Religious Organization Tax Issues
Chapter 7
Pgs. 271-302
Basic Equivalency
Not In Book

Nonprofit = Tax Exempt

The terms are considered synonymous although there are differences. Thus, churches and religious organizations as nonprofits are generally tax exempt and governed by the same law and rule with NOTABLE EXCEPTIONS!
Corporations and any community chest, fund, or foundation organized and operated exclusively for religious, education, charitable, and other specific purposes are exempt from tax.

An important requirement of this exemption is that no part of the organization’s activities can “inure” to the benefit of any private shareholder or other individual.

This is a major issue that the IRS looks for!

Prohibition against political activities which is referred to as the Johnson amendment.
The definition of a church is one that has been carefully crafted and litigated over the years because it lies at the very heart of our constitutional guarantee of the separation of church and state and to worship as we see fit.

Thus the IRS proceeds very slowly and carefully.
Definition - Continued

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.
To qualify for exemption, the church or religious organization must be organized under state law as a corporation, unincorporated association, or trust.

When the IRS refers to a religious organization, it is not referring to churches or integrated auxiliaries.
Religious Organizations
Reference to Pg. 272

- Religious Organizations:
  - Church – not one as such.
  - Parachurch
  - Ministry
  - Convention/Association of Churches
  - Integrated Auxiliaries
  - Religious Order
  - Supporting Organization
Churches As Sec. 501(c)(3) Entities Not In Book

- A church does not have to file a form 1023 or 1023-EZ to obtain exempt status.
- A religious organization does have to file one.
- Unless, that organization is under the direct control or governance of church.
- By that, it is met that the organization is an “extension” of the ministry of the church, the governing body of the church has final say in all matters, and the organization “answers” to the church.
When Forming A New Church – “Steps of Caution” – Not In Book

- Application for IRS recognition not required, but good idea if there is some “doubt” as to activities of entity.
- Verification of exemption from federal income tax.
- Verification donations deductible.
- Property tax and U.S. mail benefits.
- Be careful with property tax exemptions.
A church does not have to file a form 990, 990-EZ, or 990-N.

A religious organization not under the control of a church and a separate, exempt, entity does have to file one.

A church or religious organization may have to file a form 990-T regardless of whether they file a form 990, 990-Ez, or 990-N.
A religious organization will have to meet the operational test to obtain tax exempt status.

An organization will be regarded as meeting the test when it operates exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more exempt purposes specified in section 501(c)(3).

A religious organization must clearly define its exempt purpose when applying for tax exemption.

The IRS will closely scrutinize this purpose.
An organization does not meet the operational test and, thus, is in violation of an exempt status under section 501(c)(c)(3) IF:

1. If its net earnings “inure” or are distributed in whole or in part to the benefit of private shareholders or individuals (defined as persons having a personal and private interest in the activities) OR

2. If it is an action organization defined as entity where a substantial part of its activities is devoted to attempting legislation by propaganda or otherwise.
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.
A form 1023-EZ, application for exemption, may be submitted by an organization that has projected annual gross receipts of $50,000 or less in the current tax year and the next two years.

The organization had annual gross receipts of $50,000 or less in each of the past 3 years for which the organization was in existence.

The fair market value of the organization’s total assets does not exceed $250,000.
The return must be submitted electronically.
Religious organizations can submit a form 1023-EZ seeking approval but churches and schools cannot.
Also, organizations that are not corporations, unincorporated associations, or trusts may not file form 1023-EZ.
Otherwise, an organization must submit the lengthy form 1023 along with the many documents and explanations required.
If incomplete, the IRS will return the form 1023.
So the next time, a client tells you that they want a ministry or related organization (such as a food bank, youth function, etc. at a church) to acquire a separate tax exempt status, have a long conversation.

What are their reasons?
A study conducted by the National Taxpayer Advocate that was given to the IRS revealed that despite the IRS rejecting 6% of the applicants filing the form 1023-EZ an estimated 40% of the forms did not meet the IRS requirement for approval.

The main objection was that the organizational documents were incomplete and the applications lacked a financial narrative.
Additionally, a number of organizations were filing the form 1023-EZ when they were not allowed to do so.

