

100 Introduction

100.1 In the United States, special laws apply to churches, religious orders, religious organizations, and ministers in recognition of their unique status in society and of their guaranteed First Amendment rights. Churches, religious orders, and religious organizations receive special treatment under tax laws and generally are exempt from income tax. These organizations follow the same basic accounting principles as other nonprofit organizations, whether generally accepted accounting principles (GAAP) or another comprehensive basis of accounting (OCBOA). However, some of the issues they face are specific to religious organizations. In addition to facing unique accounting issues, these organizations also have unique operating characteristics.

The Need for Guidance

100.2 While the exact number of churches and other religious organizations is not known, there is no doubt that hundreds of thousands of such organizations exist. In addition, those organizations collectively receive billions of dollars of contributions and other revenues for which they must demonstrate good stewardship and comply with applicable tax laws and accounting principles.

100.3 **Number of Religious Organizations** According to the latest figures released by the statistics of income division of the Internal Revenue Service in its *Internal Revenue Service Data Book, 2014*, there are more than 1.7 million religious, charitable, and other tax-exempt organizations registered with the IRS. This figure includes 501(c)(3) public charities, 501(c)(3) private foundations, and other exempt organizations that have registered (i.e., applied for recognition of exempt status) by filing either IRS Form 1023 (for public charities and private foundations) or Form 1024 (for other exempt organizations). Of the more than 1.7 million registered tax-exempt organizations, approximately 1.1 million are 501(c)(3) religious, charitable, or similar organizations. However, this number does not include any religious or charitable organizations that are not required to and have not filed applications for recognition of exempt status (Form 1023) with the IRS.

100.4 Obtaining information about the number of churches and other religious organizations is especially problematic because so many of these organizations are not required to file an application for tax-exempt status or information returns with the IRS. Some researchers have estimated that there are more than 300,000 churches in existence. However, there are also thousands of other religious organizations such as ministries, private schools, interdenominational and ecumenical

organizations, and other entities whose principal purpose is the study or advancement of religion. There is no national database that collects information on the number of churches and other religious organizations. Some statistics about the number of religious organizations gathered from denominations' sources and from organizations and associations that work with or represent religious organizations are as follows:

- The National Council of Churches, which represents Protestant, Anglican, Orthodox, Evangelical, African American, historic peace churches, and ethnic-language immigrant churches, states that it represents more than 45 million people in more than 100,000 local congregations in the United States. It provides links to its member communions and congregations at www.ncccusa.org/members.
- The Hartford Institute for Religion Research provides links to almost 250 official denominational websites at <http://hirr.hartsem.edu/denom/homepages.html>.
- The United Methodist Church has reported more than 7.7 million lay members, 45,186 clergy members, and 34,892 local churches in the United States. In addition, it has reported more than 900 missionaries supported by the denomination and more than 100 colleges, universities, and theological schools.
- The Southern Baptist Convention reports nearly 16 million members who worship in more than 50,000 churches in the United States. In addition, they report that they sponsor about 5,000 home missionaries serving the United States, Canada, Guam, and the Caribbean. They also sponsor more than 5,000 foreign missionaries in 153 nations of the world.
- The U.S. Conference of Catholic Bishops, Office of Media Relations, reported in a statistical profile of the church in the United States that there were 77 million Catholics, 18,000 parishes, almost 27,000 diocesan priests, and more than 12,000 religious-order priests. In addition, it reported more than 5,000 seminary students and more than 1,400 colleges, universities, and high schools with more than 1.4 million college and high school students.
- The Church of Jesus Christ of Latter-Day Saints notes on its website that it has more than 29,000 church units (congregations) worldwide, including more than 13,000 in the U.S. Currently, worldwide and U.S. church membership is more than 15 million and 6.1 million members, respectively.

100.5 The executive summary of “A Report on Religion in the United States Today,” issued by Faith Communities in the United States, states that when the public thinks of churches, the image that comes to mind is a mega-church—a church with weekly attendance of more than 2,000 people. A study conducted by the Hartford Institute for Religion Research indicates that 54% of megachurches have between 2,000 and 3,000 members, while about 5% have more than 10,000 members. The number of megachurches has more than doubled since 1990. There are now more than 1,200 megachurches and average weekly attendance is approximately 3,900.

100.6 The reality, however, is that almost 60% of the congregations in the United States have fewer than 100 regularly participating adults and just over half are located in small town and rural settings. Indeed, a full quarter of congregations has fewer than 50 regularly participating adults, while only 2.4% have more than 1,000.

100.7 Contributions and Other Support Provided to Religious Organizations Churches and other religious organizations receive billions of dollars of contributions and other support. While the largest source of revenues for many religious organizations is contributions (e.g., church offerings, support for a capital campaign, noncash contributions of goods and services, etc.), many organizations also receive support in the form of fees for performance of services (service fees), sales of goods, third-party reimbursements, investment return, and other revenues. Several statistics about the breadth of support received by religious organizations are as follows:

- The report “Giving USA 2015” (a publication of the AAFRC Trust for Philanthropy, researched and written by the Lilly Family School of Philanthropy at Indiana University) estimates that gifts in 2014 to religious organizations and causes increased to approximately \$115 billion, an increase of approximately \$11 billion (1.1%) from giving levels in 2013. However, the report notes that religious giving is actually slowing, despite the increase this year, due to declining religious affiliation and increased giving to charitable organizations with religious connections in other subsectors. Nevertheless, religious giving still accounts for the largest subsector of giving, commanding approximately 31% of all charitable gifts given (approximately \$358 billion in 2014).
- The 10 largest ministries (ranked by revenues) in MinistryWatch's database (see paragraph 103.14) had between \$320.1 million and just over \$1 billion in revenues. Those 10 ministries had between \$317.6 million and \$1 billion in contributions.

100.8 Like other nonprofit organizations, religious organizations are under increased scrutiny on how they spend contributions. For example, if donors specify that contributions be used for a particular program, they are concerned that their contributions are spent for the intended purpose. Complying with donor-imposed restrictions may present special problems or concerns for religious organizations.

100.9 Unique Tax Issues for Religious Organizations and Ministers There are a number of unique tax provisions that apply to churches, other religious organizations, and ministers. In addition

to issues relating to various tax filing requirements, religious organizations are also subject to special rules relating to political activities and inurement of benefit, as well as other IRS requirements and audit issues. Unique tax issues for ministers include their treatment under self-employment tax, social security tax, and federal income tax withholding rules; questions about whether offerings and gifts from the congregation or church are taxable income or gifts; issues relating to royalties and honoraria; the exclusion from income tax of a parsonage allowance (or housing allowance) provided to the minister; and the treatment of business and professional expenses.

Opportunities for Practitioners

100.10 With the large number of religious organizations; the unique tax, accounting, and operational issues they face; the massive amount of inflows of contributions and other support into these religious organizations; and the current focus on accountability, good stewardship, and transparency at tax-exempt organizations; practitioners now have increasing opportunities to provide services to religious organizations.

100.11 **Services Commonly Provided to Religious Organizations** The following are the types of services most commonly provided by practitioners and other finance professionals to religious organizations:

- Bookkeeping services.

- Attestation services (i.e., compilation, review, or audit).

- Consulting services (e.g., on internal control issues, fraud investigations, purchase/installation of church management software, etc.).

- Tax services, including:
 - Preparation of a minister's tax return.

 - Preparation of a Form 990 for organizations that are not churches (i.e., ministries).

 - Preparation of a request for exemption from tax (Form 1023).

- Preparation of a tax return relating to unrelated business income tax (Form 990-T).
- Tax planning services on topics such as housing allowances, minister compensation and taxation issues, state tax issues, and consulting regarding specific transactions and activities.

100.12 Challenges Facing Practitioners Among the challenges facing practitioners who are already providing services, or who are beginning to provide accounting, reporting, tax, and other professional services, to religious organizations are:

- Lack of familiarity with the unique tax issues that face religious organizations.
- Lack of familiarity with the unique tax issues that face ministers.
- Few sources for information about how changes in tax laws and regulations affect religious organizations, employees of religious organizations, and ministers.
- Lack of familiarity with the manner in which nonprofit accounting principles apply to the activities of religious organizations.
- Few sources of authoritative guidance on accounting and reporting specifically for religious organizations.
- Lack of sources for reporting illustrations for different types of religious organizations.
- Lack of familiarity with internal control issues that are unique to religious organizations.
- Lack of familiarity with issues that face religious organizations that receive federal funds.

- Lack of familiarity with the impact of religious tenets of faith on the operations of a religious organization.

100.13 This *Guide* answers the following questions:

- What is a religious organization?
- What is a church?
- What is a parachurch?
- What is a religious order?
- Do religious organizations have to file tax returns?
- Who is a “minister” for tax purposes and why is it important?
- What is a minister's housing or parsonage allowance?
- What are the unique tax issues relating to housing and parsonage allowances?
- Are ministers employees or self-employed?
- Are individuals performing services for religious organizations employees or independent contractors?
- Do religious organization employees have to pay social security tax?

- Do ministers have to pay social security tax?
- Do ministers have to pay self-employment tax on their ministerial income?
- What is ministerial income?
- How does one account for contributions (e.g., restricted contributions, gifts-in-kind, contributed services, etc.) to a religious organization?
- Are love offerings, honoraria, personal gifts, donated assets, and donations for mission trips considered contributions for accounting purposes?
- Are love offerings to a minister taxable compensation?
- What is the difference between love offerings and benevolence?
- How does one account for promises to give (i.e., pledges) to a religious organization?
- How does one account for program and supporting service expenses of a religious organization?
- What bases of accounting may be used?
- What types of activities are subject to unrelated business income tax?

- What types of political activities may a religious organization be involved in?
- What are the intermediate sanctions rules and why are they important?
- How do the anti-terrorism laws affect religious organizations?
- How does the Sarbanes-Oxley Act of 2002 affect religious organizations?
- What are some best practices for governance and internal control?
- What makes an effective governing board?
- What are the key controls needed over revenues and cash receipts (such as church offerings, expenditures and cash disbursements, and payroll)?
- What should the organization do to prevent, deter, and detect fraud?
- What is a faith-based organization?
- What is the faith-based initiative and how does it affect funding available for religious-affiliated groups?
- What is the status of legislation relating to the faith-based initiative?
- What are the practical and legal issues when a religious organization receives government funds?

Who Is This *Guide* for?

100.14 This *Guide* is designed for practitioners and other individuals who provide accounting, attestation, reporting, tax, or other services to religious organizations and ministers. It is also designed to provide meaningful guidance for church administrators, governing boards, and other individuals. Parties who could benefit from the information in this *Guide* include:

- Practitioners who have religious organizations and/or ministers as clients.
- Practitioners and other individuals who serve on church governing boards or finance committees.
- Church financial administrators (e.g., chief financial officer, treasurer, church bookkeeper).
- Ministers.
- Church governing bodies (e.g., board of elders, board of deacons, board of directors, board of trustees) and committee members (e.g., finance committee, stewardship committee, missions board, etc.).
- Finance administrators at church denominational organizations, related agencies and associations, conferences, or districts.

100.15 **Key Topics Addressed in the *Guide*** This *Guide* provides comprehensive and practical guidance, including analysis of authoritative guidance on accounting and reporting, as well as tax regulations, for religious organizations and ministers. Some of the key issues addressed in this *Guide* are listed in Exhibit 1-1.

