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Report to the Honorable Charles B. Rangel, House of Representatives

August 1988

TAX ADMINISTRATION

Tax Law Compliance of Churches and Tax-Exempt Religious Organizations

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The Honorable Charles B. Rangel
House of Representatives

Dear Mr. Rangel:

This report responds to your request for information on how IRS reviews tax law compliance for churches and for religious organizations that are not churches. It also provides information on the difficulties IRS has identified in ensuring that churches are complying with the tax laws.

As agreed, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the issue date. At that time, we will send copies to IRS and other interested parties.

Sincerely yours,

Jennie S. Stathis

Jennie S. Stathis
Associate Director

Executive Summary

Purpose

Recent well-publicized allegations of financial abuses by tax-exempt religious broadcasters have led to increased congressional interest in the Internal Revenue Service's (IRS) oversight of churches and religious organizations, especially religious broadcasters.

Congressman Rangel asked GAO to address three questions concerning churches and other religious organizations:

- How does IRS ensure tax law compliance of religious organizations which are not churches?
- How does IRS assure that churches comply with the tax laws?
- What difficulties has IRS encountered in assuring that churches comply with the tax laws?

Background

Section 501(c)(3) of the Internal Revenue Code exempts from taxation entities that are organized and operated for, among other things, religious, charitable, scientific, or educational purposes.

For tax law purposes, IRS distinguishes between churches and religious organizations that are not churches, such as evangelical associations or religious publishers. This distinction is made necessary because churches, historically, have been exempt from many of the rules applicable to other charitable tax-exempt organizations. In several aspects of tax administration, IRS must apply different laws, regulations, and rules to churches than it does to religious organizations that are not churches. These different rules affect IRS' review of applications for tax-exempt status, the requirements for filing of annual returns, and IRS' examination process for these organizations.

Results in Brief

GAO's Work Showed That

- IRS monitors tax law compliance of tax-exempt religious organizations that are not churches in the same way it does for other charitable tax-exempt organizations.
- IRS reviews churches' compliance with the tax laws much differently than it does for other tax-exempt religious organizations.
- IRS believes it has difficulty in assuring that churches comply with the tax laws because of the (1) lack of information it receives on churches; (2) specialized audit procedures required by law; and (3) complexity of

issues common to all tax-exempt organizations, which can also affect churches.

GAO's Analysis

Religious Organizations That Are Not Churches

Religious organizations that are not churches generally are required to apply for tax-exempt status and to file annual information returns, which enables IRS to subject them to various examination programs. For fiscal years 1981 through 1987, between 2 and 3 percent of all exempt organizations that IRS examined were religious organizations that were not churches. (See ch. 2.)

Churches

Churches are excused from filing for tax-exempt status and filing annual information returns but must file tax returns if they have income in excess of $1,000 from sources substantially unrelated to their exempt purposes. The law also imposes special examination procedures that IRS must use when reviewing churches for tax law compliance. (See ch. 3.)

Religious Broadcasters

IRS views religious broadcasters either as religious organizations that are not churches, as churches, or both. There is no uniform set of tax rules specifically applicable to religious broadcasters. The rules that apply depend on how the religious broadcaster has organized its operations. If a religious broadcaster has organized his or her operations as a religious organization that is not a church and has applied for and been recognized by IRS as tax-exempt, the laws and programs applicable to all charitable tax-exempt organizations would generally apply. If a religious broadcaster has organized his or her operations as a church, special rules and programs applicable only to churches would apply.

Difficulties in Administering Tax Laws Applicable to Churches

IRS believes it has difficulty administering the tax laws applicable to churches. IRS officials said that churches generally do not file applications for recognition of tax-exempt status or file annual information returns. Also, if a church is examined, special examination procedures must be used which contribute to IRS' difficulty in administering these tax laws. Further, other issues that apply to all tax-exempt organizations, including churches and religious organizations that are not churches, can cause difficulties in administering the tax laws for

churches, according to IRS officials. These issues include, for example, determining what types of activities are not substantially related to a tax-exempt organization's purpose, for the purpose of imposing unrelated business income tax. (See ch. 4.)

When religious organizations, including religious broadcasters, organize and operate as churches, the information they provide to IRS is generally limited. As a result, IRS' ability to identify noncompliance with the tax laws usually depends on information it receives from the media and the public. The limited sources and amounts of information, along with the restrictions of the church audit procedures that IRS must apply to churches have discouraged IRS' activities in this area to the extent that IRS had completed a total of 67 examinations between fiscal years 1984 and 1987.

Recommendations

This report provides information on how IRS ensures tax law compliance of churches and other religious organizations. It contains no recommendations.

Agency Comments

IRS program officials reviewed a draft of this report and suggested some clarifications that GAO considered in preparing the final report.

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Abbreviations

EO	Exempt Organizations
GAO	General Accounting Office
IRS	Internal Revenue Service
TCMP	Taxpayer Compliance Measurement Program
UBIT	Unrelated Business Income Tax

Introduction

Recent well-publicized allegations of financial abuses by tax-exempt religious broadcasters have led to increased congressional interest in the Internal Revenue Service's (IRS) oversight of churches and religious organizations, especially religious broadcasters. There is no uniform set of tax rules specifically applicable to religious broadcasters. The rules that apply depend on how the religious broadcaster has organized his or her operations. If a religious broadcaster has organized his or her operations as a religious organization that is not a church, the laws and programs applicable to all charitable tax-exempt organizations would generally apply. If, on the other hand, a religious broadcaster has organized his or her operations as a church, special rules and programs applicable only to churches would apply.

Objectives, Scope, and Methodology

This report responds to a request from Congressman Charles B. Rangel for information on how IRS reviews tax law compliance for churches and for religious organizations that are not churches. It also provides information on the difficulties IRS has identified in ensuring that churches are complying with the tax laws. The objective of this assignment was to develop this information.

To develop this information we

- reviewed pertinent laws, regulations, court decisions, and other legal documents, including the legislative history of the Church Audit Procedures Act;
- discussed IRS policies and procedures relating to tax-exempt organizations with IRS National Office officials;
- interviewed IRS exempt organization (EO) field personnel in the seven IRS regions about policies and procedures applicable to churches and other tax-exempt religious organizations;
- obtained information on financial disclosure by churches from officials of two national religious organizations, which include major churches and religious broadcasters;
- examined case materials on, and discussed with IRS officials the status of, ongoing IRS examinations or investigations of churches, television ministries, and other religious organizations; and
- collected and analyzed IRS statistical data on tax-exempt organizations, including specific information on churches and religious organizations.

The information presented on religious organizations that are not churches is based on our review of pertinent laws, regulations, IRS procedures, IRS statistical information, and interviews with IRS officials.

The information presented on churches is largely from these same sources. However, we also examined status reports on ongoing church examination cases and we attempted to obtain church examination cases closed between January 1, 1985, and September 30, 1987, to determine why the examinations were initiated as well as the results of the examinations. IRS officials informed us they were unable to locate most of the cases we requested, primarily because of difficulties in locating closed cases at Federal Records Centers. As a result, our review was limited in two ways: first, we were unable to determine what the principal examination issues were in these closed cases and second, we were unable to get detailed information on examination results. IRS' statistical tables provide generic results of examinations, such as revocation of tax-exempt status and a category labeled, "other." Without examining the closed cases we were unable to determine the specific results for those cases listed as "other," which cover 19 (28 percent) of the 67 examinations closed in the last 4 fiscal years.

We also compared and contrasted how IRS ensures tax law compliance of churches with religious organizations that are not churches. To facilitate this comparison, we have included all information on how IRS ensures tax law compliance of religious organizations that are not churches in chapter 2 and all information on how IRS ensures tax law compliance of churches in chapter 3.

We did our work at the IRS National Office and at the Baltimore district office, one of seven IRS district offices responsible for EO matters. We contacted the remaining six district offices by telephone. IRS program officials reviewed a draft of this report and suggested some clarifications that we considered in preparing the final report. We did our work from July 1987 through December 1987 in accordance with generally accepted government auditing standards.

IRS Monitors Tax Law Compliance of Religious Organizations That Are Not Churches in the Same Way as Other Charitable Tax-Exempt Organizations

IRS monitors tax law compliance of religious organizations that are not churches in the same way as other charitable Internal Revenue Code section 501(c)(3) tax-exempt organizations.[1] These organizations generally must file an application for recognition of exemption with IRS. Similarly they are required to file annual information returns, and they are subject to IRS' EO examination process. For purposes of this report, the term "religious organization" refers to any religious organization, except churches, that is exempt from taxation under section 501(c)(3). The term "church" refers to churches and affiliated auxiliary organizations, such as religious orders. The following information on religious organizations that are not churches is based on our review of pertinent laws, regulations, and IRS procedures; IRS statistical information; and interviews with IRS officials.

How Does IRS Define Religious Organizations?

Under the tax law, religious organizations are organizations established for religious purposes, and IRS monitors their compliance with the tax laws in the same way as other section 501(c)(3) tax-exempt organizations. To qualify for tax exemption, they must meet the requirements for tax exemption under section 501(c)(3). These requirements are met if the organization is organized and operated for religious purposes and no part of its earnings, other than reasonable amounts for compensation, inures to the benefit of any private individual.[2] In addition, the organization cannot violate applicable restrictions on lobbying activities and prohibitions on political campaign activities.

There is no precise definition of "religious purposes" in the Internal Revenue Code or implementing regulations. In order to determine whether an organization meets the qualifications for section 501(c)(3) status as a religious organization, IRS considers two basic guidelines. First, the religious beliefs of the members of the organization must be sincerely held by those professing to follow them. Second, the organization's practices or rituals must not be contrary to clearly defined public policy. For example, a tax-exempt religious school that practices racial

[1] The Internal Revenue Code section 501(c)(3) exempts from taxation entities that are organized and operated for exclusively religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, or to foster amateur sports. These organizations are commonly referred to as charitable tax-exempt organizations because donations to them are generally deductible as charitable contributions on individual and corporation tax returns.

