

CHAPTER 2

Religious Organization Tax Issues

Pages 45-81



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CHAPTER 2 RELIGIOUS ORGANIZATION
TAX ISSUES

P 45

► Issue 1: Entity Tax-Exempt Status

► Issue 2: Entity Taxation and Unrelated Business Income

► Issue 3: Taxation of Service Providers

► Issue 4: Church Audits

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ISSUE 1: ENTITY TAX EXEMPT STATUS

P 47

• Must be a legal entity separate from its owners

• Organized under state law as a corporation, unincorporated association, or trust

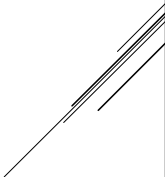
• Sole proprietorships, partnerships, individuals and loosely associated groups don't qualify

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ORGANIZATIONAL TEST

P 48

- ▶ Looks at the entity's articles of incorporation
- ▶ Limits its purpose to one or more exempt purposes
- ▶ Does not allow the organization to engage substantially in activities that don't advance the exempt purposes



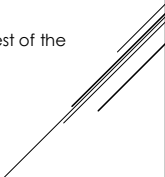
4



EXAMPLES 2.2 AND 2.3

P 49

- 2. Formed for religious and charitable purpose but articles also authorize the corporation to engage in business
- 3. Formed to foster best interest of the people and well-being of community



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LEGISLATIVE AND POLITICAL
ACTIVITIES

P 49

An organization is not organized exclusively for one or more exempt activities if the articles empower it to:

- 1. Devote a substantial amount of time to influence legislation
- 2. Participate in a political campaign
- 3. Have objectives and engage in activities of an action organization



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ACTION ORGANIZATIONS

P 50-51

- ▶ Action organizations are not operated exclusively for one or more exempt purposes
- ▶ Activities might include attempts to influence legislation or participation in a political campaign
- ▶ Facts and circumstances must be considered:

Is the primary objective of the organization to attempt to influence legislation? Or is it an analysis or research on an issue?

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DISTRIBUTION OF ASSETS ON DISSOLUTION

P 49

- ▶ Assets must also be dedicated to an exempt purpose
- ▶ Upon dissolution they must be distributed to another exempt organization, federal, state or local government
- ▶ Articles of organization should not state that the assets will be distributed to the members or shareholders on distribution

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OPERATIONAL TEST

P 50

- ▶ Not operating exclusively for one or more exempt purposes if its net earnings inure or are distributed to the benefit of private shareholders or individuals
 - Dividends
 - Unreasonable compensation
 - Transfers of property at less than FMV

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P 50

EXAMPLE 2.4

Members of the church are the pastor, wife and 2 kids.
Pastor employed by the state government.
Checks deposited into church bank account.
Church account is used for personal living expenses

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WHAT IS A CHURCH?

P 76

- Not defined by the Code but Regulations say any organization claiming to be a church
- Courts have used the following characteristics:
 - Distinct legal existence
 - Recognized creed and form of worship
 - Definite and distinct ecclesiastical government
 - Formal code of doctrine and discipline
 - Distinct religious history
 - Membership not associated with any other church or denomination
 - Organization of ordained ministers
 - Sunday schools
 - Regular worship services
 - Established place of worship



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APPLICATION FOR EXEMPTION

P 51

- Churches that meet the requirements of 501(c)(3) are automatically considered tax exempt
- All other religious organizations must apply for exempt status unless annual gross receipts do not exceed \$5000.
- Must submit application within 27 months from the end of the month in which the organization was formed
- Application is filed electronically on Pay.gov

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APPLICATION FOR EXEMPTION

P 52

► Form 1023- EZ - Must meet all:

1. Annual gross receipts of \$50,000 or less in the current and next 2 years

2. Annual gross receipts of \$50,000 or less in each of the past 3 years of existence

3. FMV of the assets doesn't exceed \$250,000

Some organizations are not eligible: foreign, LLCs, churches, schools and hospitals

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GROUP EXEMPTIONS

P 52

► A parent organization can apply for exemption on behalf of subordinate organizations

► Subordinates must be:

1. Affiliated with the central organization

2. Subject to the supervision or control of the central organization

3. Exempt under the same subsection of § 501(c)

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ISSUE #2 - ENTITY TAXATION AND UNRELATED BUSINESS INCOME

P 54

► Tax exempt organization is not taxed on its income from activity related to its exempt purpose even if the activity is a trade or business

► Income that is not related to its exempt purpose is taxed

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UNRELATED BUSINESS INCOME

P 54

- ▶ A trade or business is an activity with a profit motivation
- ▶ Use of the profits to further the exempt purpose does not necessarily make the activity substantially related to the exempt purpose
- ▶ Regularly conducted means with frequency and continuity

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NOT A REGULARLY CONDUCTED ACTIVITY – EXAMPLE 2.5

Sunset Church operates a hamburger stand at a local fair 2 weeks each year
Not the regular conduct of business

P 54

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PRODUCT SALES

P 55

- ▶ Selling products that result from the exempt purpose is generally not UBI
- ▶ If the product is further developed than what is necessary to sell it, the activity could become UBI
- ▶ Example 2.7



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P 56

-
- A black and white photograph showing the exterior of a 'The Salvation Army Family Thrift Store'. The building has a large, curved, ribbed awning over the entrance. The store's name is visible on the awning. The entrance is wide and open, showing some interior displays.