Exhibit 1-1

Key Accounting, Reporting, and Tax Issues

**Key Accounting and
Financial**

Key Tax Issues

Reporting Issues

- Contributions.
- Related entities and consolidations.
- Promises to give (faith promises).
- Fixed assets.
- Capital campaigns.
- Contributed services.
- Expenses.
- Special fund-raising events.
- Agency transactions.
- Interim financial reporting.
- OCBOA financial statements.
- Illustrative financial statements.
- Independent contractors versus employees.
- Minister's housing/parsonage allowance.
- Minister's discretionary funds.
- Self-employment and other taxes for ministers.
- Unrelated business income.
- Lobbying.
- Political activity.
- Intermediate sanctions.
- IRS audits of churches.
- Substantiation and disclosure requirements.
- Supporting organizations.
- Current IRS activities.

100.16 In addition, this *Guide* addresses operational issues such as governance, internal control, fraud, budgeting, nonprofit mail rates, church management software, and insurance.

100.17 **Topics Not Covered** This *Guide* provides a summary of the significant accounting requirements for religious organizations. Considerations that religious organizations have in common with commercial enterprises are not covered. In addition, nonprofit accounting and reporting issues that either generally are not applicable to religious organizations, or have no unique application to religious organizations, are not addressed in this *Guide*. For tax topics, this *Guide* provides guidance on the unique tax issues that apply to religious organizations and ministers. It does not provide guidance on tax issues that affect all organizations, nor does it provide guidance on how to complete Form 990, Form 1023, or individual tax returns. These topics are addressed in other PPC guides.

Other PPC resources relating to nonprofit organizations are discussed in paragraph 100.18.

Other PPC Resources Addressing Nonprofit Organizations

100.18 PPC maintains an extensive library of products relating to nonprofit organizations. Other PPC products addressing nonprofit organizations include the following:

- *PPC's 990 Deskbook.*

- *PPC's Guide to Preparing Nonprofit Financial Statements.*

- *PPC's Guide to Nonprofit GAAP.*

- *PPC's Guide to Nonprofit Contributions.*

- *PPC's Guide to Nonprofit Expenses.*

- *PPC's Nonprofit Financial and Accounting Manual.*

- *PPC's Guide to Audits of Nonprofit Organizations.*

- *PPC's Nonprofit Financial Statement Illustrations and Trends.*

- *PPC's Interactive Disclosure Library for Nonprofit Organizations.*

- *The PPC Nonprofit Update (newsletter).*

- *PPC's Guide to Cash, Tax, and Other Bases of Accounting.*

- *PPC's Guide to Single Audits.*

100.19 Other PPC resources that may be helpful include:

- *PPC's Payroll Tax Deskbook.*

- *PPC's 1040 Deskbook.*

- *PPC's SMART Practice Aids—Single Audit.*

- Checkpoint Tools for nonprofit organizations, including PPC's *Practice Aids*, PPC's *SMART Practice Aids*, PPC's *Interactive Disclosure Library*, and PPC's *Engagement Letter Generator*.

For additional information about these products, call our sales department at (800) 431-9025 or order online at tax.thomsonreuters.com.

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Checkpoint Contents

Accounting, Audit & Corporate Finance Library

Editorial Materials

Nonprofit

Religious Organizations

Chapter 1 Introduction and Overview Of Religious Organizations

101 Key Definitions and Terms—religious Organizations, Churches, and Religious Orders—
and Their Impact

101 Key Definitions and Terms—religious Organizations, Churches, and Religious Orders—and Their Impact

101.1 Although the designation of a nonprofit organization as a church, religious order, or other religious organization generally is not important for purposes of applying GAAP, the designation is important for tax laws and regulations. Therefore, the following discussion focuses on religious organizations, and more specifically churches and religious orders, from an IRS perspective.

What Is a Religious Organization?

101.2 Organizations engaged in the advancement of religion will qualify for tax-exempt status if they comply with certain requirements. The advancement of religion can be promoted through any of the following:

- A church.
- Convention or association of churches.
- Other church-run organizations, such as schools, orphanages, broadcast entities, or cemeteries.
- A religious order.

- An integrated auxiliary.
- A ministry, including a parachurch.
- Missionary activities.
- Evangelism.

101.3 Although all churches are religious organizations, not all religious organizations are churches. Many organizations have one or several facets of a traditional church but do not have enough characteristics to be classified as a church. For example, assume that a religious organization holds revival meetings, conducts crusades, and distributes religious literature. Although this organization is carrying out particular functions that are furthering religious purposes, it does not meet enough of the criteria discussed beginning at paragraph 101.5 for it to be considered a church. These organizations are known as parachurches or ministries. Perhaps the major distinction between a parachurch and a church is that a church has a *regular congregation* that *meets regularly*, whereas a parachurch does not. Parachurches are discussed further at paragraph 101.21.

101.4 The discussion beginning in paragraph 101.5 presents the characteristics of a church, and the discussion beginning in paragraph 101.8 provides guidance on why the distinction between churches and other religious organizations is important.

What Is a Church?

101.5 **Characteristics of a Church** There is no single definition of a church for tax purposes. The IRS considers the facts and circumstances of each organization applying for church status. Section 7611 of the Internal Revenue Code provides that the term *church* includes any organization claiming to be a church and any convention or association of churches. This vague and somewhat redundant definition has forced the courts to create their own definition. For example, the courts have held in numerous tax cases that, at a minimum, a church includes a body of believers or communicants who assemble regularly in order to worship. Thus, an organization that has tenets of belief and followers attending services regularly to carry out the worship demanded by those tenets of belief generally is perceived to be a church in the eyes of the court.

101.6 IRS Publication 557, “Tax-Exempt Status for Your Organization,” clarifies that a convention or association of churches is considered to be a church. The 2015 revision of Publication 557 states that an “organization which is otherwise a convention or association of a church will not fail to qualify as churches merely because the membership of the organization includes individuals as well as churches or because the individuals have voting rights in the organization.”

101.7 In addition to referring to the court-provided definition discussed in paragraph 101.5, IRS personnel use the list presented in Exhibit 1-2 of 14 church characteristics. (Those characteristics are based on guidance found in case law.) The checklist provided at Appendix 1A provides a worksheet for determining whether an organization is a church.

Exhibit 1-2

Characteristics of a Church

1. A distinct legal existence.
2. A recognized creed and form of worship.
3. A definite and distinct ecclesiastical government.
4. A formal code of doctrine and discipline.
5. A distinct religious history.
6. A membership not associated with any other church or denomination.
7. An organization of ordained ministers.
8. Ordained ministers selected after completing prescribed studies.
9. A literature of its own.
10. Established places of worship.
11. Regular congregations.

12. Regular religious services.

13. Sunday schools for the religious instruction of the young.

14. Schools for the preparation of its ministers.

The IRS acknowledges that few, if any, organizations can meet all 14 criteria. Thus, organizations that meet a preponderance of the criteria clearly should be considered a church.

101.8 Tax-exempt Status of a Church There is no legal requirement for a church, its integrated auxiliaries, or a convention or association of churches to apply to the IRS for tax-exempt status. {To obtain tax-exempt status, most nonprofit organizations prepare IRS Form 1023 [Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code]. Churches and their integrated auxiliaries are automatically exempt from filing Form 1023. IRS Form 1023 is discussed at section 102. See Section 508 of the Internal Revenue Code.}

101.9 Some churches, integrated auxiliaries, and conventions or associations of churches choose to prepare and file a Form 1023 even though they are not required to do so. [Choosing to file a Form 1023 does not subject churches to the requirement to file a Form 990 (Return of Organization Exempt From Income Tax) each year. See section 301.] The major benefit of filing Form 1023 is that it forces the IRS to recognize the church as a tax-exempt organization. It also requires the IRS to issue a determination letter upon approval of the application. That determination letter can be used as official proof to a donor that a donation is tax deductible. Many times, a donor making large donations to a religious organization will be instructed by his attorney or CPA to obtain proof that the donee organization is tax exempt. In the absence of the determination letter, the burden may shift to the donor if the IRS questions him. Because of these advantages, the authors strongly encourage all churches, integrated auxiliaries, and conventions or associations of churches to file with the IRS for tax-exempt status.

101.10 Exhibit 1-3 provides a list of benefits of securing a determination letter for a church and its integrated auxiliaries.

Exhibit 1-3

Benefits of Securing a Tax Determination Letter

- The determination letter can be used as official proof to a donor that a donation is tax

deductible.

- In order to be included in EO Select Check, an on-line search tool showing organizations recognized by the IRS as tax exempt, an organization must have a determination letter. [This search engine can be accessed at www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check and replaces IRS Pub. 78 (Cumulative List of Organizations).]
- The determination letter may serve as proof to sales tax authorities for most states that the organization is indeed tax exempt and not subject to sales tax.
- The determination letter may serve as proof to state and local tax authorities that the organization is tax exempt and perhaps not subject to state and local income, property, franchise, and *ad valorem* taxes.
- The determination letter is one of the documents usually used by the state when determining the organization's liability or exemption for state unemployment tax.
- The determination letter typically is used by the postmaster as proof of the organization's tax-exempt status to expeditiously grant special postage rates available for certain tax-exempt organizations. (See section 505 for further guidance on religious organizations obtaining special postage rates.)

101.11 IRS Audits of Churches Congress has imposed special limitations on when and how a church may undergo civil tax inquiries and examinations. Restrictions on church inquiries and examinations apply only to *churches* and to conventions or associations of churches. Those audit limitations do not apply to other religious organizations. IRS audits of churches are discussed in section 311.

101.12 Incorporation Requirements of Churches Laws vary from state to state, but churches generally are not required to incorporate. However, churches generally should incorporate for business reasons (e.g., liability protection for the minister and the governing board).

101.13 Churches and Their Integrated Auxiliaries and Other Religious Organizations The primary differences between a church and its integrated auxiliaries and another religious organization

are:

- Religious organizations other than churches (and the churches' integrated auxiliaries) must apply for tax-exempt status with the IRS (discussed beginning at paragraphs 101.8 and 102.1).
- Churches, associations or conventions of churches, and integrated auxiliaries are not required to file IRS Form 990 (discussed in section 301).

101.14 IRS Regulation 1.6033-2(h) defines the term *integrated auxiliary* as an organization that is—

- described both as a Sec. 501(c)(3) charitable organization and a public charity under IRS Secs. 509(a)(1), (2), or (3);
- affiliated with a church or convention or association of churches (see paragraph 101.15); and
- internally supported (see paragraph 101.16).

The organization must meet all three of these criteria in order to be considered an integrated auxiliary.

101.15 Affiliated. According to Reg. 1.6033-2(h)(2), an organization is affiliated with another entity for purposes of determining if it is an integrated auxiliary if it meets at least one of the following:

- a. The organization is covered by a common group exemption letter;
- b. The organization is operated, supervised, or controlled by, or in connection with [as defined in Reg. 1.509(a)-4(a)(3), (g), and (h)] such other entity; or
- c. The organization is affiliated based on the relevant facts and circumstances (e.g., the sharing of common religious doctrines, a common name, or the ability of the church or convention of churches to control the appointment of at least one of the organization's officers or directors). Other criteria are addressed in the checklist at Appendix 1B.