[2] Private inurement can take a variety of forms, including the payment of excessive compensation to an individual with an interest in the organization.

discrimination in its admissions policy could lose its tax-exempt status because racial discrimination in education is contrary to public policy.

Religious organizations can include, but are not limited to, evangelical associations, missionary societies, religious publishers, religious broadcasters, and television ministries. Where a religious broadcaster, for example, has organized his or her operations as a religious organization that is not a church, the laws and procedures discussed in this chapter would apply. Some religious broadcasters also characterize part or all of their operations as a church. Churches are afforded special treatment under the tax law, as discussed in chapter 3.

What Tax Law Requirements Apply to Religious Organizations?

Since 1969 most organizations seeking to be considered as tax-exempt have been required to apply for tax-exempt status with IRS. Religious organizations are among those required to apply for tax-exempt status. The law and implementing IRS instructions also require most tax-exempt organizations, including religious organizations, with gross receipts of $25,000 or more to file an annual information return—Form 990, "Return of Organization Exempt From Income Tax." This return is designed to provide a variety of information, including a revenue and expense schedule, a balance sheet, the program services rendered, the names of officers and directors, and other activity-oriented information.

Religious organizations, like other tax-exempt organizations, must also file Form 990-T, Exempt Organization Business Income Tax Return, if they have gross income of at least $1,000 from sources unrelated to their exempt purposes. Unrelated income is income from any trade or business that is regularly carried on and that is not substantially related to the organization's exempt purpose or function. (The app. provides more detailed discussion of the laws relating to unrelated business income tax.)

With regard to examinations for tax law compliance, religious organizations are subject to the same procedures for selection and conduct of examinations as other section 501(c)(3) organizations.

How Does IRS Monitor Religious Organizations for Tax Law Compliance?

IRS has opportunities to monitor and review religious organizations' activities through (1) the application process, (2) filing of annual information and business tax returns, and (3) the EO examination program.

According to IRS policies and procedures, when IRS receives an application for tax exemption under section 501(c)(3) from a religious organization other than a church, EO personnel at the district offices review the application to determine if the organization meets the criteria for tax-exempt status. If the EO personnel determine that the organization meets these criteria, the organization is notified accordingly and is placed on the EO master file as an exempt section 501(c)(3) organization. If the organization has or anticipates receiving gross receipts of $25,000 or more per year, the master file will be coded to show a filing requirement for a Form 990. The master file will also be coded to denote a filing requirement for a Form 990-T return, if, based on the information supplied by the organization, it appears that the organization will have gross business income of $1,000 or more from activities unrelated to its exempt purpose. The EO master file, therefore, includes the IRS-approved section 501(c)(3) religious organizations and their filing requirements. IRS does not maintain separate statistics on how many religious organizations filed for tax-exempt status or annually filed Forms 990 or 990-T.

Religious organizations required to file Form 990 information returns or Form 990-T business tax returns do so at one of seven service centers—Brookhaven, Philadelphia, Atlanta, Austin, Kansas City, Cincinnati, and Fresno. When one of these service centers receives a Form 990 return from a 501(c)(3) religious organization that is not a church, service center personnel process the return in accordance with the same procedures for other tax-exempt organizations. The return undergoes a number of checks for accuracy and consistency. After these checks are completed, information extracted from the return is sent to IRS' National Computer Center for posting to the EO master file. IRS is also required by law to make Form 990 information returns available to the public upon request.

IRS has programs to identify and contact organizations that do not file, or stop filing, Forms 990 or 990-T. According to IRS procedures, these programs seek to identify the reasons organizations do not file, such as not having gross receipts in excess of $25,000 or no longer having unrelated business income.

Religious organizations, like other section 501(c)(3) organizations, may be selected for examination in several ways. First, religious organizations that file annual information returns (Forms 990) may be selected for examination if they meet a profile of potentially highly noncompliant organizations on the basis of EO's analysis of items filed on Form 990 returns. EO has developed formulas that are designed to identify the most noncompliant organizations; these formulas take into account items on the Form 990 return with which IRS has previously found significant compliance problems.

Second, religious organizations may also be examined as part of a Taxpayer Compliance Measurement Program (TCMP). Through TCMP, IRS selects a random sample of returns for detailed examination in order to determine taxpayer compliance characteristics and to update and improve its selection formulas, discussed above. IRS completed a TCMP for Form 990 returns in 1985, and adjustments to the formulas based on this TCMP went into effect in January 1987. IRS is currently conducting a TCMP for Form 990-T returns.

Third, some religious organizations could be examined as part of special emphasis programs in which IRS targets for examination specific types of organizations. For example, fiscal year 1988 EO program objectives include special emphasis examinations for section 501(c)(3) private schools and for sections 501(c)(3) and (4) exempt organizations involved in lobbying and political activities. Section 501(c)(4) organizations are civic leagues, organizations operated exclusively for the promotion of social welfare, or local associations of employees. For the last 5 fiscal years, 1984 through 1988, IRS has not had any special emphasis programs for religious organizations.

Finally, some of these organizations may be examined as a result of information received by IRS field offices. This information may come from many sources—e.g., individuals, the media—and may suggest that certain EOs are not acting in accordance with their exempt purposes. IRS field examiners evaluate such information to determine whether an examination is warranted.

Table 2.1 provides some data on the total number of completed EO examinations for religious organizations over the last 7 fiscal years. As said previously, IRS does not maintain statistics on the number of tax-exempt religious organizations that have applied for and been recognized as

having tax-exempt status. Therefore, this table does not provide information on the percentage of all tax-exempt religious organizations IRS has examined during these years.

Table 2.1: Number of Religious Organization Returns' Examinations Completed

Fiscal year	Number of examinations of all EO returns completed	Number of examinations of religious organization returns completed	Percent of EO returns examined that are religious organizations
1981	20,102	519	2.6
1982	21,398	607	2.8
1983	22,403	534	2.4
1984	20,632	554	2.7
1985	19,609	487	2.5
1986	21,837	480	2.2
1987	18,094	358	2.0

Source: IRS' EO statistical summary

Summary

Religious organizations are exempt from taxation if they meet the criteria in section 501(c)(3). Religious organizations can include religious publishers, religious broadcasters, television ministries, evangelical associations, and other groups organized and operated for religious purposes. IRS, in administering the laws, treats religious organizations the same as other tax-exempt charitable organizations. They generally are required to apply for tax-exempt status and to file annual information returns and business tax returns, if appropriate. They may be selected for examination for tax law compliance in a variety of ways. Once selected, they are examined in accordance with the procedures applicable to all EOS. IRS generally does not keep separate statistics on the number of religious organizations that apply for tax-exempt status, are recognized by IRS as tax-exempt, or file annual 990 and 990-T returns. However, IRS statistics of EO examinations show that, over the past 7 years, 2 to 3 percent of all closed EO examinations have been of religious organizations.

IRS Reviews Churches' Tax Law Compliance Differently Than Other Tax-Exempt Religious Organizations

The Constitution recognizes the separation of church and state in the First Amendment, which provides that "Congress shall make no law respecting the establishment of religion, or prohibiting the free exercise thereof." Since the founding of the United States, churches generally have been excused from taxation as a matter of national policy. Organizations organized and operated solely for charitable, educational, or religious purposes, including churches, were exempt from paying income tax in legislation implementing the 16th Amendment, ratified in 1913, which permitted the federal government to tax income.

Churches are currently exempt from taxation under section 501(c)(3). Under this section, IRS distinguishes between churches and religious organizations that are not churches. This distinction is necessary because in several aspects of tax administration there are different laws, regulations, and rules applicable to churches than those applicable to religious organizations that are not churches.

What Is a Church?

For tax law administration purposes, IRS considers a church to be a particular type of tax-exempt religious organization. There is no definition of "church" for tax purposes in law or regulation. Rather, IRS must determine on a case-by-case basis whether a particular religious organization constitutes a church, taking into account all relevant facts and circumstances. Churches must meet the criteria for exemption under section 501(c)(3). (See ch. 2 for a discussion of the criteria for tax exemption under section 501(c)(3).) Churches must also meet additional standards to be classified as a church for tax administration purposes. IRS has developed guidelines to assist examiners in determining whether an organization meets the additional standards. These guidelines include consideration of whether the organization has the following characteristics:

(1) distinct legal existence,

(2) recognized creed and form of worship,

(3) definite and distinct ecclesiastical government,

(4) formal code of doctrine and discipline,

(5) distinct religious history,

(6) membership not associated with any other church or denomination,

(7) complete organization of ordained ministers serving their congregations,

(8) ordained ministers selected after completing prescribed courses of study,

(9) literature of its own,

(10) established place of worship,

(11) regular congregation,

(12) regular religious service,

(13) schools for the religious instruction of the young, and

(14) schools for the preparation of its ministers.

In addition, IRS considers any other facts and circumstances that may bear upon the organization's claim to church status.

IRS' guidance emphasizes that these criteria are merely a tool which IRS personnel may find helpful in making a factual determination as to whether or not an organization is a church. The criteria are not meant to be exclusive or mechanically applied.

Courts have agreed that an organization need not satisfy all 14 criteria to be classified as a church. See e.g., Church of the Visible Intelligence that Governs the Universe v. United States, 4 Cl. Ct. 55, 64 (1983). Moreover, no single criterion or set of criteria is controlling. See American Guidance Found. v. United States, 490 F. Supp. 304, 306n.2 (D.C. 1980). Thus, there is no litmus test an organization must pass to be considered a church by IRS.

In an attempt to define church for tax purposes, one court has offered the following: "At a minimum, a church includes a body of believers or communicants that assembles regularly in order to worship." American Guidance Found., 490 F. Supp. at 306. Another court stated that as long as Congress and the IRS do not expressly define church, the definition must be left "to the common meaning and usage of the word." De La Salle Inst. v. United States, 195 F. Supp. 891, 903 (N.D. Cal. 1961).

