Faithful Legal Services for the Benefit of Religious Organizations

By Jason E. Havens and Thomas O. Wells

In Moses' day, people tithed regularly. But the concept of tithing has since changed. In 2001, Americans donated an average of 3.2% of their income to charity according to one well-known survey. Jool Nie Kang, Note, *Tithing: A Fraudulent Transfer or a Moral Obligation?*, 18 BANK. DEV. J. 399, 411 (2002) (citing Independent Sector's 2001 Giving and Volunteering Survey). Beyond tithing, numerous changes have adversely affected faith-based nonprofit organizations ("religious organizations") in the United States. These changes include the tragedy of September 11, 2001, which resulted in droves of Americans looking to their religious organizations for comfort, support, and encouragement but not necessarily donating additional income because of the concurrent economic contraction.

As a result, religious organizations need skilled attorneys now as much as ever to assist them in three primary areas of taxation and estate planning: (1) tax planning and counsel to the religious organization about its own tax issues, (2) tax planning to and education of its donors about charitable planning techniques to benefit the religious organization, and (3) tax planning for related entities of the religious organization, which can be used to further its charitable purposes. This article generally explores these primary areas. It is the authors' hope that this article will equip others to serve religious organizations.

Tax Issues of Religious Organizations

A vast array of tax issues confronts religious organizations. A comprehensive discussion of these issues is obviously beyond the scope of this article, but a brief discussion of several of the main issues with which religious organizations must deal follows.

Preliminarily, advisors should consider the use of a relatively new "quick reference" resource that has not received much attention in legal literature. On July 20, 2002, the IRS released a very useful tool to help religious organizations and their advisors address a variety of tax issues. IRS Publication 1828, *Tax Guide for Churches and Religious Organizations,* serves as an outline that advisors can use to educate a religious organization on the main tax issues that can arise, including tax-exempt status, unrelated business income tax (UBIT), and reporting and recordkeeping requirements. Publication 1828 is available from the IRS web site at the "Charities & Non-Profits" area, **www.irs.gov/charities/index.html** (as of April 30, 2003). It is also available from the IRS main "Forms and Publications" page, at **www.irs.gov/formspubs/index.html** (as of April 30, 2003). Many of the IRS forms mentioned in this article are listed on the extremely helpful "Tax-Exempt Organizations Tax Kit" page, at **www.irs.gov/charities/article/0,,id=96774,00.html** (as of April 30, 2003).

Tax-Exempt Status

The first issue for a religious organization is recognition of its tax-exempt status by the IRS under Code § 501(c)(3), which is more fully explained in IRS Publication 557, *Tax-Exempt Status for Your Organization.* A significant distinction exists between a "church" and a "religious organization" for this purpose. Under Code § 508(c)(1), a "church" (and its "integrated auxiliaries") automatically qualifies for tax-exempt status and is not required to file an application for a determination letter. As a result, many churches do not have a formal determination letter from the IRS, although they are tax-exempt for federal income tax purposes. Other organizations generally must file Form 1023, *Application for Recognition of Exemption Under § 501(c)(3) of the Internal Revenue Code,* along with the appropri-

Jason E. Havens is a member of the Destin, Florida, law firm of Havens & Miller, P.L.L.C. Thomas O. Wells is a shareholder in the Miami office of Berger Singerman, P.A.

ate user fee, to seek a determination of its tax-exempt status. On the other hand, there is no exception to the general tax-exempt status filing requirement for a "religious organization" that is not also a "church." Thus, religious organizations other than "churches" must file Form 1023.

One of the benefits of filing for recognition of tax-exempt status is inclusion in IRS Publication 78, *Cumulative List of Organizations.* Many advisors use Publication 78 as a resource, particularly when verifying that an organization qualifies for tax-exempt status in the context of creating a charitable gift. Therefore, if a church does not seek formal recognition of its tax-exempt status, it could, for example, lose the opportunity to receive a charitable gift because of an insufficient description of its name in a dispositive provision or because a potential donor living in another state cannot remember the name of the church when creating an estate plan.

Recently, a viable alternative to Publication 78 has developed. In 1994, Philanthropic Research, Inc. created "GuideStar, The National Database of Nonprofit Organizations," available at **www.guidestar.org** (as of April 30, 2003). GuideStar functions as the Internet equivalent (or perhaps the functional replacement) of Publication 78, allowing advisors, donors, and religious organizations to research more than 850,000 charities in the GuideStar database. Through GuideStar, a church can become more "visible" by registering for a free listing in the extensive database.

