

CHURCH OF SCIENTOLOGY INTERNATIONAL
and
RELIGIOUS TECHNOLOGY CENTER

SUPPLEMENTAL SUBMISSION
PART I

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Ex. I-11

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TABLE OF EXHIBITS

<u>Exhibit</u>	<u>Description</u>
G-1	"DIANETICS Modern Science of Mental Health" softcover
G-2	"DIANETICS Modern Science of Mental Health" hardcover
G-3	"Organization Executive Course" Basic Staff Volume O
G-4	Literary Agreement, dated June 1, 1982 between L. Ron Hubbard and New Era Productions ApS
G-5	Sublicense Agreement, dated June 8, 1982, between New Era Publications ApS and Bridge Publications, Inc.
G-6	Sublicense Agreement, dated March 15, 1983, between New Era Publications ApS and Bridge Publications, Inc.
G-7	Amendment to March 15, 1983, Sublicense Agreement, dated February 1, 1985, between New Era Publications ApS and Bridge Publications, Inc.
G-8	Declaration of Stephen Conland
G-9	Declaration of Glen Ruh
G-10	Sublicense Agreement, dated August 19, 1982, between New Era Publications ApS and Bridge Publications, Inc.
G-11	Amendment to August 19, 1982, Sublicense Agreement, dated February 1, 1985, between New Era Publications ApS and Bridge Publications, Inc.
G-12	Agreement (E-Meter), dated August 19, 1982, between L. Ron Hubbard and New Era Publications ApS
G-13	Declaration of Dudley B. Smith
G-14	Declaration of Cruzan Alexander

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<u>Exhibit</u>	<u>Description</u>
G-15	Sublicense Agreement, dated January 2, 1986, effective as of June 8, 1982, between New Era Publications, Aps and Bridge Publications, Inc.
G-16	License Agreement, dated May 28, 1982, between Lafayette Ronald Hubbard and New Era Publications
G-17	Declaration of Jack R. Revoyr
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H-2	Package -- Dissemination of the Technology
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H-13	Package -- Church Publications
H-14	Package -- Support of Church Staff
J-1	<u>National Geographic, March 1987</u>
J-2	<u>Abramson, H.S. National Geographic: Behind America's Lens on the World (1987)</u>

TABLE OF EXHIBITS (concluded)

<u>Exhibit</u>	<u>Description</u>
J-3	The National Geographic Society 1983 IRS Form 990
J-4	The National Geographic Society 1984 IRS Form 990
J-5	Testimony of U.S. Cartographic Industry Members to the Subcommittee on Oversight Regarding the Review of Unrelated Business Income Tax (July 17, 1987).

I. Procedural Background

This submission (the "Supplemental Submission") is being filed jointly by the Church of Scientology International ("CSI") and Religious Technology Center ("RTC") for the purpose of supplementing the administrative record with respect to the determination of their exemption under section 501(c)(3) of the Code. This submission embodies certain facts and legal arguments discussed during the January 1987 conference at the National Office.

CSI and RTC applied for recognition of their exemption under section 501(c)(3) on April 22, 1983 and May 23, 1983, respectively. Between then and July 26, 1985, the Service issued a series of eight letters to CSI and six letters to RTC requesting a substantial amount of additional information on the details of their religious, ecclesiastical and financial affairs. CSI and RTC provided the IRS with extensive responses to these requests.

Subsequently, on January 7, 1986, the Service issued very lengthy initial adverse determination letters to CSI and RTC (63 pages to CSI and 70 pages to RTC) that

primarily dealt with factual and legal issues pertaining to activities conducted by CSI and RTC and, to a lesser extent, with factual and legal issues concerning the activities of Church of Spiritual Technology ("CST"), another Church of Scientology whose application for exemption has been pending before the National Office since 1983. These letters are virtually identical and are referred to individually as the "CSI Letter" or the "RTC Letter" and collectively as the "Initial Letter."

The Initial Letter tentatively determined that CSI and RTC are not entitled to exemption because they are not organized and operated exclusively for exempt purposes and because they failed to establish that they are entitled to exempt status. In particular, the Initial Letter concluded that these organizations benefited the private interests of L. Ron Hubbard through various licensing and assignment arrangements and through their "commercial-like" activities.

On July 4, 1986, CSI, RTC and CST filed an extensive protest (the "Protest") that compiled for the first time all the facts and legal arguments that had been raised over the exemption proceedings. The Protest consisted of 125 pages of detailed factual discussion and over 240 pages of argument. The Protest countered each and every

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one of the challenges contained in the Initial Letter. It also showed that the whole underpinning for the Service's position -- benefit to Mr. Hubbard -- evaporated with his death.

Subsequently, CSI, RTC and CST conferred with the Service at the National Office (the "Conference") to discuss the factual information and legal issues contained in the Initial Letter and the Protest. The Conference began on January 14. By the time it ended, six days later, the issues raised by the Service in the Initial Letter had been substantially narrowed or clarified.

As a preliminary matter, the Service acknowledged that with the amendments to their articles of incorporation, CSI, RTC and CST now are organized exclusively for exempt purposes. The Service also agreed to withdraw its position on private benefit for periods after Mr. Hubbard's death if CST demonstrates that his estate in fact is to be distributed as represented at the Conference.

Most of the issues discussed at the Conference related to activities conducted by or associated with CSI or RTC and can be classified in two basic categories --

private benefit for periods before Mr. Hubbard's death, and commercialism. With respect to private benefit, the Service focused primarily on the relationship between the Scientology religion and Mr. Hubbard, including the licensing and assignment arrangements among Mr. Hubbard, Scientology Churches, and two Church-controlled publishing companies, Bridge Publications, Inc. ("Bridge") and New Era Publications International, APS ("NEP"). The Service also inquired into certain Church-sponsored activities in support of these arrangements. The issues raised by the Service with respect to commercialism dealt primarily with the pricing of religious books, services and materials, the amount and management of Church reserves, certain "commercial-like" activities such as advertising and the payment of commissions, and a perceived overall concern with profits in general.

Very few of the substantive issues discussed during the Conference related directly to CST. Basically, the Service put forth the position that CST is so closely "connected" to CSI and RTC (and was to Mr. Hubbard) that its exemption should turn on the basis of their activities. CST pointed out that it is a separate and autonomous entity from CSI and RTC, that its application presents factual and legal issues unique only to it, and

that its exemption must therefore be determined independently of theirs. Consequently, on May 21, 1987, CSI submitted a separate supplemental submission that concerned only those issues pertaining to its exempt status, including the distribution of Mr. Hubbard's estate.

CSI and RTC now are filing their Supplemental Submission. It will be filed in two parts. This document, Part I, encompasses all factual and legal issues relating to commercialism. Part II, to be submitted within two months' time, will encompass all factual and legal issues related to benefit prior to Mr. Hubbard's death and will describe in detail the licensing and assignment arrangements with CSI and RTC and the important roles Bridge and NEP play in furthering the Scientology religion.

CSI and RTC estimate that the Service has asked several hundred questions over the course of their lengthy determination proceedings. CSI and RTC have endeavored to meet each and every issue the Service has raised but are concerned that one or two issues may have slipped by in this unprecedented onslaught of questioning. CSI and RTC therefore request the Service to inform them of any outstanding issue that may not have been addressed to its satisfaction.

This Supplemental Submission presents facts and arguments the Service has yet to address. Indeed, the death of Mr. Hubbard alone requires the Service to alter radically the position it has taken up to now. Fundamental fairness requires that CSI and RTC be given a written statement of the Service's new position, including the facts on which it is based, and have the opportunity to respond if the Service's new position is still adverse. Consequently, if the Service tentatively proposes to deny exemption in light of these additional facts and arguments, CSI and RTC respectfully request the opportunity to discuss the Service's concerns at a conference at the National Office.

II. Examination of a Church's "Commercial-Like" Activities is Prohibited by the Constitution

The Service's tentative finding in the Initial Letter that the Churches fulfill their conceded religious mission in a manner that serves an overriding commercial purpose directly contravenes the clear dictates of the First Amendment to the Constitution. The Service's inquiry based upon certain perceived "commercial factors" fosters excessive church/state entanglement in violation of the Establishment Clause.

The Establishment Clause prohibits extensive and ongoing governmental inspection of religious organizations on the grounds that it leads to a degree of entanglement that is detrimental to both government and religion. The Supreme Court has recognized the right to Church autonomy free from state interference in a series of cases. These cases explicitly recognize an organization's right to decide, free from governmental interference, matters of Church government^{1/}, Church

^{1/} Corporation of the Presiding Bishop of the Church of Jesus Christ of Latter Day Saints v. Amos, U.S. ___, 55 USLW 5005 (June 24, 1987). Kedroff v. Saint Nicholas Cathedral, 344 U.S. 94, 116 (1952)

administration^{2/}, the operation of Churches^{3/}, and all matters of faith and doctrine.^{4/} Churches have the unfettered right to select their own leaders,^{5/} define their own doctrines,^{6/} resolve their own disputes^{7/} and run their own institutions.^{8/} These rights include the fundamental freedoms to carry on religious activities,^{9/} to build churches and schools,^{10/} to conduct worship services,^{11/} to engage in the sacraments of the religion,^{12/} to spread the faith^{13/} and to solicit funds to further a religious mission.^{14/} These freedoms are intrinsic to the very existence of religions and are fundamental to First Amendment jurisprudence.

2/ Serbian Eastern Orthodox Diocese v. Milivojevic, 426 U.S. 696, 710 (1976).

3/ Kedroff, supra, 344 U.S. at 107-108.

4/ Serbian Orthodox, supra, 426 U.S. at 710.

5/ Gonzales v. Roman Catholic Arch Bishop, 280 U.S. 1 (1929). (Decided on common law grounds); Kreshik v. Saint Nicholas Cathedral of the Russian Orthodox Church, 363 U.S. 190 (1960) (per curiam).

6/ Presbyterian Church v. Mary Elizabeth Blue Hull Memorial Presbyterian Church, 393 U.S. 440, 449 (1969)

7/ Jones v. Wolf, 443 U.S. 595 (1979); Watson v. Jones, 80 U.S. 33 Wall. 679 (1871) (decided on common law grounds). (13 Wall.)

[Footnotes continued on next page]

The Establishment clause also prohibits repeated governmental intrusion through regulation and inspection into a Church's financial affairs. Tilton v. Richardson, 403 U.S. 672, 688 (1971); Walz v. Tax Commission, 397 U.S. 664, 689 (1970) (Brennan, J. concurring); Surinach v. Pesquera de Busquets, 604 F.2d 73, 78-79 (1st Cir. 1979).

The Service does not -- and cannot -- argue that the Church's religious program is a sham or that it lacks substance. The Church possesses a rich and extensive system of beliefs and program of religious services that provides spiritual fulfillment to its thousands upon thousands of adherents. Yet, the

(Footnotes continued from previous page)

8/ NLRB v. Catholic Bishop, 440 U.S. 490 (1979).

9/ McDaniel v. Paty, 435 U.S. 618, 626 (1978).
(plurality opinion)

10/ Pierce v. Society of Sisters, 268 U.S. 570 (1925) (decided on substantive due process grounds); Diatonian Society v. City of Chicago Zoning Board of Appeals, 63 Ill. App. 3d 823, 380 N.E. 2d 843 (1978).

11/ Kunz v. New York, 340 U.S. 290 (1951); O'Hair v. Andrus, 613 F.2d 931 (D.C. Cir. 1979).

12/ Brandon v. Board of Education, 635 F.2d 971 (2d Cir. 1980) (cert. den. 454 U.S. 1123 (1981)).

13/ Heffron v. International Society of Krishna Consciousness, 452 U.S. 640 (1981); Follett v. Town of McCormick, 321 U.S. 573 (1944); Murdock v. Pennsylvania, 319 U.S. 105 (1943); Largent v. Texas, 318 U.S. 418 (1943); Jones v. City of Opelika, 319 U.S. 103 (1943).

14/ Larson v. Valente, 456, U.S. 228 (1982); Murdock v. Pennsylvania, supra, 319 U.S. at 111.

Service has intruded into Church matters essential to carrying out and teaching the fundamental precepts of the religion.

The Service wishes to gather extensive information about and inspect the very details of the religion for the purpose of making a determination concerning the Church's status under the internal revenue laws. Basically, the Service intends to pass judgment on: (1) the method and manner in which the Church engages in propagation efforts to see if they further a "commercial purpose," (2) the method and manner in which the Church sells and sets prices for the Scriptures and other religious material, (3) the method and manner in which the Church establishes contributions for religious services, and (4) the amount of reserves maintained by the Church and what relationship this amount bears to the Church's anticipated needs.

It is impossible to comprehend entanglement more extensive and comprehensive than this. The Service intends to inspect, regulate and surveil matters concerning the core religious activities of worship and

the transmission of the Church's faith and values now and in the future.^{15/}

The most chilling proposition concerning the government's inspection of these purely religious matters is that it is potentially limitless. Not only is the government conditioning the determination of exemption on these sacred matters, it must, a fortiori, require continued compliance with these matters, as they exist today, as a condition for exemption for all future years. The inspection and analysis will be ongoing. And it also will involve the core beliefs of this faith.

The Service, however, may not "dictate which practices are or are not required in a particular religion." Geller v. Secretary of Defense, 423 F.Supp. 16, 17 (D.D.C. 1976). Nor may the Service adopt its own definitions of religiosity at odds with the religious beliefs of the Church. Bethel Conservative Mennonite Church v. Commissioner, 746 F.2d 388 (7th Cir. 1984). If mere inquiry into a church's labor

^{15/} Propagation efforts are recognized as a core function of religions and have long been afforded First Amendment protection. See, e.g., Murdock v. Pennsylvania, 319 U.S. 105, 111 (1943). No case remotely supports the proposition that Church autonomy can be infringed because an organization attempts to disseminate its beliefs using effective means and techniques.

relations with secular employees is forbidden by the Establishment Clause because it might improperly tread upon religious autonomy, see, e.g. NLRB v. Catholic Bishop of Chicago, 440 U.S. 490, 502 (1979), then surely the Service's attempt to inspect, regulate and judge core ecclesiastical decisions is repugnant to the First Amendment. The Service's power to interject itself into the Church's decision-making process is "a continuing [involvement] calling for official and continuing surveillance leading to an impermissible degree of entanglement." Walz v. Tax Commission, supra, 397 U.S. at 675. Such an intrusive entanglement is "an independent evil against which the Religion Clauses were intended to protect." Lemon v. Kurtzman, supra, 403 U.S. at 624.

Thus, in Surinach v. Pesquera de Busquest, 604 F.2d 73 (1st Cir. 1979) the Court refused to allow governmental inquiry into the costs of running Roman Catholic schools in Puerto Rico because the mere process of inquiry constituted "a palpable threat of state interference with the internal policies and beliefs of these Church related schools." 604 F.2d at 76-77.

The Court in Pesquera recognized that interference with a religion's decision-making process,

whether that interference is motivated by malignant or benign intentions, subverts the religion's own governance and policies contrary to the Constitution.

Moreover, it seems likely that as the regulatory process unfolds, some determination of which costs are "necessary" and "reasonable" in the running of a private school would have to be made. . . . In short, the value judgments and sense of priorities of the regulator and regulatee are likely to be grounded in wholly different concerns. And . . . (A) wholly secular objective would be furthered at the expense of one which is religious. We find it scant comfort that no such judgments have yet been brought to bear. The appellant's ability to make decisions concerning the recruitment, allocation and expenditure of their funds is intimately bound up in their mission of religious education and thus is protected by the free exercise clause of the First Amendment.

604 F.2d at 77-78. (Emphasis added).

The Church has the right to make its own decisions free from governmental intrusion concerning issues located at the religion's spiritual epicenter.^{16/} Here, the Service wishes to inspect,

^{16/} The finding of commercial purpose also violates the Churches rights under the Free Exercise Clause by conditioning exemption on the abandonment of the doctrine of exchange and by burdening Applicants' right to determine the manner in which they raise funds necessary to the survival of the religion. Hobie v. Unemployment Appeals Commission of Florida, ___ U.S. ___, 107 S.Ct. 1046 (1987); Sherbert v. Verner, 374 U.S. 398 (1943). (See Protest I-1 - I-12).

analyze and approve the Church's overall plans for expansion of the religion in the future, its policies and methods of receiving contributions for its religious services, and its policies and methods of pricing its religious artifacts. The prospect of the Service substituting its secular judgment on such matters as the amount of funds the Church needs to safeguard its future, the manner in which it disseminates the religion, and the expenditure of large sums for the acquisition or repair of buildings to house the practice of Scientology raises a chilling spectre that is inimical to our system of government.

Here, the substitution of the Service's secular objectives for the Church's own decisions is doubly damning because the concept of "commercial purpose" escapes objective definition and allows for arbitrary, ad hoc determinations detrimental to the Church. Government action which restricts the exercise of First Amendment rights by requiring prior approval or regulation of such rights must be "susceptible of objective measurement" Keyishian v. Board of Regents, 385 U.S. 589, 603-604 (1967) and "precision of regulation must be the touchstone." NAACP v. Button, 371 U.S. 415, 438 (1963). See also Big Mama Rag, Inc. v. United States, 631 F.2d 1030 (D.C. Cir. 1980). Such

regulation must also be justified by a compelling state interest and there must not exist less restrictive and entangling alternatives. Walz v. Tax Commission, 397 U.S. 664 (1970). No such objective and precise criteria justified by a compelling state interest and crafted in the least restrictive manner have been advanced here.^{17/}

These cardinal constitutional principles cannot be ignored. Matters at the heart of the Scientology faith cannot properly be separated by the Service into religious and secular components. Church activities infused with areas of belief are simply not subject to governmental inspection and surveillance. Regulation of matters concerning these core religious activities is tantamount to regulation of belief. Such governmental activity is prohibited by the First Amendment. As Justice Brennan recently noted in Corporation of Presiding Bishop v. Amos, supra:

^{17/} Applicants are aware of no other case where the Service has refused to recognize a religious organization because of the profits it derives from religious activities. The Service's finding effects a denominational preference by singling out Scientology organizations while ignoring numerous other religious organizations that engage in similar activities in support of their religions. Laws discriminating among religions are subject to strict scrutiny. See, e.g., Larson v. Valente, 456 U.S. 228 (1982).

What makes the application of a religious-secular distinction difficult is that the character of an activity is not self-evident. As a result, determining whether an activity is religious or secular requires a searching case-by-case analysis. This results in considerable ongoing government entanglement in religious affairs.

* * *

The risk of chilling religious organizations is most likely to arise with respect to nonprofit activities. The fact that an operation is not organized as a profit-making commercial enterprise makes colorable a claim that it is not purely secular in orientation.

* * *

This substantial potential for chilling religious activity makes inappropriate a case-by-case determination of the character of a nonprofit organization, and justifies a categorical exemption for nonprofit activities. Such an exemption demarcates a sphere of deference with respect to those activities most likely to be religious.

55 USLW at 5010 (Footnotes and Citations omitted).

(Concurring Opinion).

The Service cannot ignore this sphere of deference that attaches to the actions and decisions of bona fide religious organizations. Its attempt to inspect and monitor the Church's delivery of its most sacred activities violates Applicants' right to operate free from the corrosive effect of excessive

III. Commercialism is Irrelevant when
Activities are Inherently Exempt

The Service's focus on the alleged "commercial" attributes of the Applicants' religious activities is wholly misplaced. Applicants' activities and practices which the Service has called into question are sacred and inherently religious activities that accomplish but one purpose: the practice and propagation of the religion of Scientology. They do not evidence, and cannot be used to divine, a hidden nonexempt "commercial" purpose.

The Service repeatedly has recognized that Scientology is a bona fide religion and that Applicants are religious organizations. The Service further recognizes that the Applicants' activities advance their religious purposes and are central to their religious practice. Having accepted Applicants' religious character and the fact that the activities at issue contribute importantly to accomplishing Applicants' exempt religious purposes, the Service may not ignore the fair impact of these determinations. The Service is bound to accept that the questioned activities are in furtherance of Applicants' religious

purposes within the meaning of Section 501(c)(3).^{*}/ To treat the most sacred beliefs practices of the Scientology fair as "business" dealings undertaken for secular profit is to deny the religious character of the Applicants.^{**}/

^{*}/ The Service of course, is free to look for a nonexempt purpose in activities which are not inherently exemption related. After more than four years of administrative review, however, the Service has been unable to identify such a purpose from any other activities of these Applicants.

