

FEDERAL INCOME TAX ISSUES

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I. Introduction

This paper will address the definition of the term *church* and several related terms under the Internal Revenue Code, and then review eight sections of the Code that treat churches (and in some cases other religious organizations) in a special way. The paper concludes with a discussion of the propriety of these special rules.

II. Definitions

A. "Church"

The Internal Revenue Code uses the term *church* in many contexts, including the following:

1. charitable giving limitations¹
2. church pension plans under the Employee Retirement Income Security Act of 1974 (ERISA)²

¹ I.R.C. § 170(b)(1)(A)(i).

² *Id.* at §§ 410(d), 414(e).

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3. church "retirement income accounts"³
4. deferred compensation plans⁴
5. ineligibility of churches for using an "expenditure test" for determining permissible lobbying activities⁵
6. unrelated business taxable income⁶
7. unrelated debt-financed income⁷
8. exemption from the necessity of applying for recognition of tax-exempt status⁸
9. treatment of church employees for social security purposes if church waives employer FICA coverage⁹
10. unemployment tax exemptions¹⁰
11. exemption from filing annual information returns¹¹

³ *Id.* at § 403(b)(9).

⁴ *Id.* at §§ 414 and 457.

⁵ *Id.* at § 501(h).

⁶ *Id.* at § 512.

⁷ *Id.* at § 514.

⁸ *Id.* at § 508(c).

⁹ *Id.* at § 1402(j).

¹⁰ *Id.* at § 3309(b)(1).

¹¹ *Id.* at § 6033(a)(2)(A).

12. exemption from filing returns regarding liquidation, dissolution, or termination¹²
13. restrictions on the examination of financial records¹³
14. election to waive employer FICA participation¹⁴

The Internal Revenue Code occasionally uses the term *church* in connection with the term *minister*. For example, service performed by a duly ordained, commissioned, or licensed minister of a church is expressly exempted from federal employment taxes,¹⁵ unemployment taxes,¹⁶ income tax withholding requirements,¹⁷ and self-employment taxes (if a valid waiver has been timely filed).¹⁸

Despite these many references to the term *church*, the Internal Revenue Code contains no adequate definition of the term.¹⁹ This is

¹² *Id.* at § 6043(b)(1).

¹³ *Id.* at § 7605(c).

¹⁴ *Id.* at 3121(w).

¹⁵ *Id.* at § 3121(b)(8).

¹⁶ *Id.* at § 3309(b)(2).

¹⁷ *Id.* at § 3401(a)(9).

¹⁸ *Id.* at § 1402(e).

¹⁹ See generally Whelan, "Church" in the Internal Revenue Code: The Definitional Problems, 45 Fordham L. Rev. 885 (1977); Worthing, "Religion" and "Religious Institutions" under the First Amendment, 7 Pepperdine L. Rev. 313 (1980); Note, *Toward a Constitutional Definition of Religion*, 91 Harv. L. Rev. 1056 (1978).

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understandable, since a definition that is too narrow potentially interferes with the constitutional guaranty of religious freedom, while a definition that is too broad will encourage abuses in the name of religion. The United States Supreme Court has noted that "the great diversity in church structure and organization among religious groups in this country . . . makes it impossible, as Congress perceived, to lay down a single rule to govern all church-related organizations."²⁰ Nevertheless, the Code contains some limited attempts to define churches and related organizations. Prior to 1970, the income tax regulations specified that the term *church* included

a religious order or religious organization if such order or organization (a) is an *integral part* of a church, and (b) is engaged in carrying out the functions of a church, whether as a civil law corporation or otherwise. In determining whether a religious order or organization is an integral part of a church, consideration will be given to the degree to which it is connected with, and controlled by, such church. A religious order or organization shall be considered to be engaged in carrying out the functions of a church if its duties include the ministration of sacerdotal functions and the conduct of religious worship. . . .

²⁰ St. Martin Evangelical Lutheran Church v. South Dakota, 451 U.S. 772, 782 n.12 (1981).

What constitutes the conduct of religious worship or the ministration of sacerdotal functions depends on the tenets and practices of a particular religious body constituting a church.²¹

This language implied that a church is an organization whose "duties include the ministration of sacerdotal functions and the conduct of religious worship."

Section 3121(w) of the Code, which permits churches and church-controlled organizations to exempt themselves from the employer's share of FICA taxes (if certain conditions are met), defines the term *church* as follows:

For purposes of this section, the term "church" means a church, a convention or association of churches, or an elementary or secondary school which is controlled, operated, or principally supported by a church or by a convention or association of churches. For purposes of this subsection, the term "qualified church-controlled organization" means any church-controlled tax-exempt organization described in section 501(c)(3), other than an organization which--(i) offers goods, services, or facilities for sale, other than on an incidental basis, to the general public, other than goods, services, or facilities which are sold at a nominal charge which is substantially less than the cost of providing such

²¹ Treas. Reg. § 1.511-2(a)(3)(ii) (emphasis added).

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goods, services, or facilities; and (ii) normally receives more than 25 per cent of its support from either (I) governmental sources, or (II) receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in activities which are not unrelated trades or businesses, or both.²²

In the context of charitable contribution deductions, the Code defines the term *church, or convention or association of churches* as a "church, or convention or association of churches."²³

These definitions clearly are inadequate, and provide very little help in applying the many Code sections pertaining to churches. The IRS has attempted to fill this definitional vacuum by compiling a list of fourteen "criteria" which presumably characterize 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

²² I.R.C. § 3121(w)(3).

²³ Treas. Reg. § 1.170A-9(a).

8. ordained ministers selected after completing prescribed studies
9. a literature of its own
10. established places of worship
11. regular congregations
12. regular worship services
13. Sunday schools for religious instruction of the young
14. schools for the preparation of ministers

No single factor is controlling, although all fourteen may not be relevant to a given determination.

These criteria have been recognized by a number of courts. The first federal case to do so involved a claim by a husband and wife that they, and their minor child, constituted a church. The family insisted that it was a church since the father often preached and disseminated religious instruction to his son, the family conducted "religious services" in their home, and the family often prayed together at home. A federal court agreed with the IRS that the family was not a church, basing its decision on the fourteen criteria. In commenting upon the fourteen criteria, the court noted that "[w]hile some of these are relatively minor, others, e.g., the existence of an *established congregation* served by an organized ministry, the provision of *regular religious services* and religious education for the young, and the dissemination of a doctrinal code, are of central importance. The means by which an avowedly

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religious purpose is accomplished separates a 'church' from other forms of religious enterprise." In concluding that the family was not a church, the court observed: "At a minimum, a church includes a body of believers or communicants that assembles regularly in order to worship. Unless the organization is reasonably available to the public in its conduct of worship, its educational instruction, and its promulgation of doctrine, it cannot fulfill this associational role."²⁴

The IRS ruled in 1988 that a religious organization was properly exempt from federal income taxes as a "church." The organization in question was established to develop an ecumenical form of religious expression that would "unify western and eastern modes of religious practice" and place greater significance on the mystical aspects of religious truth. Some twenty or so persons met for an hour each week in the church's facilities, and were asked to pay dues of \$3 each month and subscribe to the church's ten precepts. A "Sunday school" was provided for children of members and nonmembers, and literature was produced. The IRS concluded that this organization was properly exempt from federal income taxes as a church, since it satisfied a majority of the 14 criteria. The IRS observed that

²⁴ American Guidance Foundation v. United States, 490 F. Supp. 304 (D.D.C. 1980). See also Lutheran Social Service of Minnesota v. United States, 758 F.2d 1283 (8th Cir. 1985); Church of the Visible Intelligence that Governs the Universe v. Commissioner, 83-2 U.S.T.C. para. 9726 (Ct. Cl. 1983).

the organization meets most of the 14 criteria It is fully incorporated and has a fully distinct legal existence. It has a creed and form of worship recognized by its members. Although it is still in a developing stage, it has a definite and distinct ecclesiastical government It has a formal code of doctrine and discipline as evidenced by the ten precepts While it has a history of only a few years because it is a relatively new organization, its members have documented its growth and major changes. It has what could be called an organization of ordained ministers . . . a literature of its own . . . an established place of worship . . . a regular congregation . . . and regular services including Sunday school.

The IRS noted that the church did not have a "membership not associated with any other church or denomination" since members were not required to sever their ties with other churches. However, a failure to meet this factor was "overcome" by the presence of the remaining thirteen factors.²⁵

A federal appeals court, in rejecting an individual's claim that he was exempt from federal taxes since he was a "church," relied directly on the fourteen criteria. The individual maintained that after "much Bible study" he had concluded that "if you believe you are a church and you

²⁵ Technical Advice Memorandum 8833001.

are practicing your religion to your point of view, then you can have tax exempt status because churches are exempt." He pointed out that the Internal Revenue Code contains no definition of the term *church*, and that churches are not required to file applications for exemption from federal income tax. The court, in rejecting the taxpayer's "tax-exempt" status, observed that "it is obvious that one person cannot free all his taxable income from all tax liabilities by the simple expedient of proclaiming himself a church and making some religious contributions. Common sense makes this clear." If this were not so, "there would likely be an overabundance of one-person churches paying no income taxes, and leaving to the rest of us the payment of their fair share of the expense of running the government. That attitude hardly seems like an act of churchly charity to one's neighbors." The court concluded its opinion by observing: "Every year with renewed vigor, many citizens seek sanctuary in the free exercise [of religion] clause of the first amendment. They desire salvation not from sin or from temptation, however, but from the most earthly of mortal duties--income taxes. Any salvation sought from income taxes in this court is denied."²⁶

The United States Tax Court ruled that a religious organization formed to "spread the message of God's love and hope throughout the world" and to "provide a place in which those who believe in the

²⁶ United States v. Jeffries, 854 F.2d 254 (7th Cir. 1988).

existence of God may present religious music to any persons interested in hearing such" was not a church.²⁷ The organization maintained an outdoor amphitheater on its property, at which musical programs and an occasional "retreat" or "festival" were conducted about 12 times each year. No other regularly scheduled religious or musical services were conducted. Most of the musical events were held on Saturdays so that persons could attend their own churches on Sundays. Musical services consisted of congregational singing of religious music. A minister always opened and closed these events with prayer. While it did not charge admission to its events, there was a published schedule of "donations" that were similar to admissions charges. The organization also maintained a chapel on its property that was open to the public for individual prayer. The organization applied to the IRS for recognition of tax exempt status on the ground that it was a church. Eventually, the IRS rejected the organization's exemption application on the ground that it was not a church. In reaching its decision, the IRS noted that the organization failed most of the 14 criteria used by the IRS in identifying churches. The organization maintained that it met a majority of these criteria, and appealed to the Tax Court. The Tax Court agreed with the IRS, and ruled that the organization was not a church. Significantly, it

²⁷ *Spiritual Outreach Society v. Commissioner of Internal Revenue*, 58 T.C.M. 1284 (1990), *aff'd*, 927 F.2d 335 (8th Cir. 1991).

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refused to accept the 14 criteria as the only test for determining whether or not a particular organization is a church. It did concede, however, that the 14 criteria are helpful in deciding such cases. The court noted that the organization met at least a few of the 14 criteria, and that some would not be relevant to "a newly-created rural organization." On the other hand, the court noted that the organization had no ecclesiastical government, formal creed, organization of ordained clergy, seminary, or Sunday school for the training of youth. Further, it did not produce its own religious literature (it sold literature produced by other religious organizations).