101.16 Internally Supported. According to Reg. 1.6033-2(h)(4), an organization will be considered to be internally supported *unless* it meets both of the following:

a. The organization sells admissions, products, services, or facilities to the general public (other than on an incidental basis) for something other than a nominal charge or a substantial discount from cost; and

b. The organization normally receives more than 50% of its support from a combination of governmental sources; public solicitations of contributions (e.g., a community fund drive); and receipts from the sale of admissions, goods, performance of services, or furnishing of facilities in activities that are not an unrelated business. (See paragraph 301.109 for a definition of a related business.)

101.17 Reg. 1.6033-2(h)(5) specifically includes a men's or women's organization, a seminary, a mission society, and a youth group within the definition of an integrated auxiliary.

Example 1-1: Organization is an integrated auxiliary—church-affiliated school.

New Life Church operates New Life Christian School, which is a 501(c)(3) organization. Although the school is a separate distinct legal entity, its goal is to further the exempt purpose of the church. The pastor of the church is the school's principal and the church's board members select the school's curriculum. Although the school charges tuition, the church funds approximately 70% of its expenses. The school is an integrated auxiliary because (1) it is operated by the church (i.e., the church's pastor and board members control the school's activities) and (2) it receives more than 50% of its support from the church.

Example 1-2: Organization is not an integrated auxiliary—church-affiliated publisher.

Christian Faith Publishing, Inc. was created as a 501(c)(3) organization by Holy Faith Church with the express purpose of spreading the Gospel. The board of the publishing company is appointed by the church elders and the board must present a quarterly budget to the elders for approval.

Christian Faith Publishing, Inc.'s primary activity is publishing a newsletter dedicated to Christian teachings. The newsletter is advertised in several Christian magazines and is available to the general public. Although Holy Faith Church is willing to support the publisher's endeavors, the sales generate substantial profits, and subscription income provides 65% of Christian Faith Publishing, Inc.'s support.

In this situation, Christian Faith Publishing, Inc. meets the first two tests to be an integrated auxiliary because it (1) is a tax-exempt organization and (2) is also affiliated

with a church since Holy Faith Church controls it by appointing its board members and approving its budget. However, it does not meet the internal support test. Because Christian Faith Publishing, Inc. (1) sells goods (the newsletter) to the general public for more than a nominal amount and (2) receives more than 50% of its support from the sale of goods in exempt purpose activities, it fails the internal support test and is not an integrated auxiliary of Holy Faith Church.

Example 1-3: Organization is not an integrated auxiliary—church-affiliated retirement home.

Hope Retirement Center was created as a 501(c)(3) organization by Hope Church to provide a retirement home that allows the elderly to live in an environment based on Christian principles and values. The board of Hope Retirement Center is appointed by the church board of deacons and the Center's board must present an annual budget to the board of deacons for approval.

Admission to live at the Center is open to all members of the community for a fee. The Center advertises in publications of general distribution appealing to the elderly and maintains its name on non-denominational listings of available retirement homes. Therefore, the Center offers its services for sale to the general public on more than an incidental basis. The Center receives a cash contribution of \$75,000 annually from the church. Fees received by the Center from its residents total \$150,000 annually, which equals 110% of operating costs. The Center does not receive any government support or contributions from the general public. Total support is \$225,000 (\$150,000 + \$75,000), and \$150,000 of that total is from receipts from the performance of services ($66\frac{2}{3}\%$ of total support).

In this situation, Hope Retirement Center meets the first two tests to be an integrated auxiliary because it (a) is a tax-exempt organization and (b) is also affiliated with a church since Hope Church controls it by appointing its board members and approving its budget. However, it does not meet the internal support test. Because the Center (a) offers services (use of retirement home facilities and services) to the general public for something other than a nominal amount or a substantial discount from cost and (b) receives more than 50% of its support from the sale of goods and services in exempt purpose activities, it fails the internal support test and is not an integrated auxiliary of Hope Church.

Example 1-4: Organization is an integrated auxiliary—church-affiliated retirement home.

Assume the same facts as in Example 1-3 except that the fees received by Hope

Retirement Center from the residents are only 70% of operating costs. Although the Center offers its facilities and services to the general public, it does so at a substantial discount from cost. In this situation, the Center is an integrated auxiliary of Hope Church since it passes both the affiliation and internal support tests.

101.18 Integrated auxiliaries are not required to file IRS Form 990, and they do not have to file with the IRS for exempt status. However, integrated auxiliaries are not afforded the same protection given to churches regarding IRS audits. IRS audits of churches are discussed in section 311.

What Is a Religious Order?

101.19 A *religious order* is a term primarily used when discussing IRS regulations. Religious orders generally are exempt from filing IRS Form 990, as discussed in section 301. In Rev. Proc. 91-20, the IRS provides a list of characteristics to be used in determining whether an organization qualifies as a religious order. In general, the presence of all of the stated characteristics indicates that the organization is a religious order. The first characteristic [that the organization is described in IRC Sec. 501(c)(3)] must be met or the organization is not a religious order. If one or more of the other characteristics is absent, the determination should be based on the relevant facts and circumstances. The characteristics are as follows:

- The organization must be described in IRC Sec. 501(c)(3).

- The members of the organization vow to live under a strict set of rules requiring moral and spiritual self-sacrifice and dedication to the goals of the organization at the expense of their material well-being.

- The members of the organization, after successful completion of the organization's training program and probationary period, make a long-term commitment to the organization (normally more than two years).

- The organization is, directly or indirectly, under the control and supervision of a church or convention or association of churches, or is significantly funded by a church or convention or association of churches.

- The members of the organization normally live together as part of a community and are held to a substantially stricter level of moral and religious discipline than that required of lay church members.

- The members of the organization work or serve full-time on behalf of the religious, educational, or charitable goals of the organization.

- The members of the organization participate regularly in activities such as public or private prayer, religious study, teaching, care of the aging, missionary work, or church reform or renewal.

101.20 The checklist provided at Appendix 1C provides a worksheet for determining whether an organization is a religious order.

Ministry/Parachurch

101.21 A ministry is a religious organization that does not qualify as a church under the criteria discussed at paragraph 101.7. Generally, the major distinction is that a church has a core congregation that meets regularly and a ministry does not. If a ministry lacks only a few of the characteristics of a church, it is also known as a parachurch. For example, the ministry of a traveling evangelist is to hold crusades at many churches. This ministry does not have enough of the characteristics listed in paragraph 101.7, to be classified as a church, yet it carries out some of the same functions as a church. Therefore, it can be considered a parachurch. Other ministries do not qualify as parachurches. For example, an organization that provides spiritual counseling based on Bible teachings is not a parachurch because it has very few of the characteristics of a church. Although there may be a distinction between the functions of a parachurch and other ministries, there is no difference in their tax treatment.

Supporting Organization

101.22 Another type of tax-exempt entity that can be a religious organization is a supporting organization. [IRC Sec. 509(c)(3)] These organizations carry out exempt functions by supporting other exempt organizations designated in their articles of incorporation or trust instrument. For Type I and Type II organizations, the designation can be made by name, class, or purpose. For Type III organizations, the designation generally must be made by name. If an organization does not meet this organizational test, it will not qualify as a supporting organization. The advantage of qualifying as a supporting organization is that the organization is not required to meet the public support test required of other public charities.

101.23 **Classification of Supporting Organizations** In addition to meeting the organizational test discussed in paragraph 101.22, the organization must fall into one of three categories. The IRS has divided these classifications into the following:

- *Type I*—Organizations operated, supervised, or controlled by one or more public charities. A Type I organization's relationship with its supported organization(s) resembles that of a parent-

subsidiary relationship. The supported organization elects or appoints a majority of the supporting organization's officers, directors, or trustees.

- *Type II* —Organizations supervised or controlled in connection with one or more public charities. A Type II organization's relationship with its supported organization(s) resembles that of a brother-sister relationship. The persons who control or manage the supported organizations also control the supporting organization.

- *Type III* —Organizations operated in connection with one or more public charities.

In connection with Type I and Type II organizations, the supporting organization's governing board is appointed by, or substantially similar to, that of the supported organization. Type III organizations must be responsive to the supported organization. Additionally, the supported organization must maintain significant involvement in the Type III supporting organization's activities.

101.24 The Pension Protection Act of 2006 The Pension Protection Act of 2006 (2006 Pension Act) made substantial changes to the laws concerning supporting organizations. First, it codified the IRS classifications of supporting organizations as Types I, II, and III. But the most far reaching changes apply to the Type III supporting organizations.

101.25 IRS Regulations For several years after the enactment of the 2006 Pension Act, the only guidance available in connection with supporting organizations was Reg. 1.509(a)-4, as adopted before 2006. Then, in September 2009, the IRS issued proposed regulations that were to be effective after the rules were published as final or temporary regulations. (However, these proposed regulations could be relied upon in good faith until final regulations were adopted.) In December 2012, the IRS issued final and temporary regulations addressing most of the provisions contained in the 2006 Pension Act concerning supporting organizations. For the most part, these regulations became effective December 28, 2012.

101.26 Requirements to Qualify As a Supporting Organization In order to qualify as a supporting organization, the ministry must provide support to one or more public charities. There are four requirements the organization must meet:

- *Relationship Test* —it must be operated, supervised or controlled by, or in connection with, one or more specific public charities.

- *Organizational Test* —it must be *organized* exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more specific public charities.

- *Operational Test* —it must be *operated* exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specific public charities.
- *Disqualified Person Control Test* —it must not be controlled directly or indirectly by one or more disqualified persons.

Regulation 1.509(a)-4 discusses how supporting organizations can meet these requirements.

101.27 Disqualified Persons. As discussed in paragraph 101.26, in order to qualify as a supporting organization, a ministry cannot be controlled directly or indirectly by one or more disqualified persons. For this purpose, disqualified persons include:

- A substantial contributor (i.e., a donor who makes contributions during the year equal to the greater of more than \$5,000 or 2% of total contributions).
- An owner of a more than 20% interest in a corporation, partnership, or trust which is a substantial contributor.
- A family member of one of the above. Family members include spouses, ancestors, children, grandchildren, great-grandchildren, and spouses of children, grandchildren, and great-grandchildren.
- A corporation, partnership, or trust if one of the above has at least 35% ownership.

101.28 IRS Regulation 1.509(a)-4(j) provides that a supporting organization is controlled by disqualified persons if they can cause the organization to act in a way that significantly affects its operations. This includes the right to name recipients from among the supported organizations. Generally, one or more disqualified persons are in control if they have 50% or more of the voting power of the organization's governing body or the right to exercise veto power. However, the supporting organization can establish proof of independent control in some cases. For example, a religious organization is operated in connection with a church. Although disqualified persons make up a majority of this organization's board, the organization's bishop has control over the policies of the organization. In this case, the regulations hold that there is independent control. [Reg. 1.509(a)-4(j) (2)]

101.29 Identification of Supported Organizations In addition to meeting the tests discussed in paragraph 101.26, the organizational documents of Types I and II organizations must identify the supported organizations either by their names or by class or purpose. If the organization's documents fail to do so, the supporting organization may still meet this requirement by showing the existence of a historic and continuing relationship and, by reason of this relationship, there has developed a substantial identity of interest between the supported organization and the supporting organization. In the case of a Type III organization, however, its organizational documents must include the name of its supported organization(s). Reg. 1.509(a)-4(d)(4) provides that a Type III organization will still qualify as a supporting organization even if its organizational documents permit the following in addition to naming specified supported organizations:

- The substitution of a publicly supported organization, which is designated by class or purpose, for the designated supported organization(s), but only if this substitution is conditioned upon the occurrence of an event beyond the control of the Type III organization (e.g., the loss of exemption, substantial failure or abandonment of operations, or dissolution of a designated supported organization).
- The operation of the Type III organization for the benefit of a beneficiary organization that is not a publicly supported organization, but only if the Type III organization is currently operating for the benefit of a specified supported organization and the possibility of its operating for the benefit of other than a publicly supported organization is a remote contingency. However, in this case, if the Type III organization does ultimately operate for the benefit of an organization other than a publicly supported organization, it will then cease to be a supporting organization.
- The amount of the Type III organization's support may vary between specified organizations, as long as it meets the integral part test discussed beginning at paragraph 101.32.

101.30 IRS Publication 557 (Rev. February 2015) provides an exception to the rule that a Type III organization must specify its supported organization(s) in its organizational documents. Similar to Types I and II organizations (see paragraph 101.29), a Type III organization will meet the organizational test if an historic and continuing relationship exists between it and its supported organization(s) and because of this relationship, a substantial identity of interest has developed between the organizations, even though the Type III organization's articles do not specify the supported organization(s) by name. Internal Revenue Manual (IRM) 7.20.7.1.1.1-Section I(1)C also instructs IRS personnel to consider this relationship in determining whether a Type III organization meets the organizational test.

Example 1-5: Qualifying as a supporting organization when no beneficiary organization is named.

Elderhome was formed on March 1, 2004, by members of Faith Bible Church to run a home for the aged. The members and officers of Faith Bible Church appoint the Elderhome board of directors and control its operation. Elderhome's organizational document requires it to provide no-cost housing for the elderly, but does not require that such services specifically be provided to church members. Does Elderhome qualify for nonprivate foundation status as a supporting organization?

Since caring for the aged is a longstanding function and purpose of organized religion, Elderhome is considered to be carrying out the purposes of Faith Bible Church. It is controlled by Faith Bible Church because the church members and officers appoint its board of directors [Reg. 1.509(a)-4(g)(1)]. Therefore, Elderhome qualifies as a Type I supporting organization for Faith Bible Church even though it is not specifically named in Elderhome's organizational document [Reg. 1.509(a)-4(d)(2)(iii), Ex.2].

Example 1-6: Determining if a supporting organization is supervised or controlled by a beneficiary organization.

Mary Coates, a longtime member of Faith Bible Church (Church), died in 2004, leaving a portion of her estate in trust for the Church. The trust instrument provides that the pastor and deacons are to act as its trustees and use its funds to accomplish Church's charitable purposes. Is the trust supervised or controlled by Church?

The trust's trustees are Church members influential in the management of Church. Thus, the trust is deemed to be supervised or controlled by Church and is a Type II supporting organization [Reg. 1.509(a)-4(h)(3), Ex. 3].

101.31 Type I and Type II Organizations The 2006 Pension Act also added IRC Sec. 509(f)(2), which provides that an organization that receives any contribution from controlling donors will not qualify as a Type I or Type III supporting organization. Therefore, a ministry cannot qualify as a Type I or Type III supporting organization if it receives any contribution from a controlling party [See Reg. 1.509(a)-4(f)(5)]. For this purpose, controlling parties include—

- A person (other than a public charity or an organization organized and operated exclusively for the purpose of testing for public safety) who directly or indirectly controls, either alone or together with other controlling parties, the governing body of a supported organization.
- A family member of a controlling party. Family members include spouses, siblings of a controlling party or his spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren.

- A corporation, partnership, or trust if one of the above has at least 35% ownership.

Neither IRC Sec. 509(f)(2), as amended by the 2006 Pension Act, nor the committee reports give any guidance to the meaning of *control*. The December 2012 regulations have reserved Reg. 1.509-4(a)-(f)(5)(ii) because the IRS believes that a definition of *control* is needed and intends to issue proposed regulations in the near future to provide such a definition.

101.32 Type III Supporting Organization The 2006 Pension Act divided Type III organizations into two categories but directed the Treasury Department to define these terms by issuing regulations.

- *Functionally Integrated Supporting Organization.* A Type III supporting organization which is not required under regulations established by the Secretary to make payments to supported organizations [as defined under IRC Sec. 509(f)(3)] due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organization. [IRC Sec. 4943(f)(5)(B)]

- *Non-functionally Integrated Supporting Organization.* Any Type III supporting organization [as defined under IRC Sec. 4943(f)(5)(A)] which is not a functionally integrated supporting organization [as defined under IRC Sec. 4943(f)(5)(B)]. [IRC Sec. 4942(g)(4)(A)(i)]

101.33 Before the IRS issued any guidance, there was a consensus that the existing regulations were the best authority to follow. According to those regulations, a Type III organization would be required to meet two tests:

- *Responsiveness Test.* A supporting organization is “considered to meet the 'responsiveness test' if the organization is responsive to the needs or demands of” one or more supported organizations. In order for a Type III organization to be responsive to the needs and demands of the supported organization, the organizations must have at least one officer, director, or trustee in common; at least one officer, director, or trustee of the supporting organization must have been elected or appointed by the supported organization; or the individuals must maintain a close and continuous working relationship. Because of the relationship described in these items, the supported organization must have a significant voice in the investment policies and operations of the Type III organization, including the timing and manner of the grants made by the Type III organization and its selection of grant recipients. [Reg. 1.509(a)-4(i)(2)]

- *Integral Part Test.* A supporting organization must establish that “it maintains a significant involvement in the operations of one or more publicly supported organizations and such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides.” [Reg. 1.509(a)-4(i)(3)(i)] In order for the Type III organization to meet

this test, one of the following must be met:

- The Type III organization must pay out substantially all of its income to or for the use of its supported organization and this support must be sufficiently significant in relation to the supported organization's programs to ensure its attentiveness to the supporting organization. [Reg. 1.509(a)-4(i)(3)(iii)]
- The Type III organization must perform activities that carry out the purposes or functions of the supported organization. These activities would normally be carried out by the supported organization itself if the Type III organization were not doing so. [Reg. 1.509(a)-4(i)(3)(iii)]

101.34 **IRS Regulations.** Congress has directed the IRS to issue regulations to carry out the provisions of the 2006 Pension Act. In August 2007, the IRS published its first guidance concerning the changes made by the 2006 Pension Act. Although Announcement 2007-87 stated that the guidance it provided is generally not effective until the organization's tax year beginning after the rules are published as final or temporary regulations, it could be relied upon in good faith. On September 24, 2009, the Treasury Department released proposed regulations regarding Type III supporting organizations. Like Announcement 2007-87, these proposed regulations are effective beginning with the organization's tax year beginning after the rules are published as final or temporary regulations. However, they could be relied upon in good faith.

101.35 **Final and Temporary Regulations** On December 28, 2012, the IRS published final and temporary regulations concerning the requirements for supporting organizations. The temporary regulations were also issued as proposed regulations so that the IRS could solicit comments regarding these provisions.

101.36 Reg. 1.509(a)-4(i) discusses three requirements organizations must meet in order to qualify as supporting organizations.

101.37 **Notification Requirement** The 2006 Pension Act added a provision requiring Type III supporting organizations to provide information to their supported organizations showing they are responsive to these organizations. Instead of providing the information to be reported in the notification, Congress directed the IRS to determine what information should be included.

101.38 Reg. 1.509(a)-4(i)(2) requires Type III supporting organizations to provide the following information in writing to a principal officer of each of its supported organizations each year:

- the type and amount of support it provided to the supported organization during the immediately

preceding tax year (e.g., for a Type III supporting organization operating on a calendar year, the required notification due by May 31, 2014, would describe the support provided during the calendar year 2013).

- a copy of its most recently filed Form 990 or other return required to be filed under IRC Sec. 6033. (Because there is no extension of time available for this notification, the final regulations provide the Form 990 to be provided is the most recent one filed before the due date of the notification. For example, the notification due May 31, 2014, would include the supporting organization's Form 990 for the year 2012 if it has received an extension of time to file its 2013 Form 990 and has not completed the return before May 31, 2014.)
- a copy of its governing documents, including its charter or trust instrument and bylaws, and any amendments (these items are required to be provided once unless amended or restated).

This information must be postmarked or electronically transmitted by the last day of the 5th month after the end of the Type III supporting organization's tax year. There is no extension of time available for the provision of this notice. However, Reg. 1.509(a)-4(i)(11) does provide that for supporting organizations in existence on December 28, 2012, the due date for the first notification is the later of last day of the fifth month following the end of its taxable year or the due date (including extensions) for its Form 990.

101.39 Responsiveness Test Reg. 1.509(a)-4(i)(3)(ii) provides that a Type III supporting organization will meet the responsiveness test if it meets one of the following criteria:

- One or more of the directors, officers or trustees of the supporting organization are elected or appointed by the directors, officers, trustees, or members of the supported organization.
- One or more members of the governing bodies of the supported organization are also directors, officers, or trustees of, or hold important offices in, the supporting organization.
- The directors, officers, or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors, or trustees of the supported organization.

Additionally the directors, officers, or trustees of the supported organization must have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of

making them, and the selection of recipients, and in otherwise directing the use of the income or assets of the supporting organization. [Reg. 1.509(a)-4(i)(3)(iii)]

Example 1-7: Supporting organization meets the responsiveness test.

Religious Music, Inc. is classified as a supporting organization. Its purpose is to support the music department of a specified seminary. Two board directors of Religious Music, Inc. are appointed by the trustees of the seminary. The board members of Religious Music, Inc. meet with the seminary's trustees each quarter to discuss the needs of the seminary's music department, how to use the income generated by Religious Music, Inc., and how best to invest its assets. Religious Music, Inc. also regularly provides financial statements to the seminary's trustees. In this case, Religious Music, Inc. meets the responsiveness test of Reg. 1.509(a)-4(i)(3).

Example 1-8: Supporting organization does not meet the responsiveness test.

Assume the same facts as in Example 1-7 except the board members of Religious Music, Inc. do not meet with anyone from the seminary nor does the organization provide any financial information during the year. In this case, Religious Music, Inc. does not meet the responsiveness test.

101.40 Exception for Pre-November 20, 1970 Organizations. For organizations that were supporting organizations before November 20, 1970, additional facts and circumstances such as historical and continuing relationships between the organizations may also be taken into account. [Reg. 1.509(a)-4(i)(3)(v)]

101.41 **Integral Part Test** The integral part tests for functionally integrated Type III supporting organizations and nonfunctionally integrated Type III supporting organizations are different. The integral part test for functionally integrated Type III supporting organizations is discussed in Reg. 1.509(a)-4(i)(4). The integral part test for nonfunctionally integrated Type III supporting organizations is discussed in Reg. 1.509(a)-4(i)(4).

101.42 **Integral Part Test—Functionally integrated Type III supporting organizations** Reg. 1.509(a)-4(i)(4)(A) provides that for an organization to meet this test as a functionally integrated Type III supporting organization it must meet the following requirements:

- substantially all of its activities must directly further the exempt purpose of its supported organization(s) by performing the functions of, or carrying out the purposes of, its supported organizations(s); and

- its activities would normally be engaged in by the supported organization(s) but for its involvement.

101.43 Alternatively, the organization can meet this test if it is the parent of each of its supported organizations. In this case, the supporting organization is considered the parent organization if it exercises a substantial degree of direction over the policies, programs, and activities of the supported organization and a majority of the officers, directors, or trustees of the supported organization are appointed or elected, directly or indirectly, by the governing body, members of the governing body, or officers of the supporting organization. [Reg. 1.509(a)-4(i)(4)(B)]

101.44 **Integral Part Test—Non-functionally integrated Type III supporting organizations** Reg. 1.509(a)-4(i)(5)(i)(A) provides that for an organization to meet this test as a non-functionally integrated Type III supporting organization, it must meet both a distribution requirement and attentiveness requirement.