^{**}/ Contrary to the position taken by the Service during the Conference, both the Service and the courts have recognized that certain activities are inherently related to an organization's exempt purposes. Activities which are inherently exemption related are deemed to advance exclusively exempt purposes without further analysis or inquiry. See B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352, 359 (1978) ("[P]etitioner's only role is that of a conduit linking individual researchers with interested client organizations seeking a substitute for full-time staffing. This aspect of petitioner's service is not inherently charitable, education, or scientific."); St. Joseph Farms of Indiana v. Commissioner, 85 T.C. 9, 22-23 (1985) ("[P]etitioner's equation of the farming operations with its operation of schools, boys' homes and foreign mission facilities is inaccurate. Clearly, the latter activities fall within the category of what have traditionally been considered, in and of themselves, charitable activities. Farming, on the other hand, does not fall within that category."); Rev. Rul. 69-572, 1969-2 C.B. 119 ("The performance of a particular activity that is not inherently charitable may nonetheless further a charitable purpose."). See also G.C.M. 38987 (May 13, 1983), underlying LR 8318089; G.C.M. 38841 (April 22, 1981) ("[A]n activity need not be inherently charitable or religious if it accomplishes exempt purposes."); LR 8250111, LR 8107006, and LR 8051011, all expressly holding that the sale of certain goods and services are exempt as "inherently educational."

The Service, however, maintains that it may rummage into Church matters such as the pricing of the Scriptures and religious artifacts and the manner in which the Church establishes donation levels for religious services to determine whether Applicants' admittedly religious activities further a commercial purpose. In support of its position, the Service relies on authority involving sham churches such as Parker v. Commissioner, 365 F.2d 792 (8th Cir. 1966), and cases such as Scripture Press Foundation v. United States, 285 F.2d 800 (Ct. Cl. 1961), cert. denied, 368 U.S. 985 (1962), involving a nondenominational religious publisher. In these cases and the other "church" cases on which the Service relies, the facts required the courts to divine the purpose of the activities at issue because the activities involved clearly were not, as here, inherently religious.

In Parker, the principal activity of Dr. Merle Parker's organization, the Foundation for Divine Mediation (FDM), was the seeking of contributions, donations or dues for the publication and distribution of various courses and pamphlets. 365 F.2d at 797-98. The Court of Appeals described one category of FDM's publications as follows:

A second category of F.D.M.'s publications were projects promising the subscribing customer financial reward. Though we express no opinion as to what constitutes a religious practice, these subjects appear to us to have little, if any, visible relationship to F.D.M.'s religious activities. One project was the Santa Ysabel Ming Tree Society. Individuals were induced to join the society. Upon the payment of the required "dues" they would be sent ming tree seeds with instructions on their use. Prospective customers of the ming tree seeds were promised the ability to grow \$1,000 worth of these trees on a single window sill. A course in "Suggestive Passivity Induction" was offered and sold under the promise that the practitioner of this art could earn up to \$10 an hour. F.D.M. under the tutelage of Dr. Parker initiated a "Ten Thousand Dollar Plan", the subject matter of which is not disclosed. The plan was offered to those who donated \$10 or more and promised to donate 10 per cent of all the profit they made by the use of the plan. "The Ten Thousand Dollar Plan" was later replaced by "The 25,000 Pyramid Plan" which instructed the purchaser on how to raise earthworms for profit. A ten-lesson plan entitled "Secrets of Wealth, Power, and Success" was also promoted. It cost the recipient \$23.30 and promised earnings of \$1,000 within six months. Id.

The Court also described the nature of Parker's position as head of FDM:

Dr. Parker, himself, indicated the nature of his position as the head of F.D.M. Two separate "help wanted"

advertisements inserted in a general circulation newspaper indicated that, "My business is in the field of Direct Mail Advertising and Promotion." In a letter to the Better Business Bureau, Parker wrote, "I am a mail order publisher in business to stay." In 1952 Dr. Parker's income tax return indicated that his principal business activities were "selling books and lecture courses by mail." Id. at 798.

As the Service argued in the Tax Court, the "church" itself was no more than a mailing list.

The "membership" of FDM consisted of those persons who signed and returned the solicitation forms used in announcing publications and obtaining funds for the Foundation's operations. These solicitation forms were mailed to persons on mailing lists rented or purchased by FDM. FDM kept no formal membership roll. The only place names of members were kept was on metal addressograph plates used in addressing correspondence or printing material for individual "members." Brief for Respondent at 12-13, Foundation for Divine Mediation v. Commissioner, 24 T.C.M. 411 (1964).

On these facts, it was apparent that FDM's activities in propagating Dr. Parker's "religion" negated any religious purposes and the petitioner was engaged in the publication and sale of commercial materials.

Another case relied on by the Service is General Conference of the Free Church of America v.

Commissioner, 71 T.C. 913 (1979). In General Conference the Tax Court, after holding that the petitioner failed to satisfy the organizational test of section 501(c)(3), went on to find that petitioner also had failed to establish it satisfied the operational test of that section. In response to the Internal Revenue Service's requests for information in support of petitioner's application for exemption, petitioner cited the 1st, 4th, 5th, 9th, 13th and 14th Amendments and argued the questions proposed by the Service were a violation of these constitutional rights. To make its answers even more cryptic, petitioner would frequently cite the Bible as support for its constitutional objection:

2. How do you intend to solicit new membership? You may submit descriptive or promotional material used.

2. By word of mouth. Mark 16:15, Acts 5:42.

* * * * *

4. Upon becoming a member of your organization, what are the 'doctrines and usages' members will be required to agree to and to accept?

4. Objection.

5. Describe the 'rules and usages' which your organization used to appoint your trustees.

5. Objection. I Tim. 3:1-7, 11.

* * * * *

15. Describe the religious beliefs which your organization follows. Is there a series of principles, code of conduct, or system of moral practice directly resulting from adherence to the beliefs of your religion which governs the behavior of your members? If so, describe in detail.

15. (a) Beliefs: Objection.

(b) Yes.

(c) Describe principles:
Objection. Mark 12:17.

16. What is the name of the text in which your religious doctrines and precepts are found? Provide a sample copy, if available.

16. Objection. 1 Cor. 2:9-13, 2 Cor. 3:6.

* * * * *

18. Does your organization study or preach various basic principles gathered from other religions?

18. Objection. 1 Tim. 4:6-7, 16, 2 Tim. 3:14, Titus 3:9, Matt. 6:7-8.

* * * * *

21. Provide detailed financial statements of actual income and expenditures for the period December 23, 1973, through March 30, 1977. The statement should clearly identify all sources of receipts and the purposes for which all expenditures were made. In addition, with respect to gifts, grants, contributions and membership fees the statement should show the name of, and amount received from, each person from whom you received amounts totalling more than 2 percent of your total support.

21. Objection. Matt. 6:1-4.

22. Please provide a detailed budget for calendar years 1977 and 1978, including income and expenditures.

22. Objection. Matt. 6:25-34. Matt. 10:8-11. Mark 6:8, Luke 9-3, Luke 10:4, Luke 22:35.

* * * * *

25. Furnish specific information concerning prescribed courses of study and training that persons will take in order to qualify for ordination as ministers through your organization.

25. Objection. 1 Cor. 1:17-31; 2:1. Mark 3:13-14. 71 T.C. at 920, n2.

In a third case relied on by the Service, Western Catholic Church v. Commissioner, 73 T.C. 196 (1979), exempt status was denied to an organization whose "primary if not sole, activity" was the passive investment of funds "donated" by its founders, the Sloughs. Id. at 211. The Church had no place of worship, no public religious services, and engaged in one-to-one ministry with at best a handful of the founder's friends and acquaintances. Id. at 199-200. In finding that the petitioner was operated for personal rather than religious purposes the Tax Court observed:

During the years under examination, petitioner neither conducted religious services nor performed religious functions on a group basis. Slough was petitioner's only minister, having been ordained by action of the voting members at the annual meeting held on May 15, 1972. He had no theological training prior to that time or between then and the time of trial. No other minister was hired by petitioner. . . . Although Slough claimed that there were 40 members of petitioner, only Slough, his wife and daughter, and two other individuals, one of whom was a

former employee of Slough and the other of whom knew Slough prior to the incorporation of petitioner have been identified as members. Id. at 199-200.

Neither Parker, General Conference nor Western Catholic support the Service's position that it may examine the inherently religious activities of a fully functioning church to determine an undeclared commercial purpose. Indeed, the Service's analogy to these cases is absurd and can only mean it is questioning the bona fides of the Scientology religion.

The other cases on which the Service relies also do not support the Service's position. The facts of those cases required the courts to look at the purpose motivating the disputed activity because the activity was not, in and of itself, one which per se could be deemed to advance exempt purposes.

In Scripture Press Foundation, supra, the court denied exempt status to a publishing house which had accumulated over one million dollars from selling Sunday School teaching materials at commercial rates. The court specifically noted that the organization was "not connected with any particular religious denomination or church, * 285 F.2d at 803, and concluded that the accomplishment of any religious

purpose was purely "incidental" to its objective to sell its literature. Id. at 805-806.*/

In Mutual Aid Association of the Church of the Brethern v. United States, 759 F.2d 792 (10th Cir. 1985), the Court denied exemption to a mutual insurance association organized to provide property insurance to church members and congregations. The association required scheduled premiums, invested its surplus and established reserves for losses; its underwriting practices were consistent with those of the commercial insurance industry.

In Riker v. Commissioner, T.C. Memo. 1955-225, 14 T.C.M. (C.C.H.) 903, aff'd, 244 F.2d 220 (9th Cir.

*/ There are many activities which, although not exempt if engaged in by most types of exempt organizations, qualify for exemption when conducted by churches or other religious organizations. For example, cemeteries not aligned with any religious faith have been denied exempt status, see Child v. United States, 540 F.2d 579 (2d Cir. 1976), while church-affiliated cemeteries have been recognized as exempt. See O'Leary v. Social Security Board, 153 F.2d 704 (3d Cir. 1946); Passiac Hebrew Burial Assn. v. United States, 216 F.Supp. 500 (D.N.J.) Likewise, a publisher affiliated with a specific religion was ruled exempt. Presbyterian and Reformed Publishing Co. v. Commissioner, 743 F.2d 148 (3d Cir. 1984). Similarly, the Service has recognized that while compilation of genealogical data ordinarily is not an exempt activity, Rev. Ru. 67-8, 1967-1 C.B. 142, it qualifies as exempt when done to perform religious ordinances dictated by the Mormon faith. Rev. Rul 71-580, 1971-2 C.B. 235.

1957), the court ruled, for purposes of charitable contributions, that the church there involved was not operated exclusively for exempt purposes due to its operation of numerous commercial enterprises, including a laundry and dry cleaner, restaurant, lumber yard, bulb garden, farm, and warehouse.

In Schoger Foundation v. Commission, 76 T.C. 380 (1981), the petitioner operated a mountain lodge which it characterized as a religious retreat. The Tax Court ruled that the religious activities at the lodge were only incidental to the recreational and social activities and that the lodge was therefore not operated primarily for exempt purposes.

All of the other cases cited by the Service upheld the exempt status of the affected organizations, ruling that the "commercial" activities advanced substantially exempt purposes rather than nonexempt purposes. Again the Court was required to examine the purpose of the activities only because they were not inherently religious. Bethel Conservative Mennonite Church v. Commissioner, 746 F.2d 388 (8th Cir. 1984), (Voluntary medical aid program conducted by a church congregation held to further exempt purpose.); Pulpit

Resource v. Commissioner, 70 T.C. 594 (1978), (Nondenominational journal to help clergy in religious preaching held exempt activity.); Golden Rule Church Association v. Commissioner, 41 T.C. 66 (1964), nonacq., 1964-1 C.B. 8, (Commercial-type activities including lumber processing, wood product fabrication, hotel and laundry services and a plant nursery held to be undertaken for exempt purposes.); St. Germain Foundation v. Commissioner, 26 T.C. 648 (1956), acq. 1956-2 C.B. 8, (Sale of religious literature closely associated with the religious purposes of the petitioner.); Alive Fellowship of Harmonious Living v. Commissioner, T.C. Memo 1984-87, 47 T.C.M. (C.C.H.) 1134 (1984), (Training program conducted at "resort" type facility held to further religious purpose.); and A.A. Allen Revivals, Inc. v. Commissioner, T.C. Memo 1963-281, 22 T.C.M. (C.C.H.) 1435, (Production and sale of magazines, books, music records, tape recordings and pictures held to advance the religious purpose of the organization.)

To support its position that it may examine the core religious activities of worship and the transmission of the Scientology faith for a "commercial" purpose, then, the Service relies on cases in which

either the facts describing the way the religion was propagated negate a religious purpose or the disputed activity was not in and of itself inherently exemption related. Where activities are inherently exemption related, however, as are the activities in question here, there are per se in furtherance of exempt purposes; no further analysis is required or permitted. Commercialism is not a factor to be considered.

IV. The Activities In Question Do Not
Indicate a Commercial Purpose

At the Conference, the Service began the discussion on commercialism by identifying the following factors as indicative of a commercial purpose: (1) funneling profits to the benefit of private interests, (2) setting prices to produce high profits, (3) accumulating reserves for no purpose, (4) using commercial advertising techniques, (5) failing to offer reduced-fee or free services, and (6) requiring high earnings as a policy matter.*/

Thus, the Service expressly premised its position on commercialism on benefit to private interests, the very same position it took in the Initial Letter. Its

*/ At the Conference the Service initially included payment of commissions to fundraisers as a factor. Subsequently, the Service acknowledged that paying percentage commissions to fundraisers for section 501(c)(3) organizations has been held permissible by the courts (e.g., World Family Corp. v. Commissioner, 81 T.C. 958, 968 (1981), acq. and nonacq. 1984-2 C.B. 2), and Chief Counsel (e.g., G.C.M. 38905 (Oct. 6, 1982)). As the Service has stated, percentage compensation arrangements will not jeopardize exemption so long as the arrangement affords "protection against the diversion of charitable assets." A.O.D. CC-195-013 (World Family Corp.) (Dec. 20, 1983). At the end of the discussion on commissions, the Service agreed that the commission arrangements in question protect against the diversion of Church assets and that they are reasonable and, in the context of the Scientology religion, ordinary and necessary. Finally, the Service concluded that commissions no longer is an issue in these proceedings.

rationale here is that a commercial purpose exists when some private individual reaps profits from the organization's endeavor. As CSI and RTC pointed out in the Protest, regardless of any possible merit this position may have had during Mr. Hubbard's life (and it had none), it certainly cannot be an issue for periods after his death. Consequently, the Service had no choice but to alter radically its position and base its finding of commercial purpose on other grounds. (As noted above, private benefit will be the subject of Part II of the Supplemental Submission CSI and RTC will file and will not be discussed here.)

The Service never articulated plausible grounds for finding of a commercial purpose for periods after Mr. Hubbard's death. Indeed, the only rationale the Service can offer for continuing to assert commercialism now is that the Church's present commercial purpose is "to maximize profits." In other words, that a substantial purpose of the Church is to "make money simply for the sake of accumulating more money" even the Church, according to the Service, is no more than a modern day Silas Marner leading a never-ending nightmarish quest for the dollar.

The Service based its finding on the five remaining factors, with heavier weight given high profits and nondedicated reserves. In fact, as the Service stated, the single most important factor -- to the extent there is one factor -- is the presence of nondedicated reserves since without them there essentially would be no "profits."

Below is set out the Service's position with respect to each factor when the Conference ended and then those facts necessary to meet the Service's concerns. These facts unequivocally establish that the Service is wrong on all counts. Churches of Scientology do not engage in commercial-like advertising, nor do they require high earnings as a policy matter. They do provide reduce-fee or free services. More importantly, prices and contribution rates for religious books, material and services are set at amounts designed to keep the organizations operational and help the religion expand, not to produce high profits. Finally, there simply are no undedicated reserves. Every penny in question is dedicated to a specific religious use and is so managed each day by CSI's financial personnel.

A. Advertising

At the Conference the Service began the discussion on advertising by stating that section 501(c)(3) organizations are free to use state-of-the-art advertising techniques to promote exempt purposes without jeopardizing their exemption. However, the Service noted that the techniques must further exempt purposes and not be essentially "commercial-like." According to the Service, advertising is "commercial-like" and not exemption-related if it is deceptive.

The Service explained that it believed that commercial-like advertising was being practiced because certain Churches of Scientology were publishing deceptive literature about contribution rates. As evidence of this practice, the Service pointed to Attachment 13 of the Initial Letter, a copy of the back cover of a 1982 issue of Celebrity magazine, (distributed only to Scientologists). This literature offered "greatly reduced rates" for "up to two Introductory Auditing packages consisting of 12-1/2 hours per package" to "anyone who hasn't previously had auditing."

The Service questioned whether this offer was truthful since, according to its understanding of Scientology's doctrine of exchange, all contribution rates must be "fixed" at specified rates that cannot be changed. The Service agreed to drop "commercial-like" advertising as an issue if CSI and RTC could establish that the literature in question was not deceptive.

As CST and RTC pointed out during the Conference, the Service apparently misunderstands the religion's system of fixed donations and doctrine of exchange. This system is intended to reflect a reasonable level of exchange between the parishioner and the church and is specifically designed to accomodate varying levels of exchange. When the church in question or the religion as a whole derives some unique benefit from the exchange in question, contribution rates often are reduced to reflect this greater exchange from the parishioner. For example, one very important goal of the Scientology religion is to encourage the training of auditors so more religious services can be made available to the public. To accomplish this goal, CSI permits Churches to offer a significantly-reduced contribution rate to parishioners who ask to take all the training courses necessary to become an auditor in one set program.

Similarly, Churches of Scientology have for many years offered a reduced contribution rate for providing fixed-hour programs of religious services to individuals who have never received Scientology services before. As noted above, the literature in question offered "greatly reduced rates" for up to two sets of 12-1/2 hours of services. During 1982 when the literature at issue was used, the usual contribution rate for 12-1/2 hours was \$2,125. The reduced rate available through this introductory program was \$650 at that time, about 70 percent less than the usual rate. Currently, the introductory program offers five hours of religious services (the equivalent of \$1,612) for \$50.

CSI and RTC believe that these contribution rates are "greatly reduced" and that the literature in question therefore is not deceptive. Consequently, CSI and RTC assume that "commercial-like" advertising no longer is an issue in these proceedings.

3. Reduced-Fee Services

During the Conference, CSI satisfied most of the questions the Service had raised in the Initial Letter concerning the provision of religious services for free or reduced contributions. (These matters are detailed in the section on how contribution rates are set, infra.)

The Service's only remaining concern on this issue at the end of the Conference was clarification of the Church's policy regarding the contribution rates set for members of the Sea Organization and other Church Staff members.

A staff member who is not a Sea Org member -- in most instances a staff member of a Class IV Church -- is entitled to receive all of the religious services offered at that Church for free. In addition, these staff members can also receive upper level religious services at advanced level Churches for one-half of the fixed contribution amount.

Members of the Sea Organization are entitled to receive all of their religious services, including upper level services for free.

In addition, Scientology course materials are generally made available for free to Sea Org and other staff members engaged in religious training. Sea Org members can also purchase their own volumes of the Scriptures at half-price directly from Bridge.

These free and reduced services are provided by the Church as long as these individuals remain on staff. If individuals leave employment prior to the expiration of their staff covenants, they are requested to reimburse their Church for the full amount of the services they had received. This amount declines with each year of service until five years, when a maximum reimbursement of \$2,500 is required. However, the Church has never attempted to enforce reimbursement in a court of law and, as a matter of Church policy, will never do so.

C. Pricing

At the Conference the Service raised a number of questions concerning the methods used to set prices and contribution rates for religious books, materials and services. As noted above, the Service's basic position is that prices and contribution rates are set for the purpose of maximizing profits. In this way, the Service reasons, Churches of Scientology can make even more money to hoard in reserves. To support its position, the Service pointed to two lists of contribution rates (Attachments 8 and 11 to the Initial Letter), which showed that rates for certain religious services doubled between 1982 and 1984, the years the lists were published.

The Service asked CSI and RTC to explain how prices and contribution rates for books, materials and services are set. Specifically, the Service asked whether they are set so as to encourage people to receive services or otherwise accomplish some religious purpose, or simply to produce high profits. The Service also reiterated its request for purchasing and pricing information with respect to "a representative book, E-Meter and items such as, a Class IV Minister's Badge."² CSI Letter at 56; RTC

²/ Very few Class IV Auditor's Badges are sold, despite their low price (\$15) because they may be purchased only by Scientologists who have progressed to a prescribed high level of ministerial training. Consequently, CSI decided to substitute this item with the most popular item of Scientology jewelry in terms of sales, the sterling silver

Letter at 63. Finally, the Service wanted to know what factors other than greed possibly could have prompted the 100-percent increase in contribution rates for religious services between 1982 and 1984.

1. Policy and Ecclesiastical Review

All prices and contribution rates are set pursuant to Church policy, as adopted by CSI. In general, proposals to change prices for books, E-Meters and jewelry initiate with Bridge, are approved by CSI, and are then verified by RTC. Proposals for changing contribution rates for services initiate and are approved within CSI and are then authorized by RTC. Contrary to the Service's assertions, neither L. Ron Hubbard, NEP nor any other entity establishes prices and contribution rates. (See RTC Letter at 58.)