The IRS has previously acknowledged that they felt a number of the applications were incorrect and have started an audit program to confirm the accuracy of the information and statements made on them.

This means……
In response to this study and other observations by the IRS regarding the filings, the agency has stated that examiners and determinations specialists will review the applicant’s narrative (now added/expanded) to determine if the organization’s mission and activities are within the scope of Section 501(c)(3).

Narratives with activities that are contrary to exemption requirements will be referred to a determinations specialist.
Incomplete narratives may be rejected or referred to a determinations specialist.

The examiners or determinations specialists will reject an application requesting reinstatement of tax-exempt status due to the automatic revocation for failing to file the 990 series return for 3 consecutive years if the examiners or specialists find that their research shows the applicant is seeking a foundation classification that is different from the classification at the time of revocation.

Also, new legislation redefines and expands revocations.
When processing Form 1023-EZ, tax examiners will reject an application if responses to questions indicate the applicant is not eligible to file form 1023-EZ.

The IRS has a massive backlog of thousands of applications prior to 2019 with an additional 4,000 applications filed between late December of 2018 and January of 2019.
In light of the large backlog of applications seeking IRS approval of an organization’s exempt status, the pressure to clear the backlog, and the admission that a large number of errors exist in the approvals of tax exempt status that occur in clearing the backlog, the IRS has announced their audit focus on these entities:

1. Former for profit entities that converted to 501(c)(3) charities.
2. Investment income and nonmember income of “social clubs”.

- Note: these organizations are a prime target of the IRS exempt organization examiners and the audits are brutal.
Tax Exempt Audits – Continued – Not In Book

3. Private benefit and inurement prohibitions.
   ➢ This is a particularly large area for audit scrutiny.

4. Organizations that had filed the form 1023-EZ that were ineligible to file this form for obtaining exempt status approval.

5. Employee vs independent contractor classifications.
Tax Exempt Audits – Continued – Not In Book

6. Organizations with large gaming activities such as casino night, bingo, etc. and the related tax issues generated from them.
   - Emphasis on a tax exempt entity issuing forms 1099 for prizes, etc.
   - Let me give you an example of an organization that did not…
   - Detailed examination of documents that may yield self-dealing in foundations and the failure of an organization to file form 4720 to correct them and paying the required excise taxes.
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.
Even though a church does not have to file a form 990 or 990-EZ, it may have to file a form 990-T.

The requirements are separate.

A form 990-T must be filed if the entity has gross income from what is termed “an unrelated business” of $1,000 or more.

Just because you have to file a form 990-T does not mean that you will have to have a profit but you will have to file.
As in the case of any tax return, there are filing deadlines and penalties for failure to file including the addition of interest.

An entity may file a request for extension to file the form 990-T but it must be filed before the original deadline of filing the return.
Unrelated Business Income Definition – Reference to Pg. 278

- Conducted as trade or business with a profit motive and
- Regularly carried on and
- Not related to organization’s exempt purpose.
UBIT in General – Not In Book

- To prevent tax-exempt organizations from unfairly competing with taxable for-profit businesses.
- Existence of a profit alone is not sufficient to generate a tax liability; however, do need to have a profit motive.
- IRC Sections 511-515.
What is Meant by Regularly Carried On? – Reference to Pgs. 278 & 279

- Frequency and continuity – how long have this been going on?
- Pursued in manner similar to comparable commercial activities.
- Intermittent, sporadic activities are generally not considered to be “regularly carried on”.
State laws vary: most set limitations on frequency of activities before considered taxable.

Multiple activities, such as five auctions a year, deemed not to be infrequent.

Perpetual auctions, trade shows, etc., likely considered taxable.
What is Meant by the Phrase “Not Substantially Related?” – Reference to Pgs. 279 & 280

- Does not contribute in an important manner to accomplishing exempt purpose.
- Size and extent of activity should always be considered.
- Determination is very fact-specific; depends on facts and circumstances!
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
Possible Inclusions in UBI
Pgs. 279 & 280

1. Product sales – if it results from the exempt function then it is not unrelated business income as long as the product is sold in substantially the same form it is in when the exempt functions are completed.