The court concluded by noting that "[w]hile a definitive form of ecclesiastical government or organizational structure may not be required, we are not persuaded that musical festivals and revivals (even if involving principally gospel singing . . .) and gatherings for individual meditation and prayer by persons who do not regularly come together as a congregation for such purposes should be held to satisfy the cohesiveness factor which we think is an essential ingredient of a 'church.'" This case is significant, since it represents the first time that the Tax Court has acknowledged that the 14 criteria used by the IRS in identifying churches are not an exclusive test that must be used in all cases.

A state supreme court ruled that "all fourteen factors need not be answered affirmatively in favor of there being a church for a religious organization to be classified as a church. Neither must there necessarily be a numerical majority. Mechanical evaluation is not the process to be used. Rather, the facts of each case are to be considered in their respective context and considered in light of these factors"²⁸

Such rulings demonstrate the continuing viability of the fourteen criteria. Nevertheless, these criteria are troubling because they are so restrictive that many if not most bona fide churches fail to satisfy several of them. In part, the problem results from the apparent attempt by the IRS to draft criteria that apply to both local churches and religious denominations. To illustrate, few if any local churches would meet the seventh, ninth, and fourteenth criteria, since these ordinarily would pertain only to religious denominations. In addition, many newer, independent churches often will fail the first and fifth criteria and may also fail the second, third, fourth, sixth, and eighth. It is therefore possible for a legitimate church to fail as many as ten of the fourteen criteria. The original Christian churches described in the New Testament

²⁸ Nampa Christian Schools, Foundation v. State, 719 P.2d 1178 (Idaho 1986).

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Book of Acts easily would have failed a majority of the fourteen criteria.²⁹

The criteria clearly are vague and inadequate. Some apply exclusively to local churches, others do not. And the IRS does not indicate how many criteria an organization must meet in order to be classified as a church, or if some criteria are more important than others. The vagueness of the criteria necessarily means that their application in any particular case will depend on the discretionary judgment of a government employee. This is the very kind of conduct that the courts repeatedly have condemned in other contexts as unconstitutional. To illustrate, the courts consistently have invalidated municipal ordinances that condition the constitutionally protected interests of speech and assembly upon compliance with criteria that are so vague that decisions essentially are a matter of administrative discretion. The United States Supreme Court has held that "[it] is a basic principle of due process that an enactment is void for vagueness if its prohibitions are not clearly defined. . . . A vague law impermissibly delegates basic policy matters to [government officials] for resolution on an *ad hoc* and subjective basis

²⁹ See generally S. Schlatter, The Church in the New Testament Period (P. Levertoff trans. 1955); R. Schneckenburg, The Church in the New Testament (1965); E. Schweizer, Church Order in the New Testament (1961); E. Schweizer, The Church as the Body of Christ (1964).

with the attendant dangers of arbitrary and discriminatory application."³⁰ This same reasoning also should apply in the context of other fundamental constitutional rights, such as the first amendment right to freely exercise one's religion. The IRS should not be permitted to effectively limit the right of churches and church members to freely exercise their religion on the basis of criteria that are as vague as the fourteen criteria listed above, and whose application in a particular case is essentially a matter of administrative discretion.

The criteria also are constitutionally suspect on the related ground of "overbreadth." The Supreme Court "has repeatedly held that a governmental purpose to control or prevent activities constitutionally subject to state regulation may not be achieved by means which sweep unnecessarily broadly and thereby invade the area of protected freedoms. The power to regulate must be so exercised as not, in attaining a permissible end, unduly to infringe the protected freedom. Even though the governmental purpose be legitimate and substantial, that purpose cannot be pursued by means that broadly stifle fundamental personal liberties when the end can be more narrowly achieved."³¹ Congress and the IRS undoubtedly have the authority to identify those churches that are not qualified for the tax benefits

³⁰ Grayned v. City of Rockford, 408 U.S. 104, 108-09 (1972).

³¹ N.A.A.C.P. v. Alabama, 377 U.S. 288, 307-08 (1964).

afforded by federal law, but they may not do so on the basis of criteria that sweep so broadly as to jeopardize the standing of legitimate churches. The courts understandably find the task of defining the term *church* perplexing. But they should avoid referring to the fourteen criteria as support for their conclusions, particularly in cases involving "mail-order churches" and other obvious shams for which the definitional question is not in doubt.

A number of federal courts have defined the term *church* without reference to the fourteen criteria, and have concluded that the term may include a private elementary and secondary school maintained and operated by a church,³² a seminary,³³ and conventions and associations of churches.³⁴

The United States Supreme Court has held that some church-controlled organizations that are not separately incorporated may be regarded for tax purposes as part of the church itself.³⁵

³² *St. Martin Evangelical Lutheran Church v. South Dakota*, 451 U.S. 772 (1981).

³³ *EEOC v. Southwestern Baptist Theological Seminary*, 651 F.2d 277 (5th Cir. 1981).

³⁴ *De La Salle Institute v. United States*, 195 F. Supp. 891 (N.D. Cal. 1961); Senate Report 2375, 81st Congress, 2d Session, p. 27.

³⁵ *St. Martin Evangelical Lutheran Church v. South Dakota*, 451 U.S. 772 (1981) (the Court declined to rule on the status of separately incorporated, church-controlled organizations). See *also* Treas. Reg. § 1.6033-2(g)(5)(iv), example 6; *Lutheran Social Service of Minnesota v. United States*, 758 F.2d 1283 (8th Cir. 1985).

Admittedly, any law that uses the term *church* raises definitional problems. As one court observed:

[The term *church*] can mean an organization for religious purposes. It can also have the more physical meaning of a place where persons regularly assemble for worship. . . . [I]f "church" is interpreted to mean a place where persons regularly assemble for worship, does this include merely sanctuaries, chapels, and cathedrals, or does it also include buildings adjacent thereto such as parsonages, friaries, convents, fellowship halls, Sunday schools, and rectories?³⁶

The courts in other contexts have defined the term *church* in various ways. Some of these definitions include: (1) "A body or community of Christians, united under one form of government by the profession of the same faith, and the observance of the same ritual and ceremonies."³⁷ (2) "[A]n organization for religious purposes, for the public worship of God."³⁸ (3) "The term [church] may denote either a society of persons who, professing Christianity, hold certain doctrines or observances which differentiate them from other like groups, and who use a common discipline, or the building in which such persons

³⁶ Guam Power Authority v. Bishop of Guam, 383 F. Supp. 476, 479 (D. Guam 1974).

³⁷ McNeilly v. First Presbyterian Church, 137 N.E. 691 (1923).

³⁸ Bennett v. City of LaGrange, 112 S.E. 482 (1922).

habitually assemble for public worship."³⁹ (4) "A church consists of its land and buildings, its trustees and its congregation (the people who more or less regularly attend its religious services), as well as of its faith, doctrine, ritual and clergy."⁴⁰ (5) "At a minimum, a church includes a body of believers or communicants that assembles regularly in order to worship. Unless the organization is reasonably available to the public in its conduct of worship, its educational instruction, and its promulgation of doctrine, it cannot fulfill this associational role."⁴¹ (6) "Among some ten definitions of 'church' given by the lexicographers, two have gotten into the law books generally. One is: 'A society of persons who profess the Christian religion.' The other: 'The place where such persons regularly assemble for worship.'"⁴² (7) "A church is a building consecrated to the honor of God and religion, with its members united in the profession of the same Christian faith."⁴³ (8) A Christian youth organization having no official connection with any denominational church body was a church since it "proclaims Christianity, conducts

³⁹ *First Independent Missionary Baptist Church v. McMillan*, 153 So.2d 337 (Fla. App. 1963), quoting *Baker v. Fales*, 16 Mass. 488 (1820).

⁴⁰ *Eastern Orthodox Catholic Church v. Adair*, 141 N.Y.S.2d 772 (1955).

⁴¹ *American Guidance Foundation v. United States*, 490 F. Supp. 304 (D.D.C. 1980).

⁴² *Church of the Holy Faith v. State Tax Commission*, 48 P.2d 777 (N.M. 1935).

⁴³ *Wiggins v. Young*, 57 S.E.2d 486 (Ga. 1950).

services for the worship of the Christian God and provides for the administration of the Christian sacraments to its assembled members . . .

"⁴⁴ (9) "The ordinary meaning of the term contemplates a place or edifice consecrated to religious worship, where people join together in some form of public worship."⁴⁵ (10) "[T]he word 'church' . . . includes at a minimum any religious organization which, as the whole of its activities, advocates and teaches its particular spiritual beliefs before others with a purpose of gaining adherents to those beliefs and instructing them in the doctrine which those beliefs comprise."⁴⁶ (11)

"The term 'church' means a voluntary organization of people for religious purposes who are associated for religious worship, discipline and teaching and who are united by the profession of the same faith, holding the same creed, observing the same rites, and acknowledging the same ecclesiastical authority."⁴⁷

None of these attempts is wholly satisfactory. While the 14 criteria announced by the IRS clearly are inadequate, they do contain the

⁴⁴ Young Life Campaign v. Patino, 176 Cal. Rptr. 23 (Cal. App. 1981) (an excellent discussion of the definition of church).

⁴⁵ In re Upper St. Clair Township Grange, 152 A.2d 768 (Pa. 1959).

⁴⁶ Christian Jew Foundation v. State, 653 S.W.2d 607 (Tex. App. 1983) (an excellent discussion of the term church, rejecting a proposed definition by the state of Texas as unconstitutionally preferring some churches over others).

⁴⁷ State v. Lynch, 265 S.E.2d 491 (N.C. App. 1980).

framework for a workable definition. The principal defect in the 14 criteria, as noted above, is that they attempt too much. They combine elements descriptive of both local churches and regional or national denominations. If the criteria were divided into two categories (local churches and denominational agencies) much of the confusion would be eliminated. See Table 1. Of course, no division of criteria will apply to every case. For example, the application of these criteria will differ between denominations of congregational and hierarchical polity. But the allocation of criteria illustrated in Table 1 represents a good start, and is of much greater help than the generic fourteen criteria as presently constituted.

TABLE 1
Defining the Term "Church"

critterion	local church	denomination
a distinct legal existence	X	X
a recognized creed and form of worship	X	X
a definite and distinct ecclesiastical government	X	X
a formal code of doctrine and discipline	X	X
a distinct religious history	X	X
a membership not associated with any other church or denomination	X	X

critierion	local church	denomination
an organization of ordained ministers		X
ordained ministers selected after completing prescribed studies		X
a literature of its own		X
established places of worship	X	X
regular congregations	X	X
regular worship services	X	
Sunday schools for religious instruction of the young	X	
schools for the preparation of ministers		X

B. Other Religious and Church-Related Institutions Described
in the Internal Revenue Code

The Internal Revenue Code, income tax regulations, and IRS rulings refer to a number of church-related organizations, including *conventions or associations of churches, integrated auxiliaries of a church, integral agencies of a religious organization, integral parts of a church, qualified church controlled organizations, religious and apostolic organizations, and religious orders*. These terms will be defined in the paragraphs that follow. See Table 2 at the end of this paper for a summary of these various organizations.

The term *convention or association of churches*, which appears several times in the Internal Revenue Code, has not been defined adequately. The income tax regulations define *a convention or association of churches* as "a convention or association of churches."⁴⁸ One court has observed that the phrase *conventions or associations of churches* was inserted in the Internal Revenue Code to relieve the concerns of congregational and independent churches that the term *church* included hierarchical religious denominations but not conventions or associations of congregational churches.⁴⁹ Therefore, the term *conventions or associations of churches* pertains to the organizational structures of congregational churches.

