Gifts to Support Individual Nonprofit Workers
A Summary of U.S. Tax Issues

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Gifts to support an organization's exempt purposes and programs are generally tax deductible within the limits prescribed by the law. To be tax deductible, the organization must exercise full control (administrative) over the funds to ensure that they fulfill its exempt purposes and programs. The organization also has responsibility to honor donor preferences or stipulations for particular exempt purposes.

Designating or "earmarking" for a specific individual or a foreign charity are not charitable contribution, and under accounting rules would likely be treated as "agency" transactions rather than contributions, absent the explicit and unilateral power to redirect.

1. Gifts "designated or earmarked" for specific individuals or entities

Gift that are designated or earmarked for a specific individual are not deductible as charitable contributions. This is true whenever the donor has specified, by name, the person to receive the gift, with few exceptions (such as the support of an orphan or needy child selected by the organization rather than the donor). Gifts designated for specific entities may not be deductible until remitted to that entity (the donee is acting as agent for the donor) and gifts to foreign entities are not deductible.

2. Gift in support of worker's ministries (Deputized Fund-raising)

Gifts in support of the ministry/charitable activities of a specific worker, such as missionary support, are tax deductible contributions to an organization if they are not donor designated for personal use or under individual (rather than organizational) control. The funds must be controlled by the organization to be expended only as needed for reasonable compensation and business (ministry) expenses.

Although giving through an organization to earmarked individual is not tax deductible, and conduit organizations operated to facilitate such are not tax exempt, contributions to a qualified organization for use in its exempt purposes and programs that are not earmarked for an individual are tax deductible.

Deputized fund-raising was recognized, and in at least some forms approved by the IRS in the 1950s and 60s. After decades of little attention, in the 1990s the IRS issued an adverse private letter ruling, challenged organizations' exemptions, and denied contribution deductions. The IRS appeared to believe that gifts in support of deputized fund-raising (traditional missionary ministry support) might represent non-deductible gifts to individuals rather than charitable gifts to an exempt organization. It consistently favored a "pooled" approach or system.

Recent meetings and communications with the IRS resulted in a letter, issued in February 2000, in which the IRS acknowledged that deputized fund raising was compatible with tax exemption of the organization and tax deduction of the donor's contributions if proper control exists. The following discusses key provisions that must be carefully considered.

The IRS has identified two essential principles:

1. The donor must intend to make a gift to the organization, not to the individual.
2. The organization must fully control the funds to accomplish its exempt purposes.

If either of these principles is missing, the donor's gift does not qualify for tax deduction. If the organization receives substantial support from deputized fund-raising of contributions that do not qualify, it may lose its tax-exempt status.

The IRS acknowledged that although tracking by an organization of funds raised by an individual missionary, staff member, or volunteer may show that contributions are earmarked, the organization may show that it has full control by the totality of the facts and circumstances.

The IRS suggested language to be included in solicitations that would help show that the organization has the necessary control: assuming that there is no conflicting language in other materials or understandings between the parties: "***Contributions are solicited with the understanding that the donee organization has complete discretion and control over the use of all donated funds.***"

Duties of control inherent for tax exempt organizations do not conflict with what may, from an accounting standpoint, be considered donor restricted for particular exempt purposes. The IRS concern is that gifts not be controlled or directed to particular individuals, but under organizational control for one or more exempt purposes.

Organizations should review practices and take the following action:

- ❑ Adopt the recommended language (noted above) for all solicitations and donor receipts.
- ❑ Develop training for workers communications reinforcing ministry control of resources.
- ❑ Review communications with donors (including prayer letters, newsletters, solicitation literature and donor receipts) to remove statements or assurances inconsistent with the recommended language and control elements.
- ❑ Utilize a board approved budgetary process for compensation and expenses of workers.
- ❑ Periodically review all programs and policies of the organization, including those relating to supported workers.