The substance of CSI's policy for setting prices and contribution rates is quite simple: all prices and rates are set to enable Churches of Scientology to provide the services, Scriptures and other materials of the religion to more and more members of the general public so that everyone eventually can achieve spiritual salvation. CSI accomplishes this policy by requiring all pricing proposals to undergo extensive review by the managers and

executives of the ecclesiastical hierarchy who are involved in the production, dissemination or delivery of the publication, service or material involved. This extensive review is ecclesiastically mandated to ensure each proposal meets the following three criteria.

First, the price or rate must be affordable to a broad segment of the general public. Second, the price or rate must enable the Church to recover the costs of production or delivery (whether incurred by Bridge or a Church). Third, the price or rate must produce a sufficient return to enable the Church (or Bridge) to remain operational so it can continue performing its function, replenish stocks if necessary, and expand so it can provide for or minister to an ever growing congregation.

While CSI employed different methods to implement this policy over the years, the basic policies and review procedures have remained unchanged.

The policy for books, E-Meters and jewelry contemplates that Bridge's net receipts (after costs) equal approximately one-third of its costs, and that Church bookstores receive approximately 2-1/2 times the royalty payable, less the amount of royalty. Thus, CSI's

basic formula has two parts: one factor is multiplied against Bridge's costs (for its share of receipts), and another factor is multiplied against the royalty amount (for the Church's share of receipts). The sum of the two resulting products is the suggested selling price.

The specific factors used for a particular book, E-Meter or item of jewelry differ depending on the maximum discount Bridge offers Church bookstores and the discount bookstores offer purchasers. For example, if Bridge sells a book at a 60 percent maximum discount, it will receive 40 percent of the list price if the book is sold at list. To be assured of a profit of 33-1/3 percent over its total cost, Bridge would multiply 1.33 by the factor by which it would multiply its 40 percent receipts to obtain 100 percent of the list price:

$$40\% \times 2.5 = 100\%$$

$$2.5 \times 1.33 = 3.34$$

The resulting 3.34 factor is then multiplied against Bridge's cost (for its share of receipts) and the 2.5 factor is multiplied by the total royalty (for the Church's share of the receipts).

Similarly, on a 55-percent maximum discount to bookstores for E-Meters, Bridge would receive 45 percent of the list price if the E-Meters were to be sold at list. To be assured of a profit of 33-1/3 percent over its total manufacturing cost (including overhead), Bridge multiplies 1.33 by the factor by which it would multiply its 45 percent receipts to obtain 100 percent of the list price:

$$45\% \times 2.222 = 100\%$$

$$2.222 \times 1.33 = 2.96$$

The resulting 2.96 factor is then applied against Bridge's manufacturing costs (to determine Bridge's share of the receipts), and the 2.222 factor is rounded to 2.2 and applied against the total royalty (to determine the Church's share of the receipts).

At present, and for most of the period in question, prices and rates were set pursuant to the methods and review procedures discussed below.

a. Books

Suggested prices for books are developed and initially proposed by Bridge's Manufacturing Secretary, who is in charge of the division in Bridge that produces

books, E-Meters and other materials. The Manufacturing Secretary formulates a book pricing proposal from figures compiled by his staff for all expenses Bridge incurs in producing the book -- plant costs, manufacturing costs, overhead and author royalty. With these costs in mind, the Manufacturing Secretary arrives at a price designed to achieve Church policy of: (1) making the Scriptures available at affordable prices to broad segments of the public, (2) recovering the costs of publication, and (3) producing a sufficient return to enable Bridge and Church bookstores to remain operational, replenish stock and expand.

The precise formula the Manufacturing Secretary follows to establish an approximate suggested price is to multiply the sum of Bridge's plant, manufacturing and overhead costs by 3.34, and to add the resulting product to 2.5 times the total royalty. The suggested price may then be modified slightly in light of the type of book in question. As discussed, this formula is based on a maximum discount of 60 percent and is intended to permit Bridge to realize a reasonable per copy profit of 33-1/3 percent over the combined plant, manufacturing and operational overhead costs, and to permit church bookstores to realize reasonable net receipts (not

profit), which work out to about 10 percent of the suggested price.

Once the Manufacturing Secretary finishes a proposal, he sends it to Bridge's Advisory Council for review. The Advisory Council, which is composed of the heads of Bridge's ten Divisions, coordinates daily operations among the Divisions and generally advises Bridge's senior executives. It reviews the Manufacturing Secretary's pricing proposal from the perspective of each Division in order to ensure that it is consistent with Bridge's overall goals, that the price is reasonable, and that the wholesale price is in line with Bridge's current discount structure for other books.

The Advisory Council passes its recommendations to Bridge's senior ecclesiastical governing body, the Executive Council, which is composed of Bridge's President and its Senior Vice Presidents for Marketing, Internal Affairs, Public Affairs and Trade. The Executive Council reviews and either approves, vetos or amends the Advisory Council's determination.

All proposals approved by the Executive Council are then reviewed by Bridge's Finance Banking Officer to

ensure the suggested price comports with financial policy and is economically feasible in light of Bridge's overall financial operations.

After the proposal has been reviewed and approved through the highest levels in Bridge, it is transmitted to CSI for review and approval by the senior executives of the ecclesiastical hierarchy. CSI's Senior Executive Strata is initially responsible for reviewing all pricing proposals. The Senior Executive Strata is CSI's senior management body and is responsible for coordinating strategic planning, development and expansion of the religion. Each member of the Senior Executive Strata is responsible for one of the twelve functions of the Scientology religion that contribute to its continued growth. (See Protest at B-20 to B-23.) Three of these functions -- Books, Materials and Marketing -- are involved in the book pricing process.

The members of the Senior Executive Strata responsible for these three functions are the Books Executive International (overall responsibility for Church books from production to promotion and distribution), the Marketing Executive International (responsible for the dissemination of the religion to the public and the rapid

spiritual advancement of parishioners), and the Materials Executive International (responsible for coordinating compilation, assembly and production of the Scriptures). They examine Bridge's proposal to assure that it comports with the Church's goal of continued expansion through broad dissemination of the Scriptures and still permits a reasonable return to Bridge and Church bookstores so they can replenish their inventory, remain operational and expand.

Once their review is complete, they present their proposal to CSI's International Management Executive Committee for final determination. This committee is chaired by CSI's Executive Director International and is composed of all 13 members of the Senior Executive Strata.

Proposals approved by CSI's management undergo a final review by the senior ecclesiastical body of the Scientology faith, the Watch Dog Committee ("WDC"). WDC is, in essence, an ecclesiastical board that oversees the practice, propagation and expansion of the Scientology faith. It is responsible for overseeing the entire international ecclesiastical management structure of the Church in order to ensure continued expansion of the faith.

The member of WDC with primary responsibility for reviewing book pricing proposals is WDC Pubs. WDC Pubs is the most senior ecclesiastical official that oversees the Church's publishing organizations and also serves as a trustee of International Publications Trust, the owner of all of Bridge's outstanding shares of stock. WDC Pubs reviews the determination made by the International Management Executive Committee to ensure that it is in accordance with Church policy, that it is designed to forward the Church's propagation efforts, and that it is financially feasible.

Once WDC Pubs endorses the determination, the review process within CSI is complete. The final determination is then sent to Religious Technology Center for authorization.

RTC performs a unique function with respect to the pricing of books (as well as of religious services and materials). RTC was formed for the exclusive purpose of supervising the delivery of Scientology's religious technology. Through two assignments in 1982, L. Ron Hubbard gave RTC all rights to the Scientology marks worldwide (subject to a prior limited license to NEP) and all rights to the use of the Advanced Technology in the

United States. In return for these rights, RTC agreed to delegate their use to CSI and other Churches of Scientology and then to supervise their use to ensure they are applied and are managed according to the Scriptures. Thus, the ecclesiastical authority over the marks and Advanced Technology consists of CSI on the management side and RTC on the supervisory side.

Since books bear and are sold under Scientology's marks, RTC's Authorization, Verification and Correction Unit International, as a de minimis part of its activities, supervises CSI's management of book pricing (as well as pricing in general) to ensure all final pricing proposals have been determined in accordance with the Scriptures. The Authorization, Verification and Correction Unit basically reviews all proposals and their processing through Bridge and CSI for compliance with the policies and approval procedures outlined above. If all steps were properly taken, the Authorization, Verification and Correction Unit approves the proposal for publication.

A chart illustrating this approval process follows.

EDGE PUBLICATIONS INC.

FINANCE BANKING
OFFICER (FBO)

EXECUTIVE COUNCIL (EC)

ADVISORY COUNCIL (AC)

1. MANUFACTURING SECRETARY
(MFG SEC)

CHURCH OF SCIENTOLOGY INTERNATIONAL

7. WDC PUBS ----->

6. INTERNATIONAL MANAGEMENT EXECUTIVE
COORDINATION COMMITTEE (IMEC)

5. BOOKS, MARKETING AND MATERIALS EXECUTIVES
INTERNATIONAL

RELIGIOUS TECHNOLOGY CENTER

8. AUTHORIZATION, VERIFICATION
AND CORRECTION UNIT
INTERNATIONAL (AVC)

b. E-Meters and Jewelry

Prices for both E-Meters and jewelry are set through the same procedures, which differ substantially from the procedures outlined above for books only in the member of CSI's Senior Executive Strata who begins CSI's review. As with books, suggested prices are initially formulated and proposed by Bridge's Manufacturing Secretary.

For E-Meters, the Manufacturing Secretary formulates a suggested price designed to achieve Church policy of: (1) providing E-Meters to qualified individuals at affordable prices in order to promote spiritual enlightenment and ministerial services as widely as technically feasible, (2) recovering the costs of production, (3) funding research, and (4) producing a sufficient return to enable Bridge and Church bookstores to remain operational, replenish stock and expand.

The precise formula the Manufacturing Secretary follows to establish a suggested price is to multiply Bridge's total manufacturing cost (including overhead) by 2.96, and to add the resulting product to 2.2 times the total royalty. (These factors are based upon the maximum discount to Church bookstores of 55 percent.) The suggested price may then be modified slightly in light of the particular E-Meter in question.

Since generally only a limited number of parishioners and church staff desire to purchase religious jewelry, Church policy for pricing jewelry is not specifically directed to broad dissemination goals. Rather, Church policy simply is to ensure that (1) Scientology jewelry is available at reasonable prices, considering the traditionally high cost of silver, gold and other materials, (2) Bridge and Church bookstores receive some reasonable return for making these items available to interested parishioners and staff.

The formula used to establish suggested prices for jewelry is to multiply Bridge's per unit cost (excluding royalty and overhead) by 2.5 to obtain the discounted retail price, from which the list price is calculated. The resulting price is then adjusted slightly and varies depending on the price of silver. As noted before, the objective of the formula is to permit Bridge to realize a reasonable profit of no less than 33-1/3 percent over its per unit cost (excluding royalty and overhead), and to permit Church bookstores to realize reasonable net receipts, which work out to about 15 percent of the discounted price.

After the Manufacturing Secretary finishes a proposal (whether for E-Meters or jewelry), it is reviewed

by Bridge's Advisory Council, Executive Council and Finance Banking Office under the same procedures discussed above for books.

Like proposals for books, Bridge's final determination for E-Meters and jewelry is sent to the CSI's Senior Executive Strata for review in order to assure that it comports with the Church's policies and goals. The members of the Senior Executive Strata responsible for reviewing pricing proposals for E-Meters and jewelry are the Audio-Visual and Materials Executives International. On their approval, the proposal undergoes a final determination by the International Management Executive Coordination Committee and then final ecclesiastical approval by WDC Pubs. Finally, the proposal is transmitted to RTC's Authorization, Verification and Correction Unit for authorization for publication.

A chart illustrating this approval process follows.

EDGE PUBLICATIONS INC.

CHURCH OF SCIENTOLOGY INTERNATIONAL

RELIGIOUS TECHNOLOGY CENTER

FINANCE BANKING
OFFICER (FBO)

7. WDC PUBS ----->

8. AUTHORIZATION, VERIFICATION
AND CORRECTION UNIT
INTERNATIONAL (AVC)

EXECUTIVE COUNCIL (EC)

6. INTERNATIONAL MANAGEMENT EXECUTIVE
COORDINATION COMMITTEE (IMEC)

ADVISORY COUNCIL (AC)

5. AUDIO-VISUAL AND MATERIALS EXECUTIVES
INTERNATIONAL

MANUFACTURING SECRETARY
(MFG SEC)

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c. Services

CSI policy for setting contribution levels for religious services is to set them so sufficient funding is provided to achieve the Church's primary goal of wide dissemination of the religious technology and spiritual enlightenment.

Ordinarily, a pricing officer posted below CSI's Marketing Executive International (a member of the Exec Strata) is responsible for initially proposing contribution levels for religious services, including fixed rates and any reductions in rates and scholarships. His proposal would be reviewed by the Marketing Executive International and then by the Deputy Executive Director International, Production (who is immediately junior to the Executive Director International, the senior-most official in the Church's ecclesiastical hierarchy). In actual practice during the past few years, the Executive Director International, Marketing has prepared the initial proposal, often in consultation with the Marketing Executive International.

Proposals for contribution levels are designed to achieve Church policy of (1) making the entire spectrum of Scientology's religious technology available to the

average person, (2) encouraging parishioners to train as ministers in order to increase dissemination of the technology, (3) assuring that the Churches and Missions that provide the technology to the public remain viable entities capable of expanding, and (4) providing funds for further dissemination of the technology and growth of the religion as a whole.

Church policy does not have any rigid formula for establishing contribution rates. In fact, different methods are used from time to time. All are designed simply to produce reasonable contribution levels and sufficient receipts to keep Churches operational, pay the living expenses of staff personnel, and to enable the religion to expand.

For example, the basic formula used from 1984 to 1987 for setting contribution rates for Class IV Churches contemplated that Church policy could be achieved if contributions received per staff member roughly equalled five times the average income (or "cost of living") for the particular country involved. While staff receive nominal compensation, the cost of living standard used was the average upper lower-class or lower middle-class pay scale for that country. The excess over actual staff

compensation covered overhead, staff welfare, management, reserves, and all other expenses.

This formula may be illustrated as follows:

$$\frac{\text{Receipts}}{\text{number of staff}} = (5) \times (\text{cost of living standard})$$

Suggested rates are developed under this formula by working from an assumed model religious program for an average Class IV Church with 50 staff personnel. This program would consist of 10 New Era Dianetics courses, 10 Academy level courses, 30 introductory courses (like the Essentials of Dianetics and the Dianetics workshop), and 325 hours of auditing services. CSI believed this mixture of certificate courses and auditing services represented the ideal minimum program of religious services for a typical community with a Class IV Church of average size.

In March 1987 the Deputy Executive Director International, Production reevaluated this formula and concluded that it was not fully achieving the Church's dissemination goals. Consequently, he developed a new proposal that was approved that used a formula better designed to encourage the training of auditors, which would increase delivery of the religious technology to the public, and to make religious services more affordable.

Under this formula, contribution rates for the certificate courses noted above must equal approximately one month's average income for the country in which the services will be delivered. (Again, average income is the average for the upper lower-class or lower middle-class pay scale.)

This change in method reflects the importance of a fundamental policy of the Scientology religion -- the training of auditors. There are two objectives behind this policy. First, one central belief of the Scientology faith is that parishioners gain far greater spiritual benefit if they combine intensive study of the Scriptures with their religious services. Thus, the Church encourages parishioners to enroll in training courses that complement their level of spiritual awareness they have achieved. Second, widespread training of auditors is essential if the Church is to achieve its goal of broad dissemination of the religious technology:

It has always been the intention to make Scientology available to all, but first and most especially to the able who can and will help in getting our job done.

That puts auditors and those reaching to become auditors first on the list for deserving of special consideration in regard to fees for service. These

are the most valuable beings on the planet, and they are needed in volume if we are to clear people on a planet-wide basis.

HCO Policy Letter of 15 July 1984, "Professional Rates."

In order to encourage auditor training, CSI offers special programs of reduced contribution rates and scholarships. These special programs are provided in recognition of the important contribution of auditors in achieving CSI's religious goals. They provide reductions in the amount of contribution rates to achieve a particular level of training by one-half. In addition, CSI offers special training curricula for a series of Academy level courses to ministers and ministers-in-training at substantially reduced rates.*/ All aspects of these special rates, programs, reduced rates and scholarships have been initially formulated by the Deputy Executive Director International, Production.

Their suggested proposals, when completed, are reviewed by the International Management Executive

*/ By training as auditors, Scientologists also may receive almost all of their own religious services free of charge. Ministerial training courses all require practical application of the religious technology they learn, so most ministers-in-training receive substantial services through co-auditing with other students under the guidance of the course supervisor.

Coordination Committee to assure that they align with overall Church policy. If approved, the proposals are reviewed by the Watch Dog Committee to ensure they are in accordance with Church policy, designed to forward the Church's religious goals, and are economically feasible.

Once proposals have been endorsed by CSI's ecclesiastical hierarchy, they are referred to the Authorization, Verification and Correction Unit: International of RTC. The Authorization, Verification and Correction unit reviews the proposals and their processing through CSI for compliance with the policies and approval procedures outlined above. If all steps were properly taken, the proposal is approved for publication.

A chart illustrating this approval process follows.

URCH OF SCIENTOLOGY INTERNATIONAL

RELIGIOUS TECHNOLOGY CENTER

WATCH DOG COMMITTEE (WDC) ----->

4. AUTHORIZAITON, VERIFICATION AND CORRECTION
UNIT INTERNATINAL (AVC)

INTERNATIONAL MANAGEMENT EXECUTIVE
COORDINATION COMMITTEE (IMEC)

DEPUTY EXECUTIVE DIRECTOR INTERNATIONAL,
PRODUCTION (D/ED PROD)

G-23

2. Experts on Pricing

Throughout these proceedings, CSI and RTC have endeavored to provide the Service with the information it needs to make a determination. However, the Service has consistently challenged many of the representations CSI and RTC have made and refused to accept them as true. As a consequence, CSI and RTC have found it impossible to establish facts the Service maintains are central to their exemption.

The Service's refusal to accept these representations as true violates the statutory scheme for the judicial review of adverse determination in section 7428. As discussed from F-1 to F-14 of the Protest, section 7428 provides a bifurcated system of procedural rules for determining questions of fact in exemption proceedings. In revocation proceedings like Animal Protection Institute, Inc. v. United States, 78-2 U.S.T.C. ¶ 9709 (Ct. Cl. Trial Div. 1978), the case the Service cited during the Conference in support of its position, the exempt organization is entitled to a full trial to resolve all factual and legal disputes. Both the Service and the organization are entitled to submit evidence and arguments in the case. Since both parties have the opportunity to litigate the facts and the law, the resulting decision

will collaterally estop them from relitigating the issues that were involved in the case. Consequently, in revocation cases, the Service must be sure to raise all likely issues for if it loses it cannot challenge exemption for the years that were litigated.

In initial determination cases, like the one at hand, there is no trial. Section 7428 provides only for a review of the evidence in the record. See, e.g., Houston Lawyer Referral Service v. Commissioner, 69 T.C. 570, 573 (1978); Tax Court Rule 217(a)). An applicant must furnish sufficient information to present a prima facie case that it qualifies for exemption. That is all; if the representations are complete and unequivocal, the Service cannot challenge them and must assume that they are true. See Dwayne Farms v. Commissioner, 73 T.C. 650, 664 (1980), acq. 1980-2 C.B. 1, nonacq., 1980-2 C.B. 2; Church of the Visible Intelligence that Governs the Universe v. United States, 53 A.F.T.R. 2d 406, 409 (Ct. Claims 1983). The determination and subsequent litigation must be based on the representations as made.

Unlike revocation proceedings, initial determination proceedings do not result in a judgment that collaterally estops the Service from challenging exemption for the years under issue sometime in the future. The Service's

decision in an initial determination proceeding will not bind the Service if the representations on which the Service based its determination were incomplete or false in any material respect. See, e.g., World Family Corp. v. Commissioner, 81 T.C. 958 (1983); Church of the Visible Intelligence that Governs the Universe v. United States, 53 A.F.T.R. 2d 406 (1983); S. Rep. No. 938, 94th Cong. 2d Sess. 588 (1976). Thus, even though the Service must base its initial determination on the representations as made, the Service always may subsequently test the representations and revoke exemption if they prove untrue.

In an effort to establish for once and for all the facts the Service considers critical to the issue of pricing and profits, CSI has asked five experts to analyze the methods it uses for setting prices for books, E-Meters and jewelry and determine whether the resulting prices and profits are reasonable or unreasonably high. In this way, the Service will have the assurances of expert testimony that prices are or are not set to maximize profits. The background and qualifications of these five experts are discussed below.

As their credentials amply demonstrate, each of these five experts enjoy the highest reputation throughout the country as the best in his particular field of

specialty. Their opinions -- given under penalties of perjury -- unequivocally establish that prices are not set to maximize profits. CSI and RTC trust that the Service will accept their declarations as true.

a. Experts on Book Pricing

CSI and RTC retained two experts on book pricing and publishing to examine its pricing method. Both are among the leading experts in the publishing field today and are intimately familiar with industry standards for the very details at issue here.

