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MEMORANDUM

THE WHITE HOUSE

WASHINGTON

August 15, 1983

FOR: ROGER B. PORTER

FROM: STEPHEN H. GALEBACH *SHS*

SUBJECT: Request for Clearance of Statement Concerning
School Prayer Amendment

The Christian Broadcasting Network has requested that I give them a short statement about the "silent prayer" constitutional amendment.

CBN has been one of the most effective supporters of the President's school prayer amendment, and they would like to inform their followers why a silent prayer amendment is not necessary. Deputy AG Schmuts has already testified in Congress against the silent prayer amendment.

If there is no objection, I would like to give CBN the following statement for use in their newsletter:

"The President's school prayer amendment would allow vocal prayer by students in public schools, which has been prohibited by Supreme Court decision since the early 1960s. An amendment for silent prayer is unnecessary, because the Supreme Court has never ruled against silent prayer in the schools. Such an amendment would mean a great deal of effort to produce little or no progress toward the goal of returning freedom of religious expression to the schools."

MEMORANDUM

THE WHITE HOUSE

WASHINGTON

August 17, 1983

FOR: DAVID R. GERGEN

FROM: STEPHEN H. GALEBACH *SHG*

SUBJECT: Request for Clearance of Statement Concerning
School Prayer Amendment

Roger Porter has approved the attached statement summarizing our reasons for preferring the President's school prayer amendment to a silent prayer amendment, and he asked that I get your okay before sending it to CBN.

Could we please have your response by COB August 18. Thank you very much.

cc: Roger Porter

MEMORANDUM

THE WHITE HOUSE

WASHINGTON

August 15, 1983

FOR: T. KENNETH CRIBB, JR.
FROM: WILLIAM P. BARR
SUBJECT: Appointment History to Civil Rights Commission

As you requested this morning, I have attached the three memos done to date on the history of CRC appointments.

1. July 22 memo -- Among the pertinent points in this paper are:
 - o When President Kennedy took office, all the members of the Commission submitted their resignations.
 - o When President Johnson assumed the Presidency in 1963, again all the Commissioners submitted their resignations.
 - o When Johnson was elected President in '64, he requested all the Commissioners to submit their resignations. Five of the six did so, with Father Hesburgh holding out because he thought compliance with the President's request would acknowledge that the Commission was not independent.
 - o The election of Nixon was the first change in Administration in which all or most of the members of the Commission did not tender their resignations. However, it was also the first test of the President's authority to involuntarily remove a sitting member:
 - Nixon demanded Hesburgh's resignation, and Hesburgh complied.
 - Nixon appointed Manuel Ruiz to replace Hector Garcia (a Johnson recess appointee). (See Compilation of CRC Meetings.)
 - o Nor is President Reagan the first President to use his appointment power to change the character of the Commission. Kennedy's nominations in 1961 radically transformed the body from bipartisan "neutrality" to the liberal civil rights position.

2. July 5 memo -- This memo provides additional background information supplementing the June 22 paper.

3. Compilation of Civil Rights Commission Meeting References to Independence -- An interesting point here is that nominees were invited to participate in Commission meetings prior to their confirmation. It would seem that Pendleton would have the ability to extend such an invitation to our nominees for the September meeting.

MEMORANDUM

THE WHITE HOUSE

WASHINGTON
August 16, 1983

FOR: ROGER B. PORTER
FROM: WILLIAM P. BARR *WPB*
SUBJECT: Status of Immigration Legislation

Legislative Posture

The Senate bill (S.529) passed by a vote of 76-18 on May 18. Major provisions of the bill include:

- employer sanctions with civil and criminal penalties;
- establishment of secure identification system within 3 years;
- legalization of aliens who entered the U.S. as of 1/1/80;
- prohibition of federal benefits to legalized aliens for 3 years;
- uncapped block grant to cover state welfare costs;
- transition worker program;
- budget impact 1984-88: \$8 billion.

House Judiciary Committee voted out H.R. 1510 on May 5, 1983. Major provisions of the bill include:

- employer sanctions with civil and criminal penalties but including several loopholes: citation only for first violation; voluntary compliance with employment eligibility verification requirements; and waiver of verification requirements for 24 hours which effectively exempts day labor;
- no requirement for secure identification system;
- legalization of aliens who entered the U.S. as of 1/1/82;
- full reimbursement of state and local welfare costs and education assistance for legalized aliens;
- prohibition of benefits for 5 years except for Medicaid and SSI in cases of the aged, blind and disabled and in the interest of public health or serious injury;
- transition worker program more loosely constructed than Senate version;
- budget impact 1984-88: \$11.5 billion.

Three House Committees (Agriculture, Education and Labor, and Energy and Commerce) marked up the bill in June. Major amendments would:

- eliminate loopholes in employer sanctions;
- prohibit employment discrimination based on alienage;

- establish a special counsel and U.S. Immigration Board, modelled after the NLRB, to hear employer sanction and discrimination cases; thereby avoiding district court review;
- tighten terms of H-2 temporary worker program and restore reg authority to DOL;
- establish new temporary worker program for perishable agriculture;
- require 100% reimbursement of public health programs and exempt additional public health and social service programs from 5-year denial of eligibility for benefits.

Claude Pepper, (Chairman, House Rules) has admonished the Chairmen of the Judiciary, Education/Labor, Agriculture and Energy/Commerce Committees to reach agreement on their various amendments to H.R.1510 so that he could schedule a rule on the bill and avoid a fight before the Rules Committee. He has tentatively set the week of September 19 for Rules consideration.

House Committees at Loggerheads

The Committees, after several meetings, remain at an impasse. Each committee has pride of authorship and is unwilling to support the others. Education and Labor would likely oppose the bill in its current form.

There are several substantive issues at stake which account for the divergence of the Judiciary and Education/Labor Committees.