Organizations should review practices and take the following action, continued:

- ❑ Conduct thorough screening of potential workers based on qualifications established relating to exempt purposes and not related to the amount of funds that may be raised.
- ❑ Assign supported workers to programs and project locations based upon assessment of individual skills and training and the specific needs of the ministry.
- ❑ Set annual compensation levels for all workers (maximum compensation) based on reasonable compensation assessments for similar organizations. Set salaries based on a salary system approved by the board, with consideration of factors other than the amount of money raised.
- ❑ Review financial policies and control practices to assure that control elements exist and are well documented. Among these controls should be the approval of work-related expenses, approval of general and overhead allocations, and the ability to redirect funds within the ministry's operations in the event a worker is terminated or the worker's ministry is changed.
- ❑ Be certain that there are no commitments that contributions will be paid to a particular person.
- ❑ Be certain that all elements of compensation are properly reported on required forms.
- ❑ Be certain that all reimbursements of ministry expenses are approved, based on policy guidelines approved by the board, with considerations other than the amount of money raised.
- ❑ Review practices that cause payments for missionary salary and work funds to vary based on the amount of funds available. This should include both active missionaries and retired workers. (A workers support "pooled" is most advisable.)

Internal Revenue Service
Tax Exempt and Government Entities
Exempt Organizations

IRS

tax guide for

Churches and Religious Organizations

benefits and responsibilities under the federal tax law

Congress has enacted special tax laws applicable to churches, religious organizations, and ministers in recognition of their unique status in American society and of their rights guaranteed by the First Amendment of the Constitution of the United States. Churches and religious organizations are generally exempt from income tax and receive other favorable treatment under the tax law; however, certain income of a church or religious organization may be subject to tax, such as income from an unrelated business.

The Internal Revenue Service (IRS) offers this quick reference guide of federal tax law and procedures for churches and religious organizations to help them voluntarily comply with tax rules. The contents of this publication reflect the IRS interpretation of tax laws enacted by Congress, Treasury regulations, and court decisions. The information given is not comprehensive, however, and does not cover every situation. Thus, it is not intended to replace the law or be the sole source of information. The resolution of any particular issue may depend on the specific facts and circumstances of a given taxpayer. In addition, this publication covers subjects on which a court may have made a decision more favorable to taxpayers than the interpretation by the IRS. Until these differing interpretations are resolved by higher court decisions, or in some other way, this publication will present the interpretation of the IRS.

For more detailed tax information, the IRS has assistance programs and tax information products for churches and religious organizations, as noted in the back of this publication. Most IRS publications and forms can be downloaded from the IRS Web site at www.irs.gov, or ordered by calling toll-free (800) 829-3676. Specialized information can be accessed through the Exempt Organizations (EO) Web site under the IRS Tax Exempt and Government Entities division via www.irs.gov/eo or by calling EO Customer Account Services toll-free at (877) 829-5500.

The IRS considers this publication a living document, one that will be revised to take into account future developments and feedback. Comments on the publication may be submitted to the IRS at the following address:

Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224
Attn: T:EO:CE&O

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Introduction

This publication explains the benefits and the responsibilities under the federal tax system for churches and religious organizations. The term church *is found, but not specifically defined, in the Internal Revenue Code (IRC). The term is not used by all faiths; however, in an attempt to make this publication easy to read, we use it in its generic sense as a place of worship including, for example, mosques and synagogues. With the exception of the special rules for church audits, the use of the term church throughout this publication also includes conventions and associations of churches as well as* integrated auxiliaries of a church.

Because special tax rules apply to churches, it is important to distinguish churches from other religious organizations. Therefore, when this publication uses the term "religious organizations," it is not referring to churches or integrated auxiliaries. Religious organizations that are not churches typically include nondenominational ministries, interdenominational and ecumenical organizations, and other entities whose principal purpose is the study or advancement of religion.

Churches and religious organizations may be legally organized in a variety of ways under state law, such as unincorporated associations, nonprofit corporations, corporations sole, and charitable trusts.

