

Governance Overkill Syndrome

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fully aware of the entire compensation package (including benefits and perks) for the organization's CEO and any family members of the CEO. The board should also take steps to ensure that the total compensation is reasonable compared to what similar organizations pay similarly qualified people to perform similar duties. The board can do the comparability analysis itself or through a board-authorized committee. Under the advice of good tax counsel, the board can avail itself of a "rebuttable presumption" under federal tax law that the compensation package is reasonable. Similarly, the board can utilize a well-written conflicts-of-interest policy to address related-party transactions. In adopting and applying such a policy, the board should also apply good common sense. While the organization may get the best price for office supplies from the CEO's brother's company, buying \$3 million worth of supplies from that company may not appear to be above reproach.

The board should also have a process in place to ensure that it would be made aware if the organization were to incur expenditures for travel, meals, hospitality, or other similar activities that may be considered lavish or extravagant. While a policy can be helpful in this area, simple and effective communication and oversight of expenditures in this area can be helpful as well.

Further, nonprofit boards should have appropriate oversight measures in place to ensure that donor-restricted gifts are spent in a manner that conforms to donor expectations. Basic policies and expenditure oversight can accomplish the objective. An organization's auditing firm can provide insights on effective means of doing so.

Additionally, requiring that every board meeting include standing agenda items to discuss "sensitive" topics can help dramatically reduce risk in these areas. For example, a standing agenda item may be a report of expenditures or activities in which the organization's

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Four Common IRS Church Audit Issues

by Courtney D. Jones

Church tax audits can be frightening, more so now than ever, with the prevailing climate of IRS tightening its controls on non-profits. Here is an introduction to four key issues and how to manage them.



1. Proper commencement of an IRS church audit. The first issue for a church to address is whether an IRS audit has been properly commenced. Section 7611 of the Internal Revenue Code (IRC) provides that in order to commence a church audit, an "appropriate high-level Treasury official" must determine, based on a reasonable belief of facts and circumstances recorded in writing, that the organization may not qualify for exemption as a church. Following a federal district court holding that the IRS's current procedures do not meet the requirements of section 7611¹, the Treasury Department proposed regulations published on August 5, 2009², naming the Director of Exempt Organizations as the "appropriate high-level Treasury official." These proposed regulations have not been finalized.

At a minimum, churches that receive a written IRS notification of the beginning of a church tax inquiry should be aware that there is a question as to whether the IRS's current procedures for authorizing such inquiries meet the requirements of section 7611. However, the section 7611 procedures do not apply to church examinations in which the IRS suspects civil or criminal fraud.

2. Pastoral compensation. Executive compensation is often a primary issue in IRS audits of exempt organizations, including churches. The Senate Finance Committee has also focused on this issue in recent years. In church audits, the focus is usually on the senior pastor of the church or a member of his family.

Section 4958 imposes a tax upon an "excess benefit transaction"—any transaction in which an economic benefit is provided by an applicable tax-exempt organization to any "disqualified person" if the value of the economic benefit exceeds the value of the service provided. A "disqualified person" is defined as a person in a position to exercise substantial influence over the affairs of the church.³ As the church's chief executive officer, the senior pastor is almost always a disqualified person with respect to the church.

The penalties for excess benefit transactions are severe. A tax of 25% of the value of the excess benefit is

“If your church receives a tax inquiry notice, determine if the IRS audit has been properly commenced.”

assessed against the disqualified person.⁴ And a tax of 10% of the excess benefit is assessed against the managers of the exempt organization who knowingly and willfully participated in the transaction.⁵ In addition to paying the tax, the disqualified person must pay the amount of the excess benefit back to the charity within a certain time period, or pay an additional tax of 200%.⁶

For purposes of determining whether a church's compensation arrangement gives rise to an "excess benefit transaction," the regulations specify that the compensation must be "reasonable," that is, only amounts paid for like services by like organizations under like circumstances.⁷ A senior pastor will face exposure to excise taxes if his or her compensation is not reasonable.

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The Treasury regulations outline a procedure that will establish a presumption that a transaction between a church and a senior pastor, was reasonable and, therefore, not an excess benefit transaction at the time it was entered into. This “rebuttable presumption” procedure has three parts:

- the transaction must be approved in advance by an authorized body (either the church’s governing body or an independent committee of that body) comprising individuals who do not have a conflict of interest with respect to the transaction;
- the governing body or committee must review and rely upon appropriate data regarding comparability; and
- the governing body or committee must adequately document the basis for its determination concurrently with such decision.