101.45 Distribution Requirement. The organization must make an annual distribution(s) to or for the use of its supported organization(s) by the last day of its taxable year. This distribution is known as the “annual distribution amount.” Final Reg. 1.509(a)-4(i)(5)(ii)(B) and (C) concerning the annual distribution amount have been reserved for future guidance. However, the IRS has published temporary regulations that should be followed until final regulations have been issued. Temp. Reg. 1.509(a)-4T(i)(5)(ii)(B) provides that the annual distributable amount equals the greater of—

- 85% of the supporting organization's adjusted net income [as determined under the principals of IRC Sec. 4942(f) and Reg. 53.4942(a)-2(d)] for the taxable year immediately preceding taxable year of the required distribution, reduced by income taxes imposed on the supporting organization during the immediately preceding taxable year, or

- its minimum asset amount of the immediately preceding taxable year.

Temp. Reg. 1.509(a)-4T(i)(5)(ii)(C) defines the minimum asset amount as the sum of—

- 3.5% of the fair market value of all nonexempt-use assets in excess of related acquisition debt,
- amounts received or accrued as repayments of amounts that were taken into account to meet the organization's distribution requirement for any taxable year,
- amounts received or accrued from the sale or disposition of property to the extent the property's acquisition was used to meet the organization's distribution requirement for any

taxable year, and

- amounts previously set aside to the extent it is determined that the set-aside is not necessary for the purpose for which it was set aside and was used to meet the organization's distribution requirement for any taxable year.

See Reg. 1.509(a)-4(i)(5) and Temp. Reg. 1.509(a)-4T for additional information regarding the required annual distribution requirement for non-functionally integrated Type III supporting organizations.

101.46 For a supporting organization's initial year, the annual distribution amount is zero. Additionally, the IRS can provide for a temporary decrease in this amount due to a disaster or emergency.

101.47 The IRS may allow an organization to continue its status as a supporting organization even though it fails to make its annual distribution amount if it meets the *reasonable cause exception*. To meet this exception, the organization must show that:

- the failure was due solely to an incorrect valuation of assets, a ministerial error, or unforeseen events or circumstances beyond the organization's control,
- the failure was due to reasonable cause and not willful neglect, and
- the distribution requirement is met within 180 days after the failure was or should have been discovered or within 180 days after the organization is first able to make the required distribution notwithstanding the unforeseen events or circumstances.

101.48 Attentiveness Requirement. In order to meet this requirement, the Type III nonfunctional supporting organization must distribute at least one-third of its annual distribution amount to one or more supported organizations that are attentive to its operations and to which it is responsive. [Reg. 1.509(a)-4(i)(5)(iii)]

101.49 A supported organization is considered attentive if it receives annual support that meets one of the following criteria:

- equals 10% or more of the supported organization's total support for the immediately previous taxable year, or

- is necessary to avoid the interruption of one of its functions or activities. In this case, the function or activity does not have to be the supported organization's primary one but must still be a substantial function or activity.

101.50 If a church, university, or hospital is a supported organization, the total support can be that of a department or school instead of the total support of the entire supported organization.

101.51 In some cases, the supported organization can be considered attentive based on all of the facts and circumstances, including:

- the number of organizations the supporting organization supports,
- the length and nature of the relationship between the two organizations, and
- the purpose to which the funds are put.

Of course, the more substantial the amount involved, the more likely the supported organization will be attentive to the supporting organization. However, evidence of actual attentiveness by the supporting organizations is of almost equal importance.

Example 1-9: Supporting organization meets the attentiveness requirement.

Religious Education for the Children was organized to support K through 12 schools run by churches. This organization allocates its annual distribution amount among several schools. For the year 20X1, Religious Education for the Children distributed an amount to St. Paul's Elementary School equal to 20% of the school's previous year's total support. Religious Education for the Children also made a substantial distribution to the Christian Academy. Without this distribution from Religious Education for the Children, this school would not be able to continue its music and arts departments. The distributions to these two schools accounted for 40% of Religious Education for the Children's annual distribution amount. Religious Education for the Children has met the attentiveness requirement.

Example 1-10: Supporting organization does not meet the attentiveness requirement.

Music for God Ministry supports several music ministries. This organization's annual distribution amount for the year 20X1 was \$200,000. It distributed more than 50% of it to a large tax-exempt distributor of religious music. Because of the size of the distributor's revenue and operations, the organization is deemed not to be attentive to Music for God Ministry. The ministry also distributes 25% of its annual distribution amount to Christian Community Church for its music outreach. This church has 300,000 members and annual revenues of \$2.5 million. Based on the size of the church and its revenues, it is determined that the music outreach would continue without the distribution from Music for God Ministry. Therefore, the ministry has not met the attentiveness requirement.

101.52 Distributions. In determining the amount of distributions made to supporting organizations, the cash receipts and disbursement method described in IRC Sec. 446(c)(1) must be used. The following amounts are included in determining distributions that count toward the distribution requirement:

- distributions to a supported organization to further its exempt purposes,
- the purchase price of assets used, or held for use, to carry out the supported organization's exempt functions,
- reasonable and necessary administrative expenses of the supporting organization, and
- any amount set aside for a specific project that accomplishes the exempt purposes of a supported organization to which the supporting organization is responsive, with such set-aside counting toward the annual distribution amount in the year the amount is set aside (but not the year it is paid) if at the time of the set-aside, certain requirements contained in Reg. 1.509(a)-4(i)(6)(v).

101.53 Carryover of Excess Amounts. Unlike private foundations, a supporting organization is allowed to carry forward distributions made in excess of its annual distribution amount. The excess may be carried forward for five years and in determining the order of distributions, the annual distribution amount is first reduced by the carryforward amount and then by the current year distributions. An excess amount is created for any tax year beginning after the final or temporary regulations are issued.

101.54 Asset Valuation. In order to determine the amount of the required distribution, the fair market value of the nonexempt-use assets must be established. Pursuant to Temp. Reg. 1.509(a)-4T(i)(8) [which cross-references Reg. 53.4942(a)-2(c)], this value equals the sum of:

- The average of the monthly fair market values of securities for which market quotations are readily available;
- The average of the monthly cash balances, other than cash being used, or held for use, in carrying out the supported organization(s) exempt purposes; and
- The fair market value of all other nonexempt-use assets for the period of time owned by the supporting organization during the year.

101.55 The following assets are not included:

- future interests in the income or corpus of real or personal property, other than one created by the supporting organization after August 17, 2006, until the supporting organization has constructively received the interest,
- assets of an estate until they are distributed to the supporting organization or, due to a prolonged period of administration, the estate is considered terminated for federal income tax purposes,
- present interests in trusts created and funded by another person,
- pledges of money or property, whether or not the pledges may be legally enforced, and
- assets used, or held for use, to carry out the exempt purposes of the supported organization(s).

101.56 Exempt-use Assets. As noted above, exempt-use assets are not included in calculating the amount of the required distribution. In order to be an exempt-use asset, the asset must be used or held for use to carry out the exempt functions of the supported organization(s). If the asset is not currently being used to carry out an exempt functions of a supported organization, it may still be considered an exempt-use asset if the supporting organization can establish to the satisfaction of the IRS that the asset's immediate use is not practical and definite plans exist to begin using the asset within a reasonable period of time.

101.57 Assets held for production of income or for investment are not exempt-use assets even though income produced from these assets is used for the supported organization's exempt functions. Assets held for production of income or for investment may include not only obvious assets such as stocks, bonds and rental property, but offices for employees engaged in managing these investments. The use of each asset must be analyzed.

101.58 Temp. Reg. 1.509(a)-4T(i)(8), by way of cross-referencing Reg. 53.4942(a)-2(c), provides guidance concerning mixed-use assets. If at least 95% of the total use of the property is for exempt purposes, the property is considered to be used exclusively for exempt purposes. If less than 95% of the total use is related to the exempt purposes of the supported organizations, a reasonable allocation must be made.

101.59 If a supporting organization acquires property to be used in furthering an exempt function of a supported organization but first leases it while arrangements are being made to adapt it to the intended exempt use, it will be considered an exempt-use asset as long as the income-producing use does not exceed a reasonable amount of time. The temporary regulations provide that one year is a reasonable amount of time. If the income-producing phase continues beyond a reasonable period of time, the asset will be treated as if it were disposed of at the end of the reasonable time period and its fair market value will be taken into account in determining the amount of the annual required distribution discussed at paragraph 101.45. If the asset is later used for an exempt purpose of a supported organization, the fair market value of the asset at that time is included in its distribution.

101.60 Administrative assets used by the supporting organization to further the exempt purposes of the supported organization are also considered exempt-use assets. For example, office equipment used by employees of the supporting organization to manage a youth center owned by the supporting organization but used by the supported organization would be considered exempt assets. If the office equipment is also used for investment purposes, its cost would have to be allocated between the two uses using a "reasonable method."

101.61 Reg. 1.509(a)-4T(i)(8) cross-references Reg. 53.4942(a)-2(c) for the method to be used in determining the value of each class of exempt-use assets.

101.62 **Type III Trusts** A Type III supporting organization that is a trust must continue to satisfy the pre-2006 Pension Act rules for trusts and, in addition, must establish to the IRS's satisfaction that it has a close and continuous relationship with the supported organization such that the trust is responsive to its needs and demands. A transitional rule for existing trusts provides that this rule was not effective until August 17, 2007.

101.63 **Tax Abuse of Supporting Organizations** The IRS has identified several different situations where supporting organizations have been used as tax shelters. For example, some individuals have created supporting organizations that they control for their own benefit, such as when a supporting organization receives a "charitable contribution" and then lends the funds back to the donor. Because of these abuses, Congress included several provisions in the 2006 Pension Act to penalize supporting organizations used as abusive tax shelters.

101.64 The IRS has found that some supporting organizations have little activity and do not provide meaningful support to the organization they claim to support. As a result, the IRS has been examining abuse in this area. It has established a cross-functional team to address the abuse and has examined several organizations—some established by promoters who marketed the use of supporting organizations as a way to avoid oversight constraints placed on private foundations and some chosen from a compliance check of recently-created supporting organizations.

101.65 **Conversion to Private Foundation** As discussed at paragraph 101.31, pursuant to new IRC Sec. 509(f)(2)(A), a Type I or Type III supporting organization will be converted to a private foundation if it accepts contributions from a “prohibited person.” A prohibited person is generally considered to be (a) a person who controls the governing body of the supported organization, either directly or indirectly, alone, or together with other disqualified persons (see paragraph 101.27); (b) a member of a control person's family; or (c) a 35% controlled entity [IRC Sec. 509(f)(2)(B)]. However, a public charity other than a supporting organization will not be deemed a control person. It can be very difficult to determine whether a potential donor is a prohibited person. The authors believe that a Type I or Type III supporting organization will need to establish procedures that ensure donations from prohibited persons are not accepted.

101.66 **Intermediate Sanctions** Prior to the enactment of the 2006 Pension Act, supporting organizations were subject to the same rules regarding excess benefit transactions as other public charities. (See section 310 for a discussion of Intermediate Sanctions.) The 2006 Pension Act expanded the definition of excess benefit transactions for supporting organizations to include several items.

- Any loan to a disqualified person. For purposes of this provision, the definition of *disqualified person* is the same as that for intermediate sanctions. See paragraph 310.10.
- Total amount of grants, loans, compensation, or similar payments (e.g., expense reimbursement) paid to a substantial contributor or a party related to a substantial contributor. (See paragraph 101.27 for a definition of these terms.)

101.67 **Tax on Excess Business Holdings** The 2006 Pension Act added IRC Sec. 4943(f) that applies an excess business holdings tax to supporting organizations in two instances:

- A Type II supporting organization that accepts any gift or contribution from a person who is deemed a prohibited person (see paragraph 101.31).
- A Type III supporting organization that is not functionally integrated with a supported organization. [IRC Sec. 4943(f)(1)]

See Chapter 26 of *PPC's 990 Deskbook* for an in-depth discussion of the tax on excess business holdings.

101.68 Filing Requirements Supporting organizations, regardless of type, must file form 990, even if gross receipts are less than \$50,000. However, Reg. 1.6033.6(b)(3) provides that supporting organizations that normally generate less than \$5,000 a year are not required to file Form 990 or 990-EZ. Instead, they must file Form 990-N (E-Postcard). On Form 990, Schedule A, the supporting organization must list:

- The supported organization's name, EIN, and type.
- Whether the supported organization is listed in its governing documents.
- The amount of support given to the supported organization.

Limited Liability Companies

101.69 In the past few years, tax-exempt organizations have started using limited liability companies (LLCs) for a variety of business reasons. For example, LLCs may afford legal liability protection. A religious organization might form an LLC with one or more for-profit organizations to carry out its tax-exempt purpose. In this case, the LLC is generally treated as a partnership and the religious organization must consider the ramifications that a partnership can create. See the discussion beginning at paragraph 305.47.

101.70 In addition to using LLCs for joint ventures with for-profit entities, tax-exempt organizations are finding LLCs useful for ventures with other tax-exempt organizations. In this case, the LLC must be treated as a separate entity and apply for its own exempt status by filing Form 1023. (See the discussion starting at paragraph 101.78 for requirements LLCs must meet when requesting exempt status.) In its 2001 Exempt Organization CPE Text, the IRS discussed what the LLC's governing documents must include for the LLC to qualify as a tax-exempt organization. These requirements are discussed paragraph 101.78.

101.71 Single-member LLCs A religious organization might form an LLC of which it is the only owner. This is known as a single-member LLC and is disregarded for tax purposes unless it elects to be treated as a corporation. The disregarded LLC is treated as a division of the organization while providing the advantages of being a separate entity for other purposes. See Announcement 99-102, 1999-2 CB 545.

101.72 A single-member LLC owned by a religious organization is not required to file Form 990 or Form 990-T. However, under Reg. 301.7701-2(c)(2), the LLC itself is considered the employer and is required to withhold income and social security taxes from its employees' pay and deposit both the

employees' withholding and its share of social security tax. Additionally, it is responsible for all filing requirements in connection with payroll taxes.

101.73 The single-member LLC benefits from its owner's tax-exempt status, including its exemption from federal income tax and federal unemployment tax.

101.74 **Charitable Contributions to Single Member LLCs** Although the IRS ruled many years ago that an LLC with a tax-exempt organization as its single member is a disregarded entity to be treated as a branch or division of the tax-exempt member, it has been unwilling to issue guidance concerning the tax deductibility of contributions made to the LLC until recently. In IRS Notice 2012-52, the IRS finally held that contributions made directly to an LLC with a tax-exempt organization as its only member are to be treated as if they have been made to the LLC's tax-exempt member. In order to avoid unnecessary inquiries, the IRS stated in the notice that the acknowledgement or other statement should disclose that the LLC is wholly owned by tax-exempt organization and is treated as a disregarded entity.

101.75 **Organizational Documents for Single-member LLCs** Currently, the IRS does not require a single-member LLC's articles of organization to include specific language regarding the prohibition of inurement, prohibition of political activity, and the distribution of assets upon dissolution because the entity is not treated as a separate entity. Instead, it is the owner's articles that matter. However, nothing in the LLC articles can prohibit the entity from operating exclusively for exempt purposes. For instance, a provision allowing a single-member LLC to operate "for all purposes for which LLCs may be operated" would be permissible. A provision that "the remaining assets upon dissolution are to be distributed to the members of the LLC" would also be permissible because the sole member is qualified under IRC Sec. 501(c)(3). [2001 IRS Exempt Organization CPE Text]. A single-member LLC's organizational documents do not have to contain specific language limiting the LLC's activities to exempt purposes. However, the religious organization's tax-exempt status can be jeopardized if these documents contain language indicating the LLC can operate for purposes contrary to the exempt purposes of the owner.

101.76 **Substantiating the Tax-exempt Status of a Single-member LLC** A religious organization may want proof that the LLC is a tax-exempt organization. For example, it may need such evidence to prove the LLC is exempt from state franchise tax or a donor may request proof of its exempt status. In this case, the tax-exempt organization may request a letter confirming the LLC is a disregarded entity and therefore tax exempt. Although the IRS will not issue a separate determination letter to the single-member LLC, it will send an information letter explaining the tax ramifications of owning a single-member LLC. This model letter is reproduced at Appendix 3G.

101.77 **Conversion from Single-member LLC to Separate Entity** A single-member LLC will automatically become a separate entity if it:

- admits one or more additional members,

- elects to be treated as a separate entity by filing Form 8832, or
- applies for its own exempt status.

In this case, the LLC has 27 months from the end of the month in which it becomes a separate entity to apply for its own exempt status.

101.78 Applying for Exempt Status In order to receive recognition as an exempt organization, an LLC must meet the same tests as other organizations applying for exempt status. In order to meet the organizational test, the LLC's governing documents (e.g., Articles of Organization, Operating Agreement, Regulations) must:

- Include a specific statement limiting the LLC to one or more exempt purposes.
- Specify that the LLC is operated exclusively to further the exempt purpose(s) of its members.
- State that the LLC's members are limited to public charities, governmental units, or wholly owned instrumentalities of a state.
- Include a prohibition against direct or indirect transfers of any membership interests in the LLC to entities other than public charities or governmental units or instrumentalities.
- State that the LLC's assets cannot be transferred, directly or indirectly, to any nonmember, other than a public charity or governmental unit or instrumentality, except in exchange for fair market value.
- Provide that upon the LLC's dissolution, its assets will continue to be devoted to tax-exempt purposes.
- Include a requirement that any amendments to the LLC's articles of organization or operating agreement be consistent with section 501(c)(3).

- Prohibit the LLC from merging with, or converting into, an entity that is not exempt under section 501(c)(3).
- Prohibit the LLC from distributing any assets, other than for fair market value, to members who have ceased to be either public charities or governmental units or instrumentalities.
- Include an acceptable contingency plan in the event one or more members of the LLC cease to be a public charity or a governmental unit or instrumentality.
- Provide that the LLC's tax-exempt members will expeditiously and vigorously enforce all of their rights in the LLC and pursue all legal and equitable remedies to protect their interests in the LLC.

101.79 The LLC must also represent, in a separate written statement, that all of its organizing document provisions are consistent with state LLC laws, and are enforceable at law and in equity. Additionally, the LLC must identify its members. A representation that it will obtain only exempt organizations as members in the future will not satisfy this requirement.

101.80 **State Requirements** All states, plus Washington, D.C., have enacted provisions regarding LLCs. However, there are substantial variations among the states' rules and regulations regarding LLCs. For example, Tennessee recognizes not-for-profit LLCs but only if the LLC has just one member that is a tax-exempt organization and the LLC is treated as a disregarded entity for federal tax purposes. Various states also have different filing requirements and fees.

101.81 Another issue to be considered is how a LLC formed in one state will be treated by another state when it begins to do business in that state. Therefore, it will also be necessary to review the LLC laws and regulations in other states where the LLC plans to conduct business to determine whether those states recognize foreign LLCs (i.e., those formed in other states).

Corporation Sole

101.82 Statutes in some states allow a “corporation sole” for the purpose of protecting religious assets. Religious leaders, generally bishops and pastors, incorporate to hold religious property. While held by the religious leader, the assets are protected from his creditors. This property then passes to the next office holder, not to the individual's heirs. When used as intended, a corporation sole enables religious leaders to legally separate themselves from the control and ownership of organization assets. However, legitimate use of a corporation sole is very limited today. Most churches and ministries now incorporate as separate entities.

101.83 Tax Abuse of a Corporation Sole. Some unethical promoters have marketed the corporation sole as a way for individuals to evade federal and state income taxes. For a fee, the promoter will sell the individual a package showing him how to create a one-person phony religious organization as a tax-exempt organization (a corporation sole) and transfer his assets to the new entity. Then the individual takes the position that all income is earned by the corporation sole and thus, is exempt from income tax. In Revenue Ruling 2004-27, the IRS ruled that this type of arrangement is considered to be tax evasion and will be subject to both civil and criminal penalties. Since 2004, the U.S. Justice Department has either filed complaints or obtained injunctions against several promoters of this scheme. The courts have also upheld the IRS position that an individual's compensation paid to a corporate sole, which then paid the individual's personal expenses, is a sham. (*Cortes*, TC MEMO 2014-181)

101.84 IRS Notice 2010-33 specifically identifies a corporation sole as one of four new frivolous tax positions for purposes of the IRC Section 6702 penalty. The notice states that a taxpayer's claim that income is not taxable because it is assigned or attributed to a religious organization (a "corporation sole" or ministerial trust) claimed to be tax-exempt under Section 501(c)(3) and similar arguments are described as frivolous for purposes of the penalty for a frivolous tax return. Persons who file a return based on that position are subject to a penalty of \$5,000 if the return does not contain information on which the substantial correctness of the self-assessed determination of tax may be judged or contains information that indicates the self-assessed determination of tax is substantially incorrect.

Use of Terms

101.85 Religious Organizations, Churches, and Religious Orders Throughout this *Guide* the term *religious organization* is used to include churches unless the more specific rules described beginning in paragraph 101.5 apply. Then the term *church* or *religious order* is used. In addition, the terms *church* and *religious organization* are used to include all faiths. They are used in a generic sense primarily to indicate a place of worship and to indicate the types of organizations listed in paragraph 101.2.

101.86 Minister The term *minister* is not used by all faiths. Throughout this *Guide*, it is used to denote members of clergy of all religions and denominations including priests, rabbis, imams, and similar members of the clergy. The definitions of a minister and ministerial duties are discussed in section 401.

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102 IRS Form 1023 [Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code]

102 IRS Form 1023 [Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code]

102.1 A religious organization's most valuable asset may be its exempt status. Tax exemption allows a religious organization to:

- Provide tax-deductible donor credit to donors as incentive for their contributions.
- Accumulate capital tax-free to acquire facilities necessary to administer the organization's ministry and to carry out the program services (exempt functions).
- Avoid not only federal taxes but many state and local taxes as well (except for taxes on unrelated business income, discussed in section 305).

102.2 To obtain tax-exempt status, religious organizations, except for churches and their integrated auxiliaries, must file IRS Form 1023 [Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code] or Form 1023-EZ [Streamlined Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code], if applicable. As discussed beginning in paragraph 101.9, churches and their integrated auxiliaries *may elect* to file Form 1023. If a church or its integrated auxiliary wants to receive official recognition of its exempt status, it must file Form 1023 and pay the applicable user fee. The benefits of securing a tax determination letter are presented in Exhibit 1-3.