2. Advertising – is it related to the exempt function and how integrated is it to that function?

3. Publishing – is it related to the exempt function and how integrated is it to that function?

- Note the 14 tests to make this determination from the IRS Audit Guide.
Most often income from rental of real property and incidental personal property is excluded from UBI unless, there is debt associated with rental property.

Factors:

- If personal property rent is >10% then some UBI (>50% all UBI)
- Substantial services provided – UBI
- Percentage of net income rent
- Debt-financed property
Is Rental Income UBI?  
Reference to Pg. 287

- If 85% or more of the use of any property is substantially related to an organization’s exempt purposes, the property is not treated as debt financed property.
- If unrelated to the exempt purpose but also not UBI, it still may be subject to local property taxes.
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.
Exclusions from UBI – Reference to Pgs. 280 & 281

- Bingo games [§513(f)]
- Volunteer labor exception [§513(a)(1)]
- Qualified public entertainment activities [§513(d)(2)]
Exclusions – From UBI – The Rules for Exemption – Reference to Pgs. 280 & 281

- Volunteer workforce
  - 85% or more of work performed by unpaid volunteers
- Convenience of members
  - Applies to 501(c)(3) organizations only
  - Items with useful life > 1 year cannot qualify
- Selling donated merchandise
  - 85% or more of sale items are donated
Theft and Fraud Within Religious Institutions – Not In Book

- A topic that is not discussed enough but is becoming an epidemic is the occurrence of theft and fraud by employees and even members of the clergy within a religious institution.
- Recent headlines have revealed the widespread nature of this problem.
- There is a 700% increase in frauds in a religious institutions and these are the ones that have been discovered.
The devastation to the religious entity is not only a substantial and sometimes fatal loss of large sums of money but the emotional betrayal that has occurred.

In many ways, churches and related religious institutions are ideal places for such crimes.

Why do you think this is so??
Common Frauds In Religious Organizations:

- Writing checks for non-entity expenditures that are often personal expenses of the embezzler.
- Writing checks to cash and pocketing same.
- Writing checks to individuals not known to the religious entity.
Theft and Fraud Within Religious Institutions – Continued – Not In Book

- Taking cash from the collection plate.
- Setting up fake vendors including an address that is controlled by the embezzler.
- Selling the tangible personal property of the entity sometimes on internet sites such as eBay.
The Fraud Pyramid – Not In Book

Pressure

Rationalization  Opportunity
Most Common Sources of Fraud – Lack of Internal Control

- Not requiring more than one signature.
- Not requiring an independent review of each check for an extra signature.
- Not requiring an invoice or explanation to each check.
- Not reconciling bank statements by independent person(s).
- Too many bank accounts and only one authority.
- Credit cards.
- Lack of independent annual committee audit.
The use of the word “minister” is a statutory and legal one.

It means any such person qualified under the definition regardless of race, color, creed, sex, or denomination.

In this discussion, whenever the term “minister” is used it is done so in the context of the statutory definition.
A minister is defined as a person who is ordained, licensed, or a commissioned member of the church who performs tasks within the exercise of his or her ministry as defined by the ordination, licensure or commission of the church.

There are no requirements that a minister perform his or her ordained, licensed, or commissioned tasks for the denomination that ordained, licensed, or commissioned him or her.
Specific tasks defined as ministerial by the statute and subsequent court cases include but are not limited to:

1. Performing sacramental functions such as baptisms, communion, marriages, and funerals.
2. Conducting any form of worship services.
Minister – Statutory Definition –
Continued – Reference to Pg. 290

3. Controlling, conducting, and maintaining religious organizations, boards, societies, and other integral agencies that are under the authority of a religious body that is a church or denomination.