The term *integrated auxiliary* occasionally occurs in the Internal Revenue Code and income tax regulations in connection with the term *church*. Integrated auxiliaries of churches are exempted from the requirements of applying for tax-exempt status,⁵⁰ filing annual information returns,⁵¹ and filing returns regarding dissolution.⁵² An integrated auxiliary of a church is defined by the income tax regulations

⁴⁸ Treas. Reg. § 1.170A-9(a).

⁴⁹ *Lutheran Social Service of Minnesota v. United States*, 758 F.2d 1283 (8th Cir. 1985).

⁵⁰ I.R.C. § 508(c)(1)(A).

⁵¹ *Id.* at § 6033(a)(2)(A)(i).

⁵² *Id.* at § 6043(b)(1).

as an organization that is exempt from taxation under section 501(c)(3), that is affiliated with a church, and whose principal activity is exclusively religious.⁵³ The regulations further state that an organization's principal activity will not be considered to be exclusively religious if that activity is educational, literary, charitable, or of a nature other than religious that would serve as a basis for exemption under section 501(c)(3) of the Internal Revenue Code, and that an integrated auxiliary is "affiliated" with a church if it is either controlled by or associated with a church or with a convention or association of churches.⁵⁴

The regulations cite men's and women's organizations, seminaries, missions societies, and youth groups as examples of integrated auxiliaries. The regulations cite the following examples of organizations that are not integrated auxiliaries: hospitals, separately incorporated elementary schools, orphanages, old age homes, and liberal arts colleges that are affiliated with churches. In each case the activity performed by the affiliated organization is educational, literary, charitable, or of a nature other than "exclusively religious" that would serve as a basis for exemption under section 501(c)(3) of the Code.⁵⁵

⁵³ Treas. Reg. § 1.6033-2(g)(5)(i).

⁵⁴ *Id.* at § 6033-2(g)(5)(iv).

⁵⁵ *Id.*

The Lutheran Social Service of Minnesota (LSS) challenged the income tax regulation defining *integrated auxiliary* on the ground that the requirement that an integrated auxiliary's "principal activity" be exclusively religious was unconstitutional.⁵⁶ The LSS is an independent corporation that is affiliated with several Lutheran synods. It provides a variety of services, including child care and adoption, counseling, residential treatment for mentally handicapped persons and felons, nutrition programs for the aged, and a camp for mentally and physically handicapped persons. The LSS argued, and the IRS conceded, that it satisfied the first two parts of the definition of *integrated auxiliary*: exemption from tax as an organization described in section 501(c)(3) of the Internal Revenue Code and affiliation with a church. However, the IRS maintained that LSS did not satisfy the third requirement since many of its functions were "charitable" in nature and as such would serve as a separate basis for exemption under section 501(c)(3). The LSS countered by asserting that this "exclusively religious" requirement for integrated auxiliary status was unconstitutional under the equal protection clause of the United States Constitution and the free exercise of religion clause of the First Amendment. It demonstrated that the Internal Revenue Code

⁵⁶ Lutheran Social Service of Minnesota v. United States, 583 F. Supp. 1298 (D. Minn. 1984).

itself contains no "exclusively religious" requirement, and that the legislative history supported no such test.

The IRS argued that the courts must defer to income tax regulations that "implement the congressional mandate in some reasonable manner," and that the regulation under consideration clearly furthered section 6033 of the Code in a reasonable way. The trial court agreed with the IRS that the LSS was not an integrated auxiliary.

However, this judgment was reversed by a federal appeals court on the ground that the IRS regulation defining the term *integrated auxiliary* was inconsistent with clear congressional policy insofar as it required the principal activity of an integrated auxiliary to be "exclusively religious."⁵⁷

The court observed that Congress specifically required that *religious orders* be "exclusively religious" to qualify for exemption from filing annual information returns under section 6033 of the Internal Revenue Code, but, in the same section, failed to mandate the same requirement with respect to *integrated auxiliaries*. "This omission on the part of Congress," concluded the court, "can only be viewed as an intentional and purposeful decision not to limit the group of integrated auxiliaries qualifying for the filing exception to those that are exclusively religious." To support its conclusion, the court recited the established rule of

⁵⁷ Lutheran Social Service of Minnesota v. United States, 758 F.2d 1283 (8th Cir. 1985).

statutory construction that "[w]here Congress included particular language in one section of a statute but omits it in another section of the same [statute] it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." The court also noted that "once 'exclusively religious' is defined as 'not also charitable or educational' the realm of the 'exclusively religious' becomes very narrow [since] churches themselves are not 'exclusively religious' in the sense that the . . . regulations require of their integrated auxiliaries."⁵⁸

The term *integral agency* occasionally appears in the Internal Revenue Code and associated regulations and refers to agencies that are integrally connected with churches and associations or conventions of churches. For example, ordained, commissioned, or licensed ministers are eligible for the housing allowance exclusion if they are engaged in the "administration and maintenance of religious organizations and their integral agencies."⁵⁹ In a revenue ruling, the IRS has listed the following criteria to be considered in determining whether a church-related institution is an integral agency of a religious organization:

⁵⁸ *Id.* at 1291, note 7 (quoting Whelan, "*Church*" in *the Internal Revenue Code: The Definitional Problems*, 45 *Fordham L. Rev.* 885, 899 (1977)).

⁵⁹ Treas. Reg. § 1.107-1(a).

1. whether the religious organization incorporated the institution
2. whether the corporate name of the institution indicates a church relationship
3. whether the religious organization continuously controls, manages, and maintains the institution
4. whether the trustees or directors of the institution are approved by or must be approved by the religious organization or church
5. whether trustees or directors may be removed by the religious organization or church
6. whether annual reports of finances and general operations are required to be made to the religious organization or church
7. whether the religious organization or church contributes to the support of the institution, and
8. whether, in the event of dissolution of the institution, its assets would be turned over to the religious organization or church.⁶⁰

⁶⁰ Rev. Rul. 72-606, 1972-2 C.B. 78. Integral agencies are also discussed in chapter 1.

The IRS has stated that the absence of one or more of these characteristics will not necessarily be determinative in a particular case, and, that if the application of these eight criteria in a particular case does not clearly support an affirmative or negative answer, "the appropriate organizational authorities are contacted for a statement, in light of the criteria, whether the particular institution is an integral agency, and their views are carefully considered."⁶¹

The term *integral part of a church* apparently has no further relevance in light of the obsolescence of this regulation. The term does not occur elsewhere.

The term *qualified church-controlled organization*, as defined above, describes a category of organization that is eligible for exemption from the employer's share of FICA taxes.⁶²

Finally, the Internal Revenue Code exempts *religious or apostolic associations or corporations* from federal income taxation if they have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the

⁶¹ *Id.*

⁶² See note 40, *supra*, and accompanying text.

taxable income of the association or corporation for such year.

Any amount so included in the gross income of a member shall be treated as a dividend received.⁶³

Religious or apostolic associations and corporations must file a Form 1065 each year, stating the items of gross income and deductions, along with a statement listing the names and addresses of each member and the amount of his or her distributive share of the organization's taxable income.

In 1991, the IRS issued guidance on the definition of the term *religious order*.⁶⁴ The Internal Revenue Code exempts from self-employment taxes, FICA taxes, and federal income tax withholding, compensation received for services performed by a member of a religious order in the exercise of duties required by the order. Neither the Code, nor the income tax regulations, defines the term *religious order*. To provide some certainty regarding the definition of a religious order, the IRS has published 7 characteristics that traditionally have been associated with religious orders. The IRS came up with this list by

⁶³ I.R.C. § 501(d). *See also* Riker v. Commissioner, 244 F.2d 220 (9th Cir. 1957); Rev. Rul. 78-100, 1978-1 C.B. 162; Rev. Rul. 77-295, 1977-2 C.B. 196; Rev. Proc. 72-5, 1972-1 C.B. 709.

⁶⁴ Rev. Proc. 91-20, I.R.B. 1991-10, 26. The IRS invited comments on its definition of "religious order," and so it is possible that the definition presented in the text may be modified.

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reviewing the court decisions that have addressed the issue. From now on, the IRS will use the following characteristics in determining whether or not an organization is a religious order:

- (1) The organization is described in section 501(c)(3) of the Code.
- (2) 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.
- (3) 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).
- (4) 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.
- (5) The members of the organization normally live together as part of a community and are held to a significantly stricter level of moral and religious discipline than that required of lay church members.
- (6) The members of the organization work or serve full-time on behalf of the religious, educational, or charitable goals of the organization.
- (7) 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.

The IRS stated that "generally, the presence of all the above characteristics is determinative that the organization is a religious order" and that

the absence of one or more of the other enumerated characteristics is not necessarily determinative in a particular case. Generally, if application of the above characteristics to the facts of a particular case does not clearly indicate whether or not the organization is a religious order, the [IRS] will contact the appropriate authorities affiliated with the organization for their views concerning the characteristics of the organization and their views will be carefully considered.

It is interesting that one of the cases the IRS relied on involved a claim by a Baptist church that the services of its church secretary, organist, custodian, and choir director were exempt from tax withholding since the church was a "religious order." In rejecting the church's claim, the court defined a "religious order" as "a religious body typically an aggregate of separate communities living under a distinctive rule, discipline or constitution; a monastic brotherhood or society." Under the new IRS definition, there will be very few organizations that will be able to justify an exemption from FICA or tax withholding on the

ground that they are "religious orders." Organizations that currently are relying upon an exemption from FICA coverage or the income tax withholding rules on the basis of "religious order" status should carefully review the new IRS definition to assess its impact.

There is little if any justification for the confusing number of terms employed by the Internal Revenue Code and the income tax regulations in describing church-related organizations. Such terminology suggests a confusion on the part of Congress and the IRS in dealing with church-related organizations. An even more troubling concern is the largely discretionary authority of the IRS to interpret these ambiguously defined or undefined terms.

In summary, there clearly is a need for Congress to (1) reduce the unnecessarily confusing number of terms used in the Internal Revenue Code to describe and define church-related organizations; (2) sufficiently clarify the remaining definitions so as to eliminate discretionary application by the IRS; and (3) demonstrate a greater deference to the legitimate perceptions of bona fide churches concerning those entities that are sufficiently related as to come within the definition of the term *church*. The problem is that churches and conventions and associations of churches often create a variety of subsidiary organizations to carry out their religious, educational and charitable purposes. Finding a single term that applies to all of these subsidiary organizations would be

difficult. One possibility would be to apply the broadest term presently used and eliminate the more narrow terms. This generic term probably would be the "qualified church controlled organization" defined under Code section 3121(w). This term is probably broad enough to include integrated auxiliaries, integral agencies, integral parts, many private schools, and church related organizations. This would leave the following mutually exclusive terms: church, convention or association of churches, religious or apostolic associations, and religious orders. As noted above, a qualified church-controlled organization is defined in section 3121(w)(3)(B) of the Code as

any church-controlled tax-exempt organization described in section 501(c)(3), other than an organization which (i) offers goods, services, or facilities for sale, other than on an incidental basis, to the general public, other than goods, services or facilities which are sold at a nominal charge which is substantially less than the cost of providing such goods, services, or facilities; and (ii) normally receives more than 25% of its support from either (I) governmental sources, or (II) receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in activities which are not unrelated trades or businesses, or both.

