Summary

- Entity Tax-Exempt Status
- Entity Taxation and UBTI
- Taxation of Service Providers
- Church Audits

pp. 271-301
501(c)(3) organized and operated for exempt purposes

Entity type – corp., association, or trust. Some LLCs and partnerships
Articles – organized exclusively for exempt purposes
No more than insubstantial lobbying
No political campaigning
Distribution clause
For purposes of our discussion today, the term “church” is a statutory one. When the word “church” is used we also mean synagogue, temple, mosque, etc. The term “church” has been interpreted by the Courts in this manner in accordance with a broad statutory usage in the tax code.
Formed exclusively for religious and charitable purposes within the meaning of 501(c)(3)

Meets the organizational test
7.2 - Also authorized to engage in manufacturing and operate a social club - FAILS

7.3 – Best interests, common welfare, and well being - FAILS
Legislative/Political Activities

p. 274

- Can’t authorize:
  - More than insubstantial activities influencing legislation
  - Participation in political campaign
  - Action organization (discussed later)
On dissolution assets must be distributed for exempt purpose

Figure 7.1 (p. 275) sample dissolution clause
Operational Test  p. 275

- Operates exclusively for exempt purposes
- No private inurement (earnings benefit insiders)
- No private benefit (anyone)
ABC church is Levi, his wife, and kids
Uses church $ for food, clothing, living expenses
Private inurement
Contacts or urges to contact legislative body
Advocates for/against legislation
Add’l criteria p. 276

If more than insubstantial, fails the organizational test
The LLC Question – Practitioner’s Pointer – Not In Book

- The question has risen as to whether a limited liability company formed by a church or religious organization has to obtain approval as a tax exempt entity.
- Not if it is treated as a disregarded entity!
- In fact, the formation of separate limited liability companies owned by the church or religious organization are desirable to limit liability.
- Examples are a church that inherited an oil well, rental properties, etc.
Application for Exemption

pp. 276-277

- Churches automatic
- Others 1023 or 1023-EZ
- Group exemption if
  - Affiliated
  - Subject to supervision or control
  - Exempt under same subsection
E-Filing Requirements – Not-for-Profits – Taxpayer First Act

- Requires all tax exempt entities to file their annual returns electronically.
- Requires all tax exempt and other entities to file their unrelated business income tax returns (form 990-T) electronically.
- Possible delay in electronic filing requirements for any small organization defined as having gross receipts under $200,000 for two years after enactment.
Trade or business

Regularly conducted

Not related to performance of exempt purpose or function

Ex. 7.5 food stand 2 weeks per year – not regularly conducted
What Is A Trade or Business? – Not In Book

- Furnishing goods or performing services for the purpose of producing income
- Competition with other businesses
- Conducted in a commercial manner
- Some courts have embellished definition with the criteria that business must be conducted with profit motive
Religious organization has historic dairy farm for education

- Sells milk, cream to make ice cream
- Unrelated T or B
- To disseminate religious views – OK
- Publishing unrelated material – UBTI
- Look at 14 factors from audit technique guide
Not UBTI Examples p. 280

- All volunteers
- Member convenience
- Sale of donated items, low-cost articles
Ex. 7.9 Synagogue volunteers operate retail store
Ex. 7.10 Monastery has restaurant and laundry for retreat members
Ex. 7.11 Church thrift shop sells donated items
State and Local Ramifications
Not In Book

- Just because an organization is tax exempt, does not mean that they are exempt from state and local taxes such as:
  1. Sales tax.
  2. Property taxes.
  3. Local taxes.
Low cost articles ($11.10)
Bingo
Exchange membership lists
Qualified sponsorship payment
  - Not advertising
  - Not contingent on attendance/ratings
Not a qualified sponsorship payment if:

- Made in connection w/qualified trade show or convention (attract new members or promote is OK)
- Entitles payer to acknowledgment in a periodical
Calculating UBTI pp. 283-285

- Separate for each T or B
- Increase by disallowed transportation fringe
- Exclude dividends, interest, etc.
- Deduct expenses directly connected w/ T or B
Exclusions from UBTI

- Dividends
- Interest
- Annuities
- Royalties
- Rents
- Gains from disposition (except inventory and cut timber)
Deductions from UBTI  p. 284

- Reduce by directly connected deductions
- Allocate dual use expenses
- NOL deduction – w/ limits
- Charitable contribution deduction
$1,000 specific deduction

Include share p/ship income and deductions

Ex. 7.14 Hindu Cultural Society is a partner in partnership that operates factory. Must include share of gross p/ship income (and deductions).
Include investment income if from debt-financed property

Not if 85% or more substantially related to exempt purpose

Neighborhood land rule – intend to use adjacent property in 10 years
UBTI Filing

- Form 990-T
- Total gross UBTI $1,000 or more
- File by 15th day of 5th month after tax year
Excess Benefit Transactions

- 25% excise tax when tax exempt org provides economic benefit to disqualified person
- 10% additional tax on organization mgr. who knowingly participates
Minister is any religious leader
Common law employer/employee rules apply
Income tax on all earnings (except housing allowance)
Deduct business expenses
No federal tax withholding if duly ordained and salary for ministerial services

Subject to SE tax but can request exemption
Church can elect out of employer’s portion of FICA
Employee may apply for exemption from SE tax
- Income tax
- Request exemption from SE tax
- Only SE income
- Only income from another exempt person
Housing Exclusion pp. 294-296

- Exclude housing allowance or fair-rental value of parsonage
- Still included for SE tax
- Officially designate in advance
- Have to allocate deductions between taxable and tax-exempt
1. Temple pays rabbi 12K/yr housing allowance
2. He pays $13,200 mortgage, utilities, etc.
3. Fair rental value (FRV) is 11K
4. Can exclude 11K (lowest of 1, 2, and 3)
Church allows reverend to use parsonage
Church pays $7,500 for utilities
Exclusion for utilities limited to actual cost - only 7K
Allocating Expenses

- I.R.C. 265 – allocate expenses between taxable/nontaxable income
- Excluded $ ÷ total ministry income = %
- Business expenses x %
SE ministers may be able to deduct medical/dental expenses (SE health insurance deduction)
The requirement to provide contemporaneous documentation no matter what!

It is a requirement to include the statement “no goods or services were provided” on ALL communications with a donation identified or discussed.

Please note the word “ALL.”

There is no IRS form for recognizing or documenting a donation/contribution.
I.R.C. 7611 governs
Figure 7.3 Overview of the audit process
Starting a Church Audit

- Reasonable belief
- Not exempt
- UBTI
- Other taxable income

p. 297 reasonable belief sources
Repeated (2 or more) failure to respond to IRS is reasonable belief to start an inquiry
• First notice – general explanation, right to conference
• Second notice – to examine records
Mail 2\textsuperscript{nd} not less than 15 days after 1\textsuperscript{st}

Wait 15 days after 2nd
Audit Next Steps  pp. 300-302

- Conference (if requested)
- Examine records and activities
- Final determination
- Notice of deficiency or assessment of underpayment
- 2-year SOL
Assessment and Collection

- Action based on
  - Revocation of status – 3 years
  - Qualification for exemption – 3 years
  - UBTI (6 years)
  - Other issues – no limitation if no return filed
Limit on multiple examinations

Remedies for IRS violation of audit rules limited – issue stay until comply
QUESTIONS?