4. Services that do not involve performing sacramental functions or religious services can be qualified services if they are performed for a church or agency of the church.
Services in the exercise of the ministry include being a director of a religious board, an advisor to a nonreligious company publishing a church history, or any form of being a chaplain including at such an institution as a public university.
A duly ordained, licensed, or commissioned minister is not considered a minister when:

1. He or she teaches nonreligious topics at a public university.
2. If he or she is employed by the federal government even if he or she is a chaplain in the armed forces or at a state university in a secondary role.
Minister – Statutory Definition – Continued – Not In Book

- If the statutory definitions of who is a minister are not met then despite the “title” the special tax provisions do not apply.
The Ministry As A Tax Scam – Not In Book

THE PROFESSIONAL SHOULD LOOK OUT FOR:

- Need ordination? Instant degree available right from the printer.
- “Our home is our church”.
- “Our family is our congregation”.
- “Vow of poverty means no income”.
- Often a tirade of anti-government rhetoric.
- Congregation of just self/the family.
The Ministry As A Tax Scam – Continued – Not In Book

These scams are considered extremely abusive by the IRS and state and local government and lead to severe penalties and, in some cases, criminal prosecutions.
Ministerial Income – Definition and General Rules – Reference to Pg. 290

- There are no provisions under federal law for income that is exempted from income tax.
- The basic definition of compensation and income related to one’s trade or business applies to ministerial income.
- That is any form of payments that are even remotely related to a current position or work are income.
One of the most common misconceptions is that cash given to a clergy person in the form of a “gift” is tax free.

A “gift” for federal tax purposes is defined as “proceeding from a detached and disinterested generosity...out of affection, respect, admiration, charity or like impulses”.

Ministerial Income – Definition and General Rules - Continued – Not In Book
A church used different colored envelopes to “ear mark” the designation of donations.

The color of blue was used for pastoral “gifts”.

The donors were told that the amounts placed in the envelope were not eligible for a charitable deduction.

The envelopes were given directly to the taxpayer/minister and he did not report them.

The Court held these amounts were taxable to him as income.
The reason for such a determination is that the gifts were of a compensatory nature.

Let us discuss other similar situations....
This area is one of a growing compliance problem for the Internal Revenue Service as well as state and local governments.

It is an area of stepped up enforcement by the IRS and state and local governments.

The areas of noncompliance include, but are not limited to:

1. Failure to withhold social security for employees.
Employment Tax Obligations - Continued – Not In Book

2. Failure to withhold social security from clergy.
3. Failure to make timely elections out of social security.
4. Failure to properly classify employees and clergy as employees vs. independent contractors.
5. Failure to comply with employment tax reporting requirements.
Employment Tax Obligations - Continued – Not In Book

6. Failure to issue form 1099 - Miscellaneous.
Application of Twenty Common Law Tests to the Clergy – Reference to Pg. 290

Question:
Is the clergy person controlled by the entity and does it dictate to him or her what he or she can and cannot do in his or her ministry?
Most major denominations as a matter of policy treat the clergypersons as employees.

There are many advantages to the clergyperson as well as simplicity to the religious entity.
The services of a minister are subject to social security and Medicare, unless, he or she files a Form 4361 by the second year (not consecutive years) in which he or she receives at least $400 in net earnings.

It must be for religious objections.

Be careful with waiving this coverage because....
The IRS has recently in a number of cases required the practitioner/client to furnish proof of their exemption from self-employment tax with an approved copy of the individual’s application which is form 4029 (Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits).

The practitioner should make certain that the client who claims exemption from social security and Medicare has filed the form and received an approved form 4029 in return.

Equally important, keep a copy in the client’s permanent file.
Revocation of Exemption From Self-Employment Taxes – Not In Book

A Social Security Alert!!

- In the past few years, exempted individuals have sought Social Security and Medicare coverage in advance of their eligibility.
- Clients that wish to revoke their exemption from social security and Medicare taxes need to do more than simply begin paying into social security.
- They need to file a letter with the IRS ministerial section to revoke the coverage and receive acknowledgement.
- The revocation of the exempt status is irrevocable.
Application of Twenty Common Law Tests to the Clergy and Others – Reference to Pgs. 292 & 293

- How is he or she paid?
- Is he or she reimbursed for expenses?
- Who provides the books, supplies, vestments, etc.?
- Are there benefits provided?
- Are there contracts and what do they state?
- Essentially, does it “boil down” to whether he or she is paid a salary in this entity or denomination.
- In recent years this has become a compliance issue because....
Classification – Form 1099 MISC – Not In Book

- File Form 1099-MISC for independent contractor. Penalties now being imposed. When in doubt, file a form 1099.