Clearly, local churches, church denominations, and church-controlled elementary and secondary schools qualify as

"church-controlled organizations." While it is less clear, it is reasonably certain that seminaries and Bible colleges would also qualify. The committee report on the Tax Reform Act of 1986, in construing the term "qualified church-controlled organization" in another context, noted that it included "the typical seminary, religious retreat center, or burial society, regardless of its funding sources, because it does not offer goods, services, or facilities for sale to the general public." The committee report also noted that the term "qualified church-controlled organization" included

a church-run orphanage or old-age home, even if it is open to the general public, if not more than 25% of its support is derived from the receipts of admissions, sales of merchandise, performance of services, or furnishing of facilities (in other than unrelated trades or businesses) or from governmental sources. The committee specifically intends that the [term 'qualified church-controlled organization' will not include] church-run universities (other than religious seminaries) and hospitals if both conditions (i) and (ii) exist.

Some liberalization of this definition may be required if the terms integrated auxiliaries, integral agencies, integral parts, many private schools, and church related organizations are eliminated. For example, some church-operated colleges and universities that are open to the

general public would not be qualified church controlled organizations. However, these institutions often will have an independent basis for tax-exempt status as educational (or charitable or even religious) institutions under Code section 501(c)(3).

If a single term and definition is adopted, Code references to the superseded terms would need to be amended accordingly.

III. Special Topic #1: The Church Audit Procedures Act

Section 7602 of the Internal Revenue Code gives the IRS broad authority to examine or subpoena the books and records of any person or organization for the purposes of (1) ascertaining the correctness of any federal tax return, (2) making a return where none has been filed, (3) determining the liability of any person or organization for any federal tax, or (4) collecting any federal tax. This authority has been held to apply to churches.⁶⁵

As part of the Tax Reform Act of 1969, Congress amended section 511 of the Internal Revenue Code to extend the federal tax on the unrelated business income of tax-exempt organizations to churches and religious denominations. In general, unrelated business income constitutes income from a regularly carried on trade or business not

⁶⁵ See, e.g., *United States v. Coates*, 692 F.2d 629 (9th Cir. 1982); *United States v. Dykema*, 666 F.2d 1096 (7th Cir. 1981); *United States v. Freedom Church*, 613 F.2d 316 (1st Cir. 1979).

substantially related to the exempt purposes of a tax-exempt organization. The amendment of section 511 represented a major change in the treatment of churches and denominations, previously exempt from most federal taxes, including unrelated business income taxes. The Tax Reform Act of 1969 also added section 7605(c) to the Internal Revenue Code:

No examination of the *books of account* of a church or convention or association of churches shall be made to determine whether such organization may be engaged in the carrying on of an unrelated trade or business or may be otherwise engaged in activities which may be subject to [the tax on unrelated business income] unless the Secretary (such officer being no lower than a principal internal revenue officer for an internal revenue region) [1] believes that such organization may be so engaged and [2] so notifies the organization in advance of the examination. No examination of the *religious activities* of such an organization shall be made except to the extent necessary to determine whether such organization is a church or a convention or association of churches, and no examination of the *books of account* of such an organization shall be made other than to the

extent necessary to determine the amount of tax imposed by this title.⁶⁶

Because amended section 511 created new tax liability for churches and denominations, the addition of section 7605(c) was considered necessary to protect such organizations from excessive tax audits by IRS agents investigating unrelated business activities. Accordingly, the first sentence of section 7605(c) shielded the *books of account* of churches and denominations from any IRS examination for the purpose of determining any unrelated business income tax liability unless the IRS (1) had some basis for believing that such an organization was engaged in an unrelated trade or business, and (2) notified the organization in advance of the examination.

Prior to 1985, some churches argued that section 7605(c) prohibited any IRS examination of church records not undertaken to determine whether a church was engaged in an unrelated trade or business. While it is true that section 7605(c) was enacted primarily in response to the application of the unrelated business income tax to churches and religious organizations, it certainly did not suggest that churches and religious denominations could not be examined under any other circumstances. Churches and denominations, for example, remained liable for withholding and paying employment taxes on

⁶⁶ I.R.C. § 7605(c) (emphasis added).

nonminister employees and for the payment of certain excise taxes; and they were subject to the IRS examination power to ensure that they were properly complying with such requirements. Section 7605(c) did not negate such authority. On the contrary, the second sentence of that section specifically recognized the authority of the IRS to examine (1) the *religious activities* of a church or denomination to the extent necessary to determine if it were in fact entitled to tax-exempt status, and (2) the *books of account* of a church or denomination to the extent necessary "to determine the amount of tax imposed" under any internal revenue law (including income, employment, and excise taxes). The view that section 7605(c) acknowledged the preexisting authority of the IRS to examine the activities and records of churches and denominations to ensure compliance with income, employment, and excise taxes and entitlement to tax-exempt status was endorsed by the courts⁶⁷ and legislative history,⁶⁸ and was embodied in the income tax regulations.⁶⁹

⁶⁷ See, e.g., *United States v. Coates*, 692 F.2d 629 (9th Cir. 1982); *United States v. Dykema*, 666 F.2d 1096 (7th Cir. 1981); *United States v. Life Science Church of America*, 636 F.2d 221 (8th Cir. 1980); *United States v. Holmes*, 614 F.2d 985 (5th Cir. 1980); *United States v. Freedom Church*, 613 F.2d 316 (1st Cir. 1979).

⁶⁸ H.R. Rep. No. 413, 91st Cong., 1st Sess. (1969).

⁶⁹ Treas. Reg. § 301.7605-1(c).

Section 7605(c) was criticized for its failure to provide adequate guidelines and for its insensitivity to the unique protections afforded churches by the first amendment's free exercise of religion clause. Such criticism led to the repeal of section 7605(c) in the Tax Reform Act of 1984 and the enactment of the Church Audit Procedures Act as section 7611 of the Internal Revenue Code. Section 7611 imposes detailed limitations on IRS examinations of churches for tax years beginning in 1985 or thereafter. The limitations can be summarized as follows:

1. The IRS may begin a *church tax inquiry* (defined as any inquiry to determine whether a church is entitled to tax-exempt status as a church or is engaged in an unrelated trade or business) only if (a) an *appropriate high-level Treasury official* (defined as a regional IRS commissioner or higher official) *reasonably believes* on the basis of written evidence that the church is not exempt⁷⁰ (by reason of its status as a church), may be carrying on an unrelated trade or business, or is otherwise engaged in activities subject to taxation; and (b) the IRS sends the church written *inquiry notice* containing an explanation of the following: (1) the specific concerns which gave rise to the inquiry, (2) the general subject matter of the inquiry, and (3) the provisions of

⁷⁰ Since only organizations that are exempt from federal income tax ordinarily are qualified recipients of deductible charitable contributions, an IRS inquiry into the deductibility of contributions to a particular church is the equivalent of an inquiry into the church's tax-exempt status.

the Internal Revenue Code that authorize the inquiry and the applicable administrative and constitutional provisions, including the right to an informal conference with the IRS before any examination of church records, and the First Amendment principle of separation of church and state.

2. The IRS may begin a *church tax examination* of the church records or religious activities of a church only under the following conditions: (a) the requirements of a church tax inquiry have been met, and (b) an *examination notice* is sent by the IRS to the church at least fifteen days *after* the day on which the inquiry notice was sent, and at least fifteen days *before* the beginning of such an examination, containing the following information: (1) a copy of the inquiry notice, (2) a specific description of the church records and religious activities which the IRS seeks to examine, (3) an offer to conduct an informal conference with the church to discuss and possibly resolve the concerns giving rise to the examination, and (4) a copy of all documents collected or prepared by the IRS for use in the examination and the disclosure of which is required by the Freedom of Information Act.

3. *Church records* (defined as all corporate and financial records regularly kept by a church, including corporate minute books and lists of members and contributors) may be examined only to the extent

necessary to determine the liability for and amount of any income, employment, or excise tax.

4. *Religious activities* may be examined only to the extent necessary to determine whether an organization claiming to be a church is in fact a church.

5. Church tax inquiries and church tax examinations must be completed *not later than two years* after the examination notice date.⁷¹

6. Church tax inquiries not followed by an examination notice must be completed *not later than ninety days* after the inquiry notice date.⁷²

7. The IRS can make a determination based on a church tax inquiry or church tax examination that an organization is not a church that is exempt from federal income taxation or that is qualified to receive tax-deductible contributions, or that otherwise owes any income, employment, or excise tax (including the unrelated business income tax), only if the appropriate regional legal counsel of the IRS determines

⁷¹ The two-year limitation can be suspended (a) if the church brings a judicial proceeding against the IRS, (b) if the IRS brings a judicial proceeding to compel compliance by the church with any reasonable request for examination of church records or religious activities, (c) for any period in excess of twenty days (but not more than six months) in which the church fails to comply with any reasonable request by the IRS for church records, or (d) if the IRS and church mutually agree.

⁷² The ninety-day limitation can be suspended for the same reasons listed in the preceding footnote.

in writing that there has been substantial compliance with the limitations imposed under section 7611 and approves in writing of such revocation of exemption or assessment of tax.

8. Church tax examinations involving tax-exempt status or the liability for any tax other than the unrelated business income tax may be begun only for any one or more of the *three most recent taxable years* ending before the examination notice date. For examinations involving unrelated business taxable income, or if a church is proven not to be exempt for any of the preceding three years, the IRS may examine relevant records and assess tax as part of the same audit for a total of *six years* preceding the examination notice date. For examinations involving issues other than revocation of exempt status or unrelated business taxable income (such as examinations pertaining to employment taxes), no limitation period applies if no return has been filed.

9. If any church tax inquiry or church tax examination is completed and does not result in a revocation of exemption or assessment of taxes, then no other church tax inquiry or church tax examination may begin with respect to such church *during the five-year period beginning on the examination notice date* (or the inquiry notice date if no examination notice was sent) unless such inquiry or examination is (a) approved in writing by the Assistant Commissioner of Employee Plans and Exempt Organizations of the IRS, or (b) does not

involve the same or similar issues involved in the prior inquiry or examination. The five-year period is suspended if the two-year limitation on the completion of an examination is suspended.

10. The limitations upon church tax inquiries and church tax examinations do not apply to
 - a. inquiries or examinations pertaining to organizations other than churches⁷³
 - b. any case involving a knowing failure to file a tax return or a willful attempt to defeat or evade taxes⁷⁴
 - c. criminal investigations

⁷³ The term *church* is defined by section 7611 as any organization claiming to be a church, and any convention or association of churches. The term does not include separately incorporated church-affiliated schools or other separately incorporated church-affiliated organizations.

⁷⁴ The Conference Committee Report to the Tax Reform Act of 1984 contains the following information: "In Fiscal Year 1983, the IRS closed 6,612 examinations involving alleged church tax avoidance schemes, assessing \$23,803,200 in taxes and penalties (an average assessment of \$3,600 per return) and leaving a calendar year-end inventory of 15,296 church tax avoidance cases (in addition to approximately 200 criminal investigations). In the first six months of Fiscal 1984 alone . . . the IRS assessed \$25,620,178 in taxes and penalties in 5,498 cases relating to church tax avoidance schemes. The conferees specifically intend that nothing in the church audit procedures will inhibit IRS inquiries, examinations, or criminal investigations of tax protestor or other tax avoidance schemes posing as religious organizations, including (but not limited to) tax avoidance schemes posing as mail-order ministries or storefront churches"

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d. the tax liability of a contributor to a church, or inquiries regarding assignment of income to a church or a vow of poverty by an individual followed by a transfer of property⁷⁵

e. routine IRS inquiries, including

(1) the filing or failure to file any tax return or information return by the church;

(2) compliance with income tax or FICA tax withholding;

(3) supplemental information needed to complete the mechanical processing of any incomplete or incorrect return filed by a church;

(4) information necessary to process applications for exempt status, letter ruling requests, or employment tax exempt requests; or

(5) confirmation that a specific business is or is not owned by a church.