Certain terms used throughout this publication—church, integrated auxiliary of a church, minister, and IRC section 501(c)(3)— are defined in the Glossary *on page 23.*

Tax-Exempt Status

Churches and religious organizations, like many other charitable organizations, qualify for exemption from federal income tax under IRC section 501(c)(3) and are generally eligible to receive tax-deductible contributions. To qualify for tax-exempt status, such an organization must meet the following requirements (covered in greater detail throughout this publication):

- the organization must be organized and operated exclusively for religious, educational, scientific, or other charitable purposes,
- net earnings may not inure to the benefit of any private individual or shareholder,
- no substantial part of its activity may be attempting to influence legislation,
- the organization may not intervene in political campaigns, and
- the organization's purposes and activities may not be illegal or violate fundamental public policy.

Recognition of Tax-Exempt Status

Automatic Exemption for Churches

Churches that meet the requirements of IRC section 501(c)(3) are automatically considered tax exempt and are not required to apply for and obtain recognition of tax-exempt status from the IRS.

Although there is no requirement to do so, many churches seek recognition of tax-exempt status from the IRS because such recognition assures church leaders, members, and contributors that the church is recognized as exempt and qualifies for related tax benefits. For example, contributors to a church that has been recognized as tax exempt would know that their contributions generally are tax-deductible.

Church Exemption Through a Central/Parent Organization

A church with a parent organization may wish to contact the parent to see if it has a *group ruling*. If the parent holds a group ruling, then the IRS may already recognize the church as tax exempt. Under the group exemption process, the parent organization becomes the holder of a group ruling that identifies other affiliated churches or other affiliated organizations. A church is recognized as tax exempt if it is included in a list provided by the parent organization. If the church or other affiliated organization is included on such a list, it does not need to take further action to obtain recognition of tax-exempt status.

An organization that is not covered under a group ruling should contact its parent organization to see if it is eligible to be included in the parent's application for the group ruling. For general information on the group exemption process, see Publication 4573, *Group Exemptions,* and Revenue Procedure 80-27, 1980-1 C.B. 677.

Religious Organizations

Unlike churches, religious organizations that wish to be tax exempt generally must apply to the IRS for tax-exempt status unless their gross receipts do not normally exceed $5,000 annually.

Applying for Tax-Exempt Status

Employer Identification Number (EIN)

Every tax-exempt organization, including a church, should have an employer identification number (EIN), whether or not the organization has any employees. There are many instances in which an EIN is necessary. For example, a church needs an EIN when it opens a bank account, in order to be listed as a subordinate in a group ruling, or if it files returns with the IRS (e.g., Forms W-2, 1099, 990-T).

An organization may obtain an EIN by filing Form S-4, *Application for Employer Identification Number*, in

accordance with the instructions. If the organization is submitting IRS Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code* (see below), Form SS-4 should be included with the application.

Application Form

Organizations, including churches and religious organizations, applying for recognition as tax exempt under IRC section 501(c)(3) must use Form 1023.

A religious organization must submit its application within 27 months from the end of the month in which the organization is formed in order to be considered tax exempt and qualified to receive deductible contributions as of the date the organization was formed. On the other hand, a church may obtain recognition of exemption from the date of its formation as a church, even though that date may be prior to 27 months from the end of the month in which its application is submitted.

Cost for applying for exemption. The IRS is required to collect a non-refundable fee from any organization seeking a determination of tax-exempt status under IRC section 501(c)(3). Although churches are not required by law to file an application for exemption, if they choose to do so voluntarily, they are required to pay the fee for determination.

The fee must be submitted with Form 1023; otherwise, the application will be returned to the submitter. Fees change periodically. The most recent user fee can be found at the Exempt Organizations (EO) Web site under the IRS Tax Exempt and Government Entities division via www.irs.gov/eo (key word "user fee") or by calling EO Customer Account Services toll-free at (877) 829-5500.

IRS Approval of Exemption Application

If the application for tax-exempt status is approved, the IRS will notify the organization of its status, any requirement to file an annual information return, and its eligibility to receive deductible contributions. The IRS does not assign a special number or other identification as evidence of an organization's tax-exempt status.