The first expert, Glen Ruh, is an independent book producer and publishing consultant living in Washington, D.C. Mr. Ruh provides his clients with analysis and recommendations in all major areas of publishing, including financial planning, marketing, pricing, distribution, production, and design. As an independent book producer, he is thoroughly involved in the publishing process from acquisition to production, pricing and marketing.

Mr. Ruh has worked closely with nonprofit tax-exempt organizations in the publishing field for over two decades. He began his career in publishing in 1964 as a Manuscript and Acquisitions Editor for the Gregg Division

of the McGraw-Hill Book Company in New York City. In 1967 Mr. Ruh became Special Projects Editor for the College Division of Holt Rinehart & Winston in New York, which involved him in the design and promotion of textbooks to state colleges and other high volume purchasers. In 1968 he became Managing Editor for Books for the Naval Institute Press, a nonprofit organization located in Annapolis, Maryland. The Naval Institute Press is tax-exempt under section 501(c)(3) of the Internal Revenue Code. While there, Mr. Ruh was responsible for acquiring and editing textbooks, reference books, and scholarly and special-interest books, for preparing detailed financial budgets for the Institute, and for proposing the suggested price for books.

In 1975 Mr. Ruh left the Naval Institute Press to become Associate Editorial Director of the Chilton Book Company, a nonfiction trade publishing house located in Radnor, Pennsylvania. He managed Chilton's editorial, design and production departments for general trade books and supervised a staff of approximately fifteen. He dealt with best-sellers with national media exposure and negotiated distribution and co-publishing arrangements. At Chilton, Mr. Ruh had full fiscal responsibility for establishing book prices and for program budgeting.

From 1980 through 1985 Mr. Ruh was Director of Smithsonian Books at the Direct Mail Division of the Smithsonian Institution Press. The Smithsonian Institution Press is a part of the Smithsonian Institution (and is exempt from tax under section 501(c)(3)) and is widely known as an extensive publisher of high quality books priced at the upper ranges of the market. As Director of Smithsonian Books, Mr. Ruh directed all aspects of the Smithsonian's multimillion dollar direct-mail book program and managed an editorial, production and marketing staff that developed illustrated books for sale to the Smithsonian's member and to the retail book trade. He also developed and implemented sophisticated business and marketing plans and had complete responsibility for establishing prices for direct-mail books.

The second expert, Stephen Conland, is Vice President of Moseley Associates, Inc., a management consultant to the publishing industry, and has thirty years of experience in the publishing field. Mr. Conland's career in publishing began in 1956 when he joined Berkley Publishing Corporation, a publisher of mass-market paperback books located in New York City. Three years later he acquired ownership of the company and became its publisher, which position he held until his retirement in

1977. During that period, Berkley published about 250 titles per year.

In 1965, Mr. Conland sold Berkley to G.P. Putnam's Sons. With Putnam, Berkley published hardcover books and trade paperback books in addition to mass-market paperback books. One of the hardcover best-sellers published by Berkley at that time was Plain Speaking: An Oral Biography of Harry Truman by Merle Miller. That title was a Book-of-the-Month Club selection and sold 250,000 copies. Mr. Conland's experience with best-sellers also included The Godfather.

Mr. Conland joined Moseley Associates in 1979. Moseley Associates is a nationally-known firm that specializes in providing management and consulting services to the publishers and the publishing industry in general. Moseley Associates includes some of the country's leading experts in all major areas of publishing, including organization, operations, management, expansion and financial planning, as well as appraisals. While at Moseley, Mr. Conland has had extensive experience analyzing the value, profitability, and marketing policies of numerous publishing companies.

Mr. Conland's expertise has been recognized by the government itself for many years. He has been retained by the Internal Revenue Service to prepare 197 appraisal reports of various books. He also has testified as an expert witness on behalf of the Service in five federal tax court cases involving the value and profitability of books used in tax shelters, and as an expert witness in federal court concerning the operations and costing policies of a paperback book company.

b. Experts on E-Meter Pricing

CSI also retained two experts to examine its method of pricing E-Meters. Both of these experts have extensive experience in the manufacturing industry and are eminently qualified to render an opinion on the pricing issues raised by the Service.

The first expert, Dudley Smith, has been a patent attorney and licensing executive for major U.S. manufacturing companies since the mid-1950s. In the late 1950s, Mr. Smith was appointed Manager of Licensing and Corporate Secretary for a licensing venture between Cluett, Peabody & Company (best known for their ARROW Shirts and their famous "SANFORIZED" licensing program) and West Virginia Pulp and Paper Co., known as CLUPAK.

During Mr. Smith's six years with CLUPAK, his sole daily job responsibility was licensing, i.e., formulating licensing strategy, drafting, negotiating, concluding, and administering licenses, and reporting to the Board of Directors on the CLUPAK licensing program.

In 1965, Mr. Smith was hired by Celanese Corp. as a licensing executive. His official responsibilities pertained, once again, solely to licensing. His daily work involved drafting and negotiating domestic and foreign license agreements, both as a licensee (buyer) and as a licensor (seller) of patent rights in the areas of fibers, chemicals, mechanical devices, plastics, coatings, and many diverse specialty items.

Also in 1965, Mr. Smith was afforded the opportunity to form an educational association for others involved in the licensing field. He put together a core group of individuals and formed the Licensing Executives Society, known as LES. Today, LES is the leading professional society on licensing in the world and has 21 national chapters reporting to a parent body, LES International, with over 5,000 individual members.

Since 1965 Mr. Smith has served LES in many capacities, including as President of LES US/Canada and as President of LES International. He has served on numerous

LES committees, has been a speaker and teacher on licensing at numerous annual, regional, and foreign meetings, and started the Society's publication called Les Nouvelles. Les Nouvelles has since become the most authoritative publication in the licensing field. From its founding, Mr. Smith has been a member of the editorial board, and in that capacity reviewed or participated in the review of all of the more than 1,000 licensing articles it has published.

In 1971, Mr. Smith was awarded the first LES Gold Medal, which is an award given by the LES International every few years (seven since 1965) to a worthy licensing professional executive in recognition of outstanding contributions to the profession of licensing.

During the 1970's Mr. Smith was the primary organizer, and participated as a member, of a U.S. governmental delegation to the Soviet Union to study and report to American industry on Soviet licensing practices. Subsequently, he was a United States representative on a licensing mission to the Peoples Republic of China.

The second licensing expert, Cruzan Alexander, has been a practicing patent attorney and licensing executive

for over 40 years. At the time of his retirement in 1983, he had been Chief Patent Counsel for the 3M Company for 11 years.

During Mr. Alexander's more than 40 years of practice of patent and intellectual property law, he has been extensively involved with the licensing of inventions and patents and has written and delivered numerous papers, talks, and educational seminars on various aspects of patent licensing and royalty arrangements. While at 3M he took part in or had responsibility for negotiating the majority of 3M's licensing agreements.

Mr. Alexander is past President of the Licensing Executives Society US/Canada. As the result of his extensive involvement in the field of patent and intellectual property licensing he has prepared, negotiated, and reviewed thousands of licensing agreements and has lectured extensively on the reasonableness of royalty rates in patent licensing agreements.

c. Expert on Jewelry Pricing

CSI also retained an expert to examine its pricing method for jewelry. This expert, Jack R. Revoyr, is the Licensing Administrator for the University of California,

Los Angeles ("UCLA"). UCLA is tax-exempt under section 501(c)(3). In that position he has been responsible since May of 1981 for all of UCLA's nonprofit licensing activities with respect to its name, trademarks, and merchandising properties, including jewelry products bearing the University's insignia, such as charms, bracelets, and pins.

On UCLA's behalf, Mr. Revoyr ministers more than 130 domestic and seven international licensing agreements. He is responsible for negotiating the terms of licenses (including royalty provisions), drafting contracts, reviewing products and marketing plans of UCLA's licensees (including the pricing of products), monitoring their performance and compliance with contract terms, and collecting royalties. He also prepares all reports to the UCLA's Administration on trademark and licensing matters and prepares special reports to interpret policy, anticipate future needs, and recommend policy changes. In short, Mr. Revoyr is responsible for all aspects of policy planning, management, and implementation of UCLA's extensive and successful nonprofit trademark licensing and merchandising program.

In addition to his duties at UCLA, Mr. Revoyr has been active in licensing industry affairs for many years,

and in April 1986 helped to found the Association of Collegiate Licensing Administrators, a professional educational organization with 71 university members. Mr. Revoyr also serves as consultant on trademark licensing to the Los Angeles Visitors and Convention Bureau, and designed its licensing program which operates in both the U.S. and Japan. He also advises many other universities on establishing trademark licensing programs.

3. Analysis of Pricing

CSI's objectives in setting prices and contribution rates and the review procedures through which all pricing proposals must pass. What follows, as the Service requested, is a detailed analysis of purchasing and pricing information with respect to a representative book, E-Meter and item of jewelry. This analysis, which draws from the opinions of these leading experts, establishes that prices are not set to maximize profits.

In reviewing the foregoing analysis, the Service should bear in mind that it only summarizes the basic facts and the experts' extensive analyses pertaining to the particular book, E-Meter and item of jewelry involved. The details of all facts and the complete expert analysis are contained in or attached to the affidavit each expert prepared. This information is too detailed to include in the body of the text so it is hereby incorporated by reference. CSI urges the Service to turn to these affidavits if it desires to review the actual data on which this summary is based.

CSI also would like to inform the Service of the extensive effort necessary to compile information necessary to answer the Service's questions on the pricing

and profits. The data on pricing CSI maintains is not the same as the data maintained by other for-profit and nonprofit publishing organizations. The financial system CSI and Bridge maintain to account for receipts and expenditures with respect to its books, E-Meters and jewelry is geared to reflect data related to its religious programs -- not "profits" as that term is commonly used throughout the publishing industry. For example, CSI staff and its representatives had to work with the experts extensively over a period of three to four months in order to develop figures to parallel those used by other nonprofit and for-profit publishers.

The Service's questioning, as innocuous as it may have seemed to Service representatives, in point of fact, severely disrupted the ecclesiastical management of a very important facet of the Church's religious activities. It also cost the Church a great deal of money to identify, compile and analyze the requested data. As a result, the religion of Scientology suffered a significant loss.

CSI and RTC protest this abhorrent and excessive governmental entanglement in their religious affairs. While the information requested is being provided in order

to protect, their tax exemptions, this disclosure does not constitute a waiver of their rights under the First Amendment.

a. Books

The Service asked for purchasing and pricing information for a representative book. Since CSI publishes books that fall into three general price ranges -- inexpensive, moderately priced and expensive -- CSI decided it best to provide the Service one book representative of each price range. The books selected are: Dianetics: The Modern Science of Mental Health (softcover) ("DMSMH softcover"; Exhibit G-1) for an inexpensive book, Dianetics: The Modern Science of Mental Health (hardcover) ("DMSMH hardcover"; Exhibit G-2) for a moderately-price book, and Organization Executive Course Volume 0 ("OEC"; Exhibit G-3) for an expensive book.

DMSMH softcover is a mass-market paperback. It is considered the Scientology religion's primary method of dissemination to the general public. This book also is the genesis of most of the later religious writings and developments. It introduces readers to the basic tenets and philosophy underlying the Scientology faith and the religion's sacramental services. DMSMH softcover has a

suggested list price of \$4.95. To date, over 9 million copies have been sold. Unlike almost every other Scientology book, DMSMH softcover is primarily sold to the general public through commercial bookstores located throughout the country.*/

DMSMH hardcover differs from DMSMH softcover mainly in binding, typeface and quality of paper and other material and is designed to last many years as a permanent reference book. DMSMH hardcover is a textbook (like a college textbook) and is sold primarily through Church bookstores to Scientologists enrolled in religious training courses that use it as a course text. Almost all purchasers are members of the International Association of Scientologists ("IAS") and are entitled to a 20 percent discount from the suggested list price of \$25.

OEC is the first volume of a multi-volume treatise of Scriptural issues concerning the structure and organization of Scientology churches, the religion's ecclesiastical laws, and religious policies for the administration of Scientology Churches. Volume 0 contains

*/ Bridge sells about 82 percent of all copies of DMSMH (softcover) to trade bookstores and 18 percent to Church bookstores. The only other Scientology book sold through trade bookstores is Self-Analysis, which also is considered a primary dissemination method.

basic and introductory material with respect to organizational administration. OEC is a textbook which is sold exclusively through Church bookstores and primarily to Church staff, who are members of IAS and entitled to a 20-percent discount from the suggested list price of \$90. This book also is occasionally sold by Bridge directly to Sea Org members at a 50-percent discount from the suggested list price.

All these books are published by Bridge through commercial suppliers pursuant to a sublicense with NEP, which is licensed by the author, L. Ron Hubbard. (Exhibit G-4) Bridge has published these books in the United States since 1982 pursuant to two sublicense agreements. In the first agreement, dated June 8, 1982 (Exhibit G-5), NEP granted Bridge the nonexclusive right to publish all religious literary works Mr. Hubbard had written to date in the United States, Canada and Mexico (Bridge sells directly only in the United States and Canada). In exchange, Bridge agreed to pay NEP an initial lump-sum payment of \$150,000 and royalties at sliding rates of 11 percent to 16 percent of the retail price for hardcover books (OEC and DMSMH hardcover) and 9 percent to 13 percent of the retail price for mass market paperback books (DMSMH softcover).

This agreement was superseded by a March 15, 1983 agreement (Exhibit G-6), which maintained the same sliding scale of royalty rates. Subsequently, on February 1, 1985, Bridge and NEP amended the sublicense agreement (Exhibit G-7) to change the base for the royalty rates from the retail price to the lower (20 percent) IAS discounted price. The effect of this amendment was to reduce the amount of royalties payable under the arrangement.

The primary license agreement covering these three books during the period in question was entered into between Mr. Hubbard and NEP on June 1, 1982. This agreement granted NEP the nonexclusive right to publish all religious literary works Mr. Hubbard had written to date worldwide. In exchange, NEP agreed to pay Mr. Hubbard an initial lump-sum payment of \$225,000 (of which \$150,000 is attributable to Bridge) and 92 percent of all royalties NEP received from Bridge. NEP was entitled to retain 8 percent of the royalties it collected from Bridge as compensation for its obligations under the license agreement.^{*/}

^{*/} While CSI and RTC have reserved discussion of benefit to Mr. Hubbard for Part II of their Supplemental Submission, it is worthwhile to point out at this time that both Mr. Ruh and Mr. Conland concluded that Mr. Hubbard's royalty rates were either reasonable or "consistent with," "substantially less than" or "substantially lower than" standard royalty rates for the publishing industry. See Exhibit G-9 at, ¶12 and Footnotes 2, 5 and 8; Exhibit G-8 ¶18.

Bridge sells books to Churches of Scientology (at an average discount of 60 percent of the suggested list price) or to retail bookstores (at an average discount of 50 percent of the suggested list price). Church bookstores sell almost exclusively to members of the International Association of Scientologists ("IAS"), who are entitled to a 20-percent discount from the suggested list price.

The costs, prices and profits of each book are:

	<u>DMSMH (Hardcover)</u>	<u>DMSMH (Softcover)</u>	<u>OEC</u>
<u>Bridge's Receipts:</u>			
List price	\$25.00	\$ 4.95	\$ 90.00
Discount (60 or 50%)	<u>15.00</u>	<u>2.47</u>	<u>54.00</u>
Receipts (wholesale price)	<u>\$10.00</u>	<u>\$ 2.48</u>	<u>\$36.00</u>
<u>Bridge's Costs:</u>			
Plant	\$.39	\$.00	\$.60
Manufacturing	2.49	.70	7.08
Overhead	1.87	.70	7.68
Royalty	<u>4.00</u>	<u>.64</u>	<u>14.40</u>
Total costs	<u>\$ 8.75</u>	<u>\$ 2.04</u>	<u>\$29.76</u>

Bridge's Operating Profit:

Net profit	\$10.00	\$ 2.48	\$36.00
Total costs	<u>8.75</u>	<u>2.04</u>	<u>29.76</u>
Operating profit	<u>\$ 1.25</u>	<u>\$.44</u>	<u>\$ 6.24</u>
Operating profit as a percentage of list price	<u>5%</u>	<u>9%</u>	<u>7%</u>
Operating profit as a percentage of receipts	<u>12.3%</u>	<u>12.5%</u>	<u>17.3%</u>

Bookstore operating profit:

Wholesale price	\$15.00	N/A	\$54.00
IAS discount (20% of list)	5.00		18.00
Sales commission (15% of IAS price)	3.00		10.80
Average freight	- <u>.74</u>		- <u>1.81</u>
Operating profit	<u>\$6.25</u>		<u>\$23.34</u>
Operating profit as a percentage of list price	<u>25%</u>		<u>26%</u>
Operating profit as a percentage of bookstore receipts	<u>42%</u>		<u>43%</u>

The two experts who reviewed CSI's pricing method and prices for the three representative books concluded that they are not designed to maximize profits. According to Mr. Ruh, the pricing method "is reasonable in light of the standards and practices of the publishing industry,

both nonprofit and for-profit." (Exhibit G-3 at ¶20) In fact, Mr. Ruh found that Bridge computes its overhead at rates lower than rates prevalent in the publishing industry, which is "likely to cause Bridge's retail book prices and profitability to be lower" and that Bridge "could justifiably raise its retail prices." (Id. at ¶22.)

Mr. Ruh analyzed the prices through profitability to Bridge, as the publisher. He found that Bridge's average net operating profit (its profit as a percentage of list price of nine percent on DMSMH softcover) was "reasonable and consistent with publishing industry standards." (Id. at ¶23.) Mr. Ruh concluded that Bridge's net operating profits of five percent on DMSMH hardcover and seven percent on OEC "are reasonable but are at the low end of the average net operating profit range for the textbook segment of the for-profit and nonprofit publishing industries." (Id.)

Mr. Ruh also analyzed the books' prices by the return on investment method ("ROI"), which is the most common method of analyzing profits in the publishing industry. (ROI is computed by dividing net operating profits per copy by the total costs -- plant, manufacture, overhead and royalties -- per copy of each book.) Under

this method, Mr. Ruh explains, both nonprofit and for-profit publishers seek a minimum standard of 10 percent for their return on investment. Bridge's ROI is much less comparatively -- only 3 percent for DMSMH hardcover, 4 percent for DMSMH softcover, and 7 percent for OEC. Mr. Ruh concluded:

Thus, it is my opinion that the prices for these representative books are very reasonable and in fact below the price that would be set if Bridge were seeking the industry's minimum standard return on investments.

Id. at ¶24.

Mr. Ruh plainly disagrees with the Service's unfounded assertion that prices are set to maximize profits. To the contrary, he found that prices would have to be raised "by a significant amount" to maximize profits, and even then prices would "still fit well within reasonable industry practices."

If the goal of Bridge and the Church of Scientology were to maximize profits from sales of books, the retail prices of DMSMH (hardcover and softcover) and OEC could be increased by a significant amount and still fit well within reasonable industry practices.

Id.

Mr. Conland took a different tack and analyzed prices and profits in terms of Bridge's profit as a percentage of its net return on sales and the discount

structure offered Church bookstores. He found that Bridge's profit as a percentage of its net sales of DMSMH softcover, which is 12.3 percent, is "within the range of average publishing industry profits for best-selling mass market paperbacks." (Exhibit G-9 at ¶16.)^{*/} He also found that Bridge's profit as a percentage of net sales of DMSMH (hardcover) and OEC, which are 12.5 percent and 17.3 percent, respectively, "also are consistent with average profits for textbooks in the publishing industry and are not excessive." (Id.)

Mr. Conland concluded that "Bridge's profits . . . and its book prices . . . are reasonable in light of the general practices and standards of the publishing industry," and that "the prices of these books are not set at an amount designed to maximize profits from their sales." (Id. at ¶7.)

^{*/} Mr. Conland calculated Bridge's net income for DMSMH Softcover as a percentage of gross sales (rather than net sales, as is the case for the hardcover books) because industry statistics for mass market, as paperbacks are based on gross sales (Exhibit G-9 at ¶14 and Footnote 1).

b. E-Meter

The Service has asked for purchasing and pricing information for an E-Meter. Since the Mark VI E-Meter (Regular Model) (hereinafter referred to as the "E-Meter") has had the most per unit sales for the period in question, it was selected as representative of E-Meter sales in general.

The E-Meter is used by Scientologists in receiving the principal sacrament of the Scientology religion and is sold by Churches of Scientology to individual Scientologists primarily through Church bookstores. Pursuant to Church policy, the bookstores sell E-Meters only to sincere students or fully-qualified Ministers of the Scientology religion who are members of IAS. The suggested list price of the E-Meter (Regular Model) is \$3,328.88. Its IAS discounted price is \$2,663.10.