- o Enforcement. The Education/Labor amendment strikes all of the enforcement loopholes now in H.R.1510. Justice would agree that the Education/Labor amendments strengthen the bill but the Judiciary Committee questions Education/Labor's jurisdiction for the extensive revision.
- o Discrimination. Education/Labor prohibits employment discrimination on the basis of alienage and establishes an appeal process for judicial review of complaints. They claim the measure is necessary to address the civil rights concerns raised by Hispanics and hence to ensure their support for the bill. Justice, however, does not believe that the bill will result in discrimination and is unwilling to introduce a new concept of alienage into civil rights law.

- o Judicial Review. Education/Labor proposes a judicial review process through a Special Counsel in connection with the U.S. Immigration Board, fashioned after the NLRB, for adjudicating employer sanctions and discrimination cases. Education/Labor argues that the Judiciary bill is flawed because appeals to the district court would become de novo cases and hence indefinitely delay litigation of employer sanctions, whereas the Education/Labor amendment would only allow appeals to the U.S. Immigration Board and the Court of Appeals. Justice opposes the loss of control that would result from this amendment.
- o Agricultural Labor. The Education/Labor Committee amendments tighten employment standards of the H-2 temporary worker program and maintain reg authority with the Secretary of Labor. The growers oppose such provisions and strongly support the Agriculture Committee amendments which include a new temporary worker program.

The Administration is on record, through the Attorney General's July 27th letter to Rodino, as opposing H.R.1510 unless amended to address budget concerns generated by legalization provisions and to tighten enforcement provisions. While the Education/Labor amendments address and solve the enforcement problems, the legalization budget concerns have not been addressed.

MEMORANDUM

THE WHITE HOUSE

WASHINGTON

August 18, 1983

FOR: ROGER B. PORTER

FROM: STEPHEN H. GALEBACH *SHG*

SUBJECT: Administration Position on Church Audit Procedures Act

You have asked for a report on the Church Audit Procedures Act, sponsored by Cong. Edwards as H.R.2977, and by Senator Grassley as S.1262.

I have summarized the existing state of the law and the changes that would be made by the Church Audit Procedures Act in Attachment A. Attachment A includes comments on the advantages and disadvantages of the various provisions, and compares these proposals to existing regulatory provisions.

In general, I believe this act is a rather modest and basically responsible way to address a thorny problem. The problem is that IRS needs to be able to investigate fraudulent claims of church status, while not encroaching upon legitimate churches in ways that would infringe First Amendment rights. This problem is aggravated by the fact that many churches are small, with such limited financial resources that merely having to defend against an IRS investigation is often crippling.

Politically, a broad spectrum of the religious community has become concerned in recent years over several cases in which the IRS placed heavy burdens on small churches which turned out to be legitimate churches after costly and lengthy proceedings. As a result of the widespread public concern -- ranging from the liberal National Council of Churches to the conservative National Association of Evangelicals -- there are now 62 co-sponsors for the House bill.

The bill does have a number of problems, as indicated in the comments in Attachment A, that require some fine-tuning. But the basic concept of protecting legitimate churches while allowing IRS investigation of fraudulent ones, is a worthy objective and deserves our support.

I believe our best position is to offer general support for the concept of the bill, while working with Senator Grassley and Cong. Edwards to alleviate any problems that IRS and Treasury may see in the bill. Senator Grassley's staff are flexible on the details of the bill.

Senator Grassley has scheduled hearings for September 30 on the issues covered by this bill, in his Oversight Subcommittee of the Senate Finance Committee.

Unfortunately, IRS has sent comments on this bill to Senator Grassley without going through the OMB clearance process. Attachment B, which was sent to Senator Grassley by IRS with a cover letter dated July 7, adopts a strongly negative and hostile tone. The letter exaggerates the problems in the bill, shows no sensitivity to the basic concerns underlying the broad support for the bill, and shows no willingness to work constructively toward solving whatever problems do exist in the bill.

We need to correct the damage done by the IRS letter and come to a reasoned, Administration-wide position on the bill.

Recommendations

- o Have IRS retract the letter they sent to Grassley without clearance.
- o Convene a meeting of interested persons from IRS, Treasury, OMB, and OPD, to discuss the pros and cons of the various provisions in the bill.
- o Arrive at an Administration position in time to give testimony in Grassley's subcommittee by September 30.

Note: A similar bill was introduced last session by Cong. Edwards, H.R.7128, but we took no position on it.

Summary and Comment on Church Audit Procedures Act

The Church Audit Procedures Act, introduced by Congressman Edwards as H.R.2977 and by Senator Grassley as S.1262, expands the protection that existing law gives to churches in audits by the IRS.

Existing Law

Section 7605(c) - Restriction on Examination of Churches - provides as follows:

- o In determining whether a church is subject to unrelated business income tax, the IRS may not examine the books of a church unless the regional commissioner believes that the organization in question may be engaged in activities subject to the tax and so notifies the organization in advance of the examination.
- The IRS may examine the religious activities of a church only to the extent necessary to determine whether the organization is in fact a church.
- The IRS may examine the books of account of a church only to the extent necessary to determine the amount of tax due.

(This provision was added to the Code in 1969, at the same time that Congress amended the Code to make churches subject to tax on unrelated business income.)

Church Audit Procedures Act

The new act is drafted as an amendment to Section 7605(c), adding the following provisions:

- o The IRS may not investigate a church to see if it is subject to unrelated business income tax or to see if it is truly a church, unless the regional commissioner "possesses evidence which leads him to reasonably believe" that such church is subject to tax.

COMMENT: The IRS believes this to be a "radical change," because it makes the commissioner satisfy a sort of probable cause standard. Existing law already requires, however, that the regional commissioner "believe" that the church may be engaged in taxable activity -- to require that this belief be reasonably based on some evidence does not seem to be a radical departure from existing law. Senator Grassley's staff say they are open to fine-tuning this provision, and there may well be room to reach an accommodation. The general goal of

requiring IRS to have some grounds before putting churches through an often costly procedure is a good objective, provided it can be achieved without hamstringing IRS's legitimate enforcement activities.