Public Listing of Tax-Exempt Organizations

The IRS lists organizations that are qualified to receive tax-deductible contributions in IRS Publication 78, *Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986*. This publication is sold to the public through the Superintendent of Documents, U.S. Government Printing Office, Washington, DC. Publication 78 can also be downloaded from the IRS Web site at www.irs.gov. Note that not every organization that is eligible to receive tax-deductible contributions is listed in Publication 78. For example, churches that have not applied for recognition of tax-exempt status are not included in the publication. Only the parent organization in a group ruling is included by name in Publication 78.

If you have questions about listing an organization, correcting an erroneous entry, or deleting a listing in Publication 78, contact EO Customer Account Services toll-free at (877) 829-5500.

Jeopardizing Tax-Exempt Status

All IRC section 501(c)(3) organizations, including churches and religious organizations, must abide by certain rules:

- their net earnings may not inure to any private shareholder or individual,
- they must not provide a substantial benefit to private interests,
- they must not devote a substantial part of their activities to attempting to influence legislation,
- they must not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office, and
- the organization's purposes and activities may not be illegal or violate fundamental public policy.

Inurement and Private Benefit

Inurement to Insiders

Churches and religious organizations, like all exempt organizations under IRC section 501(c)(3), are prohibited from engaging in activities that result in inurement of the church's or organization's income or assets to insiders (i.e., persons having a personal and private interest in the activities of the organization). *Insiders* could include the minister, church board members, officers, and in certain circumstances, employees. Examples of prohibited inurement include the payment of dividends, the payment of unreasonable compensation to insiders, and transferring property to insiders for less than fair market value. The prohibition against inurement to insiders is absolute; therefore, any amount of inurement is, potentially, grounds for loss of tax-exempt status. In addition, the insider involved may be subject to excise tax. See the following section on *Excess benefit transactions*. Note that prohibited inurement does not include reasonable payments for services rendered, payments that further tax-exempt purposes, or payments made for the fair market value of real or personal property.

Excess benefit transactions. In cases where an IRC section 501(c)(3) organization provides an excess economic benefit to an insider, both the organization and the insider have engaged in an *excess benefit transaction*. The IRS may impose an excise tax on any insider who improperly benefits from an excess benefit transaction, as well as on organization managers who participate in such a transaction knowing that it is improper. An insider who benefits from an excess benefit transaction is also required to return the excess benefits to the organization. Detailed rules on excess benefit transactions are contained in the Code of Federal Regulations, Title 26, sections 53.4958-0 through 53.4958-8.

Private Benefit

An IRC section 501(c)(3) organization's activities must be directed exclusively toward charitable, educational, religious, or other exempt purposes. Such an organization's activities may not serve the private interests of any individual or organization. Rather, beneficiaries of an organization's activities must be recognized objects of charity (such as the poor or the distressed) or the community at large (for example, through the conduct of religious services or the promotion of religion). Private benefit is different from inurement to insiders. Private benefit may occur even if the persons benefited are not insiders. Also, private benefit must be substantial in order to jeopardize tax-exempt status.

Substantial Lobbying Activity

In general, no organization, including a church, may qualify for IRC section 501(c)(3) status if a substantial part of its activities is attempting to influence legislation (commonly known as lobbying). An IRC section 501(c)(3) organization may engage in some lobbying, but too much lobbying activity risks loss of tax-exempt status.

Legislation includes action by Congress, any state legislature, any local council, or similar governing body, with respect to acts, bills, resolutions, or similar items (such as legislative confirmation of appointive offices), or by the public in a referendum, ballot initiative, constitutional amendment, or similar procedure. It does not include actions by executive, judicial, or administrative bodies.

A church or religious organization will be regarded as *attempting to influence legislation* if it contacts, or urges the public to contact, members or employees of a legislative body for the purpose of proposing, supporting, or opposing legislation, or if the organization advocates the adoption or rejection of legislation.

Churches and religious organizations may, however, involve themselves in issues of public policy without the activity being considered as lobbying. For example, churches may conduct educational meetings, prepare and distribute educational materials, or otherwise consider public policy issues in an educational manner without jeopardizing their tax-exempt status.