Under the law, IRS treats conventions or associations of churches and integrated auxiliaries of churches, such as religious orders, as churches. The term "convention or association of churches" was added to the law at the urging of Baptist leaders who were concerned that the term "church," standing alone, could be interpreted to mean only hierarchical churches, such as the Catholic church, but not congregational churches in which local congregations are self-governing.

What Tax Law Requirements Apply to Churches?

Under the law, churches are not required to apply for tax-exempt status; they need not inform IRS of their existence in order to claim exemption from federal income tax. However, some churches do apply for tax-exempt status because a written determination of tax-exempt status may be useful in attracting contributions or in applying for a postal permit.

As stated in chapter 2, the law requires most tax-exempt organizations with gross receipts of $25,000 or more to file an annual information return—Form 990, "Return of Organization Exempt From Income Tax." However, churches are not required to file Form 990 information returns even if their gross receipts exceed $25,000. The law does require churches, like other tax-exempt religious organizations, to file the 990-T tax return if they have an income of $1,000 or more from sources substantially unrelated to their exempt purposes.

IRS' EO examination procedures for churches are different from those for other tax-exempt religious organizations and are governed by Section 7611 of the Internal Revenue Code, enacted July 18, 1984, commonly known as the church audit procedures. According to the Joint Committee on Taxation's general explanation of the legislation enacting section 7611, this section addressed two competing concerns. First, Congress was concerned that limitations on IRS examinations of churches in the law as it existed were vague and relied too heavily on internal IRS procedures to protect the rights of churches during the audit process. Second, an increasing number of individuals were claiming church status to avoid paying taxes, and Congress wanted to ensure that IRS' investigations into these tax-avoidance schemes were not hindered.

Before the passage of section 7611, IRS' church examinations were governed by section 7605(c), which was generally less restrictive than section 7611. For example, section 7605(c) had no time limit for the completion of a church examination and did not require that a high level

IRS official have a reasonable belief that a church was not operating as a tax-exempt organization in order to initiate a church tax inquiry.

Section 7611 prescribes a series of procedures that IRS must follow to review a church's activities for tax law compliance. These procedures must be followed for all churches. The first phase of contact between IRS and the church, before the actual examination of church records, is referred to in the law as a church tax inquiry. To begin any such church inquiry, IRS must meet reasonable belief and notice requirements. The reasonable belief requirement is met if an appropriate high level Treasury official reasonably believes, on the basis of facts and circumstances, that the church may not be tax-exempt or has business income unrelated to its exempt purpose that is not reported. IRS regulations define "appropriate high level Treasury official" as an IRS Regional Commissioner or higher level official. The notice requirement is met when IRS sends a notice of inquiry to the church that must include (1) information on the specific circumstances surrounding the inquiry, (2) full disclosure of administrative procedures and constitutional rights applicable to such examinations, and (3) a general explanation of the provisions of the Internal Revenue Code that authorize the inquiry or otherwise may be involved in the inquiry. IRS must explain that there is a right to a conference. IRS may close the case at any point during the inquiry if it obtains sufficient information to resolve its concerns. An inquiry not followed by an examination must be completed 90 days after the inquiry notice date.

If the concerns that led IRS to initiate the inquiry are not resolved after the first letter, IRS may then issue a notice of examination to the church which must provide specific information on the issues that led to the examination and an offer of a conference to resolve outstanding issues. This notice cannot be sent earlier than 15 days from the date of the notice of inquiry. IRS must then wait 15 additional days before formally beginning its examination of church records. Church examinations must be completed within 2 years of the date of the notice of examination. Also, no second inquiry or examination can be initiated on the same issue within 5 years without the approval of the Assistant Commissioner for Employee Plans and Exempt Organizations.

Under section 7611, IRS examines churches for two issues: (1) does the church have unrelated business income or otherwise engage in activities subject to tax and/or (2) should the organization continue to be tax-exempt? Within these issues, however, IRS has authority to pursue most of the principal issues that tend to arise in examinations of tax-exempt

organizations. For example, within the issue of whether the organization should continue to be tax-exempt, IRS can focus on political or lobbying activities, private inurement of members, or, in general, whether the organization is operating primarily for business purposes. (See the app. for more information on church inquiry and examination procedures, for rules relating to political and lobbying activities, and for rules related to private inurement.)

IRS does have authority to question church officials and conduct investigations in certain areas without invoking the section 7611 procedures. According to the Joint Committee on Taxation's explanation, Congress did not intend that IRS would be required to invoke the church audit procedures for routine inquiries, such as inquiries to a church regarding failure to file any required returns, compliance with income tax withholding responsibilities, any supplemental information needed to process a tax return, or confirmation that a particular business is or is not owned by a church. In addition, section 7611(i) specifically excludes criminal investigations and investigations relating to the tax liability of any person other than a church. For example, IRS might initiate such an investigation of an individual on suspicion of inurement of church funds to an individual. As a practical matter, however, IRS officials told us it is unlikely that a case of inurement could be thoroughly investigated without invocation of the church audit procedures in order to examine church financial records.

How Does IRS Ensure Church Tax Law Compliance?

IRS has no formal programs specifically designed to identify churches in need of examination. According to IRS officials, generally, the only method by which IRS will initiate an examination of a church for tax law compliance is based on outside information it receives, such as from the media and the public. The information must lead to a reasonable belief that the church is acting in a manner inconsistent with its tax-exempt status or has unreported income from sources unrelated to its exempt purpose or other potential tax liabilities.

Other methods that IRS uses to select nonchurch tax-exempt organizations for examination are not used for churches. Because churches are exempt by law from filing Form 990 information returns, churches cannot be selected for examination on the basis of an analysis of items on the Form 990 return. Because churches can only be examined on the basis of a reasonable belief that the church does not qualify for tax-exempt status or has potential unrelated business income or other tax liabilities, IRS is prohibited from randomly selecting churches as part of

its TCMP programs. For similar reasons, IRS does not examine churches as part of any special emphasis programs.

If IRS receives a complaint or other adverse information about a church, the information is generally reviewed by EO examination personnel. IRS officials told us that quality of information usually is more important than quantity. For example, a detailed letter from a former financial official of a church listing potential abuses would likely weigh more heavily in determining whether to initiate the church inquiry/examination process than would several vague letters from the general public. Other district and regional officials may then review the information. However, the final decision as to whether to initiate a church inquiry rests with the Regional Commissioner.

IRS officials in the seven regions said they make church examinations in accordance with the procedures in section 7611. In some cases, regions have devised cover sheets or checklists to help ensure that examiners adhere to the time frames and notifications mandated by section 7611. Some regional officials told us they assign church examinations only to their most experienced or senior examiners.

Table 3.1 shows the numbers and results of church tax inquiry or examination cases closed over the past several years.

Table 3.1: Results of EO Church Tax Inquiry or Examination Cases for Fiscal Years 1984 Through 1987

		Results of inquiry and examination[a]				
Fiscal year	Total cases closed	Tax-exempt status revoked	Tax-exempt status modified	Unagreed disposals	No change	Other
1984	36	3	3	3	19	8
1985	20	1	3	3	4	9
1986	6	3	0	0	1	2
1987	5	5	0	0	0	0
Total	**67**	**12**	**6**	**6**	**24**	**19**

Source: IRS' EO Automated Information Management System Statistics.

[a]For a period of time after the effective date of Internal Revenue Code section 7611, IRS statistical data did not separately distinguish between church inquiries and church examinations. As a result, many cases that were not resolved at the inquiry stage but that became examination cases remained in IRS' statistical data base as inquiry cases. Without actually reviewing the closed examination cases, we could not distinguish which cases were inquiries and which proceeded to examination.

We were able to review general statistical information on church inquiry and examination cases. However, IRS officials told us they were unable to locate most of the cases that were examined primarily because of difficulties in finding the cases at Federal Records Centers. As a result, we

were unable to obtain information on the principal examination issues in these closed cases.

As of September 30, 1987, IRS had 19 church inquiries or examinations ongoing. IRS officials said the issue of private inurement has become a more common issue in such cases in recent years. In these 19 cases, the issues were private inurement in 12 of the cases, unrelated business income in 4 cases, operation as a church or status as a church in 3 cases, operation as a tax-exempt entity in 2 cases, discriminatory practices in 2 cases, excessive lobbying in 1 case, and political activities in 1 case. These numbers do not add to 19 because some cases have more than one major issue.

Because most churches do not apply for tax-exempt status or file annual information returns, IRS' review of church applications and information returns plays only a limited role in monitoring churches for tax law compliance. When IRS does receive an application for tax exemption under section 501(c)(3) from a church, EO personnel at the district offices review the application to determine if the organization meets the criteria for tax-exempt status (see ch. 2). IRS' EO personnel also review the application to determine if the organization qualifies as a church. As discussed previously, there is no firm definition of church for tax purposes in law or regulation. However, the IRS National Office has issued guidance, in the form of 14 issues for consideration (listed on pp. 15 and 16), to assist EO personnel in making such determinations. If the EO official determines that the organization qualifies as a church, the organization is notified accordingly and is listed on the EO master file as a church.

We discussed the review of church applications with EO officials from each of the seven IRS regions. In each case, officials said they use the IRS National Office guidance to assist in making a determination of church status. However, in three cases, the key districts have developed questionnaires or additional guidance that supplements the National Office guidance contained in the Internal Revenue Manual. These questionnaires cover topics, such as the church ministry, worship services, and the operation of religious schools. IRS' EO master file data as of December 31, 1987, show that 43,283 organizations were classified as churches or affiliated organizations. IRS officials said that some of these organizations are parent churches, such as the U.S. Catholic Conference, which represents numerous individual churches. A 1987 estimate by the National Council of Churches shows that there are approximately 350,000 churches in the United States.

IRS officials said few churches file annual Form 990 returns, and those that do are informed by IRS that a return is not required to be filed in subsequent years. If a service center receives a Form 990 from a church and attempts to post that return information to the EO master file, the information will not be processable. This is either because there is no record of the organization on the EO master file or, for those churches that have applied for and received tax-exempt status, their master file records are coded so that IRS does not expect to receive, and hence cannot post, a Form 990 return. After an unpostable notice is generated, service center personnel send the Form 990 return to the dead return file where it is held for shipment to a Federal Records Center. The key district personnel then send a letter to the church notifying it that it is classified as a church in IRS records and therefore need not file a Form 990 return. IRS officials said they do not track how many churches file Form 990 returns annually. These officials told us they believe that the number of churches filing Forms 990 is probably very small.