- 20 common-law factors. Avoid it if you can. Once again, the religious entity must file a form 1099 as a condition of preserving the subcontractor status if challenged.
Housing Allowance – General Considerations
Reference to Pgs. 294 - 296

- Not included in gross income of minister but is subject to self-employment tax (unless elected out of social security).
- Such payments are reported or schedule C or solely on schedule SE (self-employment tax schedule).
- Must be to a qualified minister (only) as previously discussed.
- Must be provided either as compensation or for the rendering of ministerial services that qualify for exclusion from FICA as discussed in this presentation.
Clergy Housing Allowance – Pg. 294

Gaylor v Mnuchin

- A District Court had previously ruled that clergy housing allowance violated the First Amendment and was unconstitutional.

- The Seventh Circuit Court of Appeals unanimously overturned the District Court and ruled:
  1. The code section providing for the clergy housing allowance has a secular purpose and
  2. The allowance doesn’t advance religion on behalf of the government and doesn’t foster excessive government entanglement with religion.
An exclusion form income tax for income tax purposes can be allowable whether the minister lives in a church provided house or provides his or her own home.

How much is to be determined and allocated for a housing allowance is very, very subjective and very liberal.

The courts have re-enforced the liberal allowance nature.
The allowance is limited to the lowest of:

1. Actual Compensation or
2. Actual Qualified Cost or
3. The Designated Allowance by the Governing Body or
4. The Fair Rental Value of the Home.

In many cases, the amount of the allowance is the fair rental value without regard to actual qualified costs. However…
The actual qualified costs are essentially everything spent on the housing unit. This includes, but is not limited, to mortgage principal, interest, utilities, taxes, insurance, repairs (no matter how much), etc. Get the picture?

Depreciation is not allowed.
These factors are not all inclusive but serve as just a guide to determine the amount to be allocated.

Cannot exceed reasonable pay.

Is available to part-time clergy but limited to actual compensation.

If church provides parsonage, cash allowance can be given for utilities and other home-related expenses can serve as the housing allowance if the minister pays them out of pocket.

The church’s actual payment of same is not generally treated as a housing allowance.
Housing Allowance – Factors To Consider – Continued – Not In Book

- Cannot be used against non-clerical income.
- There is essentially an acceptable “range” for a housing allowance.
- This has been recognized by the courts.
- However, the larger the allowance the greater that attention drawn to the amount.
- But, the range generally is…
Depending upon the amount designated, the housing allowance could equal 100% of the minister’s compensation.

However, an excess designated amount of housing allowance over compensation cannot be utilized as a deduction anywhere on the minister’s tax return.
Pastor Jim earned $50,000 in 2018.

He owns his own home and paid $16,000 in actual costs.

The fair market value is $24,000.

The amount of housing allowance is $16,000.

However, is it larger when due to an acceptable range? Let us discuss this.
The taxpayers received a number of checks paid to them in addition to having the church pay their electric bills.

While some of the checks had indications that they were partially for a parsonage allowance, most did not.

There was no formal designation, resolution, etc. of a parsonage allowance.

The IRS included the amounts as taxable income.
The taxpayers argued that such amounts were excludable as a parsonage allowance.

The Court found there was no formal designation of a housing allowance and sustained the IRS position.
Example of a resolution is:

“Whereas the (insert name of governing body) hereby establishes the amount of (insert amount here) as the designated housing allowance for (insert name here) for the year (insert year here) and, therefore, attests that such amount meets the requirements of IRC 162 and IRC 274 respectively”.
Cash Contributions – Documentation – Not In Book

- 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.
The IRS history of church audits is one of.....

Pg. 297 – The church audit process.
Pg. 297 – Reasonable belief.
Pg. 298 – Church tax inquiry.
Pg. 298 – Routine requests and third party records.
Pg. 299 – Scope of inquiry.
Church Audits – Pgs. 297- 304 – Continued

- Pg. 299 – Notices.
- Pg. 301 – Action after Issuance of Notice.
- Pgs. 301 -304 – Examination of records, religious activities, examination outcomes, and Regional Counsel approval.
- Pg. 302 – Two year limitation.
- Pg. 303 – Exempt status, UBTI, and multiple examinations.