- o IRS may not commence an investigation unless it first gives written notice to the church, including:
 - the sections of the Code under which IRS is authorized to proceed;
 - an explanation of the constitutional and other procedural rights of the organization;
 - an explanation of the concerns which give rise to the investigation;
 - description of evidence available to IRS to date;
 - statement of facts that IRS hopes to discover by holding the investigation.

COMMENT: Existing IRS regulations require written notice, and it is IRS's practice to give 30 days' notice, but without the details specified in this section. The first three above-listed items appear to be a positive step, since many churches could not afford skilled legal counsel to learn these items on their own. The last two items, however, may compromise the ability of IRS to conduct investigations -- this point needs to be further explored.

- o Before conducting an investigation, IRS must obtain concurrence of regional IRS counsel.

COMMENT: It would probably be better to rest on the judgment of the IRS regional commissioner, rather than giving review authority to an officer who is the regional commissioner's subordinate.

- o Before conducting an investigation, IRS must offer to meet with the church and discuss the issues at stake.

COMMENT: This appears to be a good provision, analogous to the conciliation proceedings required in other administrative contexts.

- o IRS must give 15 days' notice before conducting an examination of records, and must include in the notice a description of those church records and activities the IRS seeks to examine.

COMMENT: IRS already gives 30 days' notice, and this provision does not appear burdensome. There is a possibility that courts could step in to exclude any evidence gained from records and activities beyond those described by IRS in the notice -- but this problem could be alleviated by more specific legislative drafting.

- o IRS may only investigate religious activities of an organization claiming to be a church to the extent necessary to determine whether the organization is in fact a church, and IRS may investigate church records only to the extent necessary to determine the amount of tax imposed by this title.

COMMENT: This appears to be a reasonable limitation, similar to that already contained in Section 7605(c).

- o IRS must complete its investigations of churches within one year from the time it gives notice that it is commencing an investigation.

COMMENT: Some time limit seems appropriate, but whether one year is the appropriate figure depends on further information we will want to check with IRS.

- o For claims that IRS has violated the provisions of this act, churches may go into federal district court to obtain an injunction to prevent the Secretary from further action.

COMMENT: Prohibitory injunctive relief of this sort appears to be the most appropriate remedy, but the section should be carefully drafted to avoid giving excessive power to federal courts to control IRS investigations.

- o Churches that prevail in actions against the Secretary will be entitled to attorneys fees.

COMMENT: We need to check with IRS to learn the possible budgetary impact of this provision.

- o Three-year statute of limitations on actions by IRS to collect back taxes owed by churches.

COMMENT: This is a reasonable provision. There is generally a three-year statute of limitations for tax collection cases. The statute of limitations is waived if the taxpayer failed to file a return. Churches are not required to file returns. They should be given the three-year statute of limitations that applies to everyone else, rather than being treated the same as persons who are delinquent in failing to file returns.

- o Waives requirement for exhaustion of administrative remedies.

COMMENT: More information is needed to assess whether this provision is necessary to afford appropriate relief for churches when the IRS violates procedural provisions.

Current Law

Section 7605(c) of the Code currently provides that the Service cannot examine the books of account of a church (or a convention or association of churches) for the purpose of determining the organization's liability for unrelated business income tax, unless a Regional Commissioner believes that the organization is engaging in unrelated business activities and notifies the organization in advance of the examination. Section 7605(c) further provides that no examination of the religious activities of such an organization shall be made except to the extent necessary to determine whether the organization is a church or a convention or association of churches. Also, no examination of the books of account of the organization shall be made other than to the extent necessary to determine the amount of tax imposed by the Code.

Section 7605(c) was added to the Code by the Tax Reform Act of 1969, which extended the unrelated business income tax to churches. Section 7605(c) was intended to protect churches from unnecessary tax audits and the concomitant government intrusion into the internal financial matters of churches. See S. Rep. No. 91-552, 1969-3 C.B. 468.

Section 301.7605-1(c)(2) of the regulations liberally expands the bare statutory protections of section 7605(c). The regulation requires Regional Commissioner approval and notification prior to any examination of the "books of account" of any organization which is or claims to be a church, or a convention or association of churches. Unlike the statute, the regulation's prior approval and notification requirement is not limited to UBIT examinations of church "books of account". This again was a deliberate action taken by the Government to limit any intrusion into church affairs to the extent specifically approved by the Regional Commissioner. The regulation's requirement applied to examinations of church books of accounts for any purpose, e.g., determining charitable, estate and gift deductions, 501(c)(3) tax exempt status, verifying payments made to third-parties, and determining any other tax liability under the Code. The regulation requires that the Service must make at least two "pre-examination" contacts in writing to obtain the necessary information from the books of account. It is at this point that the Regional Commissioner must determine whether the examination is necessary because the information cannot be satisfactorily obtained in this manner. The Regional Commissioner then notifies the organization in writing at least 30 days in advance of the examination.

Proposed Bill

Section 2(a) of H.R. 2172 proposes to revamp the current section 7605(c) examination scheme.

Proposed section 7605(c)(1) would prevent the Service from commencing any investigation or proceeding (preliminary to a "formal" examination) to determine if a church (or a convention or association of churches) is liable for UBIT or does not qualify for exemption, unless the Regional Commissioner "possesses evidence" that leads him to reasonably believe that the church is engaging in unrelated business or is no longer exempt. This is a radical change from current standards, which are intended to secure information in the least intrusive manner, and would seriously hamstring the Service's ability to conduct necessary investigations. H.R. 2172's new evidentiary standard for church examinations would seem to preclude any traditional investigatory work done on the basis of allegation or third-party information and would preclude authorization for any church examination unless the Service possessed hard evidence establishing a prima facie case. (Although the bill does not spell out the new evidentiary standards, we assume that they are the ordinary standards used in court, because we perceive the thrust of this bill as the creation of several new, judicially reviewable standards for church examination.) Presumably, not meeting the new evidence standard would not only preclude authorization for church examination but also void an examination "improperly" authorized, regardless of the merits of the case.