Churches are required to file Form 990-T business tax returns if they have gross income of at least $1,000 from sources substantially unrelated to their exempt purposes. For the 12-month period ending July 31, 1987, IRS received a total of 676 Form 990-T returns from churches and affiliated organizations. IRS has no programs to identify churches that have never filed Forms 990-T but should do so. In addition, as stated above, churches are not required to and generally do not file Form 990 returns, even though these returns contain information that could assist IRS in determining if the organization should also file a Form 990-T return.

Criminal Investigations Involving Ministry Officials

Section 7611 specifically exempts certain investigations from the requirements of the church audit procedures. Among these are criminal investigations. Both IRS' Exempt Organizations Division and the Criminal Investigation Division may become involved in investigating tax avoidance schemes involving churches. One of the more common schemes that has arisen in the past is the mail order ministry. This term refers to organizations that are set up based on "church charters" purchased through the mail from organizations that claim that the charters and other "ministerial credentials" can be used to reduce or eliminate an individual's federal income tax liability.

IRS has been involved with illegal church tax avoidance schemes and mail order ministries for some time. We discussed these activities with

Criminal Investigation Division officials, who told us that their investigations have always involved individuals (e.g., ministers) and have never involved investigations of church organizations. These officials also told us that they were very active in investigating these types of cases in the late 1970s and early 1980s. They said that their efforts in this area have decreased since then and continue to decrease because of higher priority issues. Table 3.2 shows the numbers of Criminal Investigation Division church tax protestor cases initiated in the past 4 years, and the results of these cases.

Table 3.2: Results of Church Tax Protestor Cases for Fiscal Years 1984 Through 1987

Fiscal year	Total Cases initiated	Prosecution not pursued	Conviction	Acquittal	Cases pending
1984	103	67	21	1	14
1985	39	10	3	0	26
1986	27	8	3	0	16
1987	5	0	0	0	5
Total	**174**	**85**	**27**	**1**	**61**

Source: IRS Case Management and Time Reporting System Statistics.

Summary

IRS is required to make distinctions between churches and other religious organizations because they are afforded different treatment under the law. There is no definition of "church" in law or regulation. IRS makes these determinations on a case-by-case basis, considering all the relevant facts and circumstances as outlined in the 14 points used in its guidelines. The tax laws do not require churches to apply for tax-exempt status and file annual information returns. In addition, the law requires IRS to follow specific procedures when initiating and conducting an inquiry or examination of a church for tax law compliance.

IRS' efforts to monitor churches for tax law compliance are affected by the tax laws governing churches. Churches are not required to apply, and therefore most churches do not apply for tax-exempt status. Consequently, IRS has no information about most churches in the country. Few churches file annual information returns with IRS, and those that do are informed that a return is not required to be filed. IRS has no programs to identify churches in need of examination—it will however consider examining a church if it receives information that the church may not be acting in accordance with its tax-exempt status or is engaging in taxable activities. IRS has closed a total of 67 church inquiries or examinations over the past 4 fiscal years, and as of September 30, 1987, had 19 ongoing church inquiry or examination cases.

IRS has also conducted criminal investigations of individuals who have attempted to avoid paying taxes by claiming church status. These investigations are, by law, outside the scope of the church audit procedures. One of the common types of tax avoidance schemes is the so-called mail order ministry. Criminal investigations into such church tax avoidance schemes have been declining in recent years.

IRS Cites Difficulties in Administering the Tax Laws Related to Churches

In our discussions at IRS, at recent hearings before the Subcommittee on Oversight of the House Ways and Means Committee on television ministries[1] and at the Commissioner's Exempt Organization Advisory Group meetings, IRS officials identified three issues affecting their ability to effectively administer the tax laws as they relate to tax-exempt religious organizations and churches. Two issues relate specifically to churches—the issue of whether churches should file for tax-exempt status and file annual information returns, and the issue of whether the section 7611 church audit procedures limit IRS' ability to effectively monitor churches for tax law compliance. The third issue concerns the difficulty in making relatively subjective judgments about inurement, unrelated business income tax, and lobbying activities and is common to all tax-exempt organizations, including religious organizations and churches.

Information Reporting by Churches

Because churches are not required to file for exempt status or report on their activities, IRS does not have information on its master file for the vast majority of churches in the country. This lack of information affects IRS' oversight in two key ways. First, it limits IRS' ability to monitor whether the organization is organized and operating in accordance with its tax-exempt purposes. Second, for churches that have related tax-exempt organizations, the lack of information from the church may result in an incomplete picture of a group of related organizations.

Information on the application for tax exemption and on the Form 990 annual information return relates to many of the issues that can arise in determining whether an organization is organized and is being operated in accordance with its tax-exempt purposes. For example, questions on the annual information return cover the types of program services provided and whether the organization is involved in activities not previously reported to the IRS. A program service is a major objective of the organization, for example, adoptions, recreation for the elderly, or publication of journals or newsletters. Such information could be useful in helping to determine whether the organization was performing activities not in accordance with its exempt purposes and whether the organization might have unrelated business income. Also, questions on both the application and annual information return relate to compensation of

[1] Hearing on Federal Tax Rules Applicable to Tax-Exempt Organizations Involving Television Ministries before the House of Representatives, Subcommittee on Oversight, Committee on Ways and Means (Oct. 6, 1987).

officers, directors, and trustees. Such information could be useful in identifying potential private inurement.

For some churches with related religious organizations, the lack of information from the church could affect IRS' ability to obtain a complete picture of the activities and financial transactions of such groups of related organizations. For example, a religious broadcaster could organize several separate tax-exempt organizations. One organization might be a religious broadcasting facility that had applied for and been granted tax exemption under section 501(c)(3). There might be other section 501(c)(3) organizations, such as a religious publisher, an evangelical organization, or a recording studio, all of which were recognized by IRS as tax-exempt under section 501(c)(3). There also might be a section 501(c)(4) social welfare organization. Finally, the religious broadcaster may also have a church. All of the organizations recognized by IRS as tax-exempt would probably be required to file annual information returns, given that they had sufficient gross receipts. However, the church itself would not be required to file. IRS would have returns with which to review activities and financial transactions of the recognized tax-exempt organizations, but it would lack a complete picture of the income, expenses, and activities of the group of related organizations, including transactions among the organizations, because information from the church was not available.

At hearings held on October 6, 1987, before the Oversight Subcommittee of the House Committee on Ways and Means, both Treasury and IRS officials testified on the impact of churches not being required to file annual returns. Regarding current law that excepts churches from reporting requirements, Assistant Secretary (Tax Policy) Chapoton said,

> "This [exception] has consequences for the administration of the tax laws. An organization which is not entitled to be considered a church for purposes of the tax laws can nonetheless take the position that it is a church. On that basis, it can claim exemption from the filings needed by the IRS to determine whether the organization is in fact a church. Without this information, it is difficult for the IRS to identify possible violations of the law. Thus, the procedural rules make enforcement of the substantive rules difficult."[2]

[2]Statement by O. Donaldson Chapoton, Assistant Secretary (Tax Policy), Department of the Treasury, before the House of Representatives, Subcommittee on Oversight, Committee on Ways and Means (Oct. 6, 1987), p. 11.

IRS' Commissioner Gibbs spoke of the potential effects of the current tax laws for churches on the public's confidence in IRS' ability to administer the tax laws for all tax-exempt organizations:

"...Although current law imposes responsibility on the Service for enforcing the tax laws in this area, current law also imposes substantial impediments to effective enforcement action by the Service in this area. These impediments prevent the Service from dealing with tax abuses and violations in this area as effectively and efficiently as the Service is able to act in other areas of the tax law.

...We are concerned that a public perception of the Service as an agency ill-equipped to deal with law violations and abuses, except for the most flagrant and publicized ones, has the potential to undermine public confidence in the laws pertaining to tax-exempt organizations."[3]

Within the religious broadcasting community there are differing views on the desirability of churches filing some sort of annual information return. At the October 6 hearings, some religious broadcasters discussed whether churches should be required to file some sort of annual information return with IRS. A few adamantly opposed filing any kind of report with IRS, basing their objections, in part, on their interpretation of the First Amendment. Others said they recognized these concerns but had no problem filing such a return.

This issue also arose at the Commissioner's Exempt Organizations Advisory Group meeting held on September 16 and 17, 1987. During a public discussion period, two representatives of major U. S. denominations urged a cooperative effort between the churches and IRS to resolve problems in the area of tax administration. However, these representatives also said they would object strongly to any requirement for churches to file annual Form 990 returns.

Two other organizations—the Evangelical Council for Financial Accountability (Council) and the National Religious Broadcasters—have attempted to promote financial self-disclosure by churches and other religious organizations, including religious broadcasters.

The Council was incorporated in 1979 and is a voluntary association of about 400 nonprofit Christian ministries that emphasizes and encourages public disclosure of finances and programs. Council membership is limited to organizations that subscribe to a written statement affirming

[3]Statement by Lawrence B. Gibbs, Commissioner of Internal Revenue, before the House of Representatives, Subcommittee on Oversight, Committee on Ways and Means (Oct. 6, 1987), pp. 3 and 4.

a commitment to the evangelical Christian faith. In order to apply for Council membership, an organization must have applied for and been recognized by IRS as having tax-exempt status under section 501(c)(3). The Council has issued standards of operation and fund-raising to which member organizations must certify that they adhere. These include a requirement that member organizations have audited annual financial statements that must be made available to the public upon request. Also member organizations are required to have a functioning audit review committee and must be governed by a board whose majority are not employees of the member organization nor related to each other by blood or marriage. Member organizations receive a Council seal that may be used in fund-raising and promotional publications. In addition, the Council recently sponsored the publication of an accounting and financial reporting guide for use by Christian ministries. Several prominent religious broadcasters are currently members of the Council.