Measuring Lobbying Activity

Substantial part test. Whether a church's or religious organization's attempts to influence legislation constitute a substantial part of its overall activities is determined on the basis of all the pertinent facts and circumstances in each case. The IRS considers a variety of factors, including the time devoted (by both compensated and volunteer workers) and the expenditures devoted by the organization to the activity, when determining whether the lobbying activity is substantial. Churches must use the substantial part test since they are not eligible to use the expenditure test described in the next section.

Under the , a church or religious organization that conducts excessive lobbying activity in any taxable year may lose its tax-exempt status, resulting in all of its income being subject to tax. In addition, a religious organization is subject to an excise tax equal to five percent of its lobbying expenditures for the year in which it ceases to qualify for exemption. Further, a tax equal to five percent of the lobbying expenditures for the year may be imposed against organization managers, jointly and severally, who agree to the making of such expenditures knowing that the expenditures would likely result in loss of tax-exempt status.

Expenditure test. Although churches are not eligible, religious organizations may elect the expenditure test under IRC section 501(h) as an alternative method for measuring lobbying activity. Under the expenditure test, the extent of an organization's lobbying activity will not jeopardize its tax-exempt status, provided its expenditures, related to such activity, do not normally exceed an amount specified in IRC section 4911. This limit is generally based upon the size of the organization and may not exceed $1,000,000.

Religious organizations electing to use the expenditure test must file IRS Form 5768, *Election/Revocation of Election by an Eligible IRC Section 501(c)(3) Organization To Make Expenditures To Influence Legislation*, at any time during the tax year for which it is to be effective. The election remains in effect for succeeding years unless it is revoked by the organization. Revocation of the election is effective beginning with the year following the year in which the revocation is filed. Religious organizations may wish to consult their tax advisors to determine their eligibility for, and the advisability of, electing the expenditure test.

Under the , a religious organization that engages in excessive lobbying activity over a four-year period may lose its tax-exempt status, making all of its income for that period subject to tax. Should the organization exceed its lobbying expenditure dollar limit in a particular year, it must pay an excise tax equal to 25 percent of the excess.

Political Campaign Activity

Under the Internal Revenue Code, all IRC section 501(c)(3) organizations, including churches and religious organizations, are absolutely prohibited from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office. Contributions to political campaign funds or public statements of position (verbal or written) made by or on behalf of the organization in favor of or in opposition to any candidate for public office clearly violate the prohibition against political campaign activity. Violation of this prohibition may result in denial or revocation of tax-exempt status and the imposition of certain excise tax.

Certain activities or expenditures may not be prohibited depending on the facts and circumstances. For example, certain voter education activities (including the presentation of public forums and the publication of voter education guides) conducted in a non-partisan manner do not constitute prohibited political campaign activity. In addition, other activities intended to encourage people to participate in the electoral process, such as voter registration and get-out-the-vote drives, would not constitute prohibited political campaign activity if conducted in a non-partisan manner. On the other hand, voter education or registration activities with evidence of bias that: (a) would favor one candidate over another; (b) oppose a candidate in some manner; or (c) have the effect of favoring a candidate or group of candidates, will constitute prohibited participation or intervention.

Individual Activity by Religious Leaders

The political campaign activity prohibition is not intended to restrict free expression on political matters by leaders of churches or religious organizations speaking for themselves, as *individuals.* Nor are leaders prohibited from speaking about important issues of public policy. However, for their organizations to remain tax exempt under IRC section 501(c)(3), religious leaders cannot make partisan comments in official organization publications or at official church functions. To avoid potential attribution of their comments outside of church functions and publications, religious leaders who speak or write in their individual capacity are encouraged to clearly indicate that their comments are personal and not intended to represent the views of the organization. The following are examples of situations involving endorsements by religious leaders.

Example 1: Minister A is the minister of Church J, a section 501(c)(3) organization, and is well known in the community. With their permission, Candidate T publishes a full-page ad in the local newspaper listing five prominent ministers who have personally endorsed Candidate T, including Minister A. Minister A is identified in the ad as the minister of Church J. The ad states, "Titles and affiliations of each individual are provided for identification purposes only." The ad is paid for by Candidate T's campaign committee. Since the ad was not paid for by Church J, the ad is not otherwise in an official publication of Church J, and the endorsement is made by Minister A in a personal capacity, the ad does not constitute political campaign intervention by Church J.

