

Memorandum

Date: April 23, 2013

Re: Recognition of Exemptions from Federal Income Tax for Churches and Religious Organizations

I. Introduction

Churches, including associations, conventions, and integrated auxiliaries of churches (each, a “church,” and, collectively, “churches”; although the term is not defined in the Internal Revenue Code), that meet the requirements of Section 501(c)(3) of the Internal Revenue Code automatically are considered tax-exempt (and contributions to them tax-deductible to donors to the extent permitted by law) whether or not they apply for IRS recognition of their tax-exempt status.

To qualify for automatic exemption under Section 501(c)(3), a church must meet the following requirements: (i) the organization must be organized and operated exclusively for a qualifying tax-exempt purpose; (ii) no part of the organization’s net earnings may inure to the benefit of private individuals or interests; (iii) the organization may not, as a substantial part of its activities, engage in certain political and lobbying activities (for more information, Unitarian Universalist Association (the “UUA”) refers its congregations to “The Real Rules,” guidelines on political and lobbying activities, at http://www.uua.org/documents/washingtonoffice/real_rules.pdf); and (iv) the organization’s purposes and activities may not be illegal or violate fundamental public policy. Even churches that meet the requirements for automatic exemption may decide, however, to undertake the process and the expense of applying for a determination by the IRS to confirm their 501(c)(3) status and to give potential donors added assurance as to the tax-deductibility of contributions. The UUA has informed us that most UUA congregations rely on the automatic exemption and typically have not applied for such affirmative IRS recognition as tax-exempt.

Unlike churches, other religious organizations (similar to other charitable organizations) typically must apply for and receive determination letters from the IRS (in part by establishing that they meet the requirements outlined above) before they may avail themselves of the benefits of tax-exempt treatment under Section 501(c)(3) (which, in addition to assurance as to the tax-deductibility of contributions, may include, among other things, increased access to grants and enhanced liability protection for directors, officers, and volunteers).

There are several issues that a church or other religious organization needs to consider in applying for recognition as exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code. The facts and circumstances applicable to any such organization are

likely to be unique. Consequently, this memorandum is necessarily general in nature. It provides background information and identifies certain issues for churches and religious organizations to consider and does not constitute legal advice for any particular church or religious organization, or otherwise.

We have assumed that UUA congregations qualify as “churches” for Section 501(c)(3) purposes, but that related Unitarian Universalist organizations (“Related Organizations”; see <http://www.uua.org/directory/organizations/index.php> for a list of such Related Organizations) under the UUA umbrella most likely do not. The UUA has informed us that it does not have an IRS group exemption ruling that would cover its congregations or Related Organizations, but that a UUA congregation may contact the UUA through the Office of the Executive Vice President for a letter stating that the congregation is a member congregation of the UUA. This may be useful to confirm the congregation’s status as a “church.”

II. Process Overview

To obtain a determination of tax-exempt status under Section 501(c)(3), an organization (whether a church or other religious organization) must file Form 1023 (an “Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code”) with the IRS (see <http://www.irs.gov/pub/irs-pdf/f1023.pdf> for a copy of the form and <http://www.irs.gov/pub/irs-pdf/i1023.pdf> for the accompanying instructions). Form 1023 is designed to elicit the information the IRS requires to determine if an applicant organization qualifies for exemption. Completing Form 1023 can be a more or less time consuming and difficult process, depending upon the complexity of the applicant organization’s structure and level of preparation.

At a minimum, an organization that applies for recognition of tax-exempt status by filing Form 1023 must meet a number of criteria, including the following:

- The organization must have a federal employer identification number (see <http://www.irs.gov/pub/irs-pdf/fss4.pdf> for a copy of IRS Form SS-4 (an “Application for Employer Identification Number”) and <http://www.irs.gov/pub/irs-pdf/iss4.pdf> for the accompanying instructions).
- The organization’s governing documents (for a corporation, its Articles or Certificate of Incorporation and bylaws) must limit its activities to tax-exempt purposes under Section 501(c)(3). (Although it is not strictly required for tax-exempt organizations to be incorporated under state law as nonprofit corporations or other legal entities, many congregations are so incorporated—usually, but not always, in the state in which they are physically located. While churches may have chosen not to incorporate in the past, there are good reasons for churches to consider incorporation today, not the least of which is the availability of enhanced liability protections for members, directors, officers, and others.)
- Applicable state law and/or the organization’s governing documents must require that, upon its dissolution, the organization’s assets remaining after payment of its liabilities will be distributed for exempt purposes. (The UUA has informed us that the governing documents of most UUA congregations contain a dissolution clause

granting any remaining congregation assets (following the payment of all liabilities), subject to Internal Revenue Code requirements, to the UUA, unless with the prior written consent of the UUA the congregation names as the recipient a Related Organization that also is exempt under Section 501(c)(3).)

- The organization will need a conflict of interest policy establishing procedures to prevent insiders from receiving improper benefits as a result of their association with the organization (for the UUA's own conflict of interest policy, see http://www.uua.org/documents/boardtrustees/conflict_interest.pdf).