A religious organization may jeopardize its tax-exempt status. Religious organizations, like all tax-exempt entities organized under Code § 501(c)(3), cannot benefit or serve the interests of any private individual or organization. Rather, religious organizations must exist to benefit the public, including their members. In other words, a religious organization cannot function as a "shell" or "front" for the sole benefit of an individual related to the organization, a prohibition known as "private inurement." In addition, a religious organization may not promote or serve the interests of any private individual or organization, known as the prohibition against "private benefit." Religious organizations and Section 501(c)(3) organizations, in general, must also avoid substantial lobbying activity. As explained in Publication 1828, lobbying activity is generally measured by the "substantial part test," which considers the facts and circumstances of whether a substantial part of an organization's activities are focused on attempting to influence legislation. Likewise, all Section 501(c)(3) organizations are prohibited from engaging in any political campaign activity.

Unrelated Business Income Tax

A second issue for a religious organization is the unrelated business income tax (UBIT). If a religious organization engages in income-producing activities that are unrelated to its tax-exempt purposes, the net income from those activities will generally be subject to UBIT. Many organizations do not understand that raising money to further their religious purposes is not, in and of itself, "related" for purposes of UBIT analysis, and as a result, this issue arises in a number of circumstances. For example, a religious organization might decide to rent its parking spaces to devoted Southeastern Conference football fans attending the Tennessee-Florida game. Even though the net income will be used to further the organization's religious activities, the act of renting the spaces is not, itself, related to its religious purposes.

A three-part test determines whether net income constitutes UBIT: (1) the income-producing activity constitutes a trade or business, (2) the trade or business is conducted regularly, and (3) the trade or business is not substantially related to the organization's exempt purpose. Code § 512(a)(1). Despite the finding of UBIT, the resulting net income might not be subject to UBIT under one of the following three exceptions: (1) substantially all of the work in operating the trade or business is performed by volunteers, (2) the activity is conducted by the organization primarily for its members' convenience, or (3) the trade or business involves proceeds from the sale of merchandise, all of which are donated to the organization. Code § 501(a). In addition, rental income, royalties, capital gains, and interest and dividends generally do not constitute unrelated business taxable income unless the activities are financed with borrowed funds. See generally Code §§ 512(b), 514.

Reporting and Recordkeeping Requirements

A third issue is reporting and recordkeeping requirements. In general, churches are exempt from filing the annual federal information return, Form 990, *Return of Organization Exempt from Income Tax,* unless the church has generated gross unrelated business income of $1,000 or more in the subject taxable year. In addition, churches and other religious organizations are required to file Form 990-T, *Exempt Organization Business Income Tax Return,* if they generate gross unrelated business income of $1,000 or more in a given taxable year. On the other hand, religious organizations other than churches that normally receive gross receipts in excess of $25,000 in a taxable year are required by Code § 6033 to file either Form 990 or the abbreviated version, Form 990-EZ (for organizations with gross receipts of less than $100,000 and total assets of less than $250,000 at the end of the given taxable year). It is important to recognize that state income, sales, and property tax filing requirements, limitations, and exceptions may vary from these federal requirements.

Religious organizations, including churches, are generally required to withhold and report employment taxes via Form 941, *Employer's Quarterly Federal Tax Return.* Churches and religious organizations are not required to withhold Federal Unemployment Tax Act (FUTA) taxes because their employees are generally not covered under federal or state unemployment laws. Special rules apply to the compensation of ministers. See Code §§ 3306(c), 3309(a).

Churches and religious organizations are required to substantiate and disclose information regarding the charitable contributions they receive. Charities must furnish written acknowledgements to a donor who contributes more than $250 at any single time before the donor can claim a charitable contribution deduction on his or her federal income tax return. Code § 170(f)(8). As part of that acknowledgement, the charity must provide additional information to a donor if the donor receives goods or services in exchange for a single contribution, called a "*quid pro quo*" contribution. Code § 170(f)(8)(B)(iii). If a donor receives an "intangible religious benefit" in return for his or her contribution, the acknowledgment must state that fact. Exceptions to the *quid pro quo* disclosure rule are set forth in the Treasury Regulations and are summarized in Publication 1828. See Treas. Reg. § 1.170A-13(f). For example, if the donor contributes $100 and then receives a ticket to a fundraising event valued at $50, the *quid pro quo* contribution must be disclosed, even though the deductible amount does not exceed $75. Accordingly, religious organizations need to track their donors' contributions carefully.