Example 2: Minister B is the minister of Church K, a section 501(c)(3) organization, and is well known in the community. Three weeks before the election, he attends a press conference at Candidate V's campaign headquarters and states that Candidate V should be reelected. Minister B does not say he is speaking on behalf of Church K. His endorsement is reported on the front page of the local newspaper and he is identified in the article as the minister of Church K. Because Minister B did not make the endorsement at an official church function, in an official church publication or otherwise use the church's assets, and did not state that he was speaking as a representative of Church K, his actions do not constitute political campaign intervention by Church K.

Example 3: Minister C is the minister of Church I, a section 501(c)(3) organization.. Church I, publishes a monthly church newsletter that is distributed to all church members. In each issue, Minister C has a column titled "My Views." The month before the election, Minister C states in the "My Views" column, "It is my personal opinion that Candidate U should be reelected." For that one issue, Minister C pays from his personal funds the portion of the cost of the newsletter attributable to the "My Views" column. Even though he paid part of the cost of the newsletter, the newsletter is an official publication of the church. Because the endorsement appeared in an official publication of Church I, it constitutes political campaign intervention by Church I.

Example 4: Minister D is the minister of Church M, a section 501(c)(3) organization. During regular services of Church M shortly before the election, Minister D preached on a number of issues, including the importance of voting in the upcoming election, and concluded by stating, "It is important that you all do your duty in the election and vote for Candidate W." Because Minister D's remarks indicating support for Candidate W were made during an official church service, they constitute political campaign intervention by Church M.

Issue Advocacy vs. Political Campaign Intervention

Like other section 501(c)(3) organizations, some churches and religious organizations take positions on public policy issues, including issues that divide candidates in an election for public office. However, section 501(c)(3) organizations must avoid any issue advocacy that functions as political campaign intervention. Even if a statement does not expressly tell an audience to vote for or against a specific candidate, an organization delivering the statement is at risk of violating the political campaign intervention prohibition if there is any message favoring or opposing a candidate. A statement can identify a candidate not only by stating the candidate's name but also by other means such as showing a picture of the candidate, referring to political party affiliations, or other distinctive features of a candidate's platform or biography. All the facts and circumstances need to be considered to determine if the advocacy is political campaign intervention.

Key factors in determining whether a communication results in political campaign intervention include the following:

- whether the statement identifies one or more candidates for a given public office;
- whether the statement expresses approval or disapproval for one or more candidates' positions and/or actions;
- whether the statement is delivered close in time to the election;
- whether the statement makes reference to voting or an election;
- whether the issue addressed in the communication has been raised as an issue distinguishing candidates for a given office;
- whether the communication is part of an ongoing series of communications by the organization on the same issue that are made independent of the timing of any election; and
- whether the timing of the communication and identification of the candidate are related to a non-electoral event such as a scheduled vote on specific legislation by an officeholder who also happens to be a candidate for public office.

A communication is particularly at risk of political campaign intervention when it makes reference to candidates or voting in a specific upcoming election. Nevertheless, the communication must still be considered in context before arriving at any conclusions.

Example 1: Church O, a section 501(c)(3) organization, prepares and finances a full page newspaper advertisement that is published in several large circulation newspapers in State V shortly before an election in which Senator C is a candidate for nomination in a party primary. Senator C is the incumbent candidate in a party primary. The advertisement states that a pending bill in the United States Senate would provide additional opportunities for State V residents to participate in faith-based programs by providing funding to such church-affiliated programs. The advertisement ends with the statement "Call or write Senator C to tell him to vote for this bill, despite his opposition in the past." Funding for faith-based programs has not been raised as an issue distinguishing Senator C from any opponent. The bill is scheduled for a vote before the election. The advertisement identifies Senator C's position as contrary to O's position. Church O has not violated the political campaign intervention prohibition: The advertisement does not mention the election or the candidacy of Senator C or distinguish Senator C from any opponent. The timing of the advertising and the identification of Senator C are directly related to a vote on the identified legislation. The candidate identified, Senator C, is an officeholder who is in a position to vote on the legislation.

Example 2: Church R, a section 501(c)(3) organization, prepares and finances a radio advertisement urging an increase in state funding for faith-based education in State X, which requires a legislative appropriation. Governor E is the governor of State X. The radio advertisement is first broadcast on several radio stations in State X beginning shortly before an election in which Governor E is a candidate for re-election. The advertisement is not part of an ongoing series of substantially similar advocacy communications by Church R on the same issue. The advertisement cites numerous statistics indicating that faith-based education in State X is under funded. Although the advertisement does not say anything about Governor E's position on funding for faith-based education, it ends with "Tell Governor E what you think about our under-funded schools." In public appearances and campaign literature, Governor E's opponent has made funding of faith-based education an issue in the campaign by focusing on Governor E's veto of an income tax increase to increase funding for faith-based education. At the time the advertisement is broadcast, no legislative vote or other major legislative activity is scheduled in the State X legislature on state funding of faith-based education. Church R has violated the political campaign prohibition: The advertisement identifies Governor E, appears shortly before an election in which Governor E is a candidate, is not part of an ongoing series of substantially similar advocacy communications by Church R on the same issue, is not timed to coincide with a non-election event such as a legislative vote or other major legislative action on that issue, and takes a position on an issue that the opponent has used to distinguish himself from Governor E.

Example 3: Candidate A and Candidate B are candidates for the state senate in District W of State X. The issue of State X funding for a faith-based indigent hospital care in District W is a prominent issue in the campaign. Both candidates have spoken out on the issue. Candidate A supports funding such care; Candidate B opposes the project and supports increasing State X funding for public hospitals instead. P is the head of the board of elders at Church C, a section 501(c)(3) organization located in District W. At C's annual fundraising dinner in District W, which takes place in the month before the election, P gives a long speech about health care issues including the health care issues, including the issue of funding for faith-based programs. P does not mention the name of any candidate or any political party. However, at the end of the speech, P makes the following statement, "For those of you who care about quality of life in District W and the desire of our community for health care responsive to their faith, there is a very important choice coming up next month. We need more funding for health care. Increased public hospital funding will not make a difference. You have the power to respond to the needs of this community. Use that power when you go to the polls and cast your vote in the election for your state senator." C has violated the political campaign intervention prohibition as a result of P's remarks at C's official function shortly before the election, in which P referred to the upcoming election after stating a position on an issue that is a prominent issue in a campaign that distinguishes the candidates.

Inviting a Candidate to Speak

Depending on the facts and circumstances, a church or religious organization may invite political candidates to speak at its events without jeopardizing its tax-exempt status. Political candidates may be invited in their capacity as candidates, or individually (not as a candidate). Candidates may also appear without an invitation at organization events that are open to the public.

Speaking as a candidate. Like any other IRC section 501(c)(3) organization, when a candidate is invited to speak at a church or religious organization event as a political candidate, factors in determining whether the organization participated or intervened in a political campaign include the following:

- whether the church provides an equal opportunity to the political candidates seeking the same office,
- whether the church indicates any support of or opposition to the candidate. (This should be stated explicitly when the candidate is introduced and in communications concerning the candidate's appearance.)
- whether any political fundraising occurs
- whether the individual is chosen to speak solely for reasons other than candidacy for public office,
- whether the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present, and
- whether the organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

Equal opportunity to participate. Like any other IRC section 501(c)(3) organization, in determining whether candidates are given an equal opportunity to participate, a church or religious organization should consider the nature of the event to which each candidate is invited, in addition to the manner of presentation. For example, a church or religious organization that invites one candidate to speak at its well attended annual banquet, but invites the opposing candidate to speak at a sparsely attended general meeting, will likely be found to have violated the political campaign prohibition, even if the manner of presentation for both speakers is otherwise neutral.

Public forum. Sometimes a church or religious organization invites several candidates to speak at a public forum. A public forum involving several candidates for public office may qualify as an exempt educational activity. However, if the forum is operated to show a bias for or against any candidate, then the forum would be prohibited campaign activity, as it would be considered intervention or participation in a political campaign. When an organization invites several candidates to speak at a forum, among the factors it should consider are:

- whether questions for the candidate are prepared and presented by an independent nonpartisan panel,
- whether the topics discussed by the candidates cover a broad range of issues that the candidates would address if elected to the office sought and are of interest to the public,
- whether each candidate is given an equal opportunity to present his or her views on the issues discussed,
- whether the candidates are asked to agree or disagree with positions, agendas, platforms or statements of the organization, and
- whether a moderator comments on the questions or otherwise implies approval or disapproval of the candidates.

A candidate may seek to reassure the organization that it is permissible for the organization to do certain things in connection with the candidate's appearance. An organization in this position should keep in mind that the candidate may not be familiar with the organization's tax-exempt status and that the candidate may be focused on compliance with the election laws that apply to the candidate's campaign rather than the federal tax law that applies to the organization. The organization will be in the best position to ensure compliance with the prohibition on political campaign intervention if it makes its own independent conclusion about its compliance with federal tax law.

The following are examples of situations where a church or religious organization invites a candidate(s) to speak before the congregation.

Example 1: Minister E is the minister of Church N, a section 501(c)(3) organization. In the month prior to the election, Minister E invited the three Congressional candidates for the district in which Church N is located to address the congregation, one each on three successive Sundays, as part of regular worship services. Each candidate was given an equal opportunity to address and field questions on a wide variety of topics from the congregation. Minister E's introduction of each candidate included no comments on their qualifications or any indication of a preference for any candidate. The actions do not constitute political campaign intervention by Church N.

Example 2: The facts are the same as in the preceding example except that there are four candidates in the race rather than three, and one of the candidates declines the invitation to speak. In the publicity announcing the dates for each of the candidate's speeches, Church N includes a statement that the order of the speakers was determined at random and the fourth candidate declined the church's invitation to speak. Minister E makes the same statement in his opening remarks at each of the meetings where one of the candidates is speaking. Church N's actions do not constitute political campaign intervention.

Example 3: Minister F is the minister of Church O, a section 501(c)(3) organization. The Sunday before the November election, Minister F invited Senate Candidate X to preach to her congregation during worship services. During his remarks, Candidate X stated, "I am asking not only for your votes, but for your enthusiasm and dedication, for your willingness to go the extra mile to get a very large turnout on Tuesday." Minister F invited no other candidate to address her congregation during the Senatorial campaign. Because these activities took place during official church services, they are by Church O. By selectively providing church facilities to allow Candidate X to speak in support of his campaign, Church O's actions constitute political campaign intervention.

Speaking as a non-candidate. Like any other IRC section 501(c)(3) organization, a church or religious organization may invite political candidates (including church members) to speak in a non-candidate capacity. For instance, a political candidate may be a public figure because he or she: (a) currently holds, or formerly held, public office; (b) is considered an expert in a non-political field; or (c) is a celebrity or has led a distinguished military, legal, or public service career. A candidate may choose to attend an event that is open to the public, such as a lecture, concert or worship service. The candidate's presence at a church-sponsored event does not, by itself, cause the organization to be involved in political campaign intervention. However, if the candidate is publicly recognized by the organization, or if the candidate is invited to speak, factors in determining whether the candidate's appearance results in political campaign intervention include the following:

- whether the individual speaks only in a non-candidate capacity,
- whether either the individual or any representative of the church makes any mention of his or her candidacy or the election,
- whether any campaign activity occurs in connection with the candidate's attendance,
- whether the individual is chosen to speak solely for reasons other than candidacy for public office,
- whether the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present, and
- whether the organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

In addition, the church or religious organization should clearly indicate the capacity in which the candidate is appearing and should not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

Below are examples of situations where a public official appears at a church or religious organization.

Example 1: Church P, a section 501(c)(3) organization, is located in the state capital. Minister G customarily acknowledges the presence of any public officials present during services. During the state gubernatorial race, Lieutenant Governor Y, a candidate, attended a Wednesday evening prayer service in the church. Minister G acknowledged the Lieