amounts of electrical energy. As the energy, which is measured by the E-meter, diminishes, the auditor knows that the preclear has successfully dealt with "the source of that aspect of his spiritual entrapment." *Scientology*, *supra* note 1, at 37.

[92]*Scientology*, *supra* note 1, at 38.

[93]None of the cases mentioned that training is offered in group settings, a fact which seems quite relevant, but FSA 1999-1070, n.5 1999 TNT 114-20 states the following: "[W]hile Scientology 'auditing' is generally practiced in one-on-sessions, 'training' generally involves group instruction and study. In Petitioner's brief to the Tax Court in *Garrison v. Commissioner,* a proposed finding of fact states that "[t]he religious service of training is generally delivered congregationally." Garrison v. Commissioner, Tax Ct Dkt. No. 18956-88, Petitioner's Brief on the Merits, 93 TNT 42-28 at 68 (Petitioner's proposed finding of fact #321). Finally, a picture in the authorized book for the religion of Scientology illustrates training by showing a large room with persons seated at rows of tables with several standing instructors. *Scientology*, *supra* note 1, at 38-39.

[94]*Scientology*, *supra* note 1, at 38.

[95]*Id.* at 40.

[96]The Tax Court's opinion did not explain the difference between auditing and training. 83 T.C. 575. However, the Supreme Court's opinion statement of facts described each separately. 492 U.S. at 684-85.

[97]In Graham v. Commissioner, 822 F.2d 844, 850 (9th Cir. 1987), the Ninth Circuit raised the issue:

> Because we affirm the Tax Court's decision as to payment made for both auditing and training services, we need not discuss whether the payments made for training services were "in the nature of tuition." DeJong, 309 F.2d at 379

education.[98] However, neither the Circuit Courts that would have allowed the deduction nor the dissent in *Hernandez* separately discussed deductibility of expenses for training.[99]

Mandatory fixed charges were paid for the auditing and training sessions; prices varied with a session's length and level of sophistication.[100] Sessions were advertised by newspaper, magazine, and radio, by leaflets, and by free lectures and personality tests.[101] Advance payments received a 5 percent discount.[102] The Scientology Church has a doctrine of free exchange, according to which any time a person receives something she must pay something back, and consequently auditing and training sessions have rarely been provided to those who do not pay the specified prices.[103]

The majority of the Supreme Court held that the transaction was structured as a quid pro quo, and therefore payments for auditing and counseling are not deductible. The taxpayers argued that the IRS allows payments to

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[98]The Fourth Circuit noted that the government had stipulated "auditing was not 'educational,'" but there does not appear to have been a similar stipulation for training. Miller v. Internal Revenue Service, 829 F.2d 500, 504 (4th Cir. 1987), *cert. denied* 490 U.S. 1113 (1989).

[99]The Second Circuit in *Foley v. Commissioner* stated that training is "for the purposes of studying church doctrine and scripture and of attaining the background needed to qualify as auditors." 844 F.2d 94, 96 (2nd Cir. 1988), *vacated* 490 U.S. 1103 (1989). Nevertheless, it allowed a deduction for payments for training sessions. *See also* Staples v. Commissioner, 821 F.2d 1324, 1325 (8th Cir. 1987), *vacated* 490 U.S. 1103 (1989) (allowing a deduction for taking "'courses' in which [taxpayers] . . . study the doctrines, tenets, codes, policies, and practices of the Church.").

[100]Hernandez v. Commissioner, 490 U.S. 680, 685 (1989).

[101]*Id.* at 685-86.

[102]*Id.* at 686.

[103]*Id. at 685.* Justice Marshall stated that the Scientology Church "categorically barred provision of auditing or training sessions for free." *Id.* at 692 (1989). In their brief in *Garrison v. Commissioner*, the Scientologists disputed this fact. Tax Ct Dkt. No. 18956-88, Petitioner's Brief on the Merits, 93 TNT 42-28 at 70-71, 116-18 (Petitioner's proposed finding of fact Nos. 338 to 351).

churches and synagogues of other religions to be deductible even though they are structured as quid pro quo transactions, but the majority stated that it did not have a "proper factual record" for that type of determination.[104] The Court also rejected the taxpayers' claims that their constitutional rights under the First Amendment were being violated.[105] Justice O'Connor wrote a forceful dissent, which Justice Scalia joined. She argued that payments made in exchange for purely religious benefits – i.e., benefits "exclusively of spritiual or religious worth"[106] – have always been deductible and that the Scientologists are being treated unfairly. Because the unfair treatment involved religious practices, Justice O'Connor concluded that the Establishment Clause of the First

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[104]490 U.S. at 703.

[105]The taxpayers' claims were based on the Establishment and Free Exercise Clauses of the First Amendment. They argued that denying their deductions violated the Establishment Clause in two respects. First, not allowing deductions for payments for training and auditing would result in disproportionately harsh treatment for those religions that raise money by imposing fixed costs for some religious practices. Citing Larson v. Valente, 456 U.S. 228 (1982) and Lemon v. Kurtzman, 403 U.S. 602 (1971), the Supreme Court majority rejected these claims. *Id.* at 695-96. It held there was no facial differentiation among religions and no argument that section 170 was motivated by an animus to religion in general or to Scientology in particular. Second, the taxpayers argued that the Court's interpretation of section 170 would threaten government entanglement with religion because it would require valuation of religious services. The Court noted that valuation of religious practices was not required in this case and that in other cases the government could use the cost to the donee of providing the good or service, a method that does not pose an intolerable risk of government entanglement. *Id.* at 696-98. Therefore, the Establishment Clause was not violated.

The taxpayers also argued that disallowance of their deductions would violate their right to free exercise of religion because it would deter adherents from engaging in auditing and training and would interfere with the Church doctrine of exchange, which requires equality of outflow and inflow. The Court doubted that the burden of having the deduction disallowed imposed a substantial burden, but held that, even if there were a substantial burden, it would be outweighed by the public interest in a sound tax system that did not have many exceptions for a wide variety of religious beliefs. *Id.* at 698-700.

[106]490 U.S. 680, 704, 705 (1989) (dissenting opinion).

Amendment was being violated.[107]

B. The Majority's Opinion and Why It Was Wrong

The majority in *Hernandez v. Commissioner* held that payments to branch Scientology Churches for auditing and training were not deductible. A charitable contribution requires "a transfer of money or property *without adequate consideration*,"[108] and payments in the present case were part of a "quintessential quid pro quo exchange."[109] In making this determination, the Court examined "the external features of the transaction in question."[110] What was critical was that "the transaction . . . [was] structured as a quid pro quo exchange."[111] Justice Marshall, who wrote the majority opinion, emphasized the manner in which the Churches made the auditing and training available. The marketing of auditing and training was similar to that of purely commercial products, with fixed prices, discounts for early payments, and insistence that purchasers pay the specified amounts. The auditing and training sessions were an "identifiable benefit" that

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[107] *Id.* at 713.

[108] 490 U.S. 680, 691 (1989) quoting from United States v. American Bar Endowment, 477 U.S. 105, 118 (1986)) (emphasis in original).

[109] *Id.*

[110] *Id.* at 690. Several circuit courts had used a similar approach. *See* Miller v. Internal Revenue Service, 829 F.2d 500, 503 (4th Cir. 19878), *cert. denied* 490 U.S. 1113 (1989); Graham v. Commissioner, 822 F.2d 844, 849 (9th Cir. 1987), *aff'd* 490 U.S. 680 (1989); Christiansen v. Commissioner, 843 F.2d 418, 420 (10th Cir. 1988), *cert. denied* 490 U.S. 1113 (1989).

[111] 490 U.S. at 702.

the taxpayers received in return for their money.[112]

After it had been determined that the taxpayers had received an "identifiable" benefit, the type or form of the benefit was irrelevant. The taxpayers argued that quid pro quo analysis is not appropriate if the benefit is "purely religious in nature" or if "the payments [are] made for the right to participate in a religious service."[113] But the majority rejected this argument. Section 170 makes no special provision for contributions to an organization operated exclusively for religious purposes. Like organizations operated for charitable, educational, or other specified purposes, the payment is deductible only if it is "a contribution or gift," which means a payment made without the expectation of a quid pro quo.

The dissent argued that majority's approach was inconsistent with the accepted approach involving "dual character" payments.[114] An example is an "awards dinner" by a charity honoring one or more persons. Assume that a ticket costs $250. A person who wants to go has no choice, but to pay the specified amount; the sponsoring charity has structured the event so that purchase of a ticket is part of a quid pro quo transaction. The opportunity to socialize with the people at the dinner may make the cost worthwhile to a particular person. Yet we allow all attendees to deduct the excess of the price paid over the value of the

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[112]490 U.S. at 691.

[113]490 U.S. at 692.

[114]*See* Todres, *supra* note 76, at 149.

meal. Similarly, reciprocal payments are common in other religions, and the IRS routinely allows deductibility of the payments. Many synagogues condition attendance at worship services on the Jewish High Holy Days on purchase of a ticket. Mormons must tithe their income as a necessary, but not sufficient, condition for getting a temple recommend, which provides the right to be admitted to a temple. Catholics pay a mass stipend to a priest so that the fruits of the mass will be applied in accordance with the intention of the donor. Payments for these religious practices can be distinguished from the payments for auditing and training, but that is not the point. Simply identifying the payment as part of a quid pro quo is not sufficient for concluding that the payment is not a deductible contribution

The majority in *Hernandez* did recognize that characterization as a "dual character" might be appropriate.[115] A portion of the payment would be a purchase of auditing and training sessions, and a portion would be a deductible contribution; the amount of the contribution would be the excess of the payment over the value of the services that were received. The taxpayers, however, had only argued that all of their payment should be deductible. Consequently, the Court did not have to deal with the complexities that a partial deduction would present. In fact, any attempt to assign a fair market value to the auditing and training sessions, other than what the taxpayers were charged, is futile. Auditing and training are unique services sold only by Churches of Scientology. As the

[115]490 U.S. at 697-698.

Court had previously recognized, the Churches had placed distinct prices on these services,[116] and those who wanted the services had no choice, but to pay those prices.

The majority did suggest that the value could be determined by the "cost (if any) to the donee of providing the good or service,"[117] and cited three cases, the most recent of which was decided in 1972.[118] All of the cases involved private school education furnished by a church or religiously oriented organization, and the IRS had challenged only part of the contribution. In two of the cases the courts stated that the amount disallowed by the IRS represented the cost of the education,[119] and in the third the determination of the amounts allowed and disallowed was not commented on.[120] There was no discussion at all of how cost might be determined in any of the cases. Therefore, whether determination of cost is feasible – particularly in contentious cases that do not involve education of school-age children – is unsettled. In fact, it is not clear that Justice Marshall considered the difficulties at all.

What can be characterized as quid pro quo payments are fully deductible

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[116]490 U.S. at 685.

[117]490 U.S. at 698.

[118]Oppewal v. Commissioner, 468 F.2d 1000 (1st Cir. 1972); Winters v. Commissioner, 468 F.2d (778 (2nd Cir. 1972); DeJong v. Commissioner, 309 F.2d 373 (9th Cir. 1962).

[119]Oppewal v. Commissioner, 468 F.2d 1000, 1002 (1st Cir. 1972) (stating without explanation that the cost of the education was "at least six hundred and forty dollars); DeJong v. Commissioner, 309 F.2d 373, 375 (9th Cir. 1962) ("approximate cost" was stipulated).

[120]Winters v. Commissioner, 30 T.C.M. (CCH) 1238 (1971), *aff'd*, 468 F.2d 778 (2nd Cir. 1972) (disallowance of amount paid to fund established for support of school; other contributions to church not challenged).

in many contexts. It is common for universities and other large institutions to present "naming opportunities" to donors. Donors of one sum will have classrooms named after them, a larger amount may be sufficient for the library, and a building will require even a larger amount. Under these circumstances the naming opportunity can certainly be considered a quid pro quo for the contribution. Not only are deductions for charitable contributions common when there are quid pro quo transactions, but deductions are also often not allowed when there is no quid pro quo. The education cases decided in the 1960's and 1970's, which were discussed in Section II, are examples.[121] Although a payment "may not have been motivated by the provision of education services," the amount of the deductible contribution was still reduced by the value of the education.[122] Thus, a quid pro quo does not necessarily cause disallowance of a contribution, and the absence of quid pro quo does not necessarily result in a allowance of a contribution. The majority's conclusion in *Hernandez* that the payment does not qualify as a deductible charitable contribution because the transaction was structured as a quid pro quo is clearly inadequate.

A deduction for a contribution is often allowed when the donor receives a benefit; a deduction is not allowed only if there is a legally sufficient or "substantial" benefit connected with the payment to the charitable organization.[123]

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[121]*See supra* notes 58 - 64 & accompanying text.

[122]Haak v. United States, 451 F. Supp. 1087, 1092 N.5 (D.C. Mich. 1978).

[123]*See generally* Singer Company v. United States, 449 F.2d 413 (Ct. Cl. 1971).

The key question, of course, is what is a legally sufficient benefit. Naming of a building after a donor is not a sufficient benefit, but assistance in adopting a child is a sufficient benefit.[124] The error of the Supreme Court majority is that it refused to consider the nature of the benefit – auditing and training services – that the taxpayers received for their services. Should that benefit offset or vitiate a deduction for the payment?

What was compelling to the majority was that the auditing and training services were marketed in an explicitly commercial manner. Certainly, it seems anomalous to allow a deduction for a charitable contribution when the service is sold in ways that are very close (if not indistinguishable) from commercial products or services. Yet once we have accepted that deductions will be allowed for quid pro quo transactions, the extent and form of marketing should not be determinative. Should advertisements in specialized magazines be consistent with a deduction, but not advertisements in citywide newspapers? Certainly, church officials would be advised to manipulate the publicity and notices to fall on the "correct" side of the line. Form would become paramount.

[124] *See* Murphy v. Commissioner, 54 T.C. 249 (1970).

C. The Dissenting Opinion and Why It Was Wrong

In her dissent Justice O'Connor writes that the IRS "discriminates against the Chuch of Scientology"[125] when it does not allow its members to deduct payments for auditing and training. As Justice O'Connell explains, the stipulations establish that the payments are to "participate in religious services"[126] and, such payments are deductible for other religions – or at least the IRS does not challenge them. "[T]he government has only two practicable options with regard to distinctively religious *quids pro quo*: to disregard them all or to tax them all."[127] Justice O'Connor dissented, and thus her conclusion is that the former option should be chosen and that the Scientologists should be allowed to deduct their contributions .

Justice O'Connor concluded that the Scientologists should be able to deduct their payments because she thought it appropriate that all "religious *quids pro quo"* be disregarded. The facts in *Hernandez*, however, illustrate the problem with that approach. Consider the payments for auditing. The taxpayers were paying for one-on-one sessions. The service is similar to consulting with a social worker or marriage counselor. In fact, the majority noted that auditing

[125]690 U.S. at 713.

[126]490 U.S. at 705.

[127]490 U.S. at 707.

is "also known as . . . 'counseling' and 'pastoral counseling.'"[128] Payments for these services, even if made to a qualifying charitable or religious organization, are not deductible. Why should auditing be different? The answer that auditing is a religious benefit is not ultimately helpful. If the services are similar, they should have the same tax consequences. In other contexts, noncommercial or intangible benefits prevent the deduction of a charitable contribution. Adoption services and future use of sewing machines by children are benefits that prevent a payment from being a charitable contribution.[129] The same neutral principles should be applied in determining whether "religious benefits" are the type of direct benefit that should preclude a deduction for a charitable contribution. If religious benefits receive more favorable tax benefits than other benefits merely because of the religious connection, the tax law would automatically be favoring religion, the type of favoritism that, in other contexts, is perceived as violating the Establishment Clause of the First Amendment.[130]

A "religious benefit" presumably exists when there is no "secular,

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[128]490 U.S. at 685, n.2.

[129]Murpy v. Commissioner, 54 T.C. 249 (1970) (adoption services); Singer Company v. United States, 449 F.2d 413 (Ct Cl 1971) (discounts on sewing machines to schools). See also Rev Rul. 71-69 (repayment of school loans); 76-332 (weekend marriage seminar).

[130]Texas Monthly, Inc. v. Bullock, 489 U.S. 1 (1989) (sales tax exemption for religious periodicals violates establishment clause). The majority in *Hernandez* raised the possibility that "automatic deductibility of a payment made to a church that either generates religious benefits or guarantees access to a religious service" could violate the Establishment Clause, but did not make a determination. 490 U.S. at 692.

At one point, Justice O'Connor uses the phrase "spiritual or religious worth" for the type of benefit that should not vitiate a deduction for a charitable contribution. 490 U.S. at 705. But she does not suggest any possibility where a nonreligious, but spiritual, benefit, would allow a deduction. [See also NYU article.]

commercial, or nonreligious value."[131] Only adherents of the religion would value the benefit. This definition would sometimes apply to religious education. Learning about religious doctrine and ritual is generally only of value to those who adhere to the faith. Many religious faiths value both learning about and knowledge of the religion and therefore consider study to be an important religious practice. The implication of Justice O'Connell's position is that religious school tuition should be deductible. And, in fact, Justice O'Connor would have allowed a deduction for Scientologists' training, which can easily be categorized as education.[132] But what of the person who pays a qualifying educational institution for lessons in a foreign language, in sports, or in chess? Should these be deductible because they are of "spiritual benefit"? If religious education, but not these other lessons, were to be deductible, adherents of religion would be unfairly enjoying tax benefits denied to others.

D. The Confusing Legacy

The Supreme Court decision in *Hernandez v. Commissioner*[133] did not end the litigation; only a subsequent surrender by the IRS did that. Almost

[131]490 U.S. at 705.

[132]490 U.S. at 704 (dissenting opinion). Justice O'Connor distinguished auditing and training from "secularly useful education," *Id*. at 705, but not from purely religious education.

[133]490 U.S. 680 (1989).

immediately after the decision in *Hernandez* was published, a suit for refund was filed in district court by a member of the Church of Scientology[134] and a petition in Tax Court by ten others (including three couples filing jointly).[135] In both cases Scientologists argued that they should be allowed deductions for auditing and training sessions because the IRS allows deductions for payments to churches in other religions that are part of quid pro quo transactions.[136] The majority in *Hernandez* had held that it did not have a proper factual record to reach this issue.[137] In *Powell v. United States,* the District Court had dismissed the claim,[138] but the Eleventh Circuit vacated and remanded, holding that, if the taxpayers were able to substantiate their claim, they should be allowed the deductions.[139] In the Tax Court case, *Garrison v. Commissioner,* a trial had been held, and both taxpayers and the IRS had filed briefs on the merits.[140] As we now know, a closing agreement dated October 1, 1993, mooted both these cases.[141] In this agreement, the IRS, *inter alia*, agreed that payments for auditing and training

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[134]Powell v. United States, 91-1 U.S.T.C. ¶50,117 (S.D. Fla. 1990), *vacated by* 945 F.2d 374 (11thCir. 1991).

[135] Garrison v. Commissioner, Tax Ct Dkt. No. 18956-88.

[136]In Garrison, the taxpayers also made the alternative argument that they should be allowed to deduct the excess of their payment over the cost of auditing and training. Garrison v. Commissioner, Tax Ct Dkt. No. 18956-88, Petitioner's Brief on the Merits.

[137]490 U.S. at 701-03.

[138]91-1 U.S.T.C. ¶50,117 (S.D. Fla. 1990), *vacated by* 945 F.2d 374 (11thCir. 1991).

[139]945 F.2d 374 (11thCir. 1991).

[140] Garrison v. Commissioner, Tax Ct Dkt. No. 18956-88, 93 TNT 42-59

[141]*See supra* note 6 & accompanying text.

would be deductible. Litigation with an adversary relentless as the Church of Scientology could not be ended with a simple agreement, and this agreement was anything but that. About sixty single-spaced pages, it had about a four page Table of Contents, with nine major sections, including one that defines twenty-five terms.

The Scientologists have succeeded by arguing that they were treated unfairly compared to members of mainstream religions. In *Sklar v. Commissioner*, a married couple who are Orthodox Jews have argued that they are being treated unfairly compared to the Scientologists.[142] Their argument is appealing. The Sklars sent their children to religious day schools and argued that they should be able to deduct the portion of their tuition that represents religious education. The education has no secular or commercial value and therefore, like auditing and training, provides only a religious benefit. The Ninth Circuit was not sympathetic and affirmed the Tax Court's decision that a deduction was not allowable.[143] Its holding was that the Sklars should only be able to deduct the excess of their payment over the value of the secular education that their children received and they did not substantiate the value of the secular education. However, it stated in dictum that the "religious education of the Sklars' children does not appear to be similar to the 'auditing,' 'training' or other 'qualified

[142]282 F.3d 610 (9th Cir. 2002).

[143]282 F.3d 610 (9th Cir. 2002) *aff'g* 79 T.C.M. (CCH) 1818 (2000).

religious services' conducted by the Church of Scientology."[144] The court gave absolutely no explanation or support for this statement. Scientologists' training, in particular, appears to be a form of education, teaching the tenets of the religion of Scientology.[145] It can also be argued that religious education should be treated the same as auditing. The one-on-one session with the auditor is not that much different from studying with a tutor who is trying to improve the disciple's understanding of spiritual matters.[146] Finally, the court made clear its disapproval of the failure of the IRS to apply the holding of *Hernandez* to members of the Scientology Church.[147] Yet the fact remains that the IRS is continuing to allow deductions for payments for auditing and training, and the Ninth Circuit has not explained why the Sklars – or others in similar circumstances – should not be able to argue that they are being unfairly. Either the Sklars or others will undoubtedly continue making the argument. The IRS needs to explain what it is doing and be able to provide principled reasons justifying the lines it is drawing

V. 1993 Amendments

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[144]282 F.3d at 620.

[145]Participants in training "study the tenets of Scientology and seek to attain the qualifications necessary to serve as auditors." 490 U.S. at 685. For a description of training, see *supra* notes 92 - 95 & accompanying text.

[146]The Supreme Court noted that auditing is also known as "counseling" or "pastoral counseling." 490 U.S. at 685, n.2. Rev Rul. 78-189, 1978-1 C.B. 68, which disallowed deductions for payments made for auditing and training, analogized auditing to religious education. Rev. Rul 78-189 was "obsoleted" by Rev. Rul. 93-73, 1993-2 C.B. 75. *See also* Hernandez v. Commissioner, 490 U.S. 680, 710 (Justice O'Connor states that Rev. Rul. 78-189 "equates payments for auditing with tuition paid to religious schools).

[147]282 F.3d at 619-20.

In the Omnibus Budget Reconciliation Act of 1993 (OBRA), Congress enacted two provisions that are directly relevant to the tax treatment of contributions made to religious institutions when the donor is also expecting intangible religious benefits.[148] The provisions do not purport to change the substantive law concerning deductions for charitable contributions, and the legislative history supports this conclusion.[149] However, portions of these provisions are hard to reconcile with the holding in *Hernandez*, which had been decided by the Supreme Court only four years earlier.

New section 6115 of the Internal Revenue Code imposes a requirement on donee charities. It applies to a charitable organization that has received a "quid pro quo contribution," which is defined as a "payment made partly as a contribution and partly in consideration for goods or services provided to the payor by the donee organization."[150] A charitable organization that has received a quid pro quo contribution must send a written notice informing the contributor that a deduction is allowed only to the extent that the contribution exceeds the

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[148] Pub. L. No. 103-66, §§13172, 13173, 107 Stat. 312, 455-57 (adding I.R.C. §§170(f)(8)(B), 6115).

[149] S Prt. 103-37, 103d Cong., 1st Sess. at 93, n.29 (Budget Reconciliation Recommendations of the Committee on Finance)("No inference is intended, however, whether or not any payment outside the scope of the *quid pro quo* disclosure proposal or substantiation proposal is deductible (in full or in part) under the present-law requirements of section 170."); H.R. Rep. 103-111 at 785, *reprinted in* 1993 U.S.C.A.N. 378, 1016. *See also* Sklar v. Commissioner, 282 F.3d 610, 613 (9th Cir. 2002) (dictum that holding of *Hernandez* has not been modified or overruled by OBRA); Kahn, *supra* note 26 at 510-11 (concurring that holding of *Hernandez* not affected by OBRA); Todres, *supra* note 76, at 152 (same). *But see* Raby, *supra* note 6, at 217 ("[T]here is at least an inference in the 1993 act that 'intangible religious benefits' should not be considered to have any fair market value for charitable contribution purposes.").

[150] I.R.C. §6115(b).

value of goods and services provided by the organization and providing a good faith estimate of the value of the goods and services.[151] However, intangible religious benefits are generally excluded from the reporting requirement.

> A quid pro quo contribution does not include any payment made to an organization organized exclusively for religious purposes, in return for which the taxpayer receives solely an intangible religious benefit that generally is not sold in a commercial transaction outside the donative context.[152]

Auditing, as practiced by the Scientology churches, should clearly qualify as "an intangible religious benefit that generally is not sold in a commercial transaction outside the donative context." If the holding in *Hernandez* is being followed and contributors must reduce their deduction by the value of auditing services they have received, excepting the donee Scientology Church from sending the written statement to donors is hard to justify. The Conference Report gives the example of "admission to a religious ceremony" as an intangible religious benefit that

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[151]I.R.C. §6115(a)

[152]*Id. See also* H.R. Rep. 103-213 at 567, n. 39, *reprinted in* 1993 U.S.C.C.A.N. 1088, 1259. ("[C]harities are not required to make any disclosure under the *quid pro quo* disclosure provision when no benefit *other than* an intangible religious benefit is furnished to the donor.") (emphasis in original).

would generally not have to be described or valued in the written notice.[153] However, payment to attend a service would appear to be a quid pro quo that, according to the holding in *Hernandez,* should result in a reduction of a deduction for a charitable contribution.

In OBRA Congress also enacted a new substantiation requirement for those who contribute more than $250 to a qualifying charity.[154] A deduction for the contribution is allowed only if the contributor has received a written acknowledgment from the donee organization before the contributor's tax return is filed.[155] Among other requirements, the acknowledgment must provide a description and a "good faith estimate of the value.of" any goods or services that are consideration for the contribution [156] However, if the sole consideration is "intangible religious benefits," no description or valuation is required.[157] As in section 6115, intangible religious benefits must be provided "by an organization organized exclusively for religious purposes" and must "not [be] sold in a commercial transaction outside the donative context."[158] If intangible religious

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[153]H.R. Rep. Conf. Rep. No. 103-213, 103d Cong., 1st Sess. 566 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1254-55. *See also* S Prt. 103-37, 103d Cong., 1st Sess. at 93 (Budget Reconciliation Recommendations of the Committee on Finance) (admission to a religious ceremony can be disregarded for purposes of the substantiation requirement of I.R.C. § 170(f)(8).)

[154]Pub. L. No. 103-66, §13172, 107 Stat. 312, 455-56 (adding new I.R.C. §170(f)(8)).

[155]The acknowledgment must also have been received before the due date (including extensions) for filing the return. I.R.C. §170(f)(8)(C).

[156] I.R.C. §170(f)(8)(B)(iii).

[157] I.R.C. §170(f)(8)(B)(iii).

[158] I.R.C. §170(f)(8)(B).

benefits reduce the amount of a charitable contribution deduction, as the majority in *Hernandez* held, at the very least the IRS would want those benefits described. In addition, valuation by the religious organization would also seem appropriate and helpful to the IRS. In summary, the 1993 amendments, although providing only new reporting and substantiation requirements in connection with quid pro quo contributions, strongly indicate that Congress either did not approve or was not aware of the Supreme Court's holding in *Hernandez v. Commissioner*.[159]

VI. A Viable Approach

A. Auditing and Other Intangible Religious Benefits

The majority's rationale in *Hernandez v. Commisioner*[160] for disallowing the deduction -- namely, that the payment was structured as a quid pro quo -- has unacceptable consequences. The possibility that those consequences may include disallowing deductions for contributions to mainstream religions that had previously been assumed to be deductible seems to have been the reason that the IRS abandoned its victory in *Hernandez*.

Disallowance of a deduction for contributions to churches and synagogues whenever there is some quid pro quo would be neither appropriate nor feasible.

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[159] *See* Raby, *supra* note 6, at 216-17.

[160] 490 U.S. 680 (1989).

Consider a church with services open to all, but which has a membership roster and charges membership dues. A family that attends regularly will be encouraged to join and pay membership dues, which may be a fixed sum or a percentage of income. If the family does not join, it will still be able to attend, but may be ostracized by the members and just not feel welcome. Are dues in this situation a quid pro quo so that the dues might not be deductible? Clearly, the dues should be deductible. Informal pressure to join is not the direct benefit that should cause disallowance of a deduction. Similarly, we should not be willing to conclude that no deduction is allowed when a service or mass is dedicated to a particular person or cause because of a payment. We allow deductions for quid pro quo transactions when the benefit is a "naming opportunity" for a building or classroom. Dedication of a service or mass does not seem very different from dedication of a room or building.

On the other hand, Justice O'Conner's dissent attaches too much significance to the label "religious benefit." An appropriate question is why that label should act as a talisman making any payments in return for the labeled service automatically deductible. Those who do not belong to organized religions can legitimately question why that label is so powerful. Religious benefits may quite similar to the "nonreligious" benefits one receives from belonging to an athletic or social club, and finding a principled way to draw the line is problematic at best.

The discomfort that many of us have towards a full deduction for the

taxpayers in *Hernandez* goes beyond questions about the religion itself, or at least exist alongside those questions. The auditing involves one-on-one sessions with a trained provider using the religion's E-meter. Put aside questions about how closely that activity may resemble conventional counseling with a social worker or counselor. Hernandez and his cohorts were using valuable resources; the time and effort of the provider are economic inputs according to any conventional economic framework. Why should labeling that service as an "intangible religious benefit" result in deductibility? The issue is not how close the auditing was to conventional counseling or other services that have a market outside of religion. Rather the issue is that the taxpayers in *Hernandez* were consuming "something." Concluding that the "something" is an intangible religious benefit does not justify a deduction for the payment because the "something" still involves resources (such as a person's time) for which there is an opportunity cost.

The amount of their proper deduction is theoretically straightforward – the excess of the amount paid over the value of the resources that they are consuming. If they are paying $500 for the auditing, and the value of the time of the provider is $300, the deduction is $200. What is not straightforward, however, is valuing the benefits. There are no perfect choices. One might think of many different approaches, but three seem the most reasonable possibilities: the amount charged by the Scientology Church, the cost of the services to the Church, or zero. Of course, the first choice would result in no deduction at all for

those who pay the listed price for auditing and training, the second would probably result in a deduction that is less than the amount paid for auditing and training, and the third would result in a full deduction. As explained directly below, I think the second choice presents too many theoretical, as well as practical, problems and should be rejected. Between the first and third choices, the third, which values the services at zero and allows a full deduction to the taxpayers in *Hernandez*, is clearly preferable.

The majority opinion in *Hernandez* suggested that cost might be used for valuing the auditing and training services.[161] Determining the costs to the Scientology Church of providing auditing and training would clearly be difficult and time-consuming. Should costs of promotional materials be included? How should administrative costs and rent be allocated? What about the costs of recruiting and training the auditors and teachers? Businesses will often use cost accounting to make these types of calculations, but that degree of financial sophistication is unrealistic for most charities and churches. But the problems go beyond the amount of effort needed and involve conceptual issues.[162] Many religions consider it part of their mission to proselytize and thus attract new members. The fact that the new members will help support the church might have only secondary importance. Thus, for the Church of Scientology, one issue

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[161]490 U.S. at 698. *See supra* notes 117 - 120 & accompanying text.

[162]*See generally* Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation,* 85 Yale L.J. 299 (1976) (discussing similar issues in demonstrating difficulty of determining income of charitable organizations).

would be whether the efforts to propagate the religion should be considered part of the cost of publicizing the "sale" of auditing and training?[163] Litigation of these issues would involve entanglement by the federal government with religion and perhaps would cause constitutional problems.[164]

The assumption that amount the Scientology Church charges its adherents should determine the value of auditing and training would clearly be unfair. The taxpayers in *Hernandez* can argue, probably convincingly, that the Church is charging a lot more than the provider's time would be worth in any other context. Furthermore, because of their affiliation with the church and their acceptance of its beliefs, they are probably willing to pay more than they would under other circumstances. Consequently, it is likely that they are paying more for the

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[163]The trial briefs in Garrison v. Commissioner illustrate the difficulties in determining the costs of auditing and training. The IRS and the taxpayers disagreed whether only direct cost should be used, what costs were direct and what were indirect, and how indirect costs could be allocated. The issues were discussed in bewildering and mind-numbing detail. Because of the closing agreement, the Tax Court did not have to decide these issues. *See* Garrison v. Commissioner, Tax Ct Dkt. No. 18956-88, Petitioner's Brief on the Merits, ___ at __-__; Respondent's Brief on the Merits, 93 TNT 42-59 at 63-84.

[164] [T]o make a determination on the basis of the cost to the Church for providing auditing and training would cause the court to become entangeld in the Church's finances and bookkeeping operations. Such action is simply not permissible and is precisely what the members of this panel fear may happen."

Neher v. Commissioner, 852 F.2d 848, 856 (6th Cir. 1988), *vacated* 882 F.2d 217 (6th Cir. 1988). See also Mitz, *supra* note 76, at 852-54. In its brief in *Garrison v. Commissioner*, the IRS argued quite strongly that the court could not determine the cost of auditing and training.

> The barrage of conflicting evidence and testimony on cost and cost allocations in the instant cases demonstrates that entaglement and accounting problems effectively prevent this Court from arriving at an accurate determination of true "cost."

Garrison v. Commissioner, Tax Ct Dkt. No. 18956-88, Respondent's Brief on the Merits, 93 TNT 42-59 at 54.

auditing than the amount of society's resources that they are "consuming." To the extent they are paying more than the value that they are consuming, they are similar to those who pay membership dues to belong to a church or synagogue.

The third choice causes the least problems and should be used. The value of the auditing services cannot be determined, and in this situation the factual issue should be determined in favor of the taxpayer. Consequently, the auditing should be valued at zero, and the taxpayers should be able to deduct their entire payment. If it is accepted that auditing is a religious practice and serves a purpose similar to that of prayer for mainstream religions, then treating auditing in the same manner that we treat most payments to churches and synagogues – as fully deductible – is appealing. If the IRS and the courts insist that the value of auditing should be determined (or just deemed to be the amount paid), then deductibility of payments to be able to attend, or receive preferential seating at, a particular service would have to be questioned. This is the type of situation that the IRS was apparently confronted with when it agreed not to challenge deductibility of the payments for auditing and training. Perhaps, not allowing a deduction for High Holiday seats at synagogues could be justified, and a deduction for general membership dues might still be allowed. But little would be accomplished. Synagogues would just change the way they raise funds.

The approach urged here -- that courts resolve a factual issue in the way that is most favorable to the taxpayer when a conceptually correct result is impractical -- has been used in other contexts. The clearest example may be

Inaja Land v. Commissioner, which involved the conveyance of an easement and other interests in land that was primarily used as a fishing club to the City of Los Angeles in connection with a diversion of water.[165] Allocation of the taxpayer's basis in the land and improvements between the interests retained and those conveyed could not easily be determined. The allocation was necessary to determine whether the taxpayer recognized any gain, and if it did, the amount of such gain. The court allowed the taxpayer to use its entire basis to offset the consideration paid by the city, thus deferring recognition of any gain.

> Capital recoveries in excess of cost do constitute taxable income. Petitioner has made no attempt to allocate a basis to that part of the property covered by the easements. . . . Petitioner argues that it would be impracticable and impossible to apportion a definite basis to the easements here involved . . . In *Strother v. Commissioner,* 55 Fed (2d) 626, the court says: "* * * A taxpayer * * * should not be charged with gain on pure conjecture unsupported by any foundation of ascertainable fact. . . ." Applying the rule as above set out, no portion of the payment in question should be considered as income, but the full amount must be treated as a return of capital and applied in reduction of

[165] 9 T.C. 727 (1947) (acq. 1948-1 C.B.2).

petitioner's cost basis.[166]

The IRS has acquiesced in the case[167] and its holding continues to be followed.[168]

Courts have often followed a similar rule in cases involving compensation. The usual rule is that an employee who receive property other than cash from his employer must include the fair market value in income.[169] A justification for this rule is that, if the employee values the item at significantly less than market value, the employer will probably use cash rather than the property as compensation. Why give an employee a suit that costs $500 when the employee would prefer to receive a significantly smaller amount of cash? However, courts have refused to follow this rule when an employee is required to live on the business premises of the employer for bona fide business reason. In *Benaglia v. Commissioner*, the Board of Tax Appeals held that a manager of a hotel who was provided a room in the hotel and required to live there did not have to include any amount in income as a result of the lodging.[170] Because the employee had to live in the hotel to perform his job properly, the assumption that

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[166]*Id*. at 735-736.

[167]Inaja Land Co. v. Commissioner, 9 T.C. 727 (1947) (acq. 1948-1 C.B.2); Rev, Rul. 77-414, 1977-2 C.B. 299.

[168]*See* Foster v. Commissioner, 80 T.C. 34 (1983), *aff'd in part and rev'd in part on other grounds* 756 F.2d 1430 (9th Cir. 1985).

[169]Treas. Reg. §1.61-2(d)(1).

[170]36 B.T.AA. 838 (1937).

use of the premises was worth its fair market value to him is not warranted. The employer would provide the lodging, and the employee would live there, even if it could be rented for substantially more than the employee would be willing to pay. Nevertheless, the lodging must have had some value to the employee. The court could still have taxed the employee at its fair market value or some other amount, but simply held that it was not income.[171] This doctrine has been followed by other cases,[172] and subsequently was codified in section 119 of the Internal Revenue Code. [173] Another example involves an option granted to an employee to purchase the employer's stock. In *LoBue v. Commissioner*, the Supreme Court held that the employee should not include an option in income at the time it was granted because the option did not have a readily ascertainable fair market value.[174] The employee only recognized income when the option was exercised.[175] This holding is equivalent to finding the option had zero value

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[171]See *Id.* at 841, 842 (dissenting opinion of Judge Arnold).

[172]*See, e.g.,* Diamond v. Sturr, 221 F.2d 264 (2nd Cir. 1955). For a history of this "not . . . tidy" doctrine, which can be called the convenience-of-the employer doctrine, see Commissioner v. Kowalski, 434 U.S. 77, 84 - 90 (1977).

[173]*See generally* Ann. 2002-18, 2002-1 C.B. 621 (stating that IRS "will not asset that any taxpayer has understated his federal income tax liability by reason of the receipt or personal use of frequent flyer milers"); Lawrence A. Zelenak & Martin J. McMahon, *Professor Look at Taxing Basbeall and Other Found Property,* 84 Tax Notes 1299 (1999) (arguing that found property, other than cash, generally should not be taxable, because it is a form of imputed income, but taxable when sold).

[174]351 U.S. 243 (1956).

[175] The dissent written by Justice Harlan would have taxed the employee when he received the option. *Id.* at 250.

when it was granted, although it clearly had some value.[176] Nevertheless, Congress has effectively incorporated this rule into section 83 of the Internal Revenue Code.[177]

The conclusion that the taxpayers in *Hernandez* should not have to reduce their charitable contribution by the value of services they received applies only to auditing, which can be characterized as a religious practice. Training, which involves instruction in the tenets of Scientology and prepares members to become auditors is closer to education.[178] The line between education and religious practice is not always clear; one obligation of adhering to a religion may be studying and learning about it. Nevertheless, education poses separate problems and is discussed in the next section.

B. Training and Religious Education

Auditing has no meaningful market price because it has value only to Scientologists and is offered only through affiliated churches. On the other hand,

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[176]Black and Scholes have received the Nobel Prize in Economics for their determination of how options can be valued.

[177]I.R.C. § 83(e)(3). Not taxing an option until exercised is not necessarily favorable to the taxapayer. Although deferral of taxation is generally beneficial to the taxpayer, the amount of income to be recognized likely will change between the date of grant of the option and date of exercise. It may be advantageous for an employee to recognize a relatively small amount of income when an option is granted, rather than a larger amount when the option is exercised. Furthermore, the gain on sale of the stock will probably be taxed at the favorable rates for long-term capital gain. Typically, the smaller the amount of compensation income, the larger the portion that is taxed as capital gain.

[178]For more general description of training, see *supra* notes 92 - 95 & accompanying text.

marriage counseling, officiating at a marriage, or help in adopting a child are services that are readily available and valued by persons of all religious beliefs. There may be religious aspects to any of these services, especially if provided by clergy, but payments for these services should not be deductible, even if paid directly to a church. Their value can be estimated, and only payments in excess of value would be eligible for deductibility. Similarly, secular education is provided in many different types of private schools. The fact that it is offered by a church in a way that comports with religious tenets does not change the categorization. The value or cost of a private school education can be estimated and payments in expectation of education for oneself or one's children are not deductible.

Religious education poses a more difficult problem. It is possible to think of education that is of value only to adherents of a religion. Learning the details of religious ritual or dogma may be examples. The issue becomes one of characterization. Should religious education be considered to be a type of religious observance or should it be classified more generally as education? If the latter, then an approximate cost or value of education should be determinable by comparing it to similar secular offerings. Two factors support the conclusion that religious education should be treated like secular education and that its value should be subtracted from the amount paid in determining the allowable deduction for a charitable contribution. First, in many cases religious education will have value in secular pursuits. Teaching of the New and Old Testaments, of

history, and of foreign languages are frequently part of the curriculum in religious education. This knowledge may be useful in many endeavors and may add to a person's private intellectual pursuits. Second, the cost of religious education should be similar to that of secular education. Therefore, the relevant cost of even purely religious education can be reasonably estimated. Factors like the age of the students, the number of students in a classroom, and the required training and education of teachers can be taken account of.

Applying this test should not be difficult in most situations. When a church, temple, or synagogue charges a significant amount for education, that amount should be generally be accepted as its value. On the other hand, if the religious education is provided free to all members of the religious institution and is only an hour or two per week, then the cost of the education should be ignored or, equivalently, assumed to be zero. If the religious education is more than two hours per week and if no specific charge is made for the education, then deduction for a charitable contribution would be allowed only to the extent that a contribution exceeds the fair value of the education. These rules would not apply to secular education, which would almost always be deemed to have some value, although the amount charged could often be accepted as the best measure.

VII. Conclusion

A principled method for determining tax consequences is particularly important when the issue involves different religious practices.[179] Not only will those whose religious practices are receiving less favorable treatment feel discriminated against, but also there is the possibility of a violation of the First Amendment's Establishment Clause. Therefore, at least in hindsight, the IRS's surrender of its victory in *Hernandez v. Commissioner*[180] should not be surprising. Applying the holding in a principled manner would have meant rethinking deductibility of many payments to mainstream religions, and few persons or institutions, certainly neither Congress nor the IRS, favored such a re-examination.

This article has attempted to provide a framework for determining deductibility of "quid pro quo contributions" to religious institutions that can be consistently applied. When intangible religious benefits are received in exchange for such contributions, their value should be deemed to be zero. There is no market price for these benefits other than what a religious institution may ask its adherents to pay. Under these conditions, the price is not a good

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[179] *See* Powell v. United States, 945 F.2d 374, 377 (11th Cir. 1991) ("Administrative inconsistency becomes more odious when it entails an inconsistent action based upon religion."). *See also* Zorach v. Clauson, 343 U.S. 306, 314 (1952) ("The government must be neutral when it comes to competition between sects."); Epperson v. Arkansas, 393 U.S. 97, 104 (1968) ("The First Amendment mandates governmental neutrality between religion and religion. . . .").

[180] 490 U.S. 680 (1989).

indication of what the true market value should be, and the only realistic alternatives are valuing the benefits at zero or at what the religious institutions charges. Valuing the benefits at zero, and thus allowing the person making the payment a full deduction, is consistent with what has been done in other situations where the correct price or value is impossible to obtain. The Scientologists' activity of auditing should be considered an intangible religious benefit, and those who pay qualifying Scientology churches for auditing sessions should be allowed a full deduction.

Religious education, on the other hand, should not be considered an intangible religious benefit that is deemed to have a zero value. Education can be useful in many ways, and even what might be considered purely religious education usually provides background and insights that will be rewarding to a person who has learned the subject matter. Furthermore, education should usually be easy to value by comparing it to similar secular education. The Scientologists' practice of training appears similar to conventional education and those who pay for the training should not be allowed a full deduction. If their position is that they are paying more than the fair market value for the training, then they would have to show what the market price of analogous secular education would be.