The E-Meters are manufactured by Bridge, in its own facilities, and sold pursuant to a sublicense with NEP, which is licensed by the creator of the E-Meter, L. Ron Hubbard. Bridge has manufactured and sold E-Meters in the United States since 1982 pursuant to a sublicense agreement dated August 19, 1982 (Exhibit G-10). By this agreement, NEP granted Bridge the nonexclusive right to manufacture and sell the E-Meter (as well as the Mark V E-Meter) in the United States, Canada and Mexico (though

Bridge sells directly only in the United States and Canada). In exchange, Bridge agreed to pay NEP an initial lump-sum payment of \$30,000 and a royalty at the rate of 16 percent of the retail price. On February 1, 1985, Bridge and NEP amended the sublicense agreement (Exhibit G-11) to change the base for the royalty rates from the retail price to the lower IAS discounted price. The effect of this amendment was to reduce the amount of royalties payable under the arrangement.

The primary license agreement covering E-Meters during the period in question also was entered into between Mr. Hubbard and NEP on August 19, 1982. (Exhibit G-12) This agreement granted NEP the nonexclusive right to manufacture and sell Mark V and Mark VI E-Meters worldwide. In exchange, NEP agreed to pay Mr. Hubbard an initial lump-sum payment of \$60,000 (of which \$30,000 is attributable to Bridge) and 92 percent of all royalties NEP received from Bridge. NEP was entitled to retain 8 percent of the royalties it collected from Bridge as compensation for its obligations under the license agreement.*/

*/ While CSI and RTC have reserved discussion of benefit to Mr. Hubbard for Part II of their Supplemental Submission, it is worthwhile to point out at this time that both Mr. Smith and Mr. Alexander concluded that Mr. Hubbard's royalty rates are either reasonable or are "well within, and in fact below" or "significantly less than," standard rates payable to a patent owner. See Exhibit G-13 at ¶12, 16-17; Exhibit G-14 at ¶8, 11-12.

Bridge sells E-Meters to Churches of Scientology at a discount of 50 percent of the suggested list price for bulk purchases of 10 E-Meters. Church bookstores sell almost exclusively to IAS members who are entitled to a 20-percent discount from the suggested retail price.

The costs, prices and profits of the E-Meter are:

<u>Bridge's Net Profit:</u>	<u>Discounted</u>	<u>Retail</u>
Sales price	\$2,663.10	\$3,328.88
50% bulk discount on sale of 10 E-Meters to bookstores	- 1,331.55	- 1,664.44
Wholesale price received by Bridge	\$1,331.55	\$1,664.44
Royalties paid to NEP	426.10	532.62
Parts	347.15	347.15
Manufacturing cost	38.87	38.87
Operating costs	- 308.47	- 308.47
Net profit retained by Bridge	\$ 210.96	\$ 437.33
Amortized lump-sum payment**/ Effective net profit retained by Bridge	- 1.68	- 1.68
	\$ 209.28	\$ 435.65
<u>Church Bookstore Net Profit</u>		
Sales price	\$2,663.10	\$3,328.88
Wholesale price to Bridge	- 1,331.55	- 1,664.44
Gross profit to bookstores	1,331.55	1,664.44
Sales commission (5%)	133.16	166.44
Average shipping and insurance	- 3.67	- 3.67
Net profit retained by bookstores**/	\$1,194.72	\$1,494.33

*/ If the Bridge's \$30,000 lump-sum payment to Mr. Hubbard, through NEP, is spread over the 17,900 E-Meters expected to be sold before the agreement expires in July 2001, Bridge's profit is effectively reduced by \$1.68 per unit.

**/ The actual net profit retained by COS should be somewhat lower per unit than the amounts shown because, in addition to Bridge, Church bookstores also pay for the promotion of E-Meters. However, a per unit cost figure cannot be calculated accurately because the bookstores promote E-Meters, books, tapes, etc. from a single budget and often in the same materials.

The two experts who reviewed CSI's pricing method and prices for the E-Meter concluded that "the discounted and undiscounted retail prices of the E-Meter are reasonable in light of its production and delivery costs." Exhibit G-12 at ¶12; Exhibit G-13 at ¶8.

Mr. Smith and Mr. Alexander also concluded that the list price of the E-Meter (\$3,328.88) is reasonable based upon "the common manufacturing industry practice of setting retail prices at 300% to 400% above the total per unit cost of production and delivery." Specifically, the two experts found that the list price is about 385% over the per-unit production and delivery cost of \$864.60 (based on sales at the retail price). The experts also concluded that the IAS discounted price of the E-Meter (\$2,663.10) is reasonable because it is about 320% over the per-unit production and delivery costs of \$831.32 (based upon sales at the IAS price). (Exhibit G-12 at ¶24); (Exhibit G-13 at ¶19).

c. Jewelry

The Service also asked for purchasing and pricing information for a representative item of jewelry. Since the sterling silver Clear Bracelet (medium size) (the "Clear Bracelet") is one of the best selling jewelry items in terms of unit sales, it was selected as representative of jewelry sales in general. However, like all of the jewelry items sold through the Church bookstores, it is a low volume item and has sales of only about 500 units annually.

Clear Bracelets are sold only to Scientologists who have reached the Spiritual level known as "Clear," and may be purchased only through Church bookstores. The suggested retail price of the Clear Bracelet is \$138.00.

The Clear Bracelets bear a registered trademark originally owned by Mr. Hubbard, which he assigned in 1982 to the Religious Technology Center subject to his pre-existing license to NEP and NEP's sublicense to Bridge. Clear Bracelets are manufactured for Bridge by subcontractors and sold by Bridge pursuant to a sublicense with NEP dated January 2, 1986, but effective as of June 8, 1982, by which NEP granted Bridge the nonexclusive right to sell jewelry and other items bearing Scientology

trademarks originated by Mr. Hubbard. (Exhibit G-15) In exchange, Bridge agreed to pay NEP a royalty at the rate of 11 percent of the list price.

The primary license agreement covering the Clear Bracelet during the period in question was entered into between Mr. Hubbard and NEP on May 28, 1982. (Exhibit G-16) This agreement granted NEP the nonexclusive right to sell jewelry and other items bearing Scientology trademarks originated by Mr. Hubbard worldwide. In exchange, NEP agreed to pay Mr. Hubbard the entire 11% royalty (based on the list price) received from Bridge.

Although the Hubbard/NEP license and the NEP/Bridge sublicense require the payment of a royalty of 11% of the list price of jewelry items (such as the Clear Bracelet), until March 1987 Bridge was erroneously paying NEP 16% of the IAS price, and NEP was paying Mr. Hubbard 15% of the IAS price, pursuant to earlier licenses to Bridge's and NEP's predecessors that have now been superseded. Bridge and NEP have been paying royalties at the rate of 11% of the IAS price, rather than the list price, since March

*/ While CSI and RTC have reserved discussion of benefit to Mr. Hubbard for Part II of their Supplemental Submission, it is worthwhile to point out that Mr. Revoyr concluded that Mr. Hubbard's royalty rates are reasonable. See Exhibit G-17 at 116, 11.

1987 because that is the price at which the Clear Bracelets are actually sold in Church bookstores. (Mr. Hubbard's estate will be contacted to discuss recovery of any overpayment of royalties, or possible offset of future royalties by the overpaid amount.)

Bridge sells Clear Bracelets to Churches of Scientology at a discount of 30 percent of the IAS price. Church bookstores sell the Clear Bracelets exclusively to IAS members who have reached the level of "Clear," who are entitled to a 20-percent discount from the suggested retail price.

The costs, prices and profits for the Clear Bracelet are:

Bridge's Profit:

Retail list price		\$138.00
Discount to IAS Members (20%)		- 27.60
Discounted retail price		110.40
Church bookstore gross receipts (30% discount)		- 33.12
Wholesale price charged by Bridge		\$ 77.28
Per Unit Cost	\$ 46.00	
Royalty (16%)	17.66	
Operational Overhead (estimated)	5.00	
Total Cost		- 68.66
Net profit		\$ 8.62

Church Bookstore's Profit:

Gross receipts on IAS price	33.12
Sales commission (15% of sales price)	- 16.56
Net profit	\$ 16.56

Jack R. Revoyr reviewed CSI's pricing method for the Clear Bracelet and concluded that "the price of the Clear Bracelet has not been set to maximize Bridge's profit." Exhibit G-17 at 19. According to Mr. Revoyr, Bridge's discounted and undiscounted prices for the Clear Bracelet are "substantially lower than average . . . prices for comparable items of jewelry." (Id. at 111)

Moreover, Mr. Revoyr concluded that Bridge's pricing method "results in an abnormally low price" for the Clear Bracelet, and that "if Bridge's goal in pricing the Clear Bracelet were to maximize profits, it could raise its price by a very significant amount." (Id.) Specifically, Mr. Revoyr observed that the IAS price for the Clear Bracelet is only about 50% over Bridge's wholesale price (\$77.28), even though "jewelry of this type is typically priced at a rate of 200-300% over the wholesale price." (Id. at 19)

d. Services

CSI went to great lengths in trying to find an expert qualified to analyze its policy and procedure for setting contribution rates for its religious services. Over a two-month period, CSI's representatives contacted numerous managerial consultants, professors and other professionals who advise providers of various service. Not one expert contacted was qualified to express an opinion about the reasonableness of CSI's policies and methods or of the contribution rates themselves.

Quite frankly, CSI was a bit perplexed. CSI is absolutely certain that its policy and method for setting contribution levels for religious services run afoul of no rule under the tax exemption laws. As discussed above, levels are set so they will be affordable to all -- and primarily the upper lower class and lower middle class -- yet enable the Scientology faith to be practical and grow as it determines best.*/

*/ As discussed at G-17 to G-18, supra, contribution rates are set at levels designed to (1) make the entire spectrum of Scientology's religious technology available to the average person, (2) encourage parishioners to train as ministers in order to increase the dissemination of the technology, (3) assure that the Church and missions that provide the technology to the public can support a viable and expanding religious program, and (4) provide funds for further dissemination of the technology and growth of the religion as a whole.

CSI had hoped to establish this fact conclusively through the opinion of appropriate experts.

Just recently, a United States Court of Appeals clearly and succinctly stated the reason why qualified experts could not be found. As the Service is well aware, the deductibility under section 170 of contributions for Scientology services is or was at issue in cases pending before every United States Circuit Court of Appeals, except for the Federal Circuit. A central question before the courts is (or was) the value of the services received since, under established tax law, the deduction for a charitable contribution must be reduced by the value of any benefits received.

Three courts already have rendered decisions in the cases. One, the Eighth Circuit, held that the contributions qualify for deduction. The others, the First and the Ninth Circuits, held that the contributions do not qualify for deduction.

Whatever their conflicting holdings and other inconsistencies, one fundamental rule emerged from each of the three decisions the applies directly to the issue at hand -- Scientology religious services can be valued only by Scientologists. Secular man cannot quantify strictly religious services since they have value only to adherents

to the particular faith involved. As the Eighth Circuit held in allowing the deduction, "Spiritual gain to an individual church member cannot be valued by any measure known in the secular realm." Staples v. Commissioner, No. 86-1376 slip op. at 6 (8th Cir. July 1, 1987).

Who else other than a Scientologist is qualified to place a value on the spiritual experience received from Scientology's religious technology? A non-Scientologist cannot begin to answer that question without first catching a small glimpse of what this spiritual experience is like:

I was receiving some auditing, and in the auditing session I was able to recall a time in my past when I had been a very, very old lady in another body, and I had been very old and very tired and my friends, my two old friends, were sitting by the bed. And I was just tired, I was worn out. I didn't want to go on anymore. And it wasn't like pain or anything like that. And I recalled that I just, as a Thetan, a spiritual being, I said, okay, that's it, I am not going to do this anymore.

And I slid out of the body and out of the room and out into the sky, and this was what I remembered in the auditing session. And I went up into the air and it was a sunny day and there was a green hill and a blue sky and there were little children playing. And being free of the old body was such an incredible feeling. I looked at the little children and I thought, Oh, I want to go and do that again. And it was like I was able to remember then as a spiritual being, yeah, we can, you know, we can go and do this again.

As soon as I decided that that's what I wanted to do, there was just a new -- a body in the womb and that was the one I took, changing from one to another.

And what happened was that in the auditing session while I was remembering this experience, I myself left this body and could feel the freedom of being just a spirit. And it was -- there is no way to describe that feeling of freedom and that total certainty that you really are a spiritual being and not this stuff here.

And to me, that was what I had been looking for in a religion all my life. So that was when I knew this was a religion.

Graham v. Commissioner, No. 84-7794 (9th Cir.

July 17, 1987) Brief for Appellant at 14.

Is this experience worth one dollar or a hundred thousand dollars? Should it be valued in light of the costs involved in providing the religious technology to this one particular person in this one particular session, in making it available to the public at large, or in supporting the entire hierarchical Church, both for the present and for the future? Or is the value, simply put, the worth placed on this experience by every member of the Sea Organization -- one billion years of dedicated service?

Even the First and Ninth Circuits, which held for the government by disallowing a deduction, pointedly warned the Service against attempting to value these services. According to these courts, any such exercise

would violate the First Amendment's prohibition against governmental entanglement in religious affairs:

Imagine, for example, a case in which the government monitored church records in an attempt to place a monetary value on the benefit of all church services, group programs, and pastoral counselling generally available to contributing members. Such a case would present not only the problem of determining value but also the problem of excessive entanglement in the affairs of a religious institution.

Hernandez v. Commissioner, No. 86-1276, slip op. at 10 (1st Cir. June 1, 1987). Accordingly, the court was forced to accept the value placed on the services by the Church itself. Id. at 10-11. Accord, Graham v. Commissioner, No. 84-7794, slip op. at 12 (9th Cir. July 17, 1987).

The courts cannot evaluate Scientology's religious services, nor can the Service, without violating the Church's fundamental rights under the constitution. Consequently, the Service must accept CSI's representation that contribution rates for religious services are not set to maximize profits.

4. Increase in Contribution Rates

As a primary example of CSI's efforts to "maximize profits," the Service pointed to two lists of contribution rates (Attachments 8 and 11 to the Protest), which indicated that rates for certain religious services doubled between 1982 and 1984. Attachment 8 reflects contribution rates for certain services offered by Celebrity Center from approximately October 1980 to June 1981; Attachment 11 is a list of contribution rates for many of the same services that were established in the Fall of 1984.

The Service's conclusion is incorrect. These two lists do not fairly reflect the actual trend in rates; instead, they represent only two samples during a period when rates fluctuated widely. In point of fact, from April 1980 to the present, contribution rates decreased on the average by 26 percent. If inflation for this period were factored in, rates actually decreased by 66 percent.

For more than a decade before 1976 contribution rates for most Scientology services had been constant, with little change. In 1976 gradual price increases were instituted bring the contribution rates for services into line with the high rate of inflation that had occurred

since the mid-1960s. According to the United States Bureau of Labor Statistics, inflation increased prices from 1967 to 1976 by 75.4 percent. Consequently, between 1976 and 1984, contribution rates were increased and decreased as attempts were made to find the correct level consistent with the Scriptures, the needs of the Church, and the needs of the parishioners.

The two lists in question reflect the wide fluctuation in rates during this period. During the period covered by Attachment 8, October 1980 to June 1981, rates had been sharply reduced for a short period. CSI determined that rates were not consistent with the Scriptures, and it gradually increased them. Finally, in mid-1984, CSI's Deputy Executive Director, International Production and Executive Director International conducted an overall review pursuant to the formula discussed above (see pages G-18-19) and concluded that rates should be set at the then existing level.

CSI has reconstructed the contribution rates offered from April 1980 to the present to demonstrate the actual trend in rates for this period. The following table illustrates the fluctuation and general decline in rates for the services listed on Attachments 8 and 11 for that were listed for the entire period:

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	<u>Apr 80</u>	<u>Oct 80</u>	<u>June 81</u>	<u>June 83</u>	<u>Fall 84</u>	<u>Current 87</u>
Student Hat	\$1,067	\$325	\$325	\$589	\$1,000	\$500
Acad Levels (per level)	\$2,134	\$650	\$650	\$1,173	\$2,010	\$1,400
NED Course	\$4,269	\$1,200	\$1,200	\$2,144	\$4,040	\$2,100
Purification Rundown	\$1,337	\$1,000	\$1,000	\$1,789	\$2,000	\$1,400
Auditing 12 1/2 Hrs	\$3,962	\$1,250	\$1,250	\$2,472	\$4,330	\$4,030

As shown, contribution rates increased and decreased in comparable degrees, and the 1984 rates for training courses were in most cases slightly less than the rates in April 1980, and for auditing slightly higher. The actual percentage change in rates from April 1980 to Fall 1984 and to the present is as follows:

	<u>Fall 1984</u>	<u>Current 1987</u>
Student Hat	(.06)	(.53)
Acad Levels (per level)	(.06)	(.34)
NED Course	(.05)	(.51)
Purification Rundown	.50	.05
Auditing 12 1/2 Hrs	<u>(.09)</u>	<u>.02</u>
Total change	<u>.24</u>	<u>(1.31)</u>
Average change	<u>.05</u>	<u>(.26)</u>

The foregoing analysis of the trend in contribution rates from April 1980 to the Fall of 1984 shows a de minimis increase in the average rate of only 5 percent. However, since inflation for this period increased prices by 29.7 percent, the actual average rate for this period decreased by 24.7 percent.*/ Moreover, if the current level of contribution rates is taken into account, contribution rates declined from April 1980 to the present by 26 percent. And if inflation for this period (40.2 percent) is factored in, contribution rates decreased by 66 percent.

Thus, contrary to the Service's assertion, contribution rates for religious services have not doubled. They have not even increased. Since the middle part of 1980, rates actually have decreased by 66 percent.

*/ The only reason contribution rates increased at all during this period resulted from a 50-percent increase in the the rates set for the purification rundown. The Service was introduced in early 1980, and as a new service, the rates as initially set were later found to have been too low for this service. Consequently, a adjustments were necessary in order to formulate one that compats with Church policy.

D. Reserves

Most of the concerns on commercialism that the Service raised during the Conference dealt with the size, management and purpose of Church reserves. As in the Initial Letter, the Service asserted that accumulation of reserves is a very important indicia of a commercial purpose. (CSI Letter at 55-56. RTC Letter at 62-63.)

The Service agrees that section 501(c)(3) organizations may make more money than is necessary to sustain operations so long as there is an exempt purpose for accumulations. However, the Service maintains that the amount of reserves the Church hold must bear a relationship to its anticipated needs. According to the Service, there must be some concrete plan for specific uses of any reserves.

In addition, the Service asked numerous questions concerning the very details of the Church's reserves management. For example, the Service wanted to know whether all eight Scientology religious trusts participate in the reserves system, whether deposits are combined in one account, whether reserves for United States churches can be segregated, and whether income

produced by reserves remains in reserves. The Service also asked for clarification of the Church's policy for contingency reserves to cover two years of operating expenses. Finally, the Service wanted to know whether CSI ensured that reserves were expended only for purposes consistent with Church policy.

What follows is a comprehensive, detailed response that meets each and every one of the Service's concerns. This information establishes, without question of any kind, that CSI manages reserves on a daily basis, that it ensures that all reserves expenditures are for purposes that further Scientology's religious purposes, that there is a specific religious use planned for every penny, and that the amount of Church reserves is wholly insufficient to cover the Church's anticipated needs. In short, the amount of reserves is not unreasonable in light of the Church's existing religious program and anticipated needs.

1. Scientology's Central Reserves System

The Church of Scientology maintains a central reserves system to fund important programs and activities of the religion such as expansion, broad-scale dissemination, defense and emergencies. This system is unique to the Scientology religion and is founded and

managed in accordance with the administrative technology of the faith. It cannot be compared to the reserves system of any other entity or group of entities, whether secular or religious.

For example, the Church uses central reserves to fund many expenses that recur regularly over each accounting period, such as professional fees (from lawyers, accountants, etc.) and dissemination expenses (media spots, brochures, etc.). These expenditures often are of extraordinary size that benefit every Church and Mission of the Scientology faith. As a general rule, most organizations treat these and similar noncapital expenditures as current expenses payable from operating funds, not as distributions from reserves accumulated earnings.

Another difference between the Church's system of reserves and other systems lies in the relationship between reserves funding, management and expenditure. These entities fund, manage and authorize expenditures from their own reserves accounts. Under the Church's system, the Church or Trust that owns the particular account in question generally funds the account and always authorizes all expenditures from it. Management,

as explained below, is carried out by CSI's ecclesiastical hierarchy and not by the owner of the account. Thus, while CSI's staff may manage central reserves, each Church and Trust has sole discretion as to how its funds will be spent.