Satisfying all three requirements of

“In recent years, the IRS has stepped up enforcement of the prohibition against church political campaign intervention.”

the “rebuttable presumption” shifts the burden of proof of the compensation reasonableness from the church onto the IRS. Once this happens, the IRS can rebut the presumption only if it can rebut the probative value of the comparability data the authorized body used. Churches would do well to follow the “rebuttable presumption” procedure to secure the legal protections that it affords. From a stewardship perspective, it will increase the trust and confidence of members.

3. Political campaign activity. In recent years, the IRS has stepped up its enforcement of the prohibition against political campaign intervention by churches. This is evident from recent high-profile cases and reports published by the IRS and the Treasury department.⁸ Under section 501(c)(3) of the IRC, a tax-exempt charitable organization, such as a church, must not “participate in, or intervene in

(including the publishing or distributing of statements), any political campaign on behalf of—or in opposition to—any candidate for public office.”⁹ The consequences for violation of the prohibition include taxes, revocation of tax-exempt status, or both. This is a particularly sensitive issue as many churches feel a call mandated by scripture to address the moral and political issues of the day.

Accordingly, many churches inquire what activities, if any, they can engage in without endangering the church’s tax-exempt status. While the prohibition against involvement in political campaigns remains absolute, all charities may engage in and fund strictly nonpartisan activities in connection with elections. They are subject to important conditions as to how these measures are carried out and include:

- nonpartisan voter registration and get-out-the-vote activities;
- nonpartisan voter education;
- nonpartisan candidate questionnaires;
- nonpartisan legislative scorecards;
- nonpartisan candidate forums;
- personal activities of pastors or staff acting as individuals;
- activities not related to an election;
- participation by candidates in events for non-candidacy reasons;
- fundraising by candidates for a section 501(c)(3) organization;
- certain nonpartisan, arm’s-length business transactions with candidates; and
- an insubstantial amount of lobbying.¹⁰

The touchstone for distinguishing prohibited from permissible activities is that the latter must be strictly nonpartisan in both form and substance.¹¹ In determining whether an activity meets this standard, the IRS will consider any evidence showing the organization had a partisan motive in conducting the activity and whether the organization should have reasonably foreseen that the activity would benefit a particular candidate or party.¹² Therefore, while there are many election-related activities a

religious organization can support, no single fact will prevent an activity from being partisan for federal tax purposes. For example, a nonpartisan motive alone is not sufficient if the activity is, in fact, biased in favor of or against one candidate.

When considering possible activities, churches should take great care to ensure that all proposed activities meet the requirements of the law, particularly with respect to the non-partisan nature of any activity.

4. Unrelated business income tax. Finally, the IRS is likely to focus on whether or not a church has an unrelated business income tax (UBIT) liability during an audit. Organizations like churches that are exempt under section 501(c)(3) must pay UBIT, calculated at regular corporate rates, on


“A common source of unrelated business income in a church is its bookstore.”

net income generated through unrelated business activities.¹³ An activity can generate unrelated business taxable income if it is a trade or business, is regularly carried on, is not substantially related to the exercise or performance of a tax-exempt organization’s exempt purposes, and the income from that activity is not otherwise excluded from the tax.¹⁴ To be considered “substantially related,” the activity must contribute importantly to the accomplishment of the organization’s exempt purposes.¹⁵

Some church-run businesses qualify for one or more of the exceptions from UBIT: businesses run by church volunteers, carried on for the convenience of the church’s members, and those businesses that sell items donated to the church.¹⁶ Income from these church businesses is not included in a calculation of UBIT.

Notwithstanding these exceptions or other modifications¹⁷, a common source of UBIT in a church is its bookstore, particularly where there is a large inventory. Items proposed for sale in a church bookstore should be

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selected carefully to ensure that each item bears close relationship to the church's religious and other exempt purposes. For example, sales of Bibles, recorded sermons, and other religious materials are clearly substantially related to the exempt purposes of the church, but sales of secular or non-religious publications are unlikely to be considered related. Churches should also keep in mind that while they are normally exempt from the requirement to file IRS Form 990¹⁸, a church must report UBIT on IRS Form 990-T, which would be available to the public.¹⁹ 

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¹ United States v. Living Word Christian Center, No. 08-mc-37 (D. Minn. Jan. 30, 2009).

² Federal Register, Vol. 74, No. 149; www.gpoaccess.gov/fr/retrieve.html (Select Vol. 74, enter page number 39003, and click "Submit") (Last visited June 16, 2010).

³ IRC § 4958(f)(1).

⁴ IRC § 4958(a)(1).

⁵ IRC § 4958(a)(2).

⁶ IRC § 4958(b).

⁷ Treas. Reg. § 53.4958-4(b)(1)(ii)(A).

⁸ See, e.g., 2006 IRS Political Activities Compliance Initiative, report available at www.irs.gov/pub/irs-tege/2006paci_report_5-30-07.pdf (last visited June 16, 2010); Treasury Inspector General for Tax Administration report, "Improvements Have Been Made to Educate Tax-Exempt Organizations and Enforce the Prohibition Against Political Activities, but Further Improvements are Possible", available at www.treas.gov/tigta/oa_auditreports_fy08.shtml (last visited June 16, 2010);

⁹ IRC § 501(c)(3).

¹⁰ See, e.g., Rev. Rul. 2007-41, 2007-25 I.R.B. 1421; Judith E. Kindell & John Francis Reilly, Election Year Issues, in Exempt Organizations Technical Instruction Program for FY2002 (2001); IRS Publication 1828, Tax Guide for Churches and Religious Organizations ("IRS Church Guide").

¹¹ Touching the Live Wire: Tax-Exempt Organizations and Politics, Marcus S. Owens and Thomas J. Schenkelberg, Tax Issues for Healthcare Organizations, American Health Lawyers Association, Sept. 19, 2006

¹² Id; See, e.g., IRS Church Guide.

¹³ IRC § 511(a)(1).

¹⁴ IRC §§ 512(a)(1), 513(a).

¹⁵ Treas. Reg. section 1.513-1(d)(2).

¹⁶ IRC § 513(a)(1) - (3).

¹⁷ IRC § 512(b).

¹⁸ IRC § 6033(a)(3)(A)(i).

¹⁹ Pension Protection Act of 2006 (PL 109-280), Sec. 1225(a); IRC § 6104(d)(1)(A)(ii).



What's Happening on Capitol Hill?

by John Van Drunen, ECFA's Director of Compliance

This is a year with many legislative developments on Capitol Hill. Here is a summary of the most important issues for churches and other nonprofits:

- **SAMHSA reauthorization and the elimination of RFRA.** H.R. 5466, a bill recently introduced by Rep. Patrick Kennedy (D-RI) and Rep. Gene Green (D-TX), is set to reauthorize federal drug treatment programs administered by SAMHSA and includes language to ban from participation those faith-based providers that consider religion when hiring.

Specifically, the bill proposes to add to the Public Health Service Act, Title V, the requirement that every grantee and contractor must agree to "refrain from considering religion or any profession of faith when making any employment decision" about anyone who will be involved in providing the federally funded services.

This ban on religious hiring would apply "notwithstanding any other provision of federal law, including any exemption otherwise applicable" to a religious organization. This language contradicts the SAMHSA Charitable Choice language President Clinton signed into law in 2000 and could undermine the Religious Freedom Restoration Act (RFRA).

- **Employment Non-Discrimination Act (ENDA).** Both the House (H.R. 3017) and Senate (S. 1584) are considering ENDA, which would outlaw employment discrimination based on sexual orientation and gender identity (transgendered persons). The House passed a similar bill in 2007 but the Senate did not act then. The two current bills include the religious exemption from 2007 providing under the Title VII exemption (1964 Civil Rights Act) that religious



organizations are free to hire according to religion are not subject to ENDA.

Inclusion of gender identity is creating resistance from many members who might otherwise support the bill.

Speaker Nancy Pelosi has suggested no action will be taken on ENDA until the "Don't Ask, Don't Tell" Military Eligibility Law on Service by Homosexuals is finished.

- **Financial regulatory reform is signed into law.** In 2009, Congress introduced legislation that would create a new government agency called the Bureau of Consumer Financial Protection (formerly known as the CFPB). A final bill was signed into law in July 2010.

The law poses some unintended consequences for churches and ministries across the country. These consequences come through the oversight of churches and ministries that have consumer financial-related exempt purposes, such as basic financial literacy education or benevolence assistance counseling.

Due to the work of ECFA and other organizations, the law does include a section titled "Exclusion for Activities Relating to Charitable Contributions" on page 627-8, which excludes donor communications by those tax-exempt organizations recognized by the IRS. This leaves in question the implications for churches that have not been required to be officially recognized by the IRS by submitting a Form 1023. This exemption does not apply to organizations offering any consumer financial product or service to nondonors.

As regulations are still to be seen, the exact scope and ramifications of this bill are uncertain.

- **Baucus supports cell phone fix**

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