11. If the IRS has not complied substantially with (a) the notice requirements, (b) the requirement that an appropriate high-level Treasury official approve the commencement of a church tax inquiry, or (c) the requirement of informing the church of its right to an informal

⁷⁵ St. German of Alaska Eastern Orthodox Catholic Church v. United States, 840 F.2d 1087 (2nd Cir. 1988); Holy Temple Church of God in Christ, Inc. v. United States, 89-1 U.S.T.C. ¶ 9107 (C.D. Cal. 1988).

conference, the church's exclusive remedy is a stay of the inquiry or examination until such requirements are satisfied.

The fact that the IRS has authority to examine *church records* and the *religious activities* of a church or religious denomination does not necessarily establish its right to do so. The courts have held that an IRS summons or subpoena directed at church records must satisfy the following conditions to be enforceable:

1. It is issued in good faith. *Good faith* in this context means that
 - (a) the investigation will be conducted pursuant to a legitimate purpose,
 - (b) the inquiry is necessary to that purpose, (c) the information sought is not already within the IRS' possession, and (d) the proper administrative steps have been followed.⁷⁶

⁷⁶ In *United States v. Powell*, 379 U.S. 48 (1964), the United States Supreme Court held that in order to obtain judicial enforcement of a summons or subpoena the IRS must prove "that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already in the Commissioner's possession, and that the administrative steps required by the Code have been followed" *Powell* did not involve an IRS examination of church records. In *United States v. Holmes*, 614 F.2d 985 (5th Cir. 1980), a federal appeals court held that section 7605(c) narrowed the scope of the second part of the *Powell* test from mere relevancy to necessity in the context of church records since it required that an examination of church records be limited "to the extent necessary." The "necessity test" should apply to church inquiries or examinations conducted under section 7611 since the same language is employed. *United States v. Church of Scientology*, 90-2 U.S.T.C. ¶ 50,349 (D. Mass. 1990).

2. It does not violate the church's first amendment right to freely exercise its religion. An IRS subpoena will not violate a church's first amendment rights unless it substantially burdens a legitimate and sincerely held religious belief, and is not supported by a compelling governmental interest that cannot be accomplished by less restrictive means. This is a very difficult test to satisfy, not only since few churches can successfully demonstrate that enforcement of an IRS summons or subpoena substantially burdens an actual religious tenet, but also because the courts have ruled that maintenance of the integrity of the government's fiscal policies constitutes a compelling governmental interest that overrides religious beliefs to the contrary.⁷⁷

3. It does not create an impermissible entanglement of church and state.⁷⁸

⁷⁷ See, e.g., *St. German of Alaska Eastern Orthodox Catholic Church v. Commissioner*, 840 F.2d 1087 (2nd Cir. 1988); *United States v. Coates*, 692 F.2d 629 (9th Cir. 1982); *United States v. Life Science Church of America*, 636 F.2d 221 (8th Cir. 1980); *United States v. Holmes*, 614 F.2d 895 (5th Cir. 1980); *United States v. Freedom Church*, 613 F.2d 316 (1st Cir. 1979).

⁷⁸ See generally *United States v. Coates*, 692 F.2d 629 (9th Cir. 1982); *United States v. Grayson County State Bank*, 656 F.2d 1071 (5th Cir. 1981); *United States v. Freedom Church*, 613 F.2d 316 (1st Cir. 1979); *but cf.* *Surinach v. Pesquera de Busquets*, 604 F.2d 73 (1st Cir. 1979) (subpoena issued against Catholic schools in Puerto Rico violated the first amendment, since no compelling governmental interest justified the investigation); *EEOC v. Southwestern Baptist Theological Seminary*, 651 F.2d 277 (5th Cir. 1981) (application of 1964 Civil Rights Act's reporting requirements to seminary did not violate first amendment).

Further, federal law provides that if the IRS wants to *retroactively* revoke the tax-exempt status of a church, then it must show either that the church "omitted or misstated a material fact" in its original exemption application, or that the church has been "operated in a manner materially different from that originally represented."⁷⁹

Although IRS authority to examine and subpoena church records is very broad, it has limits. To illustrate, one subpoena was issued against all documents relating to the organizational structure of a church since its inception; all correspondence files for a three-year period; the minutes of the officers, directors, trustees, and ministers for the same three-year period; and a sample of every piece of literature pertaining to the church.⁸⁰ A court concluded that this subpoena was "too far reaching" and declared it invalid. It noted, however, that a "properly narrowed" subpoena would not violate the first amendment. Another federal court that refused to enforce an IRS subpoena directed at a church emphasized that "the unique status afforded churches by Congress requires that the IRS strictly adhere to its own procedures

⁷⁹ Treas. Reg. § 601.201(n)(6)(i). See *United States v. Church of Scientology of Boston*, 90-2 U.S.T.C. para. 50,349 (D. Mass. 1990).

⁸⁰ *United States v. Holmes*, 614 F.2d 985 (5th Cir. 1980). See also *United States v. Trader's State Bank*, 695 F.2d 1132 (9th Cir. 1983) (IRS summons seeking production of all of a church's bank statements, correspondence, and records relating to bank accounts, safe deposit boxes, and loans held to be overly broad).

when delving into church activities."⁸¹ The court also stressed that the safeguards afforded churches under federal law prevent the IRS from "going on a fishing expedition into church books and records."

IV. Special Topic #2: Exemption From the Necessity of Applying For Recognition of Tax-Exempt Status

Most organizations seeking recognition of exemption from federal income tax must file an application with the IRS. This is done either on IRS Form 1023 or 1024, depending on the nature of the applicant. Churches, their "integrated auxiliaries," and conventions or associations of churches are exempted by law from payment of federal income tax and therefore they are not required to file an application with the IRS.⁸² Such organizations nevertheless may find it advantageous to obtain IRS recognition of exempt status since this would avoid the need of substantiating their tax-exempt status each time the IRS questions the deductibility of contributions made by a member or adherent. A church may obtain recognition of exemption in either of two ways: (1) by filing a Form 1023 with the IRS, or (2) by being a member of a convention or association of churches that has obtained a "group-exemption ruling" from the IRS.

⁸¹ United States v. Church of Scientology of Boston, 90-2 U.S.T.C. para. 50,349 (D. Mass. 1990).

⁸² I.R.C. § 508(c)(1)(A).

If a church independently applies for and receives IRS recognition of exemption, it must notify the IRS of any material changes in its sources of support, purposes, character, or methods of operation. Churches that are included in the group exemption ruling of a convention or association of churches must annually notify their convention or association of any changes in their purposes, character, or methods of operation.

V. Special Topic #3: Exemption from Filing Annual Information Returns

Section 6033 of the Internal Revenue Code imposes upon most tax-exempt organizations the obligation of filing an annual information return with the IRS. The annual information return is prepared on IRS Form 990 and sets forth gross income, expenses, disbursements for exempt purposes, assets and liabilities, net worth, contributions received (including the names and addresses of substantial contributors), and compensation paid to certain employees. Section 6033 provides a "mandatory exemption" for (1) "churches, their integrated auxiliaries, and conventions and associations of churches"; (2) certain religious and charitable organizations whose annual gross receipts normally do not exceed \$5,000; and (3) the "exclusively religious activities of any religious order." Form 990 itself specifies that the following organizations

are exempt from the annual information return requirement: (1) "a church, an interchurch organization of local units of a church, a convention or association of churches, an integrated auxiliary of a church (such as a men's or women's organization, religious school, mission society, or youth group), or an internally supported, church-controlled organization (described in Revenue Procedure 86-23)"; (2) "a school below college level affiliated with a church or operated by a religious order"; (3) "a mission society sponsored by or affiliated with one or more churches or church denominations, if more than one-half of the society's activities are conducted in, or directed at persons in, foreign countries"; (4) "an exclusively religious activity of any religious order"; (5) "an organization whose annual gross receipts are normally \$25,000 or less."

VI. Special Topic #4: Election to Waive Employer FICA Participation

Since the beginning of the social security program in 1937, the employees of churches and most other nonprofit organizations were exempted from mandatory coverage. The exemption was designed to encourage nonprofit organizations by freeing them from an additional tax burden that they ordinarily could not pass along to customers through price increases. Churches and other nonprofit organizations

were permitted to waive their exemption by filing Forms SS-15 and SS-15a with the IRS.

In 1983, Congress repealed the exemption for calendar years beginning with 1984. The repeal of the exemption was controversial for many church leaders because it required churches to report and pay the employer's share of FICA taxes. This "tax on churches" was denounced by some as a violation of the constitutional principle of separation of church and state.

In the Tax Reform Act of 1984, Congress responded to such criticism by again amending the Social Security Act, this time to give churches a one-time irrevocable election to exempt themselves from social security coverage if they were opposed for religious reasons to the payment of the employer's share of FICA taxes and if they filed an election (Form 8274) with the IRS prior to the deadline for filing the first required quarterly employer's tax return (Form 941) after July 17, 1984 on which the *employer's* share of FICA taxes is reported. Since a Form 941 is due on the last day of the month following the end of each calendar quarter (i.e., April 30, July 31, October 31, January 31), the election for churches in existence as of July of 1984 and having at least one nonminister employee was October 30, 1984 (the day before the deadline for filing Form 941 for the quarter ending September 30). Churches either not in existence as of July of 1984, or not having

nonminister employees at that time, have until the day prior to the deadline for their first Form 941 to file an election (Form 8274).

To illustrate, a church organized in 1960, and hiring its first nonminister employee (a secretary) on September 1, 1992, had until October 30, 1992, to file the Form 8274. It must be emphasized that there is no deadline until a church has at least one nonminister employee, since the deadline corresponds to the next filing date of a church's quarterly tax return reporting the employer's share of social security taxes, and no tax or return is due until a church has nonminister employees. What about a church with only one employee—its minister? As noted in the preceding section, the preferred practice would be for the church to file quarterly 941 forms reporting the minister's compensation, even though no taxes are withheld. But would the church thereby be prevented from filing a Form 8274 at a later date in the event that it hires nonminister employees (on the ground that it already has submitted 941 forms and accordingly the deadline for filing Form 8274 has expired)? The answer is no, since Code section 3121(w) defines the deadline for filing Form 8274 as anytime prior to the date of a church's first Form 941 "for the tax imposed under section 3111." Section 3111 pertains to the employer's share of FICA taxes, and therefore a church with no nonminister

employees does not affect the deadline for filing a Form 8274 by filing 941 Forms for its minister.