The following United States Scientology Churches and Trusts participate in this system:

1. Church of Scientology International ("CSI")
2. Church of Scientology Flag Service Organization ("CSFSO")
3. Church of Scientology of California ("CSC")
4. Church of Scientology Religious Trust ("CSRT")
5. Scientology Endowment Trust ("SET")
6. Scientology Dissemination Trust ("SDT")
7. United States Scientology Films Trust ("USSFT")
8. Church of Scientology Buildings Trust ("CSBT")
9. International Scientology Religious Trust ("ISRT")
10. Church of Scientology Expansion Trust ("CSET")
11. Church of Scientology Western United States ("CSWUS")

In addition, 37 Class IV Churches and 61 Missions throughout the country also participate in the reserve system as described below.

In general, each of the 11 Churches and Trusts identified above maintains reserves in at least two separate bank accounts: one local account (usually in Los Angeles) and one in Luxembourg. In addition each maintains an account with an agent, SOR Management Services Ltd. ("SORMS"). In addition, CSI, CSFSO, SET, and CSRT maintain separate reserve accounts for the foreign currencies they hold. Class IV Churches generally maintain only local accounts in the United States. Occasionally, a Class IV Church also may maintain an account in Luxembourg.

The specific reserves accounts maintained by the Church corporation and trusts are:

	<u>Los Angeles/Local Account</u>	<u>Luxembourg Account</u>	<u>SORMS Account</u>
CSI (dollars)	yes	yes	yes
CSI (other currencies)	no	yes	yes
CSFSO (dollars)	yes	yes	yes
CSFSO (other currencies)	no	yes	yes
CSC	yes	yes	no
CSRT (dollars)	yes	yes	yes
CSRT (other currencies)	no	yes	yes
SET (dollars)	yes	yes	yes
SET (other currencies)	no	yes	yes
SDT	yes	no	yes
USSFT	yes	no	yes
CSBT	no	yes	yes
ISRT	no	yes	yes
CSET	no	no	yes
CSWUS	yes	yes	yes

Reserves accounts are funded through different procedures, depending on the Church or Trust involved. For example, the 37 Class IV Churches noted above participate in the reserves system indirectly, through CSI. Each week they send CSI a payment for the ecclesiastical management services CSI provided to that Church, which is deposited to CSI's reserves account.*/ While these funds, now in a CSI account, are subject to CSI's control, they are not used for CSI's routine operating expenses. They are used for purposes to benefit the religion as a whole -- usually dissemination, defense or capital expenditure.

Scientology Missions also participate in the reserves system indirectly through Scientology Dissemination Trust ("SDT"). Each week they send SDT a tithe equal to ten percent of their weekly receipts. These tithes are deposited into SDT's reserves accounts and are used to pay routine expenses of Scientology Missions International and to fund broad-scale dissemination programs that benefit the religion as a whole. (For example, in 1986 SDT received approximately \$1,000,000 in tithes; it expended \$600,000 for SMI's operating expenses and \$400,000 for dissemination programs.)

*/ This amount is determined weekly by the Class IV Church's Flag Banking Officer in light of the amount owed CSI and the local Church's own needs. The payment generally approximates five to ten percent of the local Church's weekly receipts.

CSFSO, on the other hand, funds its reserves accounts directly. Each week, CSFSO allocates its receipts among its operating expenses, which includes its licensing fee to RTC for use of the Advanced Technology, its management payments to CSI (around \$200,000 a week, which must cover all of CSI's operating expenses), and its film licensing payments. These represent all of CSFSO's recurring local operating expenditures; any excess of receipts over these expenses is transferred directly to CSFSO's reserves accounts.

Occasionally, a Church or Trust that maintains reserves accounts may make a grant or loan to another Scientology Church or Trust. These funds may be paid directly into a reserves account maintained by the transferee, if one is maintained, or used to establish an account for the transferee.

2. Reserves Management

As noted above, the reserves owned by a particular Church or religious Trust are expended in accordance with the determinations of its Board of Directors or Trustees. These determinations are made in alignment with the general and specific financial needs of the Scientology religion as a whole, which are coordinated

through the weekly, monthly and annual budgets and financial planning of the International Finance Network. This Network is responsible for all matters relating to the financial affairs of the hierarchical church, including budgets and reserves. (Its structure and activities are discussed in detail in Finance Series 11R attached as Exhibit H-1.)

The principal ecclesiastical body within the hierarchical church responsible for managing central reserves is the Reserves Committee. The purpose of the Reserves Committee is to ensure that central reserves are kept safe, expended only for purposes of the religion, and are increased to assure continued expansion of the church and broader defense and dissemination of the religion. A principal function of the Reserves Committee is to approve or reject (on a line item basis) monthly budgets for expenditures from central reserves. As discussed in more detail below, this monthly budget is compiled from all requests from churches for funding from central reserves.

At present, each member of the Reserves Committee is a full-time staff member of CSI and holds one of the highest ecclesiastical posts in the International Finance Network. These posts are WDC Chairman, WDC Reserves,

International Finance Director, SOR Chief and Reserves Budget Finance Officer. The area of general responsibility within the International Finance Network and the specific function on the Reserves Committee of each of these individuals are discussed below.

a. Role of ecclesiastical management

A proposal for an expenditure from central reserves generally is prepared by a staff member from the part of the church or organization that is responsible for the activity or purchase for which funding is being requested (i.e., a particular department, division, unit or office of a church). For example, the International Network of Computerized Management (the division within CSI that is responsible for establishing computer systems and programs for church management) would prepare proposals for purchasing computer equipment. The Office of Special Affairs would prepare budgets for expenses for outside professionals such as lawyers and accountants. Estates Staff would prepare a proposal to purchase new property or to remodel an existing building.

Church policy requires that every proposal for an expenditure from central reserves must set forth complete details of the proposed expenditure. Specifically, each

proposal must contain a description of the activity to be funded or asset to be purchased, the amount requested (with all supporting financial data), an explanation of why the activity or asset is necessary, how it will contribute to the expansion of the religion, and how it aligns with the goals of the religion and with the particular functions of the part of the organization that is making the proposal.

Then, the ecclesiastical hierarchy within the organization responsible for the activity or asset in question reviews each proposal to ensure it meets the foregoing criteria. A proposal is initially reviewed by the immediate seniors of the staff member who prepared it and eventually by the organization's Advisory Council and Executive Council, and from there to the Reserves Committee.

b. Role of the Reserves Committee

As noted above, the Reserves Committee is the principal body in the ecclesiastical hierarchy that is responsible for managing the religion's central reserves. It consists of five individuals -- WDC Chairman, WDC Reserves, International Finance Director, SOR Chief, and Reserves Budget Finance Officer. The

specific responsibilities and functions of these individuals are:

1. WDC Chairman. WDC Chairman is the most senior ecclesiastical official in the Church of Scientology. He chairs the the Watchdog Committee ("WDC"), which oversees the entire international ecclesiastical management structure of the Church. WDC Chairman serves as the chief executive officer of WDC.

2. WDC Reserves. WDC Reserves is the highest ecclesiastical authority in the hierarchical church with respect to central reserves. WDC Reserves is the member of WDC who oversees the finance network and reserves system of the religion. WDC Reserves has the responsibility of keeping WDC informed as to all financial matters of the Church.

3. International Finance Director. The International Finance Director is the senior ecclesiastical official of the International Finance Office. The International Finance Director oversees operation of the entire International Finance Network, which supervises all financial planning and financial operations for the hierarchical church. In general, the International Finance Director and the International

Finance Office and Network have primary responsibility for managing the receipts, expenditures and reserves for the hierarchical church. The functions and activities of the various components of the International Finance Office are explained in Exhibit C-3 of the Protest.

4. Sea Org Reserves Chief. The Sea Org Reserves Chief ("SOR Chief") is responsible for supervising the use of funds in central reserves from CSI hierarchical churches and from investments. Since a major use of central reserves is to purchase or remodel property, one of SOR Chief's most important duties concerns the status of the church's needs with respect to land and buildings. To accomplish this, SOR Chief directly supervises staff whose sole responsibility is to coordinate the Churches' real estate needs with its existing and expected plans. The senior officer on this staff, a position called International Landlord, is responsible at the international level for overseeing the planning for purchases and renovation of all properties. The International Landlord, in turn, supervises Landlords and Estates staff at the local levels who are responsible for acquisitions and remodeling of property by lower Scientology organizations.

5. Reserves Budget Finance Officer. The Reserves Budget Finance Officer ("RBFO") is responsible for compiling all budgetary proposals into a budget and for overseeing actual expenditures from reserves. The RBFO prepares the monthly budget for approval and reviews disbursements each week to ensure they are in accordance with the approved budget. The RBFO also supervises reallocations of funds among line items in between meetings of the full Reserves Committee that may be required as a result of changes in priority or unexpected emergencies. One of his duties is to monitor projects that depend or will depend on reserves for financing, including those in the earliest stages of planning.

The RBFO reviews proposals as they are received by the Reserves Committee and prepares them for review by the full committee. Ideally, proposals for expenditures from central reserves will be prepared long before the expenditure is necessary so they can be incorporated into the Finance Network's annual budget projections for large, known expenses and proposed projects for the upcoming year, such as major purchases of property and equipment acquisitions, broad dissemination plans, and certain professional fees (attorneys, accountants etc.). These long-term budget projections are used to establish a stable base against which more detailed budgets are

developed for each month of the ensuing year, as well as for coordination with management on planning and execution.

However, since the need for funding from central reserves can arise at any time during the year, organizations often submit their proposals for reserves expenditures when the need arises. Regardless of when submitted, all proposals are processed by the Reserves Committee under the same procedure.

During the last ten days of each month the Committee meets to review all proposals submitted that month to ensure that they are complete and that they promote the religion, are consistent with and will forward the aims of Scientology, and fit within the purposes of the part of the organization making the proposal. The Committee also determines whether the proposal is economically sound and whether it is authorized by international management. The Reserves Committee reviews all proposals as a composite whole against the aggregate in all reserves accounts, the ceilings set for the prior month, and the strategic and tactical planning of international management, and liabilities, and makes adjustments as needed.

As discussed above, the Reserves Committee does not have unfettered control over reserves accounts. If a proposal involves any large, unusual expenditure for a particular Church or trust, it must be approved by the Board of Directors or Trustees of the Church or Trust concerned, but only after ecclesiastical approval by management and financial approval by the Reserves Committee. These requests will be approved only if the governing board of the Church or Trust involved determines that the expenditure will promote Scientology's religious purposes. Thus, individual Churches and Trusts have complete autonomy over the use of their reserves accounts.

The RBFO prepares a monthly budget summary on the basis of the Reserves Committee's review of all the proposals, which is submitted to the Reserves Committee for final approval. All approved expenditures are consolidated into master lists that are maintained by RBFO for the Reserves Committee and also by SORMS. Individual Church organizations receive separate copies of budget approvals for their own proposed expenditures. (The amounts approved by the Reserves Committee represent ceilings above which the organizations cannot spend.)

Once the budget is approved, staff are authorized to activate their plans and incur the expenses and monitor the expenses throughout the month to ensure expenditures are kept within the approved budgeted amount.

Whenever funds need to be disbursed to pay for the approved projects, the staff concerned will submit disbursement proposals to the RBFO by Wednesday night of each week. Each Thursday the RBFO compiles these weekly disbursement proposals into weekly financial planning lists for disbursements to occur on Fridays. The RBFO summarizes these weekly disbursement proposals and then meets with the Reserves Committee each week for approval of weekly disbursements against priorly approved budgets. These approvals are then communicated to SORMS as authorization for the release of funds from reserves. SORMS may pay the expenses directly or transfer funds to the organization's local account for subsequent payment.

The method of funding of approved proposals for very large expenditures varies depending on the facts of the particular proposal. Some proposals include requests to set aside funds towards a large purchase or program that will not be implemented until the future. Since the Church's financial planning is carried out on a monthly

basis, set asides generally are requested for an expenditure that will be made in the near future usually within six months. Funds approved for set asides towards a future expenditure may be retained in a separate bank account called the Reserve Payment Account, which is managed by SCRMS.

When a very large disbursement is anticipated for the future, such as the purchase of a multi-million dollar building, but the exact property, payment date or purchase price is not yet determined, funds will be built-up in reserves for the large purchase even though not necessarily placed in a segregated account. Similarly, if the expenditure will be made in stages over a long period of time, as with the renovation of a building or certain dissemination programs, funds also will be built-up in reserves, though not necessarily placed in a separate account. Here, amounts will be drawn down regularly as approved in the weekly disbursements.

One of the RBFO's most important duties in this process is to keep abreast of the status of every project that will require a reserves expenditure, even those in the early planning stages. This function benefits both

the Reserves Committee -- by keeping it informed of anticipated needs -- as well as the organization preparing the proposal -- by giving its personnel realistic guidance on financial matters early on in the planning process.

3. Amount of reserves

Much has been said about the possible size of the Church's reserves. The Service has, for example, speculated that it exceeds any conceivable use to which the funds could be put. The Service also has maintained that the size of these reserves single-handedly establishes the Church's hidden agenda -- to accumulate money.

The facts show otherwise. At the Service's request, and only for purposes of this submission, CSI finance personnel prepared a consolidated balance sheet reflecting the combined assets, liabilities and net worth of all Scientology Trusts and Churches in the United States that participate in the central reserves system. (These Churches and Trusts were identified on page H-4.) This balance sheet settles, for once and for all, any question as to the reasonableness of the aggregate of their reserves.

Church staff devoted a great deal of time and effort to compile this financial information. Since the Church's accounting systems are not designed to produce this form of financial presentation, numerous records of all sorts had to be identified, collected

and reviewed to locate all pertinent data. This process was expensive and time consuming. It severely disrupted the very demanding normal work schedules of the staff members involved, which directly support CSI's religious mission.

The Service's probing search into the Church's financial affairs and the resulting disruption of its religious program represents a clear case of excessive entanglement in violation of the Church's First Amendment rights. While CSI and RTC have been forced to prepare and present this information in order to protect their tax status, this disclosure does not constitute a waiver of their First Amendment rights.

The Service must bear two important points in mind while reviewing this balance sheet. First, while this balance sheet is a consolidation, at the Service's request, the assets and liabilities reported are not owned on a consolidated basis. No Church or Trust can be assured that any of its liabilities will be offset by the assets owned by another Church or Trust unless that other Church or Trust authorizes the expenditure. As noted above, this requires a determination by its Board of Directors or Trustees that the expenditure

will help advance religious purposes, and is proper under their organizational documents.

Second, the figures presented are unaudited and in many cases are approximate totals. For example, figures have been rounded to the nearest \$100,000, and CSI staff personnel estimate that there could be a ten percent or more margin of error in the figures overall. However, this estimated, consolidated balance sheet represents CSI's best efforts to quantify the current financial standing of the subject organizations.

The reason CSI does not have precise financial data for these assets is that its ecclesiastical financial system is not designed to account for the current value of assets such as real property, tangible personal property and certain investments. CSI's ecclesiastical financial system is geared to reflect data related to its religious program -- dissemination, provision of religious services, and expansion -- not net worth. Thus, unless the particular financial information in question has some bearing on the dissemination of Scientology's technology -- and net worth does not -- it is not specifically provided for in CSI's ecclesiastical financial system.

Net assets will be inflated somewhat since CSI and other Churches of Scientology follow the cash-basis method of accounting and do not account for all accrued liabilities, such as interest. Finally, a significant amount of many items reported are owned by 37 Class IV Churches throughout the country that do not provide CSI with regular reports concerning the value of all their assets. CSI cannot guarantee the accuracy of values reported by these organizations for many items such as real and tangible personal property. However, CSI believes the value reported for inventory (religious books, E-Meters, etc.) is more accurate as it is derived from routine reports received from lower Churches.

The values reported for real property are based on the most recent appraisals available as of December 31, 1986. Current values may be higher, and two appraisals prepared since that date indicate values for real property should be increased by \$12 million. Most values for real property owned by Class IV Churches have been extrapolated from various internally-generated reports.

Whatever their current value, the assets classified in the real property category have no

bearing on the Church's reserves. Real property consists only of property used exclusively for religious purposes (church building, berthing, administrative offices, etc.); it does not include investments or property used for other purposes. Thus, these assets are already dedicated to a religious purpose.

Tangible property (all of which is used exclusively for religious purposes) is valued at the lower of cost or market. Investment property (primarily oil and gas properties) are valued at the lower of cost or market. The value reported for oil and gas properties is market, based on a recent valuation. (Negotiations currently are underway to dispose of these properties.)

Contributions received from parishioners for the provision of religious services in the future (their "advance contributions") are reported as other liabilities. Churches are obligated to deliver these services and to return these contributions if the parishioner decides not to receive the services.

CONSOLIDATED BALANCE SHEET
(in millions)

Assets

Current assets			
Cash	\$	13.0	
Investments (gold)		26.8	
Inventory for resale		18.4	
Certificate of deposit (frozen)		<u>2.9</u>	\$ 61.1
Fixed assets			
Real property		32.4	
Tangible property		13.5	
Investments		<u>16.0</u>	61.9
Loans receivable on investments			.8
Receivables from Scientology organizations			
Accounts receivable		7.4	
Mortgages receivable		33.8	
Loans receivable		<u>41.0</u>	<u>82.2</u>
Total Assets			<u>\$206.0</u>

Liabilities and Net Worth

Current liabilities			
Bills payable	\$	2.4	
Notes & loans payable		<u>7.0</u>	9.4
Other liabilities			
Judgment (on appeal)		30.0	
Taxes assessed		12.8	
Parishioners' advance contributions		51.5	
Mortgages payable		<u>3.1</u>	97.4
Liabilities to Scientology organizations			
Notes and loans payable		43.5	
Mortgages payable		<u>15.3</u>	<u>58.8</u>
Total liabilities			<u>165.6</u>
Net worth			<u>40.4</u>
Total liabilities and net worth			<u>\$206.0</u>

4. Planned Uses of Reserves

The preceding analysis shows a net worth of \$40.4 million (actually \$52.4 million if current appraised values of religious-use real property are included). Of course, net worth does not reflect "reserves" since most of the values reported -- such as real and tangible personal property -- already is dedicated to a religious use or obligated for a similar purpose.

The actual amount of reserves can be anything. It could be set at \$51.7 million (current assets less current liabilities), but this value would not reflect offsetting liabilities owed to third-parties (non-Scientology organizations). A more realistic value could be a negative \$28.9 million, the sum of current assets, investments and loans receivable on investments -- \$77.9 million -- less the sum of current liabilities and other liabilities -- \$106.8 million.

The Service also may want to add to this reserves value the net receivable from other Scientology organizations (\$23.4 million), for a reserves value of negative \$5.5 million. At most, the Service might add in the advance contributions, for a reserves value of \$46 million, but this would be wrong since these funds

may have to be returned to individual Scientologists if services are not provided. They are liabilities.

Whatever the value of reserves -- \$51.7 million, \$46 million, or a negative \$5.5 or \$28.9 million -- one thing is certain -- each and every dollar in these accounts is dedicated to some specified use that either supports or advances the religion of Scientology. There simply are no reserves in excess of those the Church will need to meet its anticipated needs.

For example, at the Conference and in the Protest, CSI explained in great detail the Church's finance policy to maintain sufficient funds in reserves to cover operating expenses for two years in the event of loss of funding. The Service agreed that this policy was reasonable and acknowledged that most nonprofit, tax-exempt organizations either do or should maintain reserves for this sort of contingency. As one expert on these matters advised, "Each year, funds should be set aside in such a reserve until such time as the organization is one year ahead financially; that is, could operate an entire year without any income of any kind." T. Wolf, The Nonprofit Organization -- An Operating Manual (1984) at 97.

The routine operating expenses (which excludes payments into reserves) of the United States Churches are as follows:

Two Year's Operating Expenses (in millions)		
	<u>Annual</u>	<u>Biannual</u>
Class IV Churches	37.96	75.92
Celebrity Center Network	10.40	20.80
U.S. Sea Org Orgs	15.60	31.20
CSFSO	26.00	52.00
CSI	20.80	41.60
CSC	1.56	3.12
SMI	<u>1.04</u>	<u>2.08</u>
Total	<u>113.36</u>	<u>226.72</u>

As shown, reserves are not sufficient to cover one year's worth of operating expenses, let alone the two-year contingency required by prudent, fiscal policy. Indeed, even if reserves were worth \$51.7 million -- or even \$60 million -- there are only sufficient funds to support United States Churches for about six months. Thus, there simply is no excess in reserves.

In addition to this contingency fund, CSI has definite, specific plans to use \$1⁵~~2~~6,870,350 of reserves -- more than double its value -- to finance programs that are essential for the Scientology faith to be practiced in the present and to grow in the future. These plans

all are concrete and their needs closely monitored by the Reserves Committee. In fact, the Reserves Committee already has approved most of the planned uses for immediate funding and is either making expenditures through the monthly budget process or awaiting sufficient funds.

CSI also is providing numerous exhibits to substantiate the degree to which these planned uses have been put into effect. Wherever appropriate, an exhibit package has been included to support the description of particular projects within the following text. Each package consists of a longer, detailed description of the project, including financial planning, as well as some tangible proof of its status -- photographs, slides, books, tape cassettes, video cassettes, blue prints and the like. This hard evidence establishes that these uses are all religious, bona fide and concrete.