[illegible]

P 57

This Photo by Unknown Author
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- | | | | | |
|----|----|----|----|----|
| 12 | 18 | 41 | 47 | 61 |
| 7 | 26 | 39 | 54 | 70 |
| 4 | 27 | 33 | 49 | 63 |
| 5 | 23 | 35 | 58 | 73 |
| 3 | 30 | 32 | 52 | 75 |

[illegible]

P 57

OTHER ACTIVITIES

P 57

Qualified Sponsorship Payments

- Does not include advertising:
 - Messages containing qualitative or comparison language
 - Endorsements
 - Inducements to purchase or sell products or services
- Does not include contingent payments
- Does not include payments made in connection with trade shows or conventions
- Does not include payments made for use of logo in an organization's periodical

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CALCULATING UBTI

► UBTI is gross income from a trade or business *regularly conducted* that is unrelated to exempt organization's purpose

► If there are two or more unrelated trades or business

- Calculate separately
- Cannot offset loss of one from income of another
- Cannot have a loss

UBTI Worksheet
For Religious Exempt Organizations (2012)

Worksheet	Part I	Part II
1. Gross income		
2. Exclusions from income		
3. Net income		
4. UBTI		

This worksheet for Religious Exempt Organizations is copyrighted by the IRS.

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CALCULATING UBTI

P 58-59

Exclusions from Income

Items not likely to result in serious competition for taxable business

- Dividends and interest
- Royalties
- Rents (real property only)
- Property distribution gains and losses –except inventory, property held for sale and cut timber

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CALCULATING UBTI

P 60

Deductions from UBTI

▶ Items directly connected with carrying on the trade or business

▶ Dual use expenses

▶ NOL deduction

- Limited to the lesser of NOL carryovers or 80% of taxable income
- No carryback
- Each unrelated trade or business must be calculated separately

▶ Charitable Contributions Deduction – up to 10% of UBTI

▶ Specific Deduction - \$1,000

▶ Partnership Income or Loss

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CALCULATING UBTI

P 61-62

Debt-Financed Property

▶ Ordinarily investment income would be excluded from UBTI, but it must be included if derived from debt-financed property

▶ Debt-financed property means any property held to produce income for which there is acquisition indebtedness

1. Acquire or improve
2. Would not have incurred except for acquisition or improvement
3. Reasonably foreseeable

▶ Change in use

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EXAMPLE 2.16

• Hope Families bought apartment building for homeless teens

• 2025 rented it to the public for non-exempt purposes

• Outstanding principal debt becomes acquisition indebtedness and center must include the rental income as UBTI

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CALCULATING UBTI

P 62-63

Debt-Financed Property

▶ Gifts and Bequests – Not debt financed for 10 years

▶ Debt modification

- If debt is renewed and the principal remains the same continuation of the debt
- If debt is increased, must allocate between the old and new debt

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CALCULATING UBTI

P 62-63

Exceptions to Debt-Financed Property

▶ **Exempt purpose** – 85% or more use of property substantially related to an exempt purpose. If less than 85% only amount related to the exempt purpose is not treated as debt-financed

▶ **Unrelated trade or business** – If sold, gain is includable

▶ **Excluded Activities** – Items that are already included in UBTI

▶ **Related Uses** – Owned by one or more exempt organizations

▶ **Neighborhood Land Rule** – Real property acquired with the intent of using it within 10 years

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UBTI FILING REQUIREMENTS

P 65

▶ Electronic filing of Form 990-T is required if income from unrelated businesses is \$1,000 or more

▶ Each business must be reported on a separate Schedule A

▶ Must file by the 15th day of the 5th month following the end of the year

▶ 6 month extension available – Form 8868

▶ Estimated payments are required if expected tax is \$500 or more

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EXCESS BENEFIT TRANSACTIONS

P 66

▶ Excess benefit transaction – One in which the tax-exempt organization provides economic benefit to a disqualified person

▶ Disqualified person

1. Person who can exercise substantial influence
2. Family member of that individual
3. 35% controlled entity

▶ § 4958 imposes an excise tax of 25% on the disqualified person and 10% on a manager who knowingly participated.