A timely election relieves a church of the obligation to pay the employer's share of FICA taxes (7.65% of an employee's wages in 1993), and relieves each nonminister employee of the obligation to pay the employee's share of FICA taxes (an additional 7.65% of wages in 1993). However, the employee is not relieved of all social security tax liability. On the contrary, the nonminister employees of an electing church are required to report and pay their social security taxes as self-employed individuals (the "self-employment tax") if their annual compensation exceeds \$108.28. And, this tax is significantly greater than the employee's share of FICA taxes. In 1993 for example, the self-employment tax is 15.3% of net self-employment earnings. Therefore, a church employee receiving a salary of \$10,000 in 1993 would pay \$765 in FICA taxes if his or her church did not file an election on Form 8274 (the church would pay an additional \$765). However, if the church filed the election to exempt itself from FICA taxes, the following consequences occur: (1) the church pays no FICA taxes; (2) the employee pays no FICA taxes; and (3) the employee must report and pay a self-employment tax liability of \$1,530 (an additional \$765 in taxes). However, the self-employment tax is offset by an income tax deduction of half the self-employment tax, and also by a similar deduction in computing self-employment taxes. The

employees of an electing church ordinarily will be required to use the estimated tax procedure (Form 1040-ES) to report and pay their estimated self-employment tax in quarterly installments. Alternatively, an employee of an electing church can request that an additional amount be withheld from his or her wages each pay period to cover the estimated self-employment tax liability. The church simply withholds an additional amount from each paycheck to cover an employee's estimated self-employment tax liability for the year, and then reports this additional amount as additional *income tax* (not "FICA" tax) withheld on its quarterly 941 forms. The excess income tax withheld is a credit against tax that each employee may claim on his or her federal income tax return (Form 1040, line 54), and it in effect is applied against an employee's self-employment tax liability. A similar withholding arrangement has been approved by the IRS with respect to a minister-employee's self-employment tax (see IRS Publication 517). Unless an employee makes such a request, a church that has elected to exempt itself from the employer's share of FICA taxes has no obligation to withhold social security taxes from the wages of its employees.

Many churches and church employees consider this situation unfair. Churches are free to exempt themselves from social security taxes, but only at the cost of increasing the tax liability of their employees. In response, many electing churches have increased the

salary of their employees to compensate for the increase in taxes. Of course, this leaves the church in essentially the same position as if it had not elected to be exempt—it in effect is paying social security taxes "indirectly." This dilemma, argued a church in Pennsylvania, unconstitutionally restricts the religious freedom of churches by forcing them (contrary to their religious convictions) to divert church resources away from religious and charitable functions in order to increase employee compensation (and thereby "indirectly" pay the social security tax). A federal appeals court rejected this contention.⁸³ The court based its ruling on a 1982 Supreme Court decision that upheld the imposition of the social security tax to employees of Amish farmers though this directly violated the farmers' religious beliefs. The Supreme Court had observed that "tax systems could not function if denominations were allowed to challenge the tax systems because tax payments were spent in a manner that violates their religious belief." It concluded that the broad public interest in the maintenance of the federal tax systems was of such a high order that religious belief in conflict with the payment of the taxes provides no constitutional basis for resisting them. The appeals court found this precedent controlling in resolving the challenge to social security coverage of church employees. The appeals court also

⁸³ Bethel Baptist Church v. United States, 822 F.2d 1334 (3rd Cir. 1987).

rejected the church's argument that the taxation of church employees violates the first amendment's nonestablishment of religion clause by creating an "excessive entanglement" between church and state. It also rejected the claim that the Internal Revenue Code was impermissibly discriminatory in granting clergy an exemption from social security coverage but not churches or church employees. Beginning in 1990, churches that elected to exempt themselves from the employer's share of FICA taxes will have less need to increase the compensation of nonminister employees, since such persons are now entitled to deduct half their self-employment taxes for income tax and self-employment tax purposes (this is supposed to offset the disadvantages of self-employed persons paying a self-employment tax at the combined FICA tax rate of 15.3%).

Churches that file a timely election application remain subject to income tax withholding and reporting requirements with respect to all nonminister employees and to ministers who have requested voluntary withholding. They must continue to issue W-2 forms to all nonminister employees and to ministers who are treated as employees for income tax purposes. In addition, they must file the employer's quarterly tax return with the IRS. Form 941E is the appropriate quarterly return for churches that have filed a timely election to be exempt from social security coverage. Other churches use Form 941. The law specifies that the IRS

can revoke a church's exemption from social security coverage if the church fails to issue W-2 forms for a period of two years or more to nonminister employees or ministers who report their federal income taxes as employees, and disregards an IRS request to furnish employees with such forms for the period during which its election has been in effect.

Only churches that are opposed "for religious reasons" to the payment of social security taxes are eligible for the exemption. Apparently, a local church will qualify for the exemption if it is opposed for religious reasons to the payment of social security taxes even if it is affiliated with a religious denomination that has no official position on the subject. Churches, conventions or association of churches, and elementary and secondary schools that are controlled, operated, or principally supported by a church are all eligible for the exemption. "Qualified church-controlled organizations" also are eligible for the exemption. Such organizations include most church-controlled tax-exempt organizations described in section 501(c)(3) of the Internal Revenue Code.

The Tax Reform Act of 1986 permits churches that have elected to exempt themselves from the employer's share of FICA taxes (by filing a timely Form 8274) to *revoke* their exemption. However, the Act did not specify how churches could revoke their exemption. Temporary

regulations issued by the Treasury Department specify that churches can revoke their exemption (starting with any calendar quarter after December 31, 1986) by filing a Form 941 (employer's quarterly tax return) accompanied by full payment of social security taxes for that quarter. To illustrate, if a church with three employees elects in November of 1992 to revoke its previous election to be exempt from social security taxes, it should simply submit a Form 941 on or by January 31, 1993 (the deadline for filing a Form 941 for the fourth calendar quarter) along with the applicable FICA taxes for that quarter. Of course, if a church revokes its exemption, nonminister employees are no longer treated as self-employed for social security purposes, and accordingly should no longer file quarterly estimated tax payments (their FICA taxes will be withheld from their wages).

A number of churches having nonminister employees (e.g., an office secretary) apparently do not know whether or not they have elected to exempt themselves from the employer's share of social security (FICA) taxes by filing a timely Form 8274. Churches that filed a timely election but that nevertheless paid all employment taxes due from the effective date of their election through December 31, 1986 (a fairly common practice by churches that could not remember if they ever filed the election) are treated as if they never filed the election.⁸⁴

⁸⁴ Internal Revenue News Release IR-87-94.

VII. Special Topic #5: Unrelated Business Taxable Income

Section 511 of the Code imposes a tax on the "unrelated business taxable income" of every tax-exempt organization, including churches, as a means of placing the business activities of exempt organizations on the same tax basis as the taxable business endeavors with which they compete. Churches that generate unrelated business taxable income must report such income on Form 990-T (due on the 15th day of the fifth month following the end of a church's fiscal year). Section 512 defines *unrelated business taxable income* as "the gross income derived by any organization from any unrelated trade or business regularly carried on by it" less certain deductions. Section 513 defines the term *unrelated trade or business* as "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501"

Accordingly, the following three conditions must be met before an activity of an exempt organization may be classified as an unrelated trade or business and the gross income of such activity subjected to the tax on unrelated business taxable income: (1) the activity must be a trade or

business, (2) the trade or business must be regularly carried on, and (3) the trade or business must not be substantially related to exempt purposes. The term *trade or business* generally includes any activity carried on for the production of income from the sale of goods or the performance of services. Whether or not an activity is *regularly carried on* requires a comparison of similar activities conducted by taxable organizations. For example, if a particular income-producing activity is of a kind normally conducted by commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of a few days or weeks does not constitute the regular carrying on of a trade or business. To illustrate, the operation of a sandwich stand for a few days each year at a county fair is not a trade or business that is "regularly carried on" since such a stand would not unfairly compete with commercial restaurants that operate on a year-round basis. The regulations state that certain intermittent income-producing activities occur so infrequently (e.g., a few days each year) that they will not be regarded as a trade or business that is regularly carried on.

An activity constituting a trade or business that is substantially related to the exempt purposes of an organization is not an unrelated trade or business. The regulations stipulate that for the conduct of a trade or business to be substantially related to an organization's exempt purposes, the activity must "contribute importantly to the

accomplishment of those purposes." Note, however, that the accomplishment of an organization's exempt purposes does not include a church's need for income or its ultimate use of income. In other words, the tax on unrelated business taxable income cannot be avoided by devoting all net earnings from an unrelated trade or business to an exempt activity. Section 513(a) of the Code specifically states that the term *unrelated trade or business* does not include (1) activities in which substantially all the work is performed by unpaid volunteers, (2) activities carried on by a church or other charitable organization primarily for the convenience of its members, students, or employees, or (3) selling merchandise substantially all of which has been received by the exempt organization as gifts or contributions. Many income-producing activities of churches are exempt from the tax on unrelated business income on the basis of one or more of these exemptions. To illustrate, church bake sales ordinarily are exempt because they are not regularly carried on and because they involve volunteer labor and donated merchandise. Car washes, fundraising dinners, bazaars, and many similar income-producing activities of churches are similarly exempt.

In addition, section 512(b) exempts dividends, interest, annuities, royalties, and rents from real property from the tax on unrelated business taxable income. However, section 514 of the Code states that

the exclusion of dividends, interest, annuities, royalties, and rents from the definition of unrelated business income does not apply in the case of unrelated debt-financed property. *Debt-financed property* is defined as any property held to produce income and that is subject to an "acquisition indebtedness," such as a mortgage, at any time during the year. Income derived from debt-financed property generally constitutes unrelated business taxable income unless the property falls within one of the following three exceptions:

1. Substantially all (85% or more) of the property is used for exempt purposes. Property is not used for exempt purposes merely because income derived from the property is expended for exempt purposes. If less than 85% of the use of the property is devoted to exempt purposes, only that part of the property that is not used to further exempt purposes is treated as unrelated debt-financed property.
2. Income from debt-financed property is otherwise taken into account in computing the gross income of any unrelated trade or business.
3. The property is used in a trade or business that is substantially supported by volunteer workers, that is carried on primarily for the convenience of its members, students, or employees; or that involves the selling of merchandise substantially all of which has been received by the organization as gifts or contributions.

In addition, the Code specifies that if a church acquires real property for the principal purpose of using it substantially for exempt purposes within fifteen years of the time of acquisition, the property is not treated as unrelated debt-financed property even though it may otherwise meet the definition. Furthermore, contrary to the rule that applies to other exempt organizations, the property need not be in the immediate vicinity of the church.⁸⁵ However, this rule will apply with respect to any structure on the land when acquired by the church only so long as the intended future use of the land in furtherance of the church's exempt purpose requires that the structure be demolished or removed in order to use the land in such a manner. This rule will apply after the first five years of the 15-year period only if the church demonstrates to the IRS that use of the land in furtherance of the church's exempt purposes before the expiration of the 15-year period is reasonably certain.

If a tax-exempt organization "controls" another exempt or non-exempt organization (a "controlled" organization), the interest, annuities, royalties, dividends, and rent received by the controlling organization from the controlled organization may be taxable as

⁸⁵ I.R.C. § 514(b)(3)(E).

unrelated business taxable income at a specific ratio depending on whether the controlled organization is exempt or non-exempt.⁸⁶

Exempt organizations that have unrelated business taxable income pay the corporate income tax rates on such income. The tax is levied on income after the deduction of all expenses, modifications and a \$1,000 exclusion.

VIII. Special Topic #6: Unemployment Taxes

Congress enacted the Federal Unemployment Tax Act (FUTA) in 1935 in response to the widespread unemployment that accompanied the great depression. The Act called for a cooperative federal-state program of benefits to unemployed workers. It is financed by a federal excise tax on wages paid by employers in covered employment. An employer, however, is allowed a credit of up to ninety percent of the federal tax for "contributions" paid to a state fund established under a federally approved state unemployment compensation law. All fifty states have employment security laws implementing the federal mandatory minimum standards of coverage. States are free to expand their coverage beyond the federal minimum.

From 1960 to 1970, the Act excluded from the definition of covered employment all service performed in the employ of a religious,

⁸⁶ I.R.C. § 512(b)(13).

charitable, educational, or other organization described in section 501(c)(3) which is exempt from income tax under section 501(a)." A 1970 amendment in effect narrowed this broad exemption of nonprofit organizations by conditioning federal approval of state compensation plans on the coverage of all nonprofit organizations except those specifically exempted. The Act was then amended to exempt service performed

(1) in the employ of (A) a church or convention or association of churches, or (B) an organization which is operated primarily for religious purposes and which is operated, supervised, controlled, or principally supported by a church or convention or association of churches; (2) a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order; (3) in the employ of a school which is not an institution of higher education.⁸⁷

The Act continues the exemption of "service performed in the employ of a religious . . . organization" from the federal tax. Thus, while the exemption of religious organizations under federal law remains broad, the requirement imposed on states has been significantly narrowed.

⁸⁷ I.R.C. § 3309(b).

In 1976, Congress eliminated the exemption of services performed "in the employ of a school which is not an institution of higher education" from the categories of employment that could be exempted from coverage under state programs without loss of federal approval.

In 1978 the Secretary of the Department of Labor announced that the elimination of this exemption required mandatory coverage of all the employees of church-related schools. This ruling was followed by many states, prompting a number of lawsuits.

In 1981, the United States Supreme Court ruled that the elimination of service performed "in the employ of a school which is not an institution of higher education" did not require the coverage of the employees of unincorporated church-related schools, since the continuing exemption of church employees was broad enough to cover the employees of unincorporated church-controlled elementary and secondary schools.⁸⁸ The Court concluded that the employees of separately incorporated church schools are exempt from coverage only if the school is operated primarily for religious purposes and is operated, supervised, controlled, or principally supported by a church or convention or association of churches.

⁸⁸ St. Martin Evangelical Lutheran Church v. South Dakota, 451 U.S. 772 (1981).

In summary, the following activities ordinarily are exempt from state unemployment taxes:

1. Service performed in the employ of a church, a convention or association of churches, or an organization that is operated primarily for religious purposes and that is operated, supervised, controlled, or principally supported by a church or convention or association of churches. The exemption is not limited to employees performing strictly religious duties.

2. Service performed in the employ of an unincorporated church-controlled elementary or secondary school.

3. Service performed in the employ of an incorporated religious elementary or secondary school if it is operated primarily for religious purposes and is operated, supervised, controlled, or principally supported by a church or a convention or association of churches.

4. Service performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order.

IX. Special Topic #7: Personal Liability for Failure to Comply with Withholding Obligations

Without question, the most significant federal reporting obligation for most churches is the *withholding* of "payroll taxes" (e.g., income

taxes and social security or "FICA" taxes) from the wages of nonminister employees, the *depositing* of these withheld taxes with a local bank, and the *reporting* of withholdings to the IRS on the quarterly employer's tax return (Form 941). These requirements apply to any church with at least one nonminister employee, such as an office secretary, bookkeeper, or full-time custodian. They also apply in part to a church whose minister has elected voluntary withholding of income taxes. Yet, many churches do not comply with these rules because of unfamiliarity. This can lead to substantial penalties. One of the most significant penalties is found in section 6672 of the Internal Revenue Code. This section specifies that

any person required to collect, truthfully account for, and pay over any [income tax or FICA tax] who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable for a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

Stated simply, this section says that any corporate officer, director, or employee who is responsible for withholding taxes and paying them over to the government is liable for a penalty in the amount of 100 percent of such taxes if they are either not withheld or not paid over to the

government. This penalty is of special relevance to church leaders, given the high rate of noncompliance by churches with the payroll reporting procedures.

The 100 percent civil penalty for failing to withhold (or pay over) payroll taxes to the government can be assessed against church leaders. In Policy Statement P-5-60 (part of the Internal Revenue Manual), the IRS states:

The 100 percent penalty (applicable to withheld income and social security taxes) will be used only as a collection device. If a corporation has willfully failed to collect or pay over income and employment taxes, or has willfully failed to pay over collected excise taxes, the 100 percent penalty may be asserted against responsible officers and employees of the corporation, *including volunteer members of boards of trustees of organizations referred to in section 501 of the Internal Revenue Code* [e.g., churches], whenever such taxes cannot be immediately collected from the corporation itself. . . . When the person responsible for withholding, collecting and paying over taxes cannot otherwise be determined, the Service will look to the president, secretary, and the treasurer of the corporation as responsible officers.

The IRS has often been criticized for attempting to assess the 100 percent penalty against volunteer directors of charitable organizations

having little if any control over finances. The IRS responded to this criticism in revised Policy Statement P-5-60 (in the Internal Revenue Manual), released on February 4, 1993. The revised policy contains the following significant statements:

Determination of Responsible Persons

Responsibility is a matter of status, duty, and authority. Those performing ministerial acts without exercising independent judgment will not be deemed responsible. In general, non-owner employees of the business entity, who act solely under the dominion and control of others, and who are not in a position to make independent decisions on behalf of the business entity, will not be asserted the trust fund recovery penalty. *The penalty shall not be imposed on unpaid, volunteer members of any board of trustees or directors of an organization referred to in section 501 of the Internal Revenue Code to the extent such members are solely serving in an honorary capacity, do not participate in the day-to-day or financial operations of the organization, and/or do not have knowledge of the failure on which such penalty is imposed.*

In order to make accurate determinations all relevant issues should be thoroughly investigated. An individual will not be recommended for assertion if sufficient information is not

available to demonstrate he or she was actively involved in the corporation at the time the liability was not being paid. However, this shall not apply if the potentially responsible individual intentionally makes information unavailable to impede the investigation.

This language indicates that the IRS will not assert the 100 percent penalty against uncompensated, volunteer board members of a church who (1) are solely serving in an honorary capacity, (2) do not participate in the day-to-day or financial operations of the organization, and (3) do not have knowledge of the failure to withhold or pay over withheld payroll taxes.

The risks associated with Code section 6672 are aggravated by the widespread non-compliance on the part of churches with federal payroll tax reporting obligations. Churches all too often fail to comply with the payroll tax reporting obligations--either by failing to withhold taxes or by failing to pay withheld taxes over to the government. As one court indicated, "because these [withheld taxes] accrue on the withholding date but generally are paid on a quarterly basis, they can be a tempting source of available cash to [an employer]."

Why do so many churches fail to comply with these rules? There are many reasons. Certainly these include: (1) Payroll tax reporting rules are complex. (2) Unique rules apply to churches, including the

exemption of clergy from income tax withholding, the treatment of clergy as self-employed for social security purposes, and the availability of an exemption from the employer's share of FICA taxes for some churches that file a timely application. Church treasurers cannot assume that a church can be treated like any secular business. (3) In many cases, church treasurers are volunteer, uncompensated individuals who serve for limited terms. It often is difficult for such individuals to adequately familiarize themselves with the application of federal payroll tax reporting obligations to churches.

X. Special Topic #8: Exemption from Nondiscrimination Rules Applicable to Tax-Sheltered Annuities Under Code Section 403(b)62

A tax-sheltered annuity (more properly called a section 403(b) plan) is an excellent way for a tax-exempt church or religious organization to provide retirement benefits for some or all of its employees. The employer can fund contributions through "elective deferrals" (binding and irrevocable salary reduction agreements entered into between a church and an employee before the corresponding services are performed, and lasting for at least one year) or through "nonelective deferrals" (voluntary employer contributions not funded through salary reduction agreements), and it can make the program available only to selected employees. Contributions are not permitted

out of compensation previously distributed to a participant. Whether an employee's annuity is funded through employer contributions or salary reductions, the employee's rights to the annuity must be nonforfeitable.

The complex nondiscrimination rules (prohibiting qualified employee benefit plans from discriminating in favor of highly compensated employees) do not apply to tax-sheltered annuity plans of (1) a church; (2) a convention or association of churches; (3) an elementary or secondary school that is controlled, operated, or principally supported by a church or convention or association of churches; or (4) a "qualified church-controlled organization."⁸⁹ A qualified church-controlled organization is defined in section 3121(w)(3)(B) of the Code as

any church-controlled tax-exempt organization described in section 501(c)(3), other than an organization which (i) offers goods, services, or facilities for sale, other than on an incidental basis, to the general public, other than goods, services or facilities which are sold at a nominal charge which is substantially less than the cost of providing such goods, services, or facilities; and (ii) normally receives more than 25% of its support from either (I) governmental sources, or (II) receipts from admissions, sales of

⁸⁹ I.R.C. §§ 403(b)(1)(D) and 403(b)(12)(B).

merchandise, performance of services, or furnishing of facilities, in activities which are not unrelated trades or businesses, or both.

Clearly, local churches, church denominations, and church-controlled elementary and secondary schools are qualify as "church-controlled organizations." While it is less clear, it is reasonably certain that seminaries and Bible colleges also qualify. The committee report on the Tax Reform Act of 1986, in construing the term "qualified church-controlled organization" in another context, noted that it included "the typical seminary, religious retreat center, or burial society, regardless of its funding sources, because it does not offer goods, services, or facilities for sale to the general public." The committee report also noted that the term "qualified church-controlled organization" included "a church-run orphanage or old-age home, even if it is open to the general public, if not more than 25% of its support is derived from the receipts of admissions, sales of merchandise, performance of services, or furnishing of facilities (in other than unrelated trades or businesses) or from governmental sources. The committee specifically intends that the [term 'qualified church-controlled organization' will not include] church-run universities (other than religious seminaries) and hospitals if both conditions (i) and (ii) exist."

XI. Conclusions

What is the justification for the special treatment of churches (and other religious organizations) under the Code? Are some or all of the eight examples summarized above mandated by the Constitution? Most of these special rules derive from the exemption of churches from federal income taxation under Code section 501. If this exemption is not constitutionally required, then there is little if any support for a constitutional justification for any of the eight corollary rules described in this paper. Whether or not there is a constitutional basis (under the first amendment religion clauses) for the exemption of churches from federal income taxation is a question that has eluded a definitive answer.⁹⁰ Several courts have held that religious organizations have no constitutional right to be exempted from federal income taxes. For example, one federal court has held that "tax exemption is a privilege, a matter of grace rather than right,"⁹¹ and another federal court has observed:

⁹⁰ See generally B. Hopkins, The Law of Tax-Exempt Organizations (5th ed. 1987); P. Kauper, The Constitutionality of Tax Exemptions for Religious Activities, The Wall Between Church and State 95 (D. Oaks ed. 1963); D. Kelley, Why Churches Should Not Pay Taxes (1977); Bittker & Rahdert, *The Exemption of Nonprofit Organizations From Federal Income Taxation*, 85 Yale L.J. 301 (1976); Note, *Constitutionality of Tax Benefits Accorded Religion*, 49 Colum. L. Rev. 968 (1949).

⁹¹ *Christian Echoes National Ministry, Inc. v. United States*, 470 F.2d 849, 857 (10th Cir. 1972), cert. denied, 414 U.S. 864 (1973).

We believe it is constitutionally permissible to tax the income of religious organizations. In fact there are those who contend that the failure to tax such organizations violates the no establishment clause of the First Amendment. Since the government may constitutionally tax the income of religious organizations, it follows that the government may decide not to exercise this power and grant reasonable exemptions to qualifying organizations, while continuing to tax those who fail to meet these qualifications. The receiving of an exemption is thus a matter of legislative grace and not a constitutional right.⁹²

It is nevertheless true that for as long as federal income taxes have had any potential impact on churches, religious organizations have been expressly exempted from such taxes.⁹³ Significantly, the exemption of churches is automatic. Unlike other charities, churches are not required

⁹² *Parker v. Commissioner*, 365 F.2d 792, 795 (8th Cir. 1966) (citations omitted), cert. denied, 385 U.S. 1026 (1967). See also *Bethel Conservative Mennonite Church v. Commissioner*, 80 T.C. 352 (1983), rev'd on other grounds, 746 F.2d 388 (7th Cir. 1984) ("a bona fide church is not per se exempt from taxation as a religious organization . . . [e]xemption from Federal income taxation is a privilege provided as a matter of legislative grace, not a right"); *Parshall Christian Order v. Commissioner* 45 T.C.M. 488 (1983) ("Exemption from tax is a matter of grace rather than right."); *People v. Life Science Church*, 450 N.Y.S.2d 664, 669 (1982) ("Taxation of religious organizations is constitutionally permissible under the free exercise of religion clause of the First Amendment to the Constitution.").

⁹³ *Walz v. Tax Commission*, 397 U.S. 664, 676 n.4 (1970).

to apply for and receive IRS recognition of tax-exempt status.⁹⁴ This of course assumes that the church satisfies the conditions enumerated in section 501(c)(3) of the Internal Revenue Code. Whether this legislative history indicates a congressional determination that tax exemption of churches is constitutionally mandated is unclear.

Churches and other religious organizations that engage in substantial efforts to influence legislation, that intervene in political campaigns, that are not operated exclusively for religious purposes, that are not organized exclusively for religious purposes, or the net earnings of which inures to the benefit of a private individual are not entitled to exemption. Further, in 1969 Congress elected to tax the "unrelated business income" of all religious organizations including churches.⁹⁵ Certainly such factors militate against the conclusion that religious organizations are constitutionally immune from taxation.

The United States Supreme Court, in upholding the constitutionality of state property tax exemptions for properties used solely for religious worship, suggested that a constitutional basis may

⁹⁴ I.R.C. § 508(c)(1)(A). See also IRS Publication 557. This section also exempts "integrated auxiliaries" of churches, and "conventions or associations of churches," without the necessity of filing an exemption application with the IRS. Section 508(c)(1)(B) exempts "any organization which is not a private foundation . . . and the gross receipts of which in each taxable year are normally not more than \$5,000" from the exemption application filing requirement.

⁹⁵ I.R.C. § 511(a)(2)(A).

exist for property tax exemptions.⁹⁶ The Court emphasized that the first amendment forbids the government from following a course of action, be it taxation of churches or exemption, that results in an excessive governmental entanglement with religion. The Court reasoned that eliminating the tax exemption of properties used exclusively for religious worship would be unconstitutional since it would expand governmental entanglement with religion: "Elimination of exemption would tend to expand the involvement of government by giving rise to tax valuation of church property, tax liens, tax foreclosures, and the direct confrontations and conflicts that follow in the train of those legal processes."⁹⁷

The Court observed that "exemption creates only a minimal and remote involvement between church and state and far less than taxation of churches" and that "[t]he hazards of churches supporting government are hardly less in their potential than the hazards of government supporting churches." The Court concluded that the grant of a tax exemption is not an impermissible "sponsorship" of religion since "the government does not transfer part of its revenue to churches but simply abstains from demanding that the church support the state." Such reasoning suggests that the exemption of religious organizations from federal income taxation may be rooted in part in the United States

⁹⁶ *Walz v. Tax Commission*, 397 U.S. 664 (1970).

⁹⁷ *Id.* at 674.

Constitution, at least to the extent that it can be demonstrated that the taxation of religious organizations would lead to substantial governmental entanglement with religion far greater than the entanglement occasioned by exemption.⁹⁸

On the other hand, the Supreme Court ruled unanimously in 1990 that the State of California could tax the sale of religious literature by Jimmy Swaggart Ministries, a religious organization organized "for the purpose of establishing and maintaining an evangelistic outreach for the worship of Almighty God . . . by all available means, both at home and in foreign lands," including evangelistic crusades, missionary endeavors, radio broadcasting, television broadcasting, and publishing.⁹⁹ In 1982, the Court ruled that the first amendment guaranty of religious freedom was not violated by requiring Amish employers to withhold social security taxes from their employees' wages.¹⁰⁰ The Court acknowledged that subjecting Amish employers to compulsory withholding of social security taxes violated their religious convictions. However, the Court concluded that this interference with religious convictions was outweighed by an "overriding governmental interest":

⁹⁸ See also *Committee for Public Education and Religious Liberty v. Nyquist*, 413 U.S. 756, 792-93 (1973).

⁹⁹ *Jimmy Swaggart Ministries v. Board of Equalization*, 110 S. Ct. 688 (1990). This decision is discussed in section E of this chapter.

¹⁰⁰ *United States v. Lee*, 455 U.S. 252 (1981).

Because the social security system is nationwide, the governmental interest is apparent. The social security system in the United States serves the public interest by providing a comprehensive insurance system with a variety of benefits available to all participants, with costs shared by employers and employees. The social security system is by far the largest domestic governmental program in the United States today, distributing approximately \$11 billion monthly to 36 million Americans. The design of the system requires support by mandatory contributions from covered employers and employees. This mandatory participation is indispensable to the fiscal vitality of the social security system. . . . Moreover, a comprehensive national social security system providing for voluntary participation would be almost a contradiction in terms and difficult, if not impossible, to administer. Thus, the Government's interest in assuring mandatory and continuous participation in and contribution to the social security system is very high.¹⁰¹

The Court concluded that "[b]ecause the broad public interest in maintaining a sound tax system is of such a high order, religious belief in conflict with the payment of taxes affords no basis for resisting the tax." This language would appear to diminish the availability of a

¹⁰¹ *Id.* at 258-259.

constitutionally-mandated exemption of churches from federal income taxation.

The exemption of religious organizations from federal income taxation does not constitute an impermissible "establishment of religion" in violation of the first amendment.¹⁰² The United States Supreme Court has observed that "[t]here is no genuine nexus between tax exemption and establishment of religion."¹⁰³

In summary, if the exemption of churches from federal income taxation is not required by the first amendment, then there is no constitutional basis for

- the Church Audit Procedures Act
- the exemption of churches from the need to file an application for exemption from federal income taxes (Form 1023)
- the exemption of churches from the annual information return (Form 990) filing requirement
- the eligibility of churches to exempt themselves from paying the employer's share of FICA taxes

¹⁰² United States v. Dykema, 666 F.2d 1096 (7th Cir. 1981); Swallow v. United States, 325 F.2d 97 (10th Cir. 1963), cert. denied, 377 U.S. 951 (1964).

¹⁰³ Walz v. Tax Commission, 397 U.S. 664, 675 (1970).

- the special rules that apply to the computation of the unrelated business income tax of churches
- the exemption of churches from federal unemployment taxes
- the special treatment of church officers and directors under Code section 6672
- the exemption of churches from the nondiscrimination rules that apply to Code section 403(b) nonqualified tax-sheltered annuities

Even if there is a constitutional basis for the exemption of churches from federal income taxation,¹⁰⁴ these eight special rules do not necessarily have a constitutionally-mandated basis. In fact, in most if not all of these cases the justification for the special treatment of churches is not the Constitution but expedience. For example, in 1984, when church employees for the first time were brought under social security coverage, there was widespread protest among many church leaders over what was perceived to be direct taxation of churches.

Congress quickly responded to this unrest, and the potential for massive

¹⁰⁴ Such a conclusion should not be discounted. Some of the rulings of the Supreme Court (most notably the *Walz* case) can be interpreted to support a constitutional basis for an exemption from federal income taxation. Further any attempt to subject churches to federal income taxation may be futile, since church "income" consists almost exclusively of tax-excludable gifts.

disobedience, by amending the Code to permit churches to exempt themselves from paying the employer's share of FICA taxes if they were opposed to doing so on religious grounds.¹⁰⁵ One can only imagine what the reaction would be to any attempt by Congress to impose a direct income tax on churches. Whether constitutional or not, a comfortable majority of federal legislators would find such a prospect unthinkable.

TABLE 2
Comparison of Churches and Church-Related Entities

entity	definition	exempt from federal income taxation	exempt from filing Form 990	qualified charitable contribution recipient
churches	Not defined in the Code or regulations. The IRS has developed 14 criteria for determining if a particular organization is a church, but these are of questionable legal validity. The term <i>church</i> also refers to hierarchical denominations.	yes	yes	yes
conventions and associations of churches	Not defined in the Code or regulations. The term includes religious denominations or groups of churches that are "congregational" in polity.	yes	yes	yes

¹⁰⁵ I.R.C. § 3121(w).

entity	definition	exempt from federal income taxation	exempt from filing Form 990	qualified charitable contribution recipient
integrated auxiliaries of churches or conventions or associations of churches	Defined by regulation as an entity (1) that is exempt from federal income tax under section 501(c)(3) of the Code, (2) that is affiliated with a church, and (3) whose principal activity is exclusively religious. A federal appeals court has ruled that the third requirement is invalid.	yes	yes	yes
integral agencies of religious organizations	Not defined in the Code or regulations. Rev. Rul. 72-606 lists 8 criteria to be used in determining if a particular entity is an integral agency of a church.	yes, if the organization with which it is affiliated is exempt	yes, if the organization with which it is affiliated is exempt	yes, if the organization with which it is affiliated is exempt
integral parts of churches	The term appears in Reg. 1.511-2(a)(3)(ii), and specifies that consideration must be given to the degree to which an entity is connected with, and controlled by, a church. This regulation applied only for years ending prior to 1970, and referred to organizations exempt from the unrelated business income tax. The term has no current relevance.	not applicable	not applicable	not applicable

entity	definition	exempt from federal income taxation	exempt from filing Form 990	qualified charitable contribution recipient
qualified church-controlled organizations	Defined by Code section 3121(w) as any church-controlled tax-exempt organization not engaged in an unrelated trade or business and that does not ordinarily receive more than 25% of its support from (a) governmental sources, or (b) admission receipts, sales of merchandise, performance of services, or furnishing of facilities, in activities that are not an unrelated trade or business.	only if it qualifies for exemption under another definition	only if it qualifies for exemption under another definition	only if it qualifies for exemption under another definition
private schools	Not defined in the Code or regulations.	a Supreme Court ruling suggests that an unincorporated school operated and controlled by a church may share the church's exempt status, but that a separately incorporated school (even if operated and controlled by a church) may not	a Supreme Court ruling suggests that an unincorporated school operated and controlled by a church may share the church's exempt status, but that a separately incorporated school (even if operated and controlled by a church) may not	a Supreme Court ruling suggests that an unincorporated school operated and controlled by a church may share the church's exempt status, but that a separately incorporated school (even if operated and controlled by a church) may not
religious or apostolic associations or corporations	Defined by Code section 501(d) as organizations having a common treasury, if members report their prorata share of the organization's income as gross income on their individual tax returns.	no	no, but IRS Form 1065 must be filed annually	yes

entity	definition	exempt from federal income taxation	exempt from filing Form 990	qualified charitable contribution recipient
church-related organization	IRS Notice 84-2 relieves them of the obligation to file annual information returns (Form 990). They are defined as "section 501(c)(3) organizations which are operated, supervised, or controlled by one or more churches, integrated auxiliaries, or conventions or associations of churches, and (a) which are exclusively engaged in financing, funding the activities of, or managing the funds of a church, integrated auxiliary, or convention or association of churches . . . or which maintain retirement insurance programs primarily for [such organizations]."	no	only if it qualifies for exemption under another definition	only if it qualifies for exemption under another definition
religious orders	Not defined in the Code or regulations. Rev. Proc. 91-20 lists 7 criteria to be used in determining if a particular entity is a religious order.	yes	yes, but the order must file an annual Form 1065 with the IRS	no