Persons completing a Form 1023 must have a thorough understanding of the applicant organization's mission, operations, and financial condition, including without limitation detailed information regarding the following:

- The qualifications of and compensation arrangements (if any) for the organization's directors, officers, and trustees (as applicable).
- Compensation arrangements for employees and independent contractors who are expected to receive more than \$50,000 in compensation per year.
- Family, business, or certain other relationships between officers, directors, trustees, employees, independent contractors, and "closely-connected" organizations.
- Past, present, and planned programs and activities of the organization, including without limitation qualifications for and restrictions on participation in those programs and activities.
- Existing or planned fundraising, political activities, and joint ventures.
- Current and anticipated sources of revenue.
- Financial and budget information, including an income statement and a balance sheet. Depending upon how long the organization has been in existence, it may be required to disclose up to four years of prior financial data or to forecast up to two years of financial data.

Additionally, churches are required to complete Schedule A to Form 1023, which seeks detailed information on church beliefs, worship, doctrine, history, literature, hierarchy, services, membership, places of worship, educational and training programs, relations with other churches, and other matters. Depending on their other circumstances, churches may be required to complete additional schedules to Form 1023 as well. Related religious organizations may not need to complete Schedule A, but, depending on their activities, they still may be required to complete other schedules.

In addition to current filing fees of up to \$850, an organization seeking tax-exempt recognition should be prepared to invest a substantial amount of time in completing a Form 1023. To what extent an organization requires legal assistance in completing Form 1023 depends to a significant extent on an organization's available staff resources and skill sets, and the complexity of the circumstances surrounding the specific application. In the case of a relatively straightforward application, an organization may not need much help. It may be possible for a UUA congregation to do most of the associated work without a lawyer, but, regardless, it typically is advisable to have a lawyer review an application at least briefly before submission. In any event, following an organization's Form 1023 filing, the IRS typically will

respond within a few months by issuing a determination letter recognizing the organization's tax-exempt status or by assigning the application to an agent who will request additional information to assist the IRS in determining if an exemption is justified. Rarely, the IRS will issue a proposed adverse determination. In the event that the IRS requests further information or proposes to deny an application for recognition, the applicant will need to respond quickly.

If the IRS determines that an organization that has applied for recognition of exemption is, in fact, tax-exempt, as the IRS ultimately does in most cases in which the applicant organization completes the process, the determination will be retroactive either to the date on which the Form 1023 was filed or the date of the applicant organization's formation. Churches that are automatically exempt may obtain recognition of exemption retroactive to their formation dates. For other organizations, whether the organization's tax-exempt determination is retroactive to the date of the organization's formation depends primarily upon whether it applied for tax-exempt status within 27 months of that date. Upon notification of a favorable determination, the IRS will inform an organization of its IRS reporting obligations, but organizations are well advised to consult with their accountants and tax advisors in any event. Furthermore, churches that are automatically exempt are obligated to meet requirements for tax-exempt organizations whether or not they have applied for recognition of their exemptions, and they should be familiar with these requirements in any case (see, e.g., <http://www.irs.gov/pub/irs-pdf/p557.pdf> and <http://www.irs.gov/pub/irs-pdf/p1828.pdf> for outlines of applicable IRS requirements).

III. Additional Considerations

The decision to seek an exempt determination should be a collaborative process both within an organization and between the organization and its professional advisors. An organization will want to consider a number of additional issues in connection with any analysis of its tax status. For example:

- With specific regard to churches, a church may decide that it will rely on the automatic exemption under Section 501(c)(3) described above and that it does not need a determination letter. Many churches prosper over many years without a determination letter.
- An exempt organization may be subject to additional filing and registration requirements under state and federal law, such as the filing of an annual information return with the IRS (Form 990) (while churches generally are not required to file Form 990, other religious organizations are). Similarly, 501(c)(3) exemption does not necessarily confer exemption from state and local income (or any other) taxes, so multiple exemption filings may be necessary. To ensure compliance, an organization should consult its finance person and/or accountants.
- An exempt organization's Form 1023 and supporting documents, related correspondence with the IRS, and annual information returns will be available for inspection by the public, subject to some limitations. To the extent exempt organizations solicit and receive deductible contributions, they will need to adhere to state (and local) charitable solicitation laws and the IRS' recordkeeping, substantiation, and disclosure rules.

- Exempt organizations are subject to significant restrictions on their activities, and face the potential loss of their tax-exempt status and other serious sanctions for noncompliance. Such organizations also may be subject to unrelated business income tax on net income resulting from activities unrelated to their tax-exempt purposes (see <http://www.irs.gov/pub/irs-pdf/p598.pdf> for more information).

IV. Conclusion

We hope that this memorandum provides guidance to the UUA in helping its congregations and related organizations as they decide whether and how to apply for recognition as Section 501(c)(3) organizations. As suggested above, this memorandum should not be relied upon by any organization as legal advice. Instead, before seeking a tax-exempt determination from the IRS, an organization should consult an attorney with expertise in this area of law.

It is important to remember that the process of applying for recognition as an exempt organization need not be daunting or consume substantial resources, especially for churches and religious organizations that can articulate clear exempt purposes. Such a church or religious organization, with appropriate professional advice, the ability and willingness to tell its story compellingly, and a commitment to seeing the process through, stands a very good chance of emerging at the other end in possession of a valid IRS tax-exempt determination letter.