102.3 The user fee to be submitted with Form 1023 varies depending on the gross receipts of the

organization. As of the date of publication of this *Guide*, the user fee varied from \$400 (for organizations whose average gross receipts are not expected to exceed \$10,000 during their first four years) to \$850 (for organizations whose average gross receipts are expected to exceed \$10,000) [Rev. Proc. 2014-8]. However, see the discussion at paragraph 102.8, for the reduced user fee for Form 1023-EZ. These fees reflect a U.S. Office of Management and Budget requirement that federal agencies charge user fees that reflect the full cost of providing goods and services when the benefits to the recipient otherwise exceed those received by the general public.

102.4 Form 1023 contains detailed questions regarding compensation and other arrangements with related parties. Schedule A of Form 1023 contains 17 questions specifically for churches asking for information such as the number of members, whether the members are all part of the same family, and whether the church has a written creed, statement of faith, or summary of beliefs. Form 1023 also includes questions concerning fund-raising activities, joint ventures, and activities in foreign countries. Many of the questions resulted from incorporating some of the additional information IRS personnel previously requested once the application was filed. *PPC's 990 Deskbook* provides detailed guidance on preparing Form 1023. Further discussion of completing Form 1023 is beyond the scope of this *Guide*.

Interactive Form 1023

102.5 The IRS has furnished an interactive Form 1023 on the website, www.stayexempt.irs.gov, which provides pop-up information boxes for most of the lines items on Form 1023. These boxes contain explanations and links to related information. This program leads the user through the prerequisites to filing Form 1023 with a series of “Yes” and “No” questions. Once completed, the program guides the user through the core form. If an answer to a particular question in the core form triggers a requirement for additional information, the user is directed to a supplemental page, ensuring all necessary information is included with the application.

102.6 Once all the questions on the core form and any supplemental forms have been addressed, the user must print the core form and its supplements. Only the core form and associated supplemental pages will download and print. Any documents requested during the process (e.g., articles of incorporation, by-laws, resumes, etc.) must also be included in the completed application. The final application and all supporting documentation must then be mailed to the IRS along with the user fee.

102.7 The IRS believes using the interactive 1023 will ensure:

- a. Organizations will submit more complete applications.
- b. IRS processing time will be reduced.
- c. Organizations will receive a tax-exempt determination letter sooner.

IRS Form 1023-EZ [Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code]

102.8 The IRS released Form 1023-EZ in July 2014. This form is only three pages and must be filed online at www.pay.gov. In addition to reducing the amount of paperwork required for filing as compared to the traditional Form 1023, the user fee is \$400. Although many small ministries will be eligible to file Form 1023-EZ, churches are not eligible for the new form and will still have to file the traditional Form 1023.

102.9 In order to file Form 1023-EZ, an organization must not have had annual gross receipts of more than \$50,000 for the three years preceding the year the application is filed. Additionally, the organization's projected annual gross receipts for the next three years cannot exceed \$50,000, and total assets cannot exceed \$250,000.

102.10 An organization will not qualify for Form 1023-EZ if it is:

- A foreign organization or an organization with a foreign mailing address.

- An organization that is not a corporation, unincorporated association, or trust.

- A private operating foundation.

- An organization (or successor) whose exemption was revoked for a reason other than the failure to file Form 990.

- Certain organizations applying for retroactive reinstatement after exempt status has been automatically revoked. (See paragraph 301.66 for discussion of organizations that are allowed to use Form 1023-EZ to request retroactive reinstatement.)

- A limited liability company (LLC).

- A qualified charitable risk pool.

- An organization that is a successor of a for-profit entity.

- A supporting organization pursuant to IRC Sec. 509(a)(3).

- An organization intending to invest 5% or more of its total assets in non-publicly traded securities or funds.

- An organization intending to participate in partnerships in which it shares profits and losses with for-profit entities.

- An organization intending to maintain donor-advised funds.

- One of several other types of organizations, including a church, school, hospital, Health Maintenance Organization, or credit counseling organization.

102.11 Form 1023-EZ is succinct, requiring only basic information. In completing the form, the organization must attest that its governing documents (a) limit the organization's purposes to one or more exempt purposes, (b) do not expressly empower the organization to engage in more than an insubstantial amount of activities that are not in the furtherance of one or more exempt purposes, and (c) provide that upon dissolution, the organization's remaining assets will be used exclusively for exempt purposes. The organization must also attest that it meets the political activity prohibitions. Form 1023-EZ does not include requirements to furnish governing documents, financial data, or a narrative of actual or proposed activities.

102.12 Since the release of Form 1023-EZ, many commentators have expressed concern that it does not provide enough information for the IRS to make a determination of whether the organization qualifies as an exempt organization. The IRS has also indicated it has issues about the lack of information. The IRS Chief Counsel has stated that Form 1023-EZ is now under "intense review." Additionally, the IRS is considering tougher standards for deducting donations made by a control party of an organization that has received its determination letter by submitting Form 1023-EZ. The IRS believes it is possible for a control party who is aware of potential exemption issues could claim a contribution deduction to an organization whose status is based only on erroneous or incomplete information included in Form 1023-EZ.

102.13 Rev. Proc. 2015-5 addresses the process for submitting Form 1023-EZ, including transition rules. The Rev. Proc. provides that when an eligible organization has submitted Form 1023, the IRS will accept the Form 1023-EZ for processing unless the original Form 1023 has already been assigned for review. However, the user fee sent with the original Form 1023 will not be refunded. Additionally, if the Form 1023-EZ is accepted, the filing date of the Form 1023-EZ (not the withdrawn Form 1023) will be treated as the date that the organization provided notice required under Section 508 to the Service for purposes of the due date for applications for exempt status. This provision will have no impact unless Form 1023-EZ is filed more than 27 months from the formation date of the organization.

102.14 Rev. Proc. 2015-5 also states the IRS may request additional information before processing the application or during the determination process. Additionally, the IRS intends to perform pre-determination reviews on a statistically valid random sample of Forms 1023-EZ.

Reclassification from Ministry to Church or Integrated Auxiliary

102.15 It is not uncommon for a ministry to evolve into a church or integrated auxiliary. In the past, the best method to report this change to the IRS was by filing a new Form 1023. However, now an organization desiring reclassification from a ministry to church status or recognition as an integrated auxiliary can use Form 8940 (Request for Miscellaneous Determination Under Section 507, 509(a), 4940, 4945, and 6033 of the Internal Revenue Code).

102.16 There are several advantages to using Form 8940 instead of filing a new Form 1023. First, the information requested is much less than that needed to complete Form 1023. Second, the user fee is \$400 instead of \$850 (Rev. Proc. 2014-8).

102.17 Form 8940 also is used for advance approval of various private foundation issues. Additionally, it can be used for advance approval that a potential contribution is an “unusual grant” for purposes of the public support test or a change in the type of support organization.

Changes in Exempt Activities

102.18 Organizations required to file Form 990 or 990-EZ must describe any substantial changes in their activities on the return. If the organization has not requested a new determination letter, its original determination letter may be out of date. In this case, the Exempt Organization Business Master File, which is continuously updated, is the most definitive source of the IRC section governing the organization's exempt status (not its original determination letter).

102.19 If a tax-exempt organization not required to file Form 990 or 990-EZ is considering substantial changes to its purposes or activities, it should consider requesting a private letter ruling. The IRS will issue a private letter ruling on proposed transactions and on completed transactions if the request is submitted before the return is filed for the year in which the transaction was completed. The IRS will issue letter rulings to public charities on matters involving a public charity's exempt status/ its public charity status [Pub. 4221-PC, Compliance Guide for 501(c)(3) Public Charities]

Change in Organization's Domicile

102.20 Sometimes, after a tax-exempt organization has incorporated in one state, it will decide to operate in another state because the second state allows more flexibility. In this case, the organization must consider whether it will have to file another request for tax-exempt status. If the organization reincorporates in the new state, the IRS and courts have ruled the reincorporated organization must file another Form 1023. (Rev. Rul. 67-390 and 77-469, *American New*, 74 TC 29374) The basis for these rulings was that a new entity was created when the organization reincorporated in the new state.

102.21 In November 2014, the IRS released a private letter ruling, PLR 201446025, in which it ruled an organization moving from one state to another would not have to file a new Form 1023. According to the facts, instead of filing dissolution and incorporation documents with the two states, the organization filed Articles of Domestication with the second state and a Certificate of Conversion with the first state. The IRS determined no new organization (i.e., reincorporation) was created. Instead, the organization was filing an amendment to its formation document. Therefore, the original Form 1023 was still valid.

102.22 This letter ruling appears to be the first addressing the process of changing a tax-exempt corporation's domicile from one state to another. Although this is favorable ruling for tax-exempt organizations, it should be noted (1) private letter rulings, although providing a look at the IRS position on an issue, is binding only on the organization requesting it; and (2) not all states have redomestication statutes for exempt organizations.

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Charity Watchdog Groups

103.1 Within the nonprofit sector, several charity watchdog groups compare and analyze nonprofit organizations' financial results. Some of those groups publish their findings for other interested parties. Others independently rate nonprofit organizations based on selected criteria. Those watchdog groups typically do not focus on the effectiveness of the organizations' programs toward achieving their missions. They do focus on certain percentages and ratios that indicate how much of the organizations' total expenses or revenues benefit their programs, however. In addition, some of those watchdog groups evaluate adherence to other nonfinancial standards.

103.2 The three most popular ratios used by the charity watchdog groups that focus on religious organizations are the (a) program expense ratio, (b) fundraising ratio, and (c) reserve ratio. There are differences among the groups in the methods of calculating the ratios. For example, all of the watchdog organizations consider the fund-raising ratio to be very important. However, two of the watchdogs calculate the ratio by dividing fund-raising expenses by money raised, one divides fund-raising expenses by total revenue, and a fourth calculates it two ways (dividing fund-raising expenses by total expenses and also by money raised). There are also differences in the interpretation or use of ratios. For example, most of the watchdogs indicate that charities with large reserves do not need additional resources and discourage donors from giving to them. But one of the watchdogs, Charity Navigator, indicates that wealth shows stability and that charities should not be penalized for having large reserves.

103.3 Familiarity with those watchdog groups and the standards they use to evaluate organizations will provide helpful guidance on the characteristics that other financial statement users, including potential donors, may look for in an organization. Certain membership organizations also have certain standards that the nonprofit organization may need to adhere to for membership. Accordingly, it is important for a nonprofit organization to be familiar with the primary watchdog groups and membership organizations and their standards. In addition, the organization may need to educate

potential donors or other financial statement users about how it compares to other organizations.

103.4 The primary charity watchdog groups for religious organizations include CharityWatch (formerly named the American Institute of Philanthropy), the BBB Wise Giving Alliance, Charity Navigator, and MinistryWatch. Internet sites for those groups are provided in Appendix 1D. MinistryWatch and the Evangelical Council for Financial Accountability (another organization that focuses on religious organizations) are discussed beginning at paragraph 103.5. Extensive discussion of the other listed primary watchdog groups and the standards they use is provided in *PPC's Guide to Nonprofit Contributions* and *PPC's Guide to Nonprofit Expenses*.

Groups that Focus on Religious Organizations

103.5 Examples of organizations that focus on religious organizations include the Evangelical Council for Financial Accountability and MinistryWatch. Internet sites for those groups are provided in Appendix 1D.

103.6 **Evangelical Council for Financial Accountability** The Evangelical Council for Financial Accountability (ECFA) was formed in 1979. ECFA has over 1,900 charitable, religious, missionary, social, and educational evangelical Christian nonprofit organizations as members. Its purpose is to help its member organizations obtain the public's trust through ethical practices and financial accountability. While membership in ECFA may indicate an organization is following certain good stewardship practices, not belonging to the organization is not an indication that an organization does not follow proper accounting practices.

103.7 The ECFA requires its member organizations [all 501(c)(3) organizations] to adhere to Seven Standards of Responsible Stewardship. Those standards include requirements concerning the following:

- Doctrinal issues, including a statement of faith

- Governance, including a board with a majority of independent members

- Financial oversight, including annual audited, reviewed, or compiled financial statements

- Use of resources in a responsible manner and in conformity with applicable laws and regulations

- Transparency, including financial disclosure and provision of financial statements upon written request and other disclosures as the law may require

- Related-party transactions and avoidance of conflicts of interest

- Stewardship of charitable gifts and responsible fund-raising

A complete listing of the ECFA's Seven Standards of Responsible Stewardship is available on the ECFA's Internet site at www.ecfa.org. ECFA's website contains a searchable directory of its members, allowing interested parties to determine information about those member organizations.

103.8 The ECFA does not rank or rate its member organizations according to financial information. It believes there are many factors that affect an organization's financial ratios, including the organization's size, its age, and the popularity of its programs. Accordingly, the ECFA does not believe that organizations with lower fund-raising and general and administrative percentages are necessarily more effective or efficient than organizations that have higher fund-raising and general and administrative percentages. Rather, ECFA feels that each organization should define the accomplishments of its mission through accountable reports and openness with the public.

103.9 Each member of ECFA is required to submit documentation annually that supports its compliance with the Seven Standards of Responsible Stewardship. Additionally, ECFA representatives perform on-site visits of randomly selected member organizations each year to verify compliance with the standards and identify areas of noncompliance.

103.10 Commission on Accountability and Policy for Religious Organizations. In January 2011, Senator Charles Grassley released a staff report that addressed the results of a three-year inquiry into the financial practices of six media-based Christian ministries and raised questions about certain tax and policy issues affecting nonprofit organizations. The senator asked the ECFA to lead an effort to obtain information from the nonprofit religious sector concerning the issues. He also indicated that he would prefer that solutions identified not require burdensome legislation. In response to the request, the ECFA established the Commission on Accountability and Policy for Religious Organizations. The Commission also addressed tax policy issues that it identified as warranting legislative attention in addition to those identified in the Senator's staff report. The issues considered included whether—

- churches should file the same highly detailed annual information return that other nonprofits must file (Form 990),

- legislation is needed to curb abuses of the clergy housing allowance exclusion,

- the current prohibition against political campaign intervention by churches and other nonprofits should be repealed or modified, and
- legislation is needed to clarify tax rules covering “love offerings” received by some clergy.

The Commission sought input from the Senator and his staff, Treasury Department (IRS) officials, legal experts, religious sector representatives, nonprofit sector representatives, and the general public. The Commission issued periodic updates on the nature and progress of its work to Senator Grassley and the public and issued a final report in August 2013. The Commission's website at www.religiouspolicycommission.org provides links to position papers on 17 issues, information about Commission activities and “virtual” town meetings, opportunities for public comment on the issues, and reports issued in December 2012 (discussed in the following paragraph) and August 2013 (discussed beginning in paragraph 103.12).

103.11 In December 2012, the Commission issued a report entitled *Enhancing Accountability for the Religious and Broader Nonprofit Sector*, which addresses nine issues and gives recommendations for religious and charitable organizations, the IRS/Treasury, and Congress. The following are the issues addressed in the report and a sampling of related recommendations:

- Executive compensation and excess benefit transactions
 - Nonprofit organizations should make their policies for setting the compensation of their top leaders and their conflicts-of-interest policies available to donors upon request as a demonstration of appropriate accountability.
 - Religious organizations exempt from filing Form 990—particularly the largest of such organizations—should actively participate in appropriately managed salary surveys in order to facilitate the availability of more and better comparability data.

Section 310 discusses compensation and excess benefits.

- Clergy housing exclusion
 - The IRS should improve the tax forms, worksheets, and educational guidance for members of the clergy in connection with the clergy housing exclusion.

Section 405 discusses parsonage and housing allowances.

- Churches' accountability and donor engagement
 - Churches should, as a best practice, establish appropriate measures to verifiably demonstrate (through independent accreditation by a bona fide accrediting organization, denominational oversight, or by other appropriate methods) to their members, congregants, and financial supporters that they have adequate and proper oversight regarding financial activities and that they do not engage in or tolerate abusive activities.

- IRS advisory committee for religious organizations

- Independent accreditation and ECFA's (Evangelical Council for Financial Accountability) model
 - Secular nonprofit organizations and faith groups not within the scope of ECFA's charter should consider the possibility of utilizing or forming independent accreditation organizations similar to ECFA that rigorously address good governance, accountability, and financial integrity.

 - Independent religious organizations that are not part of a larger structure such as a denomination or association with robust accountability practices and that choose not to pursue independent accreditation should adopt other practices that verifiably demonstrate to their donors and other stakeholders their commitment to accountability and financial integrity.

The ECFA is discussed beginning in paragraph 103.6.

- Religious organizations and third-party oversight

- Examinations of church leaders

- “Love” offerings
 - Religious organizations should carefully assess their roles in facilitating payments by individuals to or for the benefit of leaders of their organizations and in reporting taxable payments to the leaders of their organizations, to help ensure that their leaders are knowledgeable about, and compliant with, applicable tax law.

 - The IRS and/or the Treasury Department provide clear and authoritative guidance to religious organizations, their leaders, and their donors regarding the tax treatment of payments made directly by individuals to leaders of religious organizations and the tax treatment of payments by individuals that benefit leaders of religious organizations in circumstances where religious organizations facilitate the payments.

Section 406 discusses love offerings and other gifts.

- Public disclosure of highly sensitive information
 - A nonprofit organization that applies for recognition of exemption by filing Form 1023, or that files Form 990 series information returns, should make good-faith determinations regarding any highly sensitive information that should be redacted from public copies of those forms for the safety and protection of the organization, its workers, or others. Filing organizations should not abuse any provision in the law that prohibits the IRS from publicly disclosing such information.

The report can be accessed at

<http://religiouspolicycommission.org/CommissionReport.aspx>.

103.12 Section 309 discusses tax issues, laws, requirements, and prohibitions related to political activities of religious organizations, including political speech. In August 2013, the Commission issued its final report, *Government Regulation of Political Speech by Religious and Other 501(c)(3) Organizations—Why the Status Quo Is Untenable and Proposed Solutions*. The report, which can be accessed at <http://religiouspolicycommission.org/CommissionReport.aspx>, identifies the following reasons for the Commission's conclusion that the status quo is untenable:

- The vagueness in official guidance related to the law chills permissible speech, causes confusion among nonprofit organization leaders, and makes the law difficult for the IRS to administer.
- The Internal Revenue Service does not address the fact that some churches deliberately engage in activities that violate the prohibition as described in official IRS documents.
- For some faith communities, engagement in political communications is inextricably steeped in their history and culture. The IRS will not (and should not) enforce the prohibition in such faith communities en masse.
- Some IRS enforcement actions involving 501(c)(3) organizations have resulted in controversial outcomes and have generated allegations and popular perceptions of inconsistent or selective enforcement.
- It is not fair, appropriate, or reasonable to expect religious and other 501(c)(3) organizations to comply with a law that is regularly violated by significant segments of the sector with impunity. The fact that the government does have such an expectation results in a lack of respect for the law and its administration.

103.13 Nevertheless, the Commission concluded that law prohibiting political campaign participation and intervention by 501(c)(3) organizations should not be repealed. Instead, it proposes that definitional guidance be added to the law to clarify that certain communications made in the ordinary course of a 501(c)(3) organization's regular and customary exempt-purpose activities and that do not involve an expenditure of funds do not constitute participation or intervention in a political campaign. It also proposes that Congress adopt provisions in the law clarifying (a) the actions that constitute prohibited political campaign participation or intervention and (b) its intent that the Section 4955 excise taxes on political expenditures by 501(c)(3) organizations serve as intermediate sanctions and are to be applied as the exclusive sanction in cases where political expenditures are made by a 501(c)(3) organization that are inadvertent or are not substantial or frequent in relation to the

organization's activities as a whole. In addition, it proposes the repeal of Section 7409 of the Internal Revenue Code, which permits the IRS to obtain a court injunction prohibiting a 501(c)(3) organization from making further political expenditures.

103.14 **MinistryWatch** Wall Watchers, through its programs, collects, processes, and disseminates information, primarily to help donors make better informed giving decisions, but also to promote Christian stewardship in general. Wall Watchers currently operates MinistryWatch, which provides free informational reports and ratings of Christian ministries through a searchable database contained on its website at www.ministrywatch.com. The independent evaluations found on MinistryWatch are intended primarily as a service to donors. Information is obtained through contact with the ministries and through the research efforts of analysts.

103.15 MinistryWatch provides a "5 Star Rating," which is intended to be a measure of a ministry's financial efficiency as compared to its peers. Financial efficiency is defined as getting the most mission-related activity out of the least amount of financial resources. The 5 Star Rating is based on the calculation of ratios derived from the ministry's financial statements or its IRS Form 990. The ratios used are the:

- Fund-raising cost ratio.

- Contributions reliance ratio.

- Spending ratio.

- Program output ratio.

- Degree of long-term investment.

- Current asset turnover ratio.

103.16 Based on the ratios, each ministry receives a rating from one star (the lowest rating) to five stars (the highest rating). MinistryWatch notes that the rating is just one tool donors should use to evaluate ministries. MinistryWatch presents the 5 Star Rating in an individual ministry report along with other information and comments regarding the ministry. Because the rating is based on ratios derived from the ministry's financial statements or its Form 990, groups that qualify as churches and (a) do not file Form 990s and (b) do not provide their financial statements are not included in the

ratings.

103.17 MinistryWatch currently has approximately 500 ministries in its database. An individual report on a ministry generally provides the following information:

- General descriptions and details on the ministry and its operations.
- MinistryWatch's 5 Star Rating.
- Results of calculated financial ratios used in the 5 Star Rating.
- Summarized financial information.
- Analyst's comments and other information on the ministry.

Other Organizations

103.18 Appendix 1D provides a select listing of other organizations that can assist accountants who either serve or work for religious organizations.

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Religious Organizations

Chapter 1 Introduction and Overview Of Religious Organizations

104 Overview of This Guide

104 Overview of This *Guide*

104.1 As discussed beginning at paragraph 100.14, this *Guide* has been designed for use by both accountants and tax professionals in public practice or at religious organizations who want to understand the unique accounting, tax, and operational issues that churches and other religious organizations encounter.

104.2 Chapter 2 addresses accounting and reporting requirements under generally accepted accounting principles and special purpose frameworks. Chapter 3 addresses various tax issues faced by religious organizations, and Chapter 4 discusses complex payroll tax issues faced by religious organizations, ministers, and religious workers. Various operational issues, such as internal control, fraud, and budgeting are presented in Chapter 5. Chapter 6 discusses the faith-based initiative and how the receipt of government funds affects religious organizations. Illustrative financial statements for several different types of religious organizations are included at Appendix A.

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