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ISSUE #3 – TAXATION OF SERVICE PROVIDERS

P 67

▶ A minister is a duly ordained, commissioned or licensed minister of a religious order who provides ministerial services

▶ Broad term to describe the leader of worship in any religion

▶ Employee- employer relationship exists when the person for whom the services are performed has the right to control the result as well as the means



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INCOME TAX

P 67

▶ A minister is subject to income tax on all earnings

▶ May not be subject to tax on housing allowance

▶ Deductions:

- Unreimbursed business expenses no longer allowed on Schedule A
- Accountable plan recommended
- If not an employee, then Schedule C



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P 68

- ▶ Salary not subject to federal withholding if ordained, meet the definition of minister, and salary is for ministerial services
- ▶ They can enter a voluntary withholding agreement or pay estimated tax payments

Self-Employment tax

- ▶ Services performed are considered SE income if employee or independent contractor
- ▶ Covered under SECA not FICA
- ▶ Can opt out

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P 69

EXAMPLE 2.19

000000		☐ New	☒ Employer's initial security number	☐ Official file flag (Mail box - See note)
3 Employer's name, address, and ZIP code First Church Indianapolis, IN				
4 Control number		5 Estimated gross wages or salaries paid during calendar year \$48,000		
6 Employer's first name and initial (Last name optional)		7 Social security tax		
		8 Unemployment taxes		
9 Employer's address and ZIP code		10 Total income tax withheld		
11 State unemployment tax rate (%)		12 Federal income tax withheld		
13 Unemployment tax base (\$)		14 Social security tax base (\$)		
15 Unemployment tax amount (\$)		16 Social security tax amount (\$)		
17 Unemployment tax credit (\$)		18 Social security tax credit (\$)		
19 Unemployment tax refund (\$)		20 Social security tax refund (\$)		
21 Unemployment tax refund credit (\$)		22 Social security tax refund credit (\$)		
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99 Unemployment tax refund credit balance amount (\$)		100 Social security tax refund credit balance amount (\$)		

Reverend Mason was paid a \$48,500 Salary
He chose to make estimated payments

Reverend Mason was paid a \$48,500 Salary
He chose to make estimated payments

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P 70

- ▶ Typically treated like any other employee
- ▶ Church may elect to exclude employees from Social Security and Medicare
- ▶ Employee would then pay SE tax unless they also apply for exemption
- ▶ Ministers file Form 4361 – Exemption from SE
- ▶ Churches file Form 8274 – To exclude employees from FICA
- ▶ Church employees file Form 4029 - Exemption

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AMISH AND MENNONITE

P 70

► They pay income tax, sales tax, and property tax but do not believe in public insurance

► Can request exemption by filing Form 4029

► Does not apply to income earned outside the exempt community

Good Chart on page 71



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EXAMPLE 2.21

P 70

• Amos and Naomi Yoder are members of the Amish Community

• Amos self-employed contractor with one employee, Andrew

• Naomi works at Amish bakery owned by private corporation



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HOUSING EXCLUSION

P 72

► Ministers may exclude a housing allowance or the fair rental value of a parsonage from income

► Must include the amount for SE tax purposes

► Must be officially designated as a housing allowance before paid



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HOUSING EXCLUSION

P 72

If the minister owns the home, the lesser of the following can be excluded:

1. Amount actually used to provide the home
2. Amount designated as the rental allowance
3. Fair rental value of the home, including utilities

Minister must include in income any allowance that is more than the smallest of:

1. Reasonable salary
2. Fair rental value
3. Amount that is used to provide a home

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EXAMPLE 2.22

P 72



Housing Allowance	12,000
Mortgage Payments and utilities	13,200
FRV of home	11,000
Can exclude 11,000, must include \$1,000 in income	

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EXAMPLE 2.23

Fair rental value of parsonage	24,000
Annual Salary	67,000
Utility cost designation	7,500
Actual utility costs	7,000
Excludes from Income:	
Fair rental value + actual utilities =	31,000
Includes in Income :	
Salary + Unused utility allowance =	60,000
59,500 + 500	
For SE purposes income =	91,000



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ISSUE #4 – CHURCH AUDITS

P 75

Process

1. First written notice -Reasonable belief test met – begin inquiry

2. Church has a reasonable period to respond

3. Second notice is issued within 90 days if unresponsive or response is not adequate

4. Church may request a conference with IRS official before examination

5. Exam completed within 2 years of the date of second notice



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COMMENCING AN INQUIRY

P 75

► Reasons for an Inquiry:

• May not qualify for tax exemption as a church

• May be carrying on an unrelated business

► Reasonable Belief:

• Newspaper articles

• Television or radio

• Internet

• Creating or distributing voter guides

• Informants

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WHAT CONSTITUTES AN INQUIRY?

P 76

IRS requests information from a church that are usually contained in church records.

Routine requests for information do not constitute a church inquiry

Requests for third-party records generally do not require the procedures of 7611

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WHAT CONSTITUTES AN INQUIRY?

P 77

The procedures of §7611 also do not apply to the following:

1. Examinations of individuals- inurement, assignment of income, contributions
2. Termination or jeopardy assessments
3. Willful failure to file
4. Criminal investigations

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OUTCOMES OF EXAMINATION

P 79

1. No change in exempt status or liability
2. No change conditional on future compliance
3. Proposal to revoke exempt status
4. Assessment of income tax on unrelated business income
5. Proposal asserting other taxes

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3. Proposal to revoke tax-exempt status

P 79-80

- Regional Counsel must approve
- IRS can assess tax for most recent 3 years, can go back 6 years
- For UBTI IRS can assess for 6 years
- No limitation if the organization has not filed a return
- Contribution deductions are no longer tax deductible



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