Proposed section 7605(c)(2) would require the Service to notify the organization before any investigation is begun. This notice must include an explanation of the reasons for the investigation and a statement of the facts the Service hopes to determine from the investigation. It is probably the bill's intent to limit the investigation to the material set out in the notice. For example, if the notice states that the Service expects to find an unrelated business income liability, and the investigation unexpectedly uncovers evidence of inurement, the Service would not be allowed to use this evidence to revoke the organization's exempt status.

Proposed section 7605(c)(3) provides that no examination of church records or religious activities may be made unless the Regional Counsel concurs in the examination. The concurrence must follow the notification described in proposed section 7605(c)(4). This provision would give the Regional Counsel a veto over the Regional Commissioner's actions and would be inconsistent with current Service lines of authority.

Proposed section 7605(c)(4) requires a second notification if the Service wishes to examine any church records or religious activities. It is important to note that the proposal uses the words "church records" in lieu of the words "books of account" contained in the current law. This constitutes a significant expansion of the type of records subject to these special rules, and could be construed to include all third-party records, such as bank records. In addition, this second notice must contain a list of concerns which gave rise to the investigation, the legal and factual issues relevant to the case, and a description of all the evidence discovered to date. We believe that this last requirement would be particularly harmful to the Service's ability to conduct any fraud investigations involving church activities. It would seriously inhibit the Service's ability to develop criminal cases against mail-order ministries, tax protestor groups using a claim of church status as a shield, and cases where church organizations are being used as covers for illicit drug operations. Releasing evidence to such groups, or even acknowledging the existence of an investigation, could undermine the ability of the Service and other law enforcement agencies to prosecute such cases. As part of the second notice, the Service must offer the organization a conference to discuss the allegations in the notice. It is unclear from the proposed law who is required to hold the conference. However, the bill could be read as requiring the Regional Commissioner to personally hold the conference, since he is personally required to send the notice.

Proposed section 7605(c)(5) requires that if the Service still intends to proceed with an examination after Regional Counsel review, a third notice must be sent informing the organization of this fact. This third notice is a final notice of examination.

Proposed section 7605(c)(6) restates the last sentence of current section 7605(c). This provision indicates that the Service cannot examine churches except to the extent necessary to determine the amount of taxes imposed by the Code.

Proposed section 7605(c)(7) requires the Service to make a decision on the merits within 365 days after the date of the first notification of investigation described above. This period is extended for any time during which the organization initiates a judicial proceeding to challenge the investigation, or during which the organization refuses a reasonable request for records. Given the three-notice requirement of the law, the possible pre-examination conference, and the requirement that both the Regional Commissioner and the Regional Counsel approve the examination, we do not feel that the Service could complete a complicated church examination within the 365-day period without affecting the quality of the examination and the technical review of the issue. The time limitation would create particularly serious problems in cases referred for criminal investigation. The bill

could result in making investigations (and subsequent examinations) practically impossible. Further, the bill is unclear whether the period will be suspended if the Service is forced to litigate to enforce a summons. Arguably, if the court determined that any request in the summons is not reasonable, the period would not be suspended. In addition, the law fails to make any provision for the Service and the organization to agree to extend the 365-day period. If this is the case, the rule could well force the Service to resort to its jeopardy assessment powers against an organization where the 365-day period was coming to a close and there was need to protect the government's interest on a tax due.

Section 2(b) of H.R. 2172 provides a special statute of limitations rule for churches. Under the rule, any tax imposed under the Code, not just unrelated business income tax, must be assessed within three years of the due date of the return, whether or not any return is actually filed. This has great potential for abuse since churches are not required to file any information returns on their tax exempt status and only a small percentage of all churches file unrelated business income tax returns.

Finally, section 2(c) of H.R. 2172 would amend section 7428(b) to allow a church to seek a declaratory judgment as soon as the Service notifies it that the Service intends to revoke its church status. This provision is probably intended to cover revocations of section 501(c)(3) exempt status also. Section 7428 currently provides that an organization can seek declaratory judgment when the Service revokes its section 501(c)(3) tax exempt status or modifies or denies its status as a church. The right to this procedure comes only after the organization has exhausted all of its administrative rights. While this amendment fails to define what type of notice is intended, arguably, the initial notice of an examination for the purpose of developing information to revoke exemption might satisfy this requirement. Theoretically, we could never complete an examination and the appeal procedure before judicial review. The act also seems to add UBIT to the issues subject to declaratory judgments.

Conclusion

In sum, we view H.R. 2172 as an attempt to prohibit most church investigations and examinations, and to severely limit the Service's ability to pursue the few examinations permissible under the proposal. We think that the intent of the bill is to insulate churches from reasonable Service review of their compliance with the tax law. We cannot agree with that goal. In addition, we believe that the unintended result of H.R. 2172 would be a virtual license (due to the Service's inability to investigate) for mail-order ministries and tax protestors to use church status as a shield for their tax evasion activities.

OFFICE OF POLICY DEVELOPMENT

STAFFING MEMORANDUM

DATE: August 15 ACTION/CONCURRENCE/COMMENT DUE BY: cob August 18SUBJECT: ADMINISTRATION POSITION ON H.R. 2977, CHURCH AUDITPROCEDURES ACT

	ACTION	FYI		ACTION	FYI
HARPER	☐	☐	DRUG POLICY	☐	☐
PORTER	☐	☐	TURNER	☐	☐
BARR	☐	☐	D. LEONARD	☐	☐
BLED SOE	☐	☐	OFFICE OF POLICY INFORMATION		
BOGGS	☐	☐	HOPKINS	☐	☐
BRADLEY	☐	☐	PROPERTY REVIEW BOARD	☐	☐
CARLESON	☐	☐	OTHER		
DENEND	☐	☐	<u>Janice Farrell</u>	☐	☒
GALEBACH	☒	☐		☐	☒
GARFINKEL	☒	☐		☐	☐
GUNN	☐	☐		☐	☐
B. LEONARD	☐	☐		☐	☐
LI	☐	☐		☐	☐
McALLISTER	☐	☐		☐	☐
MONTOYA	☐	☐		☐	☐
ROPER	☐	☐		☐	☐
SMITH	☐	☐		☐	☐
SWEET	☐	☐		☐	☐
UHLMANN	☐	☐		☐	☐
ADMINISTRATION	☐	☐		☐	☐

REMARKS:

Please return this tracking
sheet with your responseEdwin L. Harper
Assistant to the President
for Policy Development
(x6515)

THE WHITE HOUSE

WASHINGTON

August 15, 1983

MEMORANDUM FOR STEPHEN H. GALEBACH

FROM: ROGER B. PORTER *rbp*

SUBJECT: Administration Position on H.R. 2977, Church Audit Procedures Act

As the attached memorandum from M. B. Oglesby indicates, Congressman Mickey Edwards has requested Administration support for his legislation, H.R. 2977. I would appreciate very much if you would determine what the current procedural requirements are, how this legislation would alter those requirements, and what you see as the principal advantages and disadvantages, if any, in the Administration supporting this legislation.

I would also appreciate your determining whether or not any similar legislation has been introduced in the past, and if the Administration has taken any position on it.

I would like to have this analysis by close of business on Thursday, August 18. If this is not possible, please let me know.

Attachment

THE WHITE HOUSE

WASHINGTON

August 1, 1983

3 AUG 1983

MEMORANDUM FOR ED MEESE

THRU: KEN DUBERSTEIN *K-D*
FROM: M. B. OGLESBY, JR. *MB*
SUBJECT: Administration Position On H.R. 2977,
Church Audit Procedures Act

Congressman Mickey Edwards (R-Oklahoma) has requested Administration support for this legislation. Senator Grassley (R-Iowa) has introduced similar legislation, S. 1262, in the Senate. This legislation is supported by the National Association of Evangelicals, the National Council of Christians and Jews, the National Council of Churches, etc.

Mickey explains that these procedural requirements for the IRS are consistent with our philosophy and Edwards urges that the Administration consider supporting his proposal.

Guidance, please.

cc: Roger Porter
Joe Wright

MEMORANDUM

THE WHITE HOUSE

WASHINGTON

September 23, 1983

FOR: JOHN A. SVAHN
FROM: MICHAEL M. UELMANN
SUBJECT: Church Audit Procedures Act

We have a good opportunity here to get out front on a bill that has strong support from the President's religious constituency. Unless there is prompt action by the White House, however, Treasury and IRS will testify against the bill next Friday.

The attached memo of September 19 from Oglesby and Duberstein gives a quick summary of the legislative situation. I have confirmed that the bill does have strong and enthusiastic support from religious groups, especially those who most favor the President. The bill has 70 cosponsors in the House. There does not seem to be any organized political opposition. Politically, it makes no sense to testify against the bill.

I understand that Ed Meese is inclined, tentatively at least, to support this legislation. Ken Cribb is likely to schedule this topic for a meeting early next week -- probably the 8:30 meeting on Monday.

To bring you up to speed on the legal considerations involved here, I have attached a memo Steve Galebach prepared last month in response to an earlier query from Legislative Affairs.

22 SEP 1983

THE WHITE HOUSE

WASHINGTON

September 19, 1983

MEMORANDUM FOR JAMES A. BAKER
EDWIN MEESE
MICHAEL DEEVER
DAVE STOCKMAN
FAITH WHITTLESEY

THRU: KENNETH M. DUBERSTEIN *Kr D.*
FROM: M. B. OGLESBY, JR. *MO*
SUBJECT: Church Audit Procedures Act

On May 11, 1983, Congressman Mickey Edwards (R-OK), with a group of bipartisan co-sponsors, introduced H.R. 2977, the Church Audit Procedures Act. The legislation amends the Internal Revenue Code to improve IRS procedures concerning investigations and audits of churches. The bill is supported by such diverse groups as the National Conference of Christians and Jews, the National Association of Evangelicals, the New York Civil Liberties Union (ACLU-affiliate), the Moral Majority and Christian Voice.

Congressman Edwards has been seeking an Administration endorsement of this legislation. The office of Tax Policy at the Treasury Department has recommended Administration opposition to H.R. 2977. Treasury officials are scheduled to testify before the House Ways and Means Committee on September 30, and will convey the position developed by the Office of Tax Policy unless the decision is reversed prior to that time.

The Church Audit Procedures Act has the endorsement of many conservative supporters of the President and of his core constituency in the conservative movement. Interestingly, the bill also has the support and has been co-sponsored by Members as liberal as George Crockett (D-MI) and Ron Dellums (D-CA).

Because this legislation is supported by such diverse groups and by Members from all parts of the political spectrum, I hope that we can review our position and avoid the probable adverse reaction from some of our friends in the Congress.

Guidance, pls.

MEMORANDUM

THE WHITE HOUSE

WASHINGTON

August 18, 1983

FOR: ROGER B. PORTER
FROM: STEPHEN H. GALEBACH *SHG*
SUBJECT: Administration Position on Church Audit Procedures Act

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I have summarized the existing state of the law and the changes that would be made by the Church Audit Procedures Act in Attachment A. Attachment A includes comments on the advantages and disadvantages of the various provisions, and compares these proposals to existing regulatory provisions.

In general, I believe this act is a rather modest and basically responsible way to address a thorny problem. The problem is that IRS needs to be able to investigate fraudulent claims of church status, while not encroaching upon legitimate churches in ways that would infringe First Amendment rights. This problem is aggravated by the fact that many churches are small, with such limited financial resources that merely having to defend against an IRS investigation is often crippling.

Politically, a broad spectrum of the religious community has become concerned in recent years over several cases in which the IRS placed heavy burdens on small churches which turned out to be legitimate churches after costly and lengthy proceedings. As a result of the widespread public concern -- ranging from the liberal National Council of Churches to the conservative National Association of Evangelicals -- there are now 62 co-sponsors for the House bill.

The bill does have a number of problems, as indicated in the comments in Attachment A, that require some fine-tuning. But the basic concept of protecting legitimate churches while allowing IRS investigation of fraudulent ones, is a worthy objective and deserves our support.

I believe our best position is to offer general support for the concept of the bill, while working with Senator Grassley and Cong. Edwards to alleviate any problems that IRS and Treasury may see in the bill. Senator Grassley's staff are flexible on the details of the bill.

Senator Grassley has scheduled hearings for September 30 on the issues covered by this bill, in his Oversight Subcommittee of the Senate Finance Committee.

Unfortunately, IRS has sent comments on this bill to Senator Grassley without going through the OMB clearance process. Attachment B, which was sent to Senator Grassley by IRS with a cover letter dated July 7, adopts a strongly negative and hostile tone. The letter exaggerates the problems in the bill, shows no sensitivity to the basic concerns underlying the broad support for the bill, and shows no willingness to work constructively toward solving whatever problems do exist in the bill.

We need to correct the damage done by the IRS letter and come to a reasoned, Administration-wide position on the bill.

Recommendations

- o Have IRS retract the letter they sent to Grassley without clearance.
- o Convene a meeting of interested persons from IRS, Treasury, OMB, and OPD, to discuss the pros and cons of the various provisions in the bill.
- o Arrive at an Administration position in time to give testimony in Grassley's subcommittee by September 30.

Note: A similar bill was introduced last session by Cong. Edwards, H.R.7128, but we took no position on it.

Summary and Comment on Church Audit Procedures Act

The Church Audit Procedures Act, introduced by Congressman Edwards as H.R.2977 and by Senator Grassley as S.1262, expands the protection that existing law gives to churches in audits by the IRS.

Existing Law

Section 7605(c) - Restriction on Examination of Churches - provides as follows:

- o In determining whether a church is subject to unrelated business income tax, the IRS may not examine the books of a church unless the regional commissioner believes that the organization in question may be engaged in activities subject to the tax and so notifies the organization in advance of the examination.
- The IRS may examine the religious activities of a church only to the extent necessary to determine whether the organization is in fact a church.
- The IRS may examine the books of account of a church only to the extent necessary to determine the amount of tax due.

(This provision was added to the Code in 1969, at the same time that Congress amended the Code to make churches subject to tax on unrelated business income.)

Church Audit Procedures Act

The new act is drafted as an amendment to Section 7605(c), adding the following provisions:

- o The IRS may not investigate a church to see if it is subject to unrelated business income tax or to see if it is truly a church, unless the regional commissioner "possesses evidence which leads him to reasonably believe" that such church is subject to tax.

COMMENT: The IRS believes this to be a "radical change," because it makes the commissioner satisfy a sort of probable cause standard. Existing law already requires, however, that the regional commissioner "believe" that the church may be engaged in taxable activity -- to require that this belief be reasonably based on some evidence does not seem to be a radical departure from existing law. Senator Grassley's staff say they are open to fine-tuning this provision, and there may well be room to reach an accommodation. The general goal of

requiring IRS to have some grounds before putting churches through an often costly procedure is a good objective, provided it can be achieved without hamstringing IRS's legitimate enforcement activities.

- o IRS may not commence an investigation unless it first gives written notice to the church, including:
 - the sections of the Code under which IRS is authorized to proceed;
 - an explanation of the constitutional and other procedural rights of the organization;
 - an explanation of the concerns which give rise to the investigation;
 - description of evidence available to IRS to date;
 - statement of facts that IRS hopes to discover by holding the investigation.

COMMENT: Existing IRS regulations require written notice, and it is IRS's practice to give 30 days' notice, but without the details specified in this section. The first three above-listed items appear to be a positive step, since many churches could not afford skilled legal counsel to learn these items on their own. The last two items, however, may compromise the ability of IRS to conduct investigations -- this point needs to be further explored.

- o Before conducting an investigation, IRS must obtain concurrence of regional IRS counsel.

COMMENT: It would probably be better to rest on the judgment of the IRS regional commissioner, rather than giving review authority to an officer who is the regional commissioner's subordinate.

- o Before conducting an investigation, IRS must offer to meet with the church and discuss the issues at stake.

COMMENT: This appears to be a good provision, analogous to the conciliation proceedings required in other administrative contexts.

- o IRS must give 15 days' notice before conducting an examination of records, and must include in the notice a description of those church records and activities the IRS seeks to examine.

COMMENT: IRS already gives 30 days' notice, and this provision does not appear burdensome. There is a possibility that courts could step in to exclude any evidence gained from records and activities beyond those described by IRS in the notice -- but this problem could be alleviated by more specific legislative drafting.

- o IRS may only investigate religious activities of an organization claiming to be a church to the extent necessary to determine whether the organization is in fact a church, and IRS may investigate church records only to the extent necessary to determine the amount of tax imposed by this title.

COMMENT: This appears to be a reasonable limitation, similar to that already contained in Section 7605(c).

- o IRS must complete its investigations of churches within one year from the time it gives notice that it is commencing an investigation.

COMMENT: Some time limit seems appropriate, but whether one year is the appropriate figure depends on further information we will want to check with IRS.

- o For claims that IRS has violated the provisions of this act, churches may go into federal district court to obtain an injunction to prevent the Secretary from further action.

COMMENT: Prohibitory injunctive relief of this sort appears to be the most appropriate remedy, but the section should be carefully drafted to avoid giving excessive power to federal courts to control IRS investigations.

- o Churches that prevail in actions against the Secretary will be entitled to attorneys fees.

COMMENT: We need to check with IRS to learn the possible budgetary impact of this provision.

- o Three-year statute of limitations on actions by IRS to collect back taxes owed by churches.

COMMENT: This is a reasonable provision. There is generally a three-year statute of limitations for tax collection cases. The statute of limitations is waived if the taxpayer failed to file a return. Churches are not required to file returns. They should be given the three-year statute of limitations that applies to everyone else, rather than being treated the same as persons who are delinquent in failing to file returns.

- o Waives requirement for exhaustion of administrative remedies.

COMMENT: More information is needed to assess whether this provision is necessary to afford appropriate relief for churches when the IRS violates procedural provisions.

Current Law

Section 7605(c) of the Code currently provides that the Service cannot examine the books of account of a church (or a convention or association of churches) for the purpose of determining the organization's liability for unrelated business income tax, unless a Regional Commissioner believes that the organization is engaging in unrelated business activities and notifies the organization in advance of the examination. Section 7605(c) further provides that no examination of the religious activities of such an organization shall be made except to the extent necessary to determine whether the organization is a church or a convention or association of churches. Also, no examination of the books of account of the organization shall be made other than to the extent necessary to determine the amount of tax imposed by the Code.

Section 7605(c) was added to the Code by the Tax Reform Act of 1969, which extended the unrelated business income tax to churches. Section 7605(c) was intended to protect churches from unnecessary tax audits and the concomitant government intrusion into the internal financial matters of churches. See S. Rep. No. 91-552, 1969-3 C.B. 468.

Section 301.7605-1(c)(2) of the regulations liberally expands the bare statutory protections of section 7605(c). The regulation requires Regional Commissioner approval and notification prior to any examination of the "books of account" of any organization which is or claims to be a church, or a convention or association of churches. Unlike the statute, the regulation's prior approval and notification requirement is not limited to UBIT examinations of church "books of account". This again was a deliberate action taken by the Government to limit any intrusion into church affairs to the extent specifically approved by the Regional Commissioner. The regulation's requirement applied to examinations of church books of accounts for any purpose, e.g., determining charitable, estate and gift deductions, 501(c)(3) tax exempt status, verifying payments made to third-parties, and determining any other tax liability under the Code. The regulation requires that the Service must make at least two "pre-examination" contacts in writing to obtain the necessary information from the books of account. It is at this point that the Regional Commissioner must determine whether the examination is necessary because the information cannot be satisfactorily obtained in this manner. The Regional Commissioner then notifies the organization in writing at least 30 days in advance of the examination.

Proposed Bill

Section 2(a) of H.R. 2172 proposes to revamp the current section 7605(c) examination scheme.

Proposed section 7605(c)(1) would prevent the Service from commencing any investigation or proceeding (preliminary to a "formal" examination) to determine if a church (or a convention or association of churches) is liable for UBIT or does not qualify for exemption, unless the Regional Commissioner "possesses evidence" that leads him to reasonably believe that the church is engaging in unrelated business or is no longer exempt. This is a radical change from current standards, which are intended to secure information in the least intrusive manner, and would seriously hamstring the Service's ability to conduct necessary investigations. H.R. 2172's new evidentiary standard for church examinations would seem to preclude any traditional investigatory work done on the basis of allegation or third-party information and would preclude authorization for any church examination unless the Service possessed hard evidence establishing a prima facie case. (Although the bill does not spell out the new evidentiary standards, we assume that they are the ordinary standards used in court, because we perceive the thrust of this bill as the creation of several new, judicially reviewable standards for church examination.) Presumably, not meeting the new evidence standard would not only preclude authorization for church examination but also void an examination "improperly" authorized, regardless of the merits of the case.

Proposed section 7605(c)(2) would require the Service to notify the organization before any investigation is begun. This notice must include an explanation of the reasons for the investigation and a statement of the facts the Service hopes to determine from the investigation. It is probably the bill's intent to limit the investigation to the material set out in the notice. For example, if the notice states that the Service expects to find an unrelated business income liability, and the investigation unexpectedly uncovers evidence of inurement, the Service would not be allowed to use this evidence to revoke the organization's exempt status.

Proposed section 7605(c)(3) provides that no examination of church records or religious activities may be made unless the Regional Counsel concurs in the examination. The concurrence must follow the notification described in proposed section 7605(c)(4). This provision would give the Regional Counsel a veto over the Regional Commissioner's actions and would be inconsistent with current Service lines of authority.

Proposed section 7605(c)(4) requires a second notification if the Service wishes to examine any church records or religious activities. It is important to note that the proposal uses the words "church records" in lieu of the words "books of account" contained in the current law. This constitutes a significant expansion of the type of records subject to these special rules, and could be construed to include all third-party records, such as bank records. In addition, this second notice must contain a list of concerns which gave rise to the investigation, the legal and factual issues relevant to the case, and a description of all the evidence discovered to date. We believe that this last requirement would be particularly harmful to the Service's ability to conduct any fraud investigations involving church activities. It would seriously inhibit the Service's ability to develop criminal cases against mail-order ministries, tax protestor groups using a claim of church status as a shield, and cases where church organizations are being used as covers for illicit drug operations. Releasing evidence to such groups, or even acknowledging the existence of an investigation, could undermine the ability of the Service and other law enforcement agencies to prosecute such cases. As part of the second notice, the Service must offer the organization a conference to discuss the allegations in the notice. It is unclear from the proposed law who is required to hold the conference. However, the bill could be read as requiring the Regional Commissioner to personally hold the conference, since he is personally required to send the notice.

Proposed section 7605(c)(5) requires that if the Service still intends to proceed with an examination after Regional Counsel review, a third notice must be sent informing the organization of this fact. This third notice is a final notice of examination.

Proposed section 7605(c)(6) restates the last sentence of current section 7605(c). This provision indicates that the Service cannot examine churches except to the extent necessary to determine the amount of taxes imposed by the Code.

Proposed section 7605(c)(7) requires the Service to make a decision on the merits within 365 days after the date of the first notification of investigation described above. This period is extended for any time during which the organization initiates a judicial proceeding to challenge the investigation, or during which the organization refuses a reasonable request for records. Given the three-notice requirement of the law, the possible pre-examination conference, and the requirement that both the Regional Commissioner and the Regional Counsel approve the examination, we do not feel that the Service could complete a complicated church examination within the 365-day period without affecting the quality of the examination and the technical review of the issue. The time limitation would create particularly serious problems in cases referred for criminal investigation. The bill

could result in making investigations (and subsequent examinations) practically impossible. Further, the bill is unclear whether the period will be suspended if the Service is forced to litigate to enforce a summons. Arguably, if the court determined that any request in the summons is not reasonable, the period would not be suspended. In addition, the law fails to make any provision for the Service and the organization to agree to extend the 365-day period. If this is the case, the rule could well force the Service to resort to its jeopardy assessment powers against an organization where the 365-day period was coming to a close and there was need to protect the government's interest on a tax due.

Section 2(b) of H.R. 2172 provides a special statute of limitations rule for churches. Under the rule, any tax imposed under the Code, not just unrelated business income tax, must be assessed within three years of the due date of the return, whether or not any return is actually filed. This has great potential for abuse since churches are not required to file any information returns on their tax exempt status and only a small percentage of all churches file unrelated business income tax returns.

Finally, section 2(c) of H.R. 2172 would amend section 7428(b) to allow a church to seek a declaratory judgment as soon as the Service notifies it that the Service intends to revoke its church status. This provision is probably intended to cover revocations of section 501(c)(3) exempt status also. Section 7428 currently provides that an organization can seek declaratory judgment when the Service revokes its section 501(c)(3) tax exempt status or modifies or denies its status as a church. The right to this procedure comes only after the organization has exhausted all of its administrative rights. While this amendment fails to define what type of notice is intended, arguably, the initial notice of an examination for the purpose of developing information to revoke exemption might satisfy this requirement. Theoretically, we could never complete an examination and the appeal procedure before judicial review. The act also seems to add UBIT to the issues subject to declaratory judgments.

Conclusion

In sum, we view H.R. 2172 as an attempt to prohibit most church investigations and examinations, and to severely limit the Service's ability to pursue the few examinations permissible under the proposal. We think that the intent of the bill is to insulate churches from reasonable Service review of their compliance with the tax law. We cannot agree with that goal. In addition, we believe that the unintended result of H.R. 2172 would be a virtual license (due to the Service's inability to investigate) for mail-order ministries and tax protestors to use church status as a shield for their tax evasion activities.

OFFICE OF POLICY DEVELOPMENT

STAFFING MEMORANDUM

DATE: August 15 ACTION/CONCURRENCE/COMMENT DUE BY: cob August 18SUBJECT: ADMINISTRATION POSITION ON H.R. 2977, CHURCH AUDITPROCEDURES ACT

	ACTION	FYI		ACTION	FYI
HARPER	☐	☐	DRUG POLICY	☐	☐
PORTER	☐	☐	TURNER	☐	☐
BARR	☐	☐	D. LEONARD	☐	☐
BLED SOE	☐	☐	OFFICE OF POLICY INFORMATION		
BOGGS	☐	☐	HOPKINS	☐	☐
BRADLEY	☐	☐	PROPERTY REVIEW BOARD	☐	☐
CARLESON	☐	☐	OTHER		
DENEND	☐	☐	<u>Justice Foreil</u>	☐	☒
GALEBACH	☒	☐		☐	☒
GARFINKEL	☒	☐		☐	☐
GUNN	☐	☐		☐	☐
B. LEONARD	☐	☐		☐	☐
LI	☐	☐		☐	☐
McALLISTER	☐	☐		☐	☐
MONTAYA	☐	☐		☐	☐
ROPER	☐	☐		☐	☐
SMITH	☐	☐		☐	☐
SWEET	☐	☐		☐	☐
UHLMANN	☐	☐		☐	☐
ADMINISTRATION	☐	☐		☐	☐

REMARKS:

Please return this tracking
sheet with your responseEdwin L. Harper
Assistant to the President
for Policy Development
(x6515)

THE WHITE HOUSE

WASHINGTON

August 15, 1983

MEMORANDUM FOR STEPHEN H. GALEBACH

FROM: ROGER A. PORTER *REP*

SUBJECT: Administration Position on H.R. 2977, Church Audit Procedures Act

As the attached memorandum from M. B. Oglesby indicates, Congressman Mickey Edwards has requested Administration support for his legislation, H.R. 2977. I would appreciate very much if you would determine what the current procedural requirements are, how this legislation would alter those requirements, and what you see as the principal advantages and disadvantages, if any, in the Administration supporting this legislation.

I would also appreciate your determining whether or not any similar legislation has been introduced in the past, and if the Administration has taken any position on it.

I would like to have this analysis by close of business on Thursday, August 18. If this is not possible, please let me know.

Attachment

THE WHITE HOUSE

WASHINGTON

August 1, 1983

3 AUG 1983

MEMORANDUM FOR ED MEESE

TO: BEN DUBERSTEIN *to D.*
FROM: M. B. OGLESBY, *MB*
SUBJECT: Administration Position On H.R. 2977,
Church Audit Procedures Act

Congressman Mickey Edwards (R-Oklahoma) has requested Administration support for this legislation. Senator Grassley (R-Iowa) has introduced similar legislation, S. 1262, in the Senate. This legislation is supported by the National Association of Evangelicals, the National Council of Christians and Jews, the National Council of Churches, etc.

Mickey explains that these procedural requirements for the IRS are consistent with our philosophy and Edwards urges that the Administration consider supporting his proposal.

Guidance, please.

cc: Roger Porter
Joe Wright