Planned uses of accumulated reserves fall into six categories: 1) dissemination of the technology, 2) legal defense of the religion, 3) acquisition, construction, and renovation of Church property, 4) equipment needed to carry out religious functions, 5) Church public relations activities and publications, and 6) support

of Church staff. These projects will be funded by a total of \$126,870,350 from reserves.

a. Dissemination of the technology

The Reserves Committee plans to devote \$43,514,631 from reserves in 1987-88 to disseminate the Scientology religion to the public by 1) instituting an intensive dissemination campaign for two basic books, namely, Dianetics: The Modern Science of Mental Health and Self Analysis, 2) establishing Hubbard Dianetics Foundations in each U.S. Scientology Church, 3) circulating within Church organizations materials encouraging parishioners to partake of higher level training and counselling, and 4) encouraging parishioners and the public to partake of the Purification Rundown. The central unit within CSI responsible for these activities is known as the Central Marketing Unit, the sole purpose of which is to disseminate the religious technology of the Church.

(1) Public dissemination of books

The preferred and most successful method of dissemination is to get the public to read a book by Mr. Hubbard to learn what Dianetics and Scientology are all about. For this reason, the bulk of dissemination

expenditures is used for Dianetics: The Modern Science of Mental Health and Self Analysis. These books set forth the basic principles of Dianetics and Scientology.

Wide public dissemination of these books, through National Dianetics Campaigns -- involving expensive prime-time television spots, TV talk shows, a Dianetics TV show, Dianetics introductory films on cable television, increased public relations and news media announcements, seminars, and video distribution -- have proven to be the most important and successful of the Church's propagation efforts.

Expenditures for book dissemination are submitted to the Reserves Committee as part of monthly budgets, and sometimes are submitted and approved on a long-range basis. In the first half of 1987, approximately \$4.1 million was spent for public dissemination of books. Between now and the end of 1988 it is estimated that an additional \$25.2 million of reserves will be devoted to book dissemination campaigns.

(2) Establishing Hubbard Dianetics Foundations

Hubbard Dianetics Foundations are responsible for delivering basic Dianetics services and conducting

seminars to educate the general public on the immediate and practical uses of this religious technology. The Reserves Committee anticipates spending \$3,144,360 to establish Hubbard Dianetics Foundations in every Scientology organization, and expenditures for this purpose are submitted as part of monthly budgets.

(3) Circulation of dissemination materials within Church organizations

In addition to public dissemination campaigns, CSI also disseminates materials within Church organizations to encourage parishioners to partake of higher-level counselling and training to increase their spiritual awareness and well being.

To date in 1987, approximately \$1.1 million of reserves has been spent by CSI for this type of dissemination, and the Reserves Committee expects to spend another \$2,670,271 for this purpose through 1988.

(4) Promoting the Purification Rundown

L. Ron Hubbard discovered a method of totally cleansing a body of all residual drugs and toxins while simultaneously increasing spiritual awareness known as the Purification Rundown. The Church intends to launch a

major campaign to disseminate this technology to the general public, and the Reserves Committee plans to devote \$12 million to this campaign between now and the end of 1988.

A more detailed description of these uses is attached as Exhibit H-2.

b. Legal defense of the religion

The Reserves Committee authorizes approximately \$1 million per month, or \$12 million annually in 1987 and 1988, for legal and accounting fees, court costs, and other expenses relating to the defense of the religion and the activities of the Church. These defense expenditures, which are paid out of reserves and are approved as part of monthly budgets, cover the following types of legal and accounting activities:

1. Litigation to enforce the Church's trademarks;
2. Other civil litigation;
3. Litigation and negotiations with the Service and state and local tax agencies;
4. Legal and other professional consultation; and
5. Professional fees to accounting firms.

The Church has instituted several trademark infringement actions, funded by reserves, to safeguard the integrity of the marks and the purity of the Scriptures. (These legal actions will be discussed in greater detail in Part II of the Supplemental Submission). The enforcement of the marks, although costly, is vital to the Church.

Reserves also are utilized to defend actions brought against the Church that raise important First Amendment questions affecting the entire religion. Those cases often raise complex legal issues and contain inflated claims for damages.

The Church has also expended substantial funds from reserves to vindicate violations of its Constitutional and civil rights by local, state and federal agencies, and to litigate under the Freedom of Information Act (FOIA).

In the process of obtaining tax exemption and resolving questions with the Service, the Church also has expended substantial funds from reserves to respond to the Service's voluminous requests for information. Other substantial legal fees are incurred in connection with audits, tax planning, and tax-related litigation.

In addition to expenses for litigation, reserves also pay legal fees for consultation with attorneys and accountants on routine legal matters.

A more detailed description of this use is attached as Exhibit H-3.

c. Acquisition, construction and renovation of Church property

The Church is presently engaged in major construction and renovation projects, which will be funded by reserves at a total cost of \$52,434,158, in Clearwater, Florida, and in the Los Angeles, California area.

(1) The CSFSO facilities, Clearwater, Florida

The Church of Scientology Flag Service Org, Inc. ("CSFSO") is the largest Scientology Church, and its facilities house the largest Scientology religious retreat delivering the most advanced levels of auditing and training available to parishioners. CSFSO ministers to the spiritual needs of over 1,000 parishioners from around the world at any one time. Most parishioners who come to CSFSO stay in Church facilities.

The nine buildings and other properties currently owned and operated by the Church in Clearwater include one large central residential facility, three smaller residential facilities, one large residential complex, and four administrative office buildings. All of these buildings are fully utilized for delivery of religious

services, administrative support services or parishioner and staff berthing and dining facilities. None of these buildings is new. In fact, the main building is over 50 years old and has required enormous amounts of restoration simply to bring it up to code, such as complete rewiring and re-plumbing. Many of the buildings require extensive renovations to bring them up to modern standards of electrical, plumbing, air conditioning, heating, ventilation, roofing, structural soundness, etc.

These renovation and remodelling projects on the main building have been proceeding over the past three years at a total cost to date of approximately \$4 million from reserves. An additional \$4 million from reserves will be spent to remodel and extend berthing spaces, to expand student study and technical administrative areas, to build additional auditing rooms, to expand the bookstore and storage areas, to remodel dining, canteen, and entry areas, to refurbish showers, baths, medical facilities, garage and swimming pool, to repair the physical plant; and for other renovation and construction.

Another \$1,160,000 from reserves will be spent to renovate another large residential facility which contains living and dining facilities for parishioners. Plans call for a major overhaul of the property including new roof, plumbing, air-handlers, walls, ceilings, floors, windows, fixtures, furnishings, dining facilities, and galley equipment, construction of new auditing rooms, and construction of increased berthing and auditing facilities.

About \$350,000 from reserves also will be spent to renovate the largest administrative building. Plans include converting the front lobby into a Scientology museum, installing a new roof, performing major structural work, and completing new interior walls, ceilings, floors, furnishings, display cabinets, etc.

The Reserves Committee approved all of these plans in a 1983 proposal, but far more has been spent than was originally planned, and the plans have expanded since that time. Updates and funding requests for these projects are submitted on a weekly basis, and it is currently estimated that a total of \$5,558,500 from reserves will be spent for all of these projects on the Clearwater properties over the next 1-2 years.

A more detailed description of this use is attached as Exhibit H-4.

(2) Churches in the Los Angeles Area

The Reserves Committee expects to spend a total of \$46,875,658 for the following major property acquisition, construction, and renovation projects in the Los Angeles area.

(a) The Cedars Complex

The old Cedars of Lebanon building complex in Hollywood was purchased in 1976 to house in one central location a number of Scientology Churches that were scattered about the Los Angeles area. Over the past decade this building has been used by literally thousands of Church staff and parishioners, which has resulted in enormous wear and tear on the facility. Extensive renovation of the property is now required.

The Church must expand and restructure the Sunset Boulevard entrances to the Complex because they were not designed for the large number of people that use them daily. This will require demolition and reconstruction of exterior and interior walls, floors,

and decks, roofing, structural work, and removal of debris. The estimated costs for this project are over \$400,000, plus \$200,800 for double insulated glass that filters out ultra-violet and infra-red light and saves enormous amounts of energy.

Other plans include expanding dining facilities at a cost of \$130,000, modification of office space (including new lighting and air conditioning) at a cost of \$1,300,000, replacement of office equipment at a cost of \$160,000, and repainting the exterior and interior of the complex at a cost of \$500,000.

The Church also plans to build a museum to exhibit an informative view of Mr. Hubbard's life and work. This will be flanked by a new facility for expanded introductory religious services and a parking structure to accommodate the increase influx of parishioners. The estimated total cost of these projects is \$5,400,000.

Current expansion rates also require new premises for several large organizations currently located at the Complex. An extensive search for new properties in the Los Angeles area has been ongoing for several

months. Prices for the properties viewed to date have ranged from \$5 to \$18 million and the price range currently being considered is about \$15 million. Planned facilities will provide housing and working spaces for over 600 of the staff currently living and working in the Cedars Complex. These facilities will include offices, berthing, kitchens, laundry, and all that is needed to make the facilities self-contained.

Once appropriate facilities are chosen, renovations will be required before they can be used. Projected costs for these renovations, as calculated for one property that was examined, would add approximately \$1.6 million to the purchase costs.

The Reserves Committee is fully informed and aware of this project through close consultations and the exchange of communication with the Church Architect who has prepared extensive drawings for these projects, and will provide funding for an appropriate facility. In addition, the Reserves Budget Finance Officer meets regularly with staff who are working on the project to keep the Reserves Committed up-to-date on the status of the plans. A total of \$15,000,000 from reserves is expected to be devoted to this project.

A more detailed description of this planned use is attached as Exhibit H-5.

(b) The Hollywood Inn Building

This eight-story building currently houses approximately 167 adult staff members and 146 children, but it is old and contains a large amount of unusable and inefficiently used space. Massive renovations will be required to modernize and convert this building to either of two uses currently being considered: (1) creating additional berthing space for parishioners visiting Los Angeles area Churches (estimated cost: \$186,635), or (2) converting the building to an administrative office building, which would require building a 100-car parking facility. A three-level parking structure. This project will cost \$621,600, and with a four-level structure, \$828,000.

To remodel this older, inefficient floor plan, nonessential interior walls must be removed to create a modern, "open plan" office space. The remodeling cost would include full demolition of seven floors, roof construction, plumbing repairs, fire suppression, electrical work, and mechanical repair (cooling and heat), at an estimated cost of \$776,000. The

construction of interior walls and dropped ceilings, and the installation of insulated windows and carpets with pads will cost \$321,992, bringing the total for remodelling this structure to \$1,097,992.

The Reserves Committee expects to devote a total of about \$22,000,000 to the projects at the Cedars Complex and the Hollywood Inn. Although the Reserves Committee has determined that these renovations are critical, funding has not yet been finalized for these renovations because planning is ongoing. The Committee continues to closely monitor this project through the Reserves Budget Officer.

A more detailed description of this planned use is attached as Exhibit H-6.

(c) Boarding School for Children

A search is currently underway for a suitable property to establish a ranch-style boarding school for the approximately 450 children of the Los Angeles area Sea Organization staff members. Over the past year, a great deal of research has gone into locating the proper site, which must have approximately 75-100 acres of land. Twenty-one properties have been considered

and researched over the last few years ranging in price from \$1.1 to \$2.2 million.

The estimated cost of this facility, which has already been committed to this project from reserves, is \$1.7 million for purchase and renovation, plus \$972,000 for the first year operating expenses, for a total of \$2,672,000. The Reserves Committee is monitoring this project and has assisted in preparing financing proposals therefor.

A more detailed description of this planned use is attached as Exhibit H-7.

(d) Restoration of the Manor

Fifield Manor is a 60 year old Hollywood landmark which currently houses the Church of Scientology Celebrity Center, where artists and celebrities in various fields are trained in the Scriptures and tenets of Scientology and receive spiritual counselling. The Manor has deteriorated and needs to be refurbished so that it can continue to fulfill its vital function to Scientology.

Restoration and renovations planned for the Manor have been ongoing for several years and include work on the exterior to improve its appearance and to save the building from further deterioration. This work includes replacing and sealing part of the roof and retiling the rest, building a scaffold around the building for waterblasting, resealing, and repainting the entire building, grading and landscaping the grounds, and installing new exterior lighting.

Extensive renovations also are planned for the interior, including creating smaller, more efficiently designed rooms, moving, restoring, and decorating each room, building interior walls, upgrading the electrical and water supplies, total rewiring and plumbing, installing a new air conditioning system, and renovating the dining facilities.

After the main renovations of the building and other new construction are completed, the small theatre at the Manor will be replaced by a much larger theater and workshops in the space that is presently a parking garage. The bookstore in the Manor also will be expanded to display all of the books of the religion.

To accommodate expansion of delivery of religious technology, construction of a new Church of Scientology Celebrity Center building adjacent to the main Manor building will begin in early 1988.

The Reserves Committee has reviewed several plans and proposals for these renovations and anticipates that the estimated costs for the execution of the plans will be \$9,343,000 in appropriations for their execution. The Reserves Budget Finance Officer has also visited the Manor on numerous occasions to obtain a working knowledge of this project and to keep Reserves Committee abreast of its progress.

A more detailed description of this use is attached as Exhibit H-8.

(e) Gilman Hot Springs

The Gilman Hot Springs property, a 500-acre facility located in Southern California, houses administrative facilities for use by the highest levels of CSI's ecclesiastical management and Golden Era Productions. The number of staff within these units is now over 500 and growing. The current office space facilities (including space used for the delivery of

religious services to staff), and utilities are inadequate for ecclesiastical management to perform their duties and to continue to expand. Thus, the Reserves Committee has approved a plan which includes the expansion of one building, renovation to gain better utilization of existing space, the construction of another small office building, and upgrading the utilities servicing the property.

Plans are also underway to construct six new buildings to house staff members and to remodel an existing building to house professional Scientology artists and performers engaged in various film and music projects at Gilman Hot Springs.

The Church also plans to have its own farm, which will produce several basic foodstuffs for use exclusively by staff members residing on the property. These products will not be resold.

The Reserves Committee has reviewed plans for these projects for which a total of \$13,362,666 is expected to be expended. The Reserves Budget Finance Officer tours Gilman frequently to review project planning and makes financial recommendations to the

Reserves Committee. He also is kept informed by the Church Architect on the progress of the project.

A more detailed description of this planned use is attached as Exhibit H-9.

d. Equipment needed to carry out religious functions

The Reserves Committee has approved or is considering approval of about \$35,402,561 to purchase the following equipment to carry out the Church's religious purposes:

1. Computer equipment for the Church as a whole.
2. Transcribing and publishing equipment for the Church's compilation projects.
3. Tape and film production and duplication equipment for Golden Era Productions.

(1) Computer equipment

To accomplish needed computerization of the Church, a separate organization was within CSI established called International Network of Computer

Organized Management (INCOMM). The purpose of this organization is to establish and operate an international computer system for the Church. To date, the Church has spent over \$10 million on computer hardware and development of software. This includes 150 central processing computers, approximately 1,000 individual user terminals and supporting equipment, several tons of air conditioning, optical character readers, extra disc storage, tapes to operate as memory backups, and security provisions. Expenditures for this equipment were approved by the Reserves Committee.

Plans for 1988 call for computerizing fifty Churches in a network connected to a central computer system. To do this the Church will require three mainframe central computers, software, storage discs, approximately 100 peripheral terminals and supporting communications equipment, a large satellite dish, software development and hardware and software maintenance contracts. In addition, each of the 50 Churches will require multiple terminals and data input stations in quantities commensurate with their size.

The Reserves Committee has approved feasibility studies on this computerization project, has determined

that these expenses are critical to continued expansion of the religion, and has set aside funds for them. The estimated cost of the computerization project, which will be submitted as a standard budget item, is \$21,430,000.

A more detailed description of this planned use is attached as Exhibit H-10.

(2) Transcribing and publishing equipment

The LRH Compilations Unit (Comps Unit) was originally established as a "Tapes to Books" project for the purpose of transcribing all of Mr. Hubbard's tape-recorded lectures and compiling the transcriptions into books and other forms of publication. However, the age of many of the tapes results in poor sound quality, which has stalled the transcription process. Antiquated typewriting and typesetting equipment also has slowed this vital project.

To facilitate the transcribing of the tapes and the compilation of the tape transcriptions into books, the Comps Unit needs modern, high quality sound play-back equipment (including reel-to-reel tape decks, headphones, cassette tape decks, and equalizers),

computer equipment for specialized word-processing (including IBM AT personal computers, high capacity disc drives, modems, printers, word processors, and software), and sophisticated typesetting and photocopying equipment. The computer equipment also will be utilized for the Comps Unit's long-term goal of compiling volumes of all of Mr. Hubbard's written works not yet in book form.

The research and planning for this new equipment is complete and the estimated financial expenditures of \$757,561 from reserves are expected to be approved later this year.

A more detailed description of this planned use is attached as Exhibit H-11.

(3) Tape and film production equipment

Golden Era Productions (Gold), occupies most of the Gilman Hot Springs property. Gold reproduces Mr. Hubbard's Scientology lectures and also produces religious films, which together with books comprise the bulk of the Scriptures.

Many of these lectures were recorded 20 or more years ago and as a result, the audio quality is poor. Additionally, through the years the master tapes have deteriorated, further lessening the quality of the original recording. These original tapes must be "mixed" to improve the sound quality, which requires the use of very sophisticated and expensive equipment. After mixing, the tapes are then copied onto cassettes for dissemination.

The current production facilities are producing at their maximum capacity and must be more than doubled to handle the demands for these lectures in both English and foreign speaking countries. Thus, the Church plans to add two additional lecture mixing rooms, which will require additional mixing and editing equipment. To double production, new production and high-speed copying lines will be required, and will be housed in a new building.

Gold also produces films which play a key role in both the dissemination and application of the technologies of Dianetics and Scientology. The production of these films is no small task. Every action that is required to make a Hollywood film is

required to make a Scientology film (directing, make-up, lighting, camera, sound recording, editing, music soundtrack, mixing, etc.), but currently there is only one studio. The only way to increase the speed of production is to expand the film shooting facilities.

The first vital facilities to be constructed will be an additional film studio and a building to construct and store sets and props. The film editing and final assembly facilities also will be expanded to keep pace with increased production.

Current color film negative stock begins to deteriorate after four years. To preserve Scientology films for future generations, the Reserves Committee expects to approve funds to create a laboratory for film preservation and for production of "release copies" of films. This film lab requires the construction of a building and the installation of equipment which, while expensive, is a necessary expenditure which will save enormous amounts of funds over the long term.

CSI is also purchasing 500 specially modified projectors to replace the Churches' current obsolete

systems. This plan will provide the Churches with a high-quality standard projection system that is much less expensive than they could purchase individually.

The Church also plans to move the E-Meter production operations to Gold to assure that E-Meter are produced according to the highest possible standards.

The Reserves Committee has approved the plan to speed up tape and film production and related activities by creating the needed facilities. The Reserves Budget Finance Officer regularly monitors the progress of these plans and makes recommendations to the Reserves Committee regarding specific projects. The Reserves Committee anticipates budgeting \$13,215,000 for the purchase of this equipment and the construction of these facilities, not including Gold's operating costs.

A more detailed description of this planned use is attached as part of Exhibit H-9.

e. Church publications and public relations activities

It is a maxim of Scientology management that when Mr. Hubbard's image is not present in and around an organization, the organization is likely to fail because its personnel forget the source of its Scriptures and are apt to employ nonstandard substitutes for the Scriptures. Promoting Mr. Hubbard's image in association with the Church also attracts parishioners to the Church and provides a constant symbol of the need to maintain the purity of the religious technology.

The LRH Public Relations Office International ("RPR") [see Protest B-29-30] was established to accomplish these purposes. Members of the RPR staff in each continental office, through LRH Communicators on staff in each organization, implement internal public relations campaigns designed to increase staff proficiency and parishioner satisfaction, and publicly promote Mr. Hubbard's image to increase community goodwill and Church membership.

RPR is engaged in the following public relations activities:

1. an international project to standardize the quotations and photographs of Mr. Hubbard that are displayed on the premises of every Church organization;
2. a campaign to promote the standard usage of the Scriptures in the delivery of auditing and training;
3. a project to upgrade deteriorating photographs of Mr. Hubbard so that they are usable for Dianetics and Scientology publications and awards;
4. a program to give small Christmas gifts to executives and staff of some Church organizations;
5. a Church expansion incentive campaign known as the "LRH Birthday Game;"
6. five annual international celebrations for all Scientologists; and
7. publication of Good News, a monthly newsletter for Scientologists; HOTLINE, a newsletter for Church Public Relations Officers; an inspirational calendar for Scientologists; the "LRH Booklet" for educating the public about Mr. Hubbard's religious work; and "Ron Mag," which provides information about Mr. Hubbard's many significant achievements and contributions to the Church and society.