National Religious Broadcasters is an association of approximately 1,300 religious broadcasters whose primary objectives are to assure that religious broadcasters continue to have access to the airwaves and to promote excellence in religious programming. The National Religious Broadcasters recently developed a code of ethics for members who are exempt from taxation under section 501(c)(3) and who solicit funds over the airwaves. This code requires, among other things, that these members make available to the public an annual report and financial statements on their operations. At its 1988 annual convention, the National Religious Broadcasters voted to make compliance with this code a requirement for membership.

Church Examination Procedures

IRS is required to use special church audit procedures when examining churches for tax law compliance. IRS field office and National Office officials told us that section 7611 restricts IRS' ability to (1) conduct church examinations and (2) actively monitor churches for tax law compliance outside the examination process.

Several IRS field officials we talked to cited provisions of section 7611 as significantly restricting the ability of IRS to examine churches. Two provisions, one involving the "reasonable belief" standard and one involving the time limitation for completing examinations, received the most comments. Under section 7611, IRS can only initiate a church inquiry or examination if a Regional Commissioner, or higher level official, reasonably believes that a church is engaged in taxable activities or is no longer eligible for tax-exempt status. One official said it was sometimes

difficult to decide what evidence is sufficient to meet this standard. Under section 7611, IRS is also required to complete any church examination and make a final determination not later than 2 years from the date of the examination notice. An IRS field official told us that because many churches often do not have the sophisticated accounting records or documentation on income and expenditures, examinations may take longer than usual. Also, other provisions in the law, such as the various required approvals by IRS Regional Counsels and other IRS officials may further make the 2-year time limit for concluding examinations difficult to meet.

In addition to IRS field officials' views, we discussed the administration of section 7611 with IRS officials from the Office of the Assistant Commissioner (Employee Plans and Exempt Organizations.) These officials expressed the opinion that in several ways, section 7611 can cause difficulty in administering the tax laws for churches. They raised the following concerns about this section:

- First, the statute provides that the term church includes any organization claiming to be a church. IRS officials said this effectively allows an organization to determine for itself whether it is a church and thus whether it should file an application for recognition of exemption and annual information returns.
- Second, an organization can assert or deny a claim to church status at any time, including during the examination process.
- Third, IRS faces difficulty in completing some church examinations within the 2-year time limit, particularly for large, complex cases or cases where reliable accounting records are lacking. This has required IRS, in some cases, to use substantial additional resources to meet the time limit.

We discussed with IRS officials the numbers of church inquiries and examinations conducted before and after December 31, 1984, the effective date of section 7611. These officials said that under the old rules for church examinations (section 7605(c)), IRS settled more questions about church activities informally—for example, through correspondence—without resorting to the initiation of church inquiry or examination procedures, which would be required to answer such questions under the new rules (section 7611).

We also discussed with IRS' National Office officials the effects of section 7611 on IRS' efforts to monitor churches for tax law compliance outside

the examination process. IRS officials said that as a result of the reasonable belief standard set forth in this section, IRS has been reluctant to actively monitor churches. An IRS National Office official told us that IRS did not now have in place and would not have in the future any agency-wide programs to actively monitor churches for tax law compliance. However, some regional officials told us they collect information, such as from the mass media or other sources, on churches and maintain files of such information.

Other Tax Law Administration Difficulties

IRS has some of the same problems in administering the tax laws for churches and religious organizations as it does for other tax-exempt organizations. These problems center on interpretations IRS must make in determining such matters as what constitutes (1) inurement, (2) "substantially related" activities (for purposes of determining whether an organization has unrelated business income), and (3) substantial lobbying activities.

An organization cannot qualify for tax-exempt status if any part of its net earnings inures to the benefit of a private individual. Inurement can take the form of excessive compensation to an individual within the organization. In order to determine whether compensation is excessive, IRS generally looks to comparable employment agreements—the size of the compensation relative to the size of the organization and the nature of the services provided by the individual. Treasury officials have said that it is sometimes difficult to determine what are appropriate comparable employment agreements. For example, in the case of religious broadcasters, should the compensation involved be compared to other religious leaders, other broadcast personalities, or other fund-raisers? Assistant Treasury Secretary Chapoton has said that the difficulty of determining reasonable compensation and, hence, inurement exists across a wide range of charitable organizations. He has suggested that Congress may want to consider prescribing procedural safeguards against unreasonable compensation, such as allowing compensation above a specified dollar amount only with the approval of an independent compensation committee.

Churches and all other section 501(c)(3) organizations are subject to a tax, the unrelated business income tax (UBIT), on business income derived from activities not substantially related to their exempt purposes. UBIT was enacted in 1950 and was extended to churches in 1969. IRS officials have said that UBIT is often difficult to administer because there are no concrete rules for determining the relatedness of an income-

producing activity to an exempt purpose. For churches, IRS has the added difficulty that there is no associated Form 990 information return to examine to determine if the organization should file an unrelated business income tax return. In fact, IRS has no programs to identify churches that should file UBIT returns but that are not currently doing so. The Oversight Subcommittee of the House Committee on Ways and Means is currently considering potential changes to the law to provide for better administration of UBIT.

Churches and all other section 501(c)(3) organizations are not permitted to engage in substantial lobbying activities. The determination of what constitutes substantial lobbying activities causes two major difficulties for IRS. First, IRS must determine whether the activities involved are "lobbying." Second, IRS must then determine whether these lobbying activities are substantial.

Summary

Current tax laws contain special rules relating to churches that have consequences for IRS' ability to administer the laws effectively. In particular, IRS officials believe that the fact that churches are not required to file for exempt status or report financial information annually to IRS makes it difficult for IRS to monitor these organizations for tax law compliance. Within the church and religious broadcaster communities there are varying views on the need for, or desirability of, filing annual financial information with IRS. Two organizations have suggested that churches' voluntary self-disclosure would be a useful tool for promoting financial accountability of churches and religious broadcasters, possibly as an alternative to filing annual information returns.

IRS officials also believe that the church audit procedures, contained in section 7611, can cause difficulties in initiating and conducting examinations or investigations of churches that may not be in compliance with the tax laws. IRS officials told us that much more evidence is required to initiate church examinations than for other tax-exempt organizations. Examination initiation must be approved by Regional Commissioners, and examinations must be completed within restrictive time frames.

Some of the same difficulties IRS has in administering the tax-exempt laws for other section 501(c)(3) organizations are applicable to churches. These include determining if compensation is private inurement, deciding whether income producing activities are "substantially unrelated" to the church's or religious organization's exempt purposes, and determining compliance with lobbying activity prohibitions.

When religious organizations, including religious broadcasters, organize and operate as churches, the information they furnish to IRS is generally limited. As a result, IRS' ability to identify noncompliance with the tax law usually depends on information it receives from the media and the public. The limited sources and amounts of information, along with the restrictions of the church audit procedures that IRS must apply to churches have discouraged IRS' activities in this area.

Joint Committee on Taxation, Overview of Tax Rules Application to Exempt Organizations Engaged in Television Ministries (JCS-21-87), October 5, 1987

[JOINT COMMITTEE PRINT]

OVERVIEW OF TAX RULES APPLICABLE TO EXEMPT ORGANIZATIONS ENGAGED IN TELEVISION MINISTRIES

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON OCTOBER 6, 1987

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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(III)

INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing on October 6, 1987, on the Federal tax rules applicable to tax-exempt organizations engaged in television ministries.

In its press release on the hearing dated September 14, 1987, the Subcommittee stated that it "intends to consider the Internal Revenue Service's administration and enforcement of present Federal tax law, and television ministries' interpretation of, and compliance with, these rules." The release also states that "the Subcommittee is not undertaking to investigate any specific television ministry or tax-exempt organization," and is "not questioning religious practices or beliefs." Further, the release notes, "Constitutional issues involved in the Federal tax laws that the Subcommittee will be reviewing have been addressed by the courts." Accordingly, the release states that "the Subcommittee will not consider any such matters at the hearing, but rather, will focus on the operation of present-law rules."

This pamphlet,[1] prepared in connection with the hearing, contains an overview of tax rules applicable to exempt organizations engaged in television ministries. The tax rules described in this pamphlet, which generally apply to churches or other religious organizations (whether or not engaged in broadcast ministries), relate to (a) the tax status of churches and other religious organizations (including rules relating to filing an exemption application and information returns), (b) the prohibition on inurement of net earnings of a tax-exempt religious or charitable organization to private interests, (c) restrictions on the political and lobbying activities of charitable organizations, (d) application of the unrelated business income tax to religious organizations, (e) the tax treatment of transfers to charities in exchange for goods or services, and (f) restrictions on IRS audits of churches.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Overview of Tax Rules Applicable to Exempt Organizations Engaged in Television Ministries* (JCS-21-87), October 5, 1987.

(1)

OVERVIEW OF TAX RULES APPLICABLE TO EXEMPT ORGANIZATIONS ENGAGED IN TELEVISION MINISTRIES

A. Tax Status of Churches and Other Religious Organizations

General rules

An organization that is formed and operated exclusively for religious purposes qualifies for exemption from Federal income tax, and is eligible to receive tax-deductible contributions, provided that no part of its net earnings inures to the benefit of any private individual and that the organization does not violate applicable restrictions on lobbying activities and prohibitions on political campaign activities (secs. 501(c)(3) and 170). For example, a nonprofit religious broadcasting station may qualify for tax-exempt status under section 501(c)(3) where the station broadcasts worship services conducted by ministers, religious guidance, and inspirational music, and does not devote more than an insubstantial amount of broadcast time to commercially sponsored nonreligious programs.[2]

More favorable tax rules apply in the case of churches than in the case of other types of religious organizations. Churches are not required to file an exemption application with the IRS, or to receive a determination of tax-exempt status from the IRS, as a condition of exemption from income tax or eligibility to receive tax-deductible contributions;[3] also, churches are not required to file annual information returns with the IRS.[4] In addition, as described below, IRS audits of churches are subject to special restrictions.

A religious organization that constitutes a church is classified as a public charity rather than as a private foundation, whether or not the organization is publicly supported.[5] Accordingly, donors to churches (like donors to other public charities) generally receive more favorable treatment of their contributions than donors to certain other types of charitable organizations.

Definitions

The terms "religious" and "church" are not defined in either the Internal Revenue Code or Treasury regulations. For administrative purposes, the IRS has formulated certain criteria to which it refers in ascertaining whether a religious organization constitutes a

[2] Rev. Rul. 68-563, 1968-2 C.B. 212, amplified in Rev. Rul. 78-385, 1978-2 C.B. 174. Any income received from the presentation of commercial programs, including income from the sale of advertising for air time, is subject to the unrelated business income tax under secs. 511-513 (Rev. Rul. 78-385).

[3] Sec 508(c)(1)(A). This exception to the exemption application requirement also applies to conventions or associations of churches and to integrated auxiliaries of churches.

[4] Sec. 6033(a)(2)(A)(i). This exception to the information return requirement also applies to conventions or associations of churches, integrated auxiliaries of churches, and the exclusively religious activities of any religious order.

[5] Secs. 509(a)(1), 170(b)(1)(A)(i). This rule also applies to conventions or associations of churches.

(2)

church. The IRS position is that, in order to qualify as a church for Federal income tax purposes, an organization must satisfy at least some of the following criteria: (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 or discipline; (5) a distinct religious history; (6) a membership not associated with any other church or denomination; (7) a complete organization of ordained ministers ministering to their congregations and selected after completing prescribed courses of study; (8) a literature of its own; (9) established places of worship; (10) regular congregations; (11) regular religious services; (12) schools for the religious instruction of the young; (13) schools for the preparation of its ministers; and (14) any other facts and circumstances that may bear upon the organization's claim to church status.[6]

The U.S. Tax Court has stated that these criteria developed by the IRS for administrative purposes are useful guidelines, but not controlling rules, in determining whether an otherwise tax-exempt religious organization qualifies for the narrower category of a church. In making this determination, the Tax Court has taken into account such factors as whether such an organization provides regular religious services, conducted by an organized ministry, for established congregations at established places of worship; whether the organization has a distinct religious history and beliefs that set it apart from other recognized religions; and whether the organization has more than merely incidental associational aspects.[7]

For example, in a recent case,[8] the Tax Court held that an organization (the Foundation of Human Understanding) that spread the teachings of its founder through radio broadcasts, books, pamphlets, and a magazine and also regularly conducted religious services constituted a church for Federal income tax purposes. The broadcasting and publishing activities accounted for a large percentage of the organization's total expenditures and receipts. Noting that "the call to evangelize or otherwise spread one's religious beliefs is, undeniably, an integral part of many faiths," the Court also found that the organization's substantial broadcasting and publishing activities did not "overshadow the other indications" that it constituted a church. The Court emphasized that the organization, which employed nine ordained ministers, regularly conducted religious services several times a week at two locations where its followers congregated. Finding that the organization's associational aspects were "much more than incidental" and that other criteria listed by the IRS had been met, the Court concluded that the organization constituted a church for Federal income tax purposes.

Courts have uniformly rejected claims of tax-exempt status for, or deductibility of contributions to, "mail-order ministries" and similar situations where individuals attempt to claim "church" status as part of tax-avoidance schemes.[9] Mail-order ministries gen-

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[6] *See* IRS Manual 7(10)69 Exempt Organizations Examination Guidelines Handbook, sec. 321.3 (April 5, 1982).

[7] *See, e.g., Foundation of Human Understanding* v. *Comm'r*, 88 T.C. No. 75 (1987) (reviewed by the Court); *Pusch* v. *Comm'r*, 39 T.C.M. 838, *aff'd.* 628 F.2d 1353 (5th Cir. 1980).

[8] *Foundation of Human Understanding* v. *Comm'r*, *supra*, note 7.

[9] *See, e.g., Miedaner* v. *Comm'r*, 81 T.C. 272, 282 (1983); *Basic Bible Church* v. *Comm'r*, 74 T.C. 846 (1980); Rev. Rul. 81-94, 1981-1 C.B. 330; Rev. Rul. 78-232, 1978-1 C.B. 69.

erally are situations where a secularly employed individual places all of his or her wages in an organization created through the use of a mail-order charter under which the organization pays for the individual's living expenses.

B. Prohibition of Inurement to Private Interests

In general

An organization cannot qualify for tax-exempt status as a church, or other religious or charitable organization, and is not eligible to receive tax-deductible contributions, if any part of its net earnings inures to the benefit of a private individual (secs. 501(c)(3), 170). This prohibition is intended to ensure that the organization fulfill the rationale for such tax benefits by devoting itself exclusively to the public good, and to prevent the organization from conferring financial benefits (other than reasonable compensation) on persons having a personal or private interest in its activities.[10]

In applying the prohibition on inurement, court decisions have closely scrutinized churches or other entities that are controlled by one person because of the potential for abuse in such organizations, and have stated that such a closely controlled organization must make full disclosure to the court of all relevant facts bearing on its exemption application or claim of exempt status.[11]

Forms of inurement

Private inurement can take a variety of forms, including the payment of dividends or excessive compensation to an individual with an interest in the organization.[12] In determining whether an employee or other recipient of payments from an exempt organization has received excessive compensation, all benefits received in exchange for services—such as bonuses, deferred compensation, below-interest or unsecured loans, payments of personal expenses, the personal use of cars, airplanes, or residences, and other benefits—are taken into account, as well as salaries.

Reasonable compensation generally is defined as the amount that would ordinarily be paid for like services by like organizations under like circumstances (*see* Treas. Reg. sec. 1.162-7(b)(3)). Under this standard, reasonableness generally is determined by reference to comparable employment agreements. Relevant factors cited in assessing comparability have included the date on which the service contract was made, the size of the organization, the nature of the services provided, and the individual's qualifications, experience, and familiarity with the organization.

Private inurement can occur through means other than the payment of dividends or excessive compensation. In a recent decision,[13] the Ninth Circuit Court of Appeals upheld revocation of the

[10] *See* Treas. Reg. secs. 1.501(c)(3)-1(c)(2), 1.501(a)-1(c), 1.501(c)(3)-1(d)(1)(ii).

[11] *See, e.g., Church of Scientology of California v. Comm'r*, 1987-2 U.S.T.C. par. 9446 (9th Cir. 1987), *aff'g* 83 T.C. 381 (1984); *Bubbling Well Church of Universal Love v. Comm'r*, 74 T.C. 531, 535 (1980), *aff'd*, 670 F.2d 104 (1981).

[12] *See, e.g., Founding Church of Scientology v. U.S.*, 412 F.2d 1197 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970); *Unitary Mission Church v. Comm'r*, 74 T.C. 507 (1980), *aff'd*, 647 F.2d 163 (2d Cir. 1981); *Easter House v. U.S.*, — F.2d — (Ct. Cl. 1987); *cf. Presbyterian and Reformed Publishing Co. v. Comm'r*, 743 F.2d 148 (3d Cir. 1984) (salaries held reasonable).

[13] *Church of Scientology of California v. Comm'r*, 1987-2 U.S.T.C. par. 9446 (9th Cir. 1987).

exemption of the Church of Scientology (California) on a finding of inurement, through means other than salary payments, of net earnings to the benefit of L. Ron Hubbard, founder of the Church, and others. The facts cited by the Court included (1) the Church's aggressive marketing of Hubbard's works and its practice of copyrighting publications authored by Church employees in his name, in conjunction with payments of substantial royalties; (2) Hubbard's "unfettered control over millions of dollars in Church assets," in the absence of testimony and documentation to trace the source and use of these funds; and (3) payment of 10 percent of the gross income of Scientology congregations, franchises, and organizations to Hubbard. The exact dollar amount of these latter payments was deemed irrelevant, the Court held, inasmuch as the statute provides that "no part" of an exempt organization's net earnings may inure to a private individual.

Nonabusive compensation arrangements

In some circumstances, payments based on a percentage of net profits have been held not to violate the prohibition on inurement. For instance, the IRS has permitted tax-exempt organizations to adopt percentage compensation arrangements if the following five circumstances are present:

(1) the arrangement derives from a completely arm's-length contractual relationship, with the service-provider having no participation in the management or control of the organization;

(2) the contingent payments serve a real and discernible business purpose independent of any purpose to operate the organization for the benefit of the service-provider;

(3) the amount of the compensation is not dependent principally on revenue of the exempt organization but rather on the accomplishment of the objectives of the compensatory contract;

(4) review of the actual operating results reveals no evidence of abuse or unwarranted benefits; and

(5) there is a ceiling or reasonable maximum so as to avoid the possibility of a windfall benefit to the service-provider based on factors having no direct relationship to the level of service provided.[14]

In addition, the Internal Revenue Service has permitted a tax-exempt organization to offer its employees a qualified profit-sharing plan, so long as the amount contributed to the plan constituted reasonable compensation and the plan met other requirements of Federal law.[15] In doing so, the IRS acknowledged that such plans further an exempt purpose by increasing employee productivity.

Parsonage allowance

In general

The Code provides an exclusion from gross income for (1) the rental value of a home furnished to a minister as part of the minister's compensation, or (2) a rental allowance paid to a minister as part of compensation to the extent used to rent or provide a home (sec. 107). The rental allowance exclusion applies to amounts of

[14] G.C.M. 38905 (June 11, 1982).
[15] G.C.M. 38283 (February 15, 1980).

compensation used during the year to rent or otherwise provide a dwelling, including directly related expenses. Thus, the exclusion applies to the value of a dwelling furnished to the minister, together with furniture, fixtures, and appliances; rent or mortgage payments for a residence; costs of improvements or remodeling; and expenditures for utilities, insurance, and maintenance and repair.[16]

Under the present law, there is no limit on the amount of the exclusion for a parsonage allowance, provided that the amount does not exceed reasonable compensation for the minister's services, and any rental allowance is, in fact, used by the minister to rent or otherwise provide a home.[17]

Deductibility of interest and tax

In 1983, the IRS ruled that a minister could not claim deductions for mortgage interest and real estate taxes on a residence to the extent such expenditures were allocable to tax-free housing allowances received by the minister. The IRS took the position that where a taxpayer incurred expenses for purposes for which tax-exempt income was received, permitting a full deduction for such expenses would lead to a double benefit not allowed under section 265 (disallowing deductions for expenses allocable to tax-exempt income).

The Tax Reform Act of 1986 overruled the IRS position and provided that section 265 shall not disallow otherwise allowable deductions for interest paid on a mortgage on, or real property taxes paid on, the home of a minister, on account of an excludable parsonage allowance. Accordingly, a minister may exclude the amount of compensation received as a housing allowance, and (if the minister itemizes deductions) may offset other income with deductions for expenditures for residential mortgage interest and real estate taxes.

C. Restrictions on Political and Lobbying Activities

In general

Charitable organizations for which deductions are allowed for Federal income tax purposes, including churches, cannot engage in any political activity and cannot engage in more than an insignificant amount of lobbying activity (secs. 501(c)(3) and 170(c)(2)).[18] Thus, if a church intervenes in a political campaign or engages in substantial lobbying, including through the use of broadcast facilities, then its tax-exempt status may be jeopardized.[19]

[16] *See* Treas. Reg. sec. 1.107-1(c); *Jimmy L. Swaggart v. Comm'r*, 48 T.C.M. 759 (1984).

[17] Treas. Reg. sec. 1.107-1(a); Rev. Rul. 78-448, 1978-2 C.B. 105.

[18] In the case of exempt organizations for which charitable deductions for contributions are not allowed for Federal income tax purposes, the rules are much less restrictive. In some cases, both lobbying and political activities are allowed so long as those activities are not the principal activity of the organization. For a discussion of the rules governing political and lobbying activities of different types of exempt organizations, see Joint Committee on Taxation, *Lobbying and Political Activities of Tax-Exempt Organizations* (JCS-5-87), March 11, 1987.

[19] The question of whether or not the tax-exempt status of a church can be revoked because of its participation in political or lobbying activities raises a number of constitutional issues. For cases involving these issues, see *Christian Echoes National Ministry, Inc. v. United States*, 470 F.2d 849 (10th Cir. 1972) (religious organization which broadcast radio and television shows

Continued

Political activity

Because section 501(c)(3) organizations are subject to a ban on political activity, the principal issue presented by this rule is, simply, the definition of "political" activity. In general, prohibited political activity involves the participation or intervention, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office.[20] The office involved can be national, state, or local; and it is not required that the election be contested or involve the participation of political parties.[21]

The determination of what constitutes intervention in a political campaign requires weighing all relevant facts and circumstances.[22] Section 501(c)(3) specifically mentions "the publishing or distributing of statements" that support or oppose a candidate as examples of political intervention. Other clear examples would include making or soliciting campaign contributions, providing publicity or volunteer assistance, and paying expenses of a political campaign. In many cases, the critical issue in determining whether an activity constitutes intervention in a political campaign is whether it reflects or advances a preference between competing candidates.[23]

When members of an organization are involved in political activities, it is necessary to determine whether such activities are attributable to the organization, or instead are undertaken independently by the individuals in their private capacities. In general, principles of agency are relevent to this determination. For example, acts undertaken by individuals under actual or purported authority to act for the organization, and acts planned or ratified by the organization, are considered activities of the organization.[24] Where an exempt organization uses a business subsidiary as a "guise" for carrying out particular activities without restriction, the subsidiary's activities are attributed to the parent.[25]

Lobbying activity

In contrast to the absolute ban on political activity, a church or other organization seeking exemption under section 501(c)(3) is permitted to engage in some lobbying activity provided that the activity is not "substantial." Thus, it is necessary for purposes of section 501(c)(3) not only to define "lobbying" activity, but also to determine the meaning of the term "substantial."

In general, a section 501(c)(3) organization is engaged in lobbying activity if it advocates the adoption or rejection of legislation. For

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found not to be tax-exempt on ground that it engaged in political and lobbying activities); *In re United States Catholic Conference and National Conference of Catholic Bishops*, 824 F.2d 156 (2d Cir. 1987) (holding that trial court had colorable basis for exercise of subject matter jurisdiction over lawsuit alleging that the Catholic Church has engaged in political activity violative of section 501(c)(3) by opposing candidates who support the allowability of abortions). Such constitutional issues are beyond the scope of this pamphlet.

[20] Sec. 501(c)(3); Treas. Reg. sec. 1.501(c)(3)-1(c)(3)(iii).

[21] Treas. Reg. sec. 1.501(c)(3)-1(c)(3)(iii); Rev. Rul. 67-71, 1967-1 C.B. 125.

[22] *See, e.g.*, Rev. Rul. 78-248; 1978-1 C.B. 154.

[23] Endorsing a candidate for public office constitutes intervention in a political campaign. *See, e.g.*, G.C.M. 39941 (November 7, 1985). It also has been held that opposing a candidate likewise constitutes intervention, even if the organization does not formally endorse the candidate's opponent. *See, e.g.*, *Christian Echoes National Ministry*, *supra*. *See also* section 201(a) of H.R. 2942, introduced on July 15, 1987, which would codify that position.

[24] *See* G.C.M. 34631 (October 4, 1971).

[25] *See* G.C.M. 33912 (August 15, 1968).

this purpose, the term "legislation" includes action by Congress or any State or local legislative body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure.[26] Lobbying includes such activities as (1) directly contacting members of a legislative body (or their staffs) to propose, support, or oppose legislation, (2) grass roots lobbying (urging the public to contact legislators or legislative staffs to propose, support, or oppose legislation), and (3) more generally, advocating the adoption or rejection of legislation.[27]

If it is determined that an organization otherwise qualifying under section 501(c)(3) has engaged in lobbying, it is then necessary to determine whether the lobbying activity was substantial. The Internal Revenue Code does not explain the meaning, in this context, of the term "substantial"; and there is no precise mechanical rule for determining the substantiality of an organization's lobbying activities in relation to its other activities.[28] In particular, an arithmetical percentage test (e.g., looking at the percentage of the budget, or of employees' time, spent on lobbying), while relevant, has been held not determinative.[29] The reason for not looking solely at the percentage of time or money spent by an organization on lobbying is that such an approach might give an incomplete picture to the extent that it does not reflect any volunteer time and publicity devoted to the lobbying activities by an organization, and the continuous or intermittent nature of the organization's involvement in such activities.[30]

D. Unrelated Business Income Tax

Elements of an unrelated trade or business

Under present law, tax-exempt organizations are subject to tax on their unrelated business income. Subject to specified exceptions and modifications, income derived from an activity of an otherwise tax-exempt organization is subject to the unrelated business income

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[26] Treas. Reg. sec. 1.501(c)(3)-1(c)(3)(ii). Attribution principles, similar to those applied with political activities, are used to determine if the lobbying activities of members of an organization are attributable to the organization itself.

[27] There are a number of circumstances, however, in which commenting on proposed legislation is not treated as lobbying. These include (1) making available the results of nonpartisan analysis, provided the organization takes no position, and (2) providing technical advice or assistance in response to a formal request by a governmental body. *See* Rev. Rul. 64-195, 1964-2 C.B. 138, Rev. Rul. 70-449, 1970-2 C.B. 111. In addition, lobbying may not include certain activities that are directly in the self-interest of the exempt organization itself, such as commenting on legislation that might affect any organization's existence, powers and duties, or tax-exempt status. Moreover, lobbying may not include soliciting government funds for the organization's programs. *See Slee v. Comm'r* 42 F.2d 184 (2d Cir. 1930).

[28] Under section 501(h), enacted by Congress in 1976, certain organizations seeking to qualify under section 501(c)(3) can elect to have the amount of lobbying in which they may engage measured under a precise arithmetical test (which sets separate limits on direct lobbying and grass roots lobbying) rather than just the general "substantiality" standard. However, certain types of organizations, including churches, cannot elect the application of section 501(h). Churches were made ineligible for section 501(h) election at their own request, after expressing concerns that both prior law and the rules under section 501(h) might infringe upon their constitutional rights under the First Amendment. *See* Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* at p. 415.

[29] *See Seasongood v. Comm'r*, 227 F.2d 907 (6th Cir. 1955), (where less than 5 percent of an organization's time and effort were spent on lobbying activities, such activities were not substantial in relation to the organization's other activities); *Haswell v. United States*, 500 F.2d 1133 (Ct. Cl. 1974), *cert. denied*, 419 U.S. 1107 (1975) (the fact that an organization spent between 16.6 percent and 20.5 percent of its budget on lobbying provided a strong indication of substantiality).

[30] G.C.M. 36148 (January 28, 1975).

tax (UBIT) if (1) the income is derived from a trade or business, (2) the trade or business is regularly carried on by the organization, and (3) the conduct of the trade or business is not substantially related (aside from the organization's need for revenues or the use it makes of such revenues) to the organization's performance of its tax-exempt functions (secs. 512(a), 513(a); Treas. Reg. sec. 1.513-1(a)).

Definition of trade or business

In general, any activity that is carried on for the production of income from the sale of goods or the performance of services constitutes a trade or business for purposes of the UBIT. Such an activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or other endeavors that may be related to the organization's exempt purposes.[31] For example, advertising activities do not lose their identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization.[32] If an activity carried on for profit constitutes an unrelated trade or business, no part of the activity will be disregarded merely because it does not result in profit.[33]

Regularly carried on test

Even if an exempt organization conducts an unrelated trade or business, the income therefrom is not subject to the UBIT unless the activity is "regularly carried on" by the organization (sec. 512(a)). This test looks to the frequency and continuity of the income-producing activities, and the manner in which the exempt organization conducts the activities as compared with the manner in which commercial activities are normally pursued by taxable businesses. Specific business activities of an exempt organization ordinarily are deemed to be regularly carried on "if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations."[34]

Substantially related test

Even if a tax-exempt organization regularly carries on a trade or business, the income from that activity is subject to the UBIT only if the activity is unrelated to the basis for the organization's tax-exempt status—i.e., only if the activity is not substantially related (other than through the production of funds) to the purposes for which the organization's exemption is granted.[35]

The Treasury regulations provide that in order to meet the "substantially related" test, the business activity must "contribute importantly" to the accomplishment of the organization's exempt purposes. Whether this test is met depends in each case on the facts and circumstances involved.[36] In appropriate circumstances, com-

[31] Sec. 513(c); Treas. Reg. sec. 1.513-1(b).
[32] Treas. Reg. 1.513-1(b).
[33] Sec. 513(c); Treas. Reg. sec. 1.513-1(b).
[34] Treas. Reg. sec. 1.513-1(c).
[35] Sec. 513(a); Treas. Reg. sec. 1.513-1(d).
[36] Treas. Reg. sec. 1.513-1(d).

mercial endeavors such as the operation of a winery or a farm have been held not substantially related to the exempt purpose of religious organizations.[37]

In determining whether business activities contribute importantly to accomplishing exempt purposes, the size and extent of the activities are weighed against the nature and extent of the exempt function which they are said to serve. Thus, if an organization derives income from activities that are in part related to the performance of its exempt functions, but that are conducted on a larger scale than reasonably necessary to perform those functions, the income attributable to that portion of the activities exceeding the exempt function needs constitutes unrelated business income.[38]

Excluded activities and income

Certain activities are exempt from the UBIT. For instance, the tax does not apply to income earned by a tax-exempt charity from a trade or business carried on by the organization primarily for the convenience of its members or employees (sec. 513(a)(2)). And it does not apply to income from an activity in which substantially all the work is performed without compensation (sec. 513(a)(1)). This latter exclusion has been held to exclude from the UBIT farming by the brothers of a Catholic monastic order when the brothers received no compensation for their labor but only support allowances unrelated to their services.[39]

In addition, certain types of income (and associated deductions) are excluded from the UBIT. The UBIT generally does not apply to dividends, interest, royalties (including overriding royalties), annuities, certain rents, gains on the disposition of property (other than inventory property), gains on the lapse or termination of securities options written by the organization in connection with its investment activities, and amounts received in connection with certain securities loans.

The exclusions from income generally do not apply to the extent the income is derived from debt-financed property, the use of which is not substantially related to the organization's exempt purposes.[40] A percentage of the income from property reflecting the degree to which such property is debt financed is included in unrelated business taxable income.

E. Transfers to Charities in Exchange for Goods or Services

Under present law, payments which qualify as a "contribution or gift" within the meaning of section 170(c) are deductible by the donor.[41] Although the Internal Revenue Code does not define the

[37] *See St. Joseph Farms* v. *Comm'r*, 85 T.C. 9 (1985) (operation of farm); *De La Salle Institute* v. *United States*, 195 F. Supp. 891 (1961) (operation of winery).

[38] Treas. Reg. sec. 1.513-1(d).

[39] *See St. Joseph Farms*, *supra* n. 37.

[40] Other exceptions to the definition of debt-financed property for purposes of section 514 generally resemble exceptions to the scope of unrelated business taxable income applying for purposes of sections 511-513. See section 514(b). For further description of the unrelated business income tax rules, see Joint Committee on Taxation, *Overview of the Unrelated Business Income Tax on Exempt Organizations* (JCS-16-87), June 20, 1987.

[41] The taxpayer generally has the burden of proving that a particular payment is a "contribution or gift." *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 436, 440 (1934); *Welch* v. *Helvering*, 290 U.S. 111 (1933).

phrase "contribution or gift," in general, it is construed as requiring a voluntary transfer of property to a qualifying organization, made without consideration.[42] Thus, if a taxpayer makes a payment to a church or other religious organization and in return receives, or expects to receive, an economic benefit (i.e., a *quid pro quo*), then the payment does not constitute a deductible charitable contribution.[43]

Examples of payments to churches or religious organizations that do not qualify as deductible contributions include: (1) payments to a church for use of facilities for a wedding,[44] (2) tuition payments to parochial schools,[45] (3) payments to a religious home to care for a relative of the payor,[46] and (4) payments for the purchase of raffle tickets.[47]

If the transferor receives, or can reasonably expect to receive, property or services in return for making a payment to a church or religious organization, then a presumption arises that the payment is not a deductible contribution.[48] However, a portion of the total payment may still be deductible if the taxpayer establishes that this portion of the payment exceeded the value of the benefits received.[49] When the benefit received is in the form of goods or services generally priced in a competitive market, the value of the economic benefit conferred can be measured by reference to the competitive price.[50] If the benefit received is not normally sold in a competitive market, only that portion of the payment which exceeds a reasonable estimate of the fair market value of the benefit may be designated as a charitable contribution.

F. Restrictions on Church Tax Inquiries and Examinations

In general

Because of the sensitive relationship between church and state, Congress has adopted specific statutory rules governing church inquiries and examinations. These rules are intended to protect the privacy of churches while permitting reasonable IRS examinations.

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[42] *See DeJong* v. *Comm'r*, 36 T.C. 896 (1961), *aff'd.* 309 F.2d 373 (9th Cir. 1962); Rev. Rul. 76-185, 1976-1 C.B. 60.

[43] *See, e.g., Miller* v. *Comm'r*, No. 86-2090 (4th Cir. September 18, 1987) (Church of Scientology member's payments for religious counseling were not deductible gifts but were payments for services), *Graham* v. *Comm'r*, 83 T.C. 575 (1984) (same). *But see Staples* v. *Comm'r*, 821 F.2d 1324 (8th Cir. 1987) (payments for religious counseling held deductible on ground that participation in religious practices is not a recognizable economic benefit under sec. 170).

[44] *See, e.g., Summers* v. *Comm'r*, para. 74,162 P-H Memo T.C.

[45] *See, e.g., Fausner* v. *Comm'r*, 55 T.C. 620 (1971); *Winters* v. *Comm'r*, 468 F.2d 778 (2d Cir. 1972).

[46] *See, e.g.*, Rev. Rul. 58-303, 1958-1 C.B. 61. But see *Wardwell* v. *Comm'r*, 301 F.2d 632 (8th Cir. 1962).

[47] *See, e.g., Goldman* v. *Comm'r*, 388 F.2d 476 (6th Cir. 1967). In some cases where *de minimis* benefits are conferred which are clearly incidental to the benefits that inure to the organization as a whole or members of the general public, a deduction may be available. See, *e.g., Miller* v. *Comm'r, supra*; Rev. Rul. 70-47, 1970-1 C.B. 49 (pew rents and periodic dues of church are deductible).

[48] Rev. Rul. 67-246, 1967-2 C.B. 104.

[49] Rev. Rul. 76-185, 1976-1 C.B. 60 (payments made to finance restoration of historic mansion, in exchange for right to live in mansion for 15 years not deductible unless in excess of value received.)

[50] *See United States* v. *American Bar Endowment*, 106 S. Ct. 2426 (1986) (payments for insurance did not exceed market value); *Werbianskyj* v. *Comm'r*, 34 T.C.M. 467 (1975) (products brought from Girl Scouts not deductible, no showing that price paid was substantially greater than products' value).

Initiation and first notice

The IRS may begin a church tax inquiry or examination into whether the organization qualifies for tax exemption as a church or whether it is carrying on an unrelated trade or business or otherwise is engaged in taxable activities only if the IRS regional commissioner (or a higher IRS or Treasury official) reasonably believes, on the basis of facts and circumstances recorded in writing, that the organization may be engaged in such business or activities.

Upon beginning a church tax inquiry, the appropriate regional commissioner is required to provide written notice to the church. This notice must include an explanation of the concerns that gave rise to the inquiry and the general subject matter of the inquiry, specific enough to allow the church to understand the particular church activities or behavior at issue.

Second notice and subsequent proceedings

The IRS may examine church records or religious activities only if, at least 15 days before the examination, the IRS provides a tax examination notice in addition to the general tax inquiry notice previously provided.

As part of this notice, the church must be offered one opportunity to meet with an IRS official to discuss the concerns that gave rise to the inquiry and the general subject matter of the inquiry. The purpose of the conference is to inform the church, in general terms, of the stages of the church tax inquiry and examination procedures and to discuss the relevant issues that may arise as part of the inquiry, in an effort to resolve the issues of tax exemption or tax liability without examining church records or activities.

Generally, the IRS must complete any church tax inquiry and examination, and make a final determination, no later than two years after the date on which the notice of examination is mailed to the church.

Approval of determinations and requested examinations

The appropriate IRS regional counsel must approve (1) any determination that an organization does not have tax-exempt status as a church (sec. 501(a)), (2) any determination that such an organization is not eligible to receive tax-deductible contributions (sec. 170(c)), or (3) the issuance of a notice of deficiency to a church following a church tax examination (or, in cases where deficiency procedures are inapplicable, the assessment of any underpayment of tax by the church). Moreover, the IRS Assistant Commissioner (Employee Plans/Exempt Organizations) in general must approve any second tax inquiry or examination of a church within five years of any earlier inquiry or examination involving the same or similar issues.

Scope of inquiry and examination procedures

The church tax inquiry and examination procedures do not apply to inquiries or examinations that relate primarily to the tax status

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or liability of persons other than the church. Thus, not subject to the special church rules are inquiries or examinations regarding (1) the inurement of church funds to a particular individual or to another organization, which inurement may result in the denial of all or part of such individual's or organization's deduction for contributions to the church, (2) the assignment of income or services or excessive contributions to a church, and (3) a vow of poverty by an individual or individuals followed by a transfer of property or an assignment of income or services to the church.

In addition, the special church tax procedures do not apply to any case involving a knowing failure to file a return or a willful attempt to defeat or evade income or employment taxes, or to criminal investigations.

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