An Overview Of Tax Issues For Religious Congregations

Ellen P. Aprill

Religious freedom has its price.

MANY TAX LAWYERS ARE ASKED TO SERVE on the governing bodies of their religious congregations. Yet religious congregations are subject to some unique rules that tax lawyers are unlikely to have encountered. This article discusses the issues that I have most often been asked, or should have been asked, in the many years that I have been giving pro bono advice to religious congregations of my own religious tradition, locally, regionally, and nationally. The issues discussed are: a) requirements for setting compensation, b) lobbying and political activities, c) substantiation of charitable contributions, d) charitable fundraising, e) payroll taxes and withholding for clergy, f) parsonage and housing allowances, and g) discretionary funds. The discussion of applicable rules is designed to be accessible to lay leaders and congregational staff, whether volunteer or professional. Different groups of leaders and volunteers have interest in different topics; each topic is designed to stand alone, and thus there is some overlap in coverage. Moreover, to be as inclusive as possible of our country’s many different religious traditions, I have used the terms “religious congregation” and “clergy,” although the Internal Revenue Code uses the terms “church” and “minister” of the gospel, which it has interpreted broadly. See, e.g., IRC §§170(b)(1)(A)(i), 508(c)(1)(A), 7611, 107, 1402(c)(4), 3121(b)(8)(A). (All section references are to the Internal Revenue Code unless otherwise indicated.)
OVERVIEW • Religious congregations are exempt from income tax, but nonetheless must comply with many tax laws. They must also comply with other applicable federal and state laws, particularly state corporate laws applicable to nonprofit religious organizations and state property and sales tax laws.

Exempt Status

Exemption And Reporting

Religious congregations are not required to file an application with the IRS to be exempt under section 501(c)(3), but many do file Form 1023, application for exemption, to be on the published IRS list of section 501(c)(3) charities eligible to receive tax-deductible contributions. §508(c)(1)(A); Publication 78, Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986, available at http://www.irs.gov/charities/article/0,,id=96136,00.html. Religious congregations do not need to file the annual federal information returns (Form 990) required of other kinds of charities. §6033(a)(3)(A)(i). State filing laws, however, may differ.

Intermediate Sanctions

The law designed to reduce the risk of revocation of exempt status does not exempt religious congregations and requires that, in setting compensation for clergy and others, particular care be taken in obtaining comparables and in recording the basis for the compensation package. §4958. See below.

Political Activities And Lobbying

Religious congregations cannot intervene in elections and are limited in the amount of lobbying they can do. §501(c)(3). See below.

Contributions, Fundraising

Dues And Fees

Religious congregations must acknowledge contributions of $250 or more (including dues); and they must inform members of the value of goods or services (other than intangible religious benefits) received in exchange for contributions. §170(f)(8). Difficult issues arise in connection with religious education and with donation of automobiles. See below.

Fundraising

Various fundraising activities, such as advertising in tribute books or newsletters and sale of scrip, must be done carefully so as not to subject religious congregations to the federal tax on unrelated business income. See generally §§511-514. That is, exempt organizations—including religious congregations—are not taxed on income related to their exempt purposes, but are subject to income tax on income from unrelated activities. Being subject to unrelated business tax will not jeopardize exempt status, unless such unrelated activities come to dominate the organization. Fundraising activities may also be subject to state and local regulation. See below.

Many congregations have begun to encourage their members to consider sophisticated estate planning techniques, such as charitable lead trusts or charitable remainder trusts, to benefit the congregation. Such plans must comply with all applicable tax rules, and members should consult their own tax advisors to understand the consequences.

Issues For Clergy And Other Staff

Income Tax Withholding, Social Security, Medicare

Clergy are subject to a unique set of tax rules regarding their compensation. Those regularly employed by a congregation are almost always consid-
erred to be employees, but withholding of income tax is not required and they are subject to self-employment rather than employee payroll taxes. §§3401(a)(9), 1402(a)(8), 1402(c)(4), and 3121(b)(8(A). Their compensation should be reported on Form W-2, with no social security or Medicare tax withheld, not on Form 1099. See below.

**Parsonage Or Housing Allowance**

Clergy may exclude from income for purposes of the income tax the fair rental value of their housing, if certain requirements, including formal action by the religious congregation’s board, are met. §107; Treas. Reg. §1.107-1. The amount of this housing allowance, along with clergy salary, is, however, subject to self-employment tax. §1402(a)(8). See below.

**Discretionary Funds**

An official statement of the religious congregation about the purpose and use of discretionary funds will help protect clergy from any assertion that these funds represent additional income to them. See below.

**Other Employee Issues**

For both clergy and non-clergy employees, some benefits are subject to income tax and payroll taxes and some are not. In many cases, the tax consequences of benefits, such as medical benefits and tuition discounts, will depend on how they are structured and to whom they are offered. For non-clergy employees, failure to comply with withholding and payroll tax laws risks the particularly stringent penalties on those who had the responsibility to deposit these funds. See §6672.

**SUMMARY OF “INTERMEDIATE SANCTION” PROVISIONS APPLICABLE TO TAX-EXEMPT ORGANIZATIONS**

The tax law makes it especially important to obtain comparable data in setting compensation. Some years ago Congress passed legislation, known as intermediate sanctions, requiring that nonprofit organizations pay reasonable compensation. §4958, Treas. Reg. §53.4958-4. Violation of these rules can lead to imposition of sizeable excise taxes on senior staff and organization managers (which include directors or trustees) of the organization. §§4958(a)-(b), (f)(2); Treas. Reg. §53.4958-1(d)(2).

The IRS has issued regulations regarding this legislation. Treas. Reg. §53.4958-1 through §53.4958-8. These regulations give a presumption of reasonableness for compensation (and other transactions, such as sales and contracts) if and only if the organization follows very specific procedures. Treas. Reg. §53.4958-6. The procedures include the organization obtaining and relying upon appropriate data as to comparability for compensation of those who have substantial influence over the organization and who receive total economic benefits above a specified amount ($110,000 for 2009 and 2010). IRS Notice 2009-94.

These procedures also require that the organization concurrently record the compensation package, the basis for the compensation package (including the comparables), and those who voted on the compensation package. Under the regulations, even small organizations (defined as those with gross receipts under $1 million) must obtain three comparables to have the benefit of the presumption of reasonable compensation.

This law does not exempt religious organizations, although the regulations state that the IRS will comply with the Church Audit Act. Treas. Reg. §53.4958-8(b). Under the Church Audit Act, the IRS could seek to impose these taxes only if it has a reasonable belief that such taxes are due and various notice requirements have been met. See generally §7611. The IRS has proposed but not finalized regulations under the Church Audit Act.