The Reserves Committee expects to authorize expenditures of \$5,610,200 on these projects between now and the end of 1988. (This figure includes only one appropriation for annual events, such as the Christmas Campaign and the five annual celebrations.) RPR's funding for these projects is approved as part of its monthly budget submissions.

A more detailed description of this use is attached on Exhibit H-12.

The Reserves Committee also expects to spend \$5,784,000 in 1987 to publish three Church periodicals as part of its dissemination activities. The funding for these publications, described below, is approved as part of the monthly budget submissions:

Freedom News Journal, published monthly and funded entirely by reserves, promotes social reform activities and offers possible solutions to social problems. Freedom is, for the most part, distributed free of charge because its return from subscription rates barely covers mailing costs.

Scientology Today, a monthly periodical designed for parishioners, briefs Scientologists on Church activities. This magazine is distributed free of charge.

Crusader, a newspaper published by the Religious Freedom Crusade (an ad hoc group of ministers, founded and led primarily by Scientologists), is distributed monthly to about 171,000 American clergymen to educate them about First Amendment issues involving freedom of religion. The Church plans to increase the circulation of Crusader to over one million in 1988.

A more detailed description of this use is attached as Exhibit H-13.

f. Support of Church staff

As part of their staff position, Sea Organization members are provided by the Church with their food, accommodations, medical and dental care, a small weekly stipend for incidentals, and uniforms. These expenses generally are routine and not paid by reserves. However, the Church has decided that all Sea Org members should be provided with new uniforms to enhance the Church's public image. This is an extraordinary purchase that will be paid by reserves.

There are different styles of uniforms for different occasions or positions. After extensive research and negotiation with several clothing manufacturers, an order for uniforms was placed earlier this year at a total cost of about \$1.5 million. The cost of uniforming all Sea Org members in the U.S., which was the subject of a proposal to the Reserves Committee and has already been budgeted, will total approximately \$2,125,000 and will be paid from reserves.

A more detailed description of this use is attached as Exhibit H-14.

E. Emphasis on Finance

The final factor the Service identified at the Conference as evidencing a commercial purpose is an overall emphasis on "high earnings" and finance as a policy matter. The Service reiterated its allegations in the Initial Letter that "the primary role of CSI and RTC is to monitor and ensure maximization of profits and proper allocation of income. (CSI Letter at 54; RTC Letter at 61.) The Service maintained that this factor is established because the express policy of the Church as stated in its Scripture, is to "make money" and "more money," CSI unilaterally appropriates funds belonging to lower Scientology organizations for its own purposes, a disproportionate portion of Church literature and staff personnel are devoted to financial matters, and high prices are regularly charged in order to generate substantial reserves for no purpose.

CSI and RTC have discussed in length the Service's concerns with respect to pricing and reserves -- which, along with benefit, are the underpinnings of the Service's initial adverse determination -- and unequivocally established that neither are unreasonable. As has been shown, the Service's understanding of true facts concerning pricing and

reserves is just plain wrong. The Service's understanding of the other facts listed above also is wrong. Financial monitoring is only one of the many activities in which CSI engages. And the sole purpose of this one particular activity is inherently exemption related: to ensure that Churches are able to exist and disseminate Scientology's religious technology. RTC, on the other hand, monitors financial matters as a de minimis part of its activities. Its primary role is to ensure that CSI and its licensees apply Scientology's religious technology according to the Scriptures.

The Service's misunderstanding of the actual facts is aptly demonstrated by its assertion that Church policy is geared to profiteering. The Service supports this position by quoting passages from several policy letters. One such quotation is from an HCO Policy Letter entitled "Finance Series 11R -- Income Flows and Pools -- Principles of Money Management." (Exhibit H-1.) Expressly stated under the hearing "Governing Policy" at the end of this policy are the exhortations to "MAKE MONEY," "MAKE MORE MONEY," and "MAKE OTHER PEOPLE PRODUCE SO AS TO MAKE MONEY."

The import of this quotation cannot be understood unless it is read in context. Making money is policy, but as shown by the policy letter from which the quotation is taken, making money is the policy only of CSI's Finance Network. This particular policy letter was one in a series of policy letters on finance directed to personnel working in the Finance Network (the Flag Banking Officers). (Hence the title "Finance Series 11R.") It was not directed to other personnel, nor was it intended to apply to other networks working in the ecclesiastical hierarchy. Indeed, the policy letter specifically classified the statements in question as "The governing policy of Finance"

The Service also quoted from an issue included as Attachment 12 to the Initial Letter, to the effect that Scientology organizations must make "far more money than the organization needs to operate" and that "some organizations are making far less money than they need to make." A formula immediately following these statements required the organizations in question to allocate their contributions and receipts among six expenditure categories: salary, general liability fund (for litigation costs and contingencies), payments to Flag (for management services), promotion, running

(operating) costs, and backbills. The implication to be drawn from this, according to the Service, is that some Churches are forced to generate "more than they need" so the excess can be funnelled to other Scientology organizations.

Again the Service completely misunderstands the facts. The issue in question was directed to financial personnel (the Flag Banking Officer) of organizations having financial difficulty. It was specifically intended to help organizations that were facing insolvency, or already insolvent, to become more responsible fiscally so they can continue providing Scientology's technology to the public. Indeed, the issue specifically provided that "this issue is not for any organization which is solvent or is rapidly improving its solvency." Notably, the purpose of each allocation in question -- salary, contingencies, management, promotion, operating costs and backbills -- serves a specific and legitimate need for an organization embroiled in financial difficulty. The thing this issue evidences is sound fiscal prudence.

The Service simply cannot excise specific quotations on financial policy from randomly-selected

issues and expect to understand their import. Discrete passages from Scientology's Scriptures have meaning only when they are read in context with the Scriptures as a whole. To whom is the issue directed? What subject does it address? How does this particular subject fit into the entirety of Scientology's administrative and religious technology. All these questions must be asked and answered before a particular quotation can be understood.

Another fact the Service alleged repeatedly during the Conference was that funds flow "from the bottom to the top" of the hierarchical Church, to the financial detriment of the lower organizations. In effect, the Service views the hierarchical Church as a pyramid scheme, headed by a vampire-like Mother Church and supported by subservient smaller Churches whose sole purpose is to feed the Mother Church's insatiable quest for money until their coffers are bone dry.

Again, the Service is wrong. Funds may flow "from the bottom to the top" of the ecclesiastical hierarchy, but they always come back down again to the direct benefit of the lower Churches. These benefits take the form of large-scale and extraordinary

programs, capital facilities, and other expenditures that enable lower Churches to accomplish their religious goals.

For example, Class IV Churches provide CSI a portion of their weekly receipts (generally between five and ten percent) in exchange for the ecclesiastical management services CSI provided to it. These funds go directly to CSI's central reserves and are not used to cover its routine operating expenses (which are provided for by CSFSO).

Similarly, individual Missions provide the Scientology Dissemination Trust ("SDT") with roughly ten percent of their weekly contributions in exchange for the ecclesiastical managerial services they receive from Scientology Missions International ("SMI"), their Mother Church. SDT contributes a portion of these funds to SMI to cover SMI's routine operating costs. The balance is maintained in SDT's bank accounts, which are all included in the central reserves system.

As discussed in the section on reserves, central reserves are used primarily for extraordinary expenditures beyond the financial capability of any

single Church, such as broad-scale dissemination programs (television and radio spots, newspaper inserts, etc.), capital improvements (the purchase or renovation of a new church building, a taping studio, or a printing facility, etc.), and direct financial assistance to lower Churches that become insolvent.

For example, this year CSFSO spent over \$4.1 million from its reserves to disseminate Dianetics: The Modern Science of Mental Health and Self-Analysis. Last year, SDT spent \$400,000 from its reserves for similar purpose. No single Class IV Church or even a group of Class IV Churches could afford the cost of this program, even though dissemination of these books has been found to be the most effective means of introducing the public to the Scientology faith and attracting new parishioners to local Churches and Missions.

Sure, the Service can trace the flow of funds from lower Scientology organizations directly to the reserves accounts that are maintained by higher organizations. But the Service cannot stop here. It must also follow the flow down again to see how the funds are used.

The final evidence of preoccupation with profits that the Service presented during the Conference was a disproportionately large number of staff personnel and Scriptures devoted to financial matters. The Service's apparent impression is that CSI's staff only do two things -- run the cash registers and run to the bank -- and look to the Scriptures only to find out how.

Obviously, the Service does not understand the role finance plays in the Church of Scientology despite its exhaustive questioning over the past few years. It is a part of the religion's administrative technology and performs a support function, pure and simple. Its only purpose is to ensure that sufficient funds are available to provide the buildings, personnel, material and other programs that are necessary to disseminate Scientology's religious technology to the public. The Church's Finance Network supports delivery of the technology; not vice versa.

The subordinate role finance plays with the Church overall is reflected by number of its staff who work in finance. CSI estimates that approximately four percent of its staff works full time in its own Treasury Divisions and International Finance Network (40 of 1,000 staff). In average and larger Churches

(With 50 to 200 staff) the percentage is about the same -- four percent. Similarly, Church policy Scriptures concerning finances comprise less than one percent of the Scriptures (consisting of 29,541 written pages and 98,202 page equivalents of film and recorded tapes).

The Service must recognize a fundamental fact of life in this day and age. Many Scientology organizations are mutually dependent for funds and CSI has an important responsibility to make sure that adequate funding is available for the religious activities of all organizations that are a part of the hierarchial church. Funding is essential for more than just current operating expenses. There must be sufficient funds for proselytization, for expansion of religious programs and capital facilities, and for contingent liabilities. See Murdock v. Pennsylvania, 319 U.S. 105, 111 (1943) ("a religious organization needs funds to remain a going concern").

Unless CSI -- as the head of ecclesiastical authority for the Scientology faith -- can ensure that adequate funds are available for these purposes, the Scientology religion will not be able to realize its full potential.

V. Conclusion

There. Now you have it. The very details of the financial affairs of the Church of Scientology, which do nothing more than substantiate what CSI and RTC have been assuring the Service throughout these proceedings -- Churches of Scientology do not operate for a commercial purpose. They show that CSI, RTC and other Church organizations in the ecclesiastical hierarchy operate exclusively for a religious purpose.

There is no deceptive advertising, and the Church's only activity in finance is to support the dissemination of Scientology religious technology. Religious services are provided for affordable contributions set at amounts necessary to enable the organization to continue delivering the services. Religious services also are provided without charge and for reduced contributions to deserving Scientologists. Prices for books, E-Meters and jewelry are not set to maximize profits but rather to recover costs and enable the organization to continue providing these religious materials. Indeed, prices (as well as "profits") are either reasonable or unreasonably low -- across the board. And as to undedicated reserves, there simply

are none. Every penny, every dime, every dollar that the Church now has on deposit is targeted for some specific religious use.

The only question at this point is what the Service will do with all the information it has collected. What standard will it bear in determining whether these religious organizations serve a sacred or a commercial purpose? Is the Service qualified to pass judgment on the reasonableness or wisdom of Church policy and practice? Surely the Service cannot pretend that it knows better than CSI how to disseminate Scientology's religious technology.

Once again, CSI and RTC protest this broad-ranging inquiry. No other church in this country has been put to such an unbridled test. Indeed, even "run-of-the-mill" publishing houses, to which CSI has been compared, fare much better under the internal revenue laws. And they are not protected by the First Amendment's Religion Clauses against this sort of an inquiry.

A case in point is The National Geographic Society (the "Society"), listed in IRS Publication 78 as a publicly-supported section 501(c)(3) organization.

Everyone knows what the Society does -- its primary activity is publication of one of the most beautiful magazines in this country, National Geographic, a virtual bounty of wonder and fantasy. (Exhibit J-1.) The Society, like no other section 501(c)(3) organization, is as American as apple pie.

In recent months another side of the Society has been exposed that hardly qualifies as charitable. In National Geographic: Behind America's Lens on the World (1987) ("National Geographic"), Washington Post financial editor Howard S. Abramson has provided the public with a penetrating analysis of the Society's financial and "charitable" affairs. (Exhibit J-2.)

As a preliminary matter, Mr. Abramson questioned the charitable nature of this wonderful magazine, the primary benefit of Society membership:

Grosvenor told the reporter that the average National Geographic Society member in 1984 was forty-three years old, earned \$25,000 a year, had 2.2 children, attended college for one year, was employed in a professional or managerial capacity, and liked to spend time outdoors. The Society's membership is about evenly divided between the sexes.

National Geographic at 250. Moreover, Mr. Abramson was hard put to find anything charitable about the Society's current extensive activities:

But as it has grown up, the Society has evolved into an organization that is quite far removed from its original stated goals, as a smaller and smaller percentage of its revenue has gone to research and exploration, and more of its booming treasury has been spent to feed its seemingly insatiable desire to grow ever larger and more profitable. More of its money is being used to raise even more money, even though its annual "profits" (what the Society calls, in the jargon of the tax business, "excess of receipts over expenses and disbursements"), \$30,076,831 in 1983, already would make most corporate treasurers proud.

National Geographic at 7.

Rather, all Mr. Abramson found, after his years of research, was "one of the largest and most profitable diversified publishing companies in the world, with annual receipts well in excess of \$325 million," the "third largest circulation of any magazine in the United States," "one of the country's largest mail-order houses," the "largest purveyor of globes and maps in the world," and the "fifty-fifth ranking media company in American in 1983 . . . with more media sales revenue than Reader's Digest, Playboy

and Penthouse International Ltd." National Geographic
at 5-6.

There is no charity in this, nor is there any
other purpose described in section 501(c)(3):

Gardiner Greene Hubbard's goal was to create an organization of inquisitive, high-minded men both to help chart the globe and to inform other intelligent, curious people about their discoveries -- in short, to promote "the increase and diffusion of geographic knowledge." Alexander Graham Bell's idea was to fund this research, exploration, and publication chain by selling memberships to the masses, but still keeping the Society focused as an educational organization. The Chief's goal was to funnel 15 percent of gross revenues into exploration and research.

. . .

Yet, astonishingly, in 1983, the National Geographic Society awarded research and exploration grants totaling only \$3.18 million, less than 1 percent of its gross revenue. And even that figure is misleading, since many of those "grants" led to articles for the National Geographic, and would perhaps have been more accurately classified as publishing expenses. The next year, the Society reported that its research grants jumped to \$4.3 million. But most of that increase involved projects destined for publication in a new research journal of very limited circulation that the Society was preparing.

The Society also spent about \$3.4 million during 1983 on its little museum on the ground floor of one of its headquarters buildings, on running its news service and library, and in charitable contributions and memberships. In that year, the Society earned some \$170 million from membership dues, almost \$98 million in publication sales, \$13 million from a new children's magazine, National Geographic World, and \$2.5 million from television films and documentaries. It reported a "surplus" of \$30,076,831.

National Geographic at 229-230.

Indeed, Mr. Abramson's conclusions already had been reached by others:

Mainly, what the government is subsidizing [through tax exemptions] is an expensively operated magazine, put out for the entertainment of an affluent readership and filled with innocuous articles on faraway places -- something that, it seems, the readers ought to pay for themselves without the help of the nonreading public.

Lila Locksley, "The National Geographic: How to Be Non-Profit and Get Rich," Washington Monthly, September 1977, pp. 47-48.

How do the Churches of Scientology, the most vital and active organizations of the Scientology faith, compare to a "run-of-the-mill" publishing house

carrying out an "educational" program that is not commensurate with its resources? Assuming the two are comparable, and they are not, a few facts show that the Society -- not CSI or RTC -- should be the subject of these proceedings. For example:

-- The Society's Forms 990 for 1983 and 1984 (Exhibits J-3 and J-4) show total revenue of \$326.6 and \$326.8 million respectively -- more than enough to fund Churches of Scientology in the United States for over two years -- and excess of receipts over expenditures of \$30.1 and \$16.8 million, respectively.

-- The Society's net worth, as these forms show, was \$182.3 million at the end of 1983 and \$198.3 million at the end of 1984. This amount is about four times the reserves values given here, and almost equal to the value of total assets -- excluding any liabilities whatsoever. Moreover, the Society's representations in its 1984 Form 990 make it clear that it has no concrete plans on how it will use this fortune:

As the Society had no endowment given when it organized, the Board of Trustees has been conservative in expenditure and has followed the

policy of adding to the financial reserve of the Society a portion of any operating surplus. This reserve is maintained so that the Society may have funds to make up deficits which may occur in any given year's operation; may have funds for the erection of buildings when needed; can meet increasing capital and operational costs of printing, paper, engraving, and the like; can continually improve on the quality of its official journal which is sent to each member monthly; and may be in a position to extend its basic research programs, to sponsor more exploratory expeditions, and enlarge its educational services for the schools and general public.

Exhibit J-4 at Exhibit B, pages 1-2.

-- The Society's representatives state that about seven percent of its personnel (approximately 246 out of 3,500 staff) work in finance and accounting, almost double the percentage working in these areas of the Church.

-- In the recent Congressional hearings on the unrelated business income tax the members of the cartographic industry in the United States introduced financial and market analysis of the Society's cartographic business activities (Exhibit J-5) that showed that as a result of its tax exemption, the Society has been able to (1) gobble up a 33-percent share of the cartographic market since 1956, which

prior to that time was the sole domain of taxable companies, and (2) realize net income equal to 12-percent of its net sales, while clobbering taxable companies down to only 1 percent of their sales.

There is no comparison between Churches of Scientology and the National Geographic Society. Nor can there ever be one. The Churches of Scientology are the most sacred organizations of the Scientology faith. They are purely religious institutions with no counterpart in the secular world. The activities in question all substantially and directly further the practice and the dissemination of the Scientology religion. They involve the very sacramental and sacerdotal functions of the ecclesiastical Church. They are purely and inherently religious.

Early on the U.S. Supreme Court -- and the Service itself -- recognized that traditional 501(c)(3) standards, even though grounded on public policy like nondiscrimination, have no bearing on churches and other purely religious activities and institutions as a result of the First Amendment. For example, in Revenue Ruling 75-231, the Service rules that it may deny exemption to racially discriminatory schools operated

by churches even where the discrimination is founded upon religious principles. G.C.M. 35986 (Sept. 13, 1974), which underlies the revenue ruling, was careful to note that it was dealing with "essentially secular activities" and that "[t]he state is not free to impose a tax upon the conduct of an inherently religious program like the door to door evangelizing which was before the court in Murdock v. Pennsylvania, 319 U.S. 105, 112 (1944) and Follett v. McCormick, 321 U.S. 573 (1944)." (Emphasis added.)

Similarly, in upholding the Service's position, the Supreme Court also was careful to note the very same point: "We deal here only with religious schools -- not with churches or other purely religious institutions; here, the governmental interest is in denying public support to racial discrimination in education." Bob Jones University v. United States, 461 U.S. 574, 604 n.29 (1983) (emphasis in original).

CSI and RTC protest the Service's broad-ranging, unfettered inquisition into matters of no concern to the secular world. More importantly though, CSI and RTC protest the discriminatory treatment they have received when other organizations with the barest claim

to section 501(c)(3) status are handled with kid gloves -- even to the extent of being afforded the benefit of some "secret law."

For some time now CSI's representatives have asked the Service for some guidance in pricing, reserves, and the other matters at issue. CSI simply wanted to know how it stood under the Service's expectations as it would have had the opportunity to modify its activities, if necessary, to meet the Service's concerns. The Service's response was plain and simple: it refused to give any guidance that would have assured tax exemption. As the Service knows, exemption materially enhances CSI's ability to disseminate the Scientology's religious technology throughout the world.

CSI and RTC have recently learned that the Service does give such guidance to other organizations -- specifically the National Geographic Society -- to the benefit of a privileged few:

Despite their inability to disburse "profits" in the form of dividends, the Society's directors have lavished the best of worldly goods on themselves and their upper-echelon employees. They work in flawlessly appointed suites perched atop marble, granite, and glass towers from which

they can look down on some of Washington's most expensive downtown real estate, over at the fortresslike Russian embassy, the Washington Hilton, and the Washington Post building. Its middle- and upper-level employees have chauffeur-driven limousines at their disposal. And not only is expense never spared on its publications or its top employees, but it is actually encouraged, partly because of the Internal Revenue Service's informal guidelines that set minimum income-to-production-cost ratios for nonprofit publications.

National Geographic at 8-9. (Emphasis supplied.)

CSI and RTC could care less about some "informal guidelines" or other secret law the Service bestows on other organizations since these standards have no bearing on its publishing activities -- which are purely religious. CSI and RTC are genuinely concerned, however, that they have been treated less favorably than organizations that do not enjoy their First Amendment rights.

Fundamental fairness requires that CSI and RTC be treated like any other church or religious institution conducting purely religious activities. Since there is no outstanding issue as to private benefit for periods after January 24, 1986, fair treatment calls for recognition of their exemptions from that date on.