Finally, all charitable organizations, including churches and religious organizations, are required to maintain financial records. The IRS provides no specific format for recordkeeping by churches and religious organizations. No time requirements are specified for this purpose either, although Publication 1828 illustrates guidelines for retention of records by churches and religious organizations.

Planning Techniques to Benefit Religious Organizations

Entire treatises address the subject of charitable planning techniques, which can certainly be used to benefit religious and other nonprofit organizations. Again, a broad discussion of this topic is beyond the scope of this article. Several techniques, however, should be highlighted.

As a preliminary matter, advisors can use general explanations available freely to educate religious organizations and potential donors on the basic requirements and uses of charitable planning techniques. One of the most helpful resources, the *Charitable Giving and Tax-Exempt Organizations Handbook*, was produced by the tax attorneys of McGuire, Woods LLP several years ago and is available at **www.mcguirewoods.com/news-resources/publications/taxation/charitable_giving_handbook.asp** (as of April 30, 2003). The *Charitable Giving and Tax-Exempt Organizations Handbook* provides an overview of the charitable planning tax rules, reporting requirements, and charitable giving techniques, with their respective tax consequences.

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Another resource that advisors can use to find research materials and explanations of technical charitable planning matters is the Planned Giving Design Center (PGDC), available at **www.pgdc.net** (as of April 30, 2003). The PGDC was created by Kallina & Ackerman, LLP in 1998. After freely registering, advisors can access the "Gift Planner's Digest," which features monthly professional articles on charitable planning, Kallina & Ackerman's sample charitable remainder trust (CRT) forms, and much more. Advisors may find other helpful charitable planning Internet sites via "Legal Research for Estate Planners" (**www.jasonhavens.net**), the personal site of one of the authors.

Outright Gifts

First, donors can make outright gifts to religious organizations. IRS Publication 526, *Charitable Contributions*, provides a practical guide for such donors, including the issues arising from tithing. One of the most important aspects of the rules governing outright charitable gifts is the applicable percentage limitation of the gift, which is either 20%, 30%, or 50%, depending on the donor's adjusted gross income, the type of property contributed, and the type of charity receiving the gift. These rules, outlined in Publication 526, apply not only to outright gifts, but also to gifts made in trust. See also Code § 170.

Charitable Remainder Trusts

Second, if donors desire to benefit religious organizations in trust, donors can create a charitable remainder trust (CRT) to benefit religious organizations. Generally, a CRT benefits the donor and/or his or her spouse during their lifetimes, with the remaining trust assets distributed to one or more charitable organizations at the expiration of the trust term. The term of a CRT generally cannot exceed 20 years if expressed as a fixed term, but it may continue until the death of the last income beneficiary. The donor receives a charitable deduction based upon the anticipated value of the remainder interest to be distributed to the charitable organization.

Many varieties of charitable remainder trusts have developed over the years. The most "basic" varieties include the charitable remainder annuity trust (CRAT) and the charitable remainder unitrust (CRUT). In a CRAT, the donor receives a fixed annual distribution, generally expressed as a dollar figure or a percentage of the CRAT's assets based on the *initial* net fair market value of the CRAT's assets. In a CRUT, the donor receives an annual fixed distribution equal to at least 5% of the *annual* fair market value of the CRUT's assets. As a result, the distributions from the CRUT can fluctuate and can increase with the appreciation in the CRUT's investment portfolio, but the CRAT can provide a hedge against inflation in the portfolio.

More advanced versions of CRTs include the Net Income CRUT (NICRUT) and the Net Income CRUT with Make-Up Provisions (NIMCRUT). These CRTs generally provide additional flexibility by varying the income distribution to the donor, depending on the performance of the CRT's investment portfolio and also on the determination of income for state trust accounting purposes. Advisors should consult one of the numerous helpful articles on the various "flavors" of CRTs.

Charitable Lead Trusts

Third, donors can create a charitable lead trust (CLT). The CLT basically works in the opposite manner of a CRT. In other words, the charitable organization receives the income interest, with the remaining trust assets distributed to beneficiaries at the expiration of the trust term. The donor receives a charitable deduction based upon the anticipated value of the income interest to be distributed to the charitable organization. The CLT generally comes in two "flavors," the charitable lead annuity trust (CLAT) and the charitable lead unitrust (CLUT). Again, advisors should consult one of the many useful articles available on CLTs.

Charitable Gift Annuities

Fourth, some religious organizations may be able to offer charitable gift annuities. In basic terms, the donor contributes property to the religious organization, and the religious organization agrees to provide an annuity to the donor either for a specified period of time or for the donor's lifetime. The remaining assets in the annuity at its expiration pass to the religious organization. See generally Terry L. Simmons, *Planning Opportunities with Gift Annuities*, in CHARITABLE GIVING TECHNIQUES (ALI-ABA May 30–31, 2002). The major drawback to a charitable gift annuity is the liability of the organization to pay the annuity out of its general assets, which can pose serious problems if the religious organization experiences financial difficulties or the investment portfolio of the charitable gift annuity does not perform adequately. In addition, many states highly regulate charitable gift annuities, which may make it impossible or impractical for many small organizations to undertake an effective charitable gift annuity program.

Attorneys must obviously approach advice in this context with caution because of the ethical issues that might arise. If the attorney represents the religious organization, he or she should generally recommend independent counsel for the potential donor interested in a charitable trust to benefit the religious organization. This problem does not generally arise in the charitable gift annuity situation, when the attorney has prepared the charitable gift annuity in the past and is not involved in the donor's decision to create his or her charitable gift annuity. For an example of one of the many issues in this context, see John B. Jarboe, *Undue Influence & Gifts to Religious Organizations*, 35 CATH. LAW. 271 (1994).

Pooled Income Fund

Finally, religious organizations should consider a pooled income fund. The religious organization creates the pooled income fund, which is managed by trustees appointed by the religious organization. Instead of an annuity or a unitrust interest, the pooled income fund creates a lifetime income interest for the donor's benefit. The donor contributes property to the fund in exchange for units, which entitle the named beneficiary to a proportional share of the fund's actual income during each year for the named beneficiary's lifetime (or for a series of joint lives). At the death of the last surviving income beneficiary, the beneficiary's share of the fund's assets passes to the charitable organization.

From the religious organization's perspective, pooled income funds offer several advantages. Like a charitable gift annuity, the religious organization creates and administers the pooled income fund, reducing legal and accounting costs for the donor and eliminating the need for a separate trust vehicle. The religious organization can also commingle and diversify the investments of the pooled income fund. Similar to a CRT, the donor receives a charitable deduction based upon the anticipated value of the proportionate remainder interest to be distributed from the pooled income fund to the charitable organization. On the other hand, these flexible aspects of pooled income funds may represent disadvantages to a donor who desires more control over the charitable vehicle's investments. Finally, distributions from a pooled income fund are generally taxed as ordinary income to the named beneficiary under the regular trust income tax rules, as opposed to the tiered system applicable to distributions from CRTs. Finally, the administrative costs associated with creating and maintaining a pooled income fund may place it out of the reach of some organizations.

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Tax Planning for Religious Organizations' Related Entities

Attorneys representing religious organizations must again refer to the distinction between a "church" and a "religious organization." Not only do churches receive special treatment under the Code, namely in the form of exemptions from filing for recognition of tax-exempt status and from filing informational tax returns, but their "integrated auxiliaries" also receive the same preferential treatment.

Governmental and judicial authorities have struggled to provide definitions of a "church" and its "integrated auxiliaries." The guidance provided generally defines an integrated auxiliary as "a [Code] Section 501(c)(3) organization, affiliated with a church, and whose principal activity is 'exclusively religious.' " Nina J. Crimm, *Tax Issues of Religious Organizations*, 868-1st Tax Mgmt. Portfolio (BNA) 2002 at A-26 (citing, *inter alia,* Treas. Reg. § 1.6033–2(g)(5)(i)-(iii)).

In some cases, a church should consider the formation of a separate entity to undertake certain activities. For example, a church may wish to form an affiliated organization to engage in political or lobbying activities otherwise disallowed by Code § 501(c)(3). The creation of a separate Code § 501(c)(4) organization in such circumstances would insulate the church from jeopardizing its tax-exempt status. A religious organization and other nonprofit organizations often form separate entities for fundraising purposes as well, in part to limit their liability exposure for fundraising activities.

Other considerations concerning this topic abound. In general, attorneys should approach the creation, interaction, and administration of the related entities of a religious organization cautiously. Proposed planning should not jeopardize the religious organization's tax-exempt status. Liability exposure (and management of any risk) is also a serious concern. In some cases, the uncertainties associated with planning for a related entity of a religious organization will justify the request of a private letter ruling from the IRS.

Conclusion

As this article illustrates, religious organizations definitely need the counsel of attorneys and advisors to assist them, their donors (if appropriate), and their related entities. Attorneys should at least consider giving their time and talents to help religious organizations. Although this area of law is complicated and should be approached with diligence, prudence, and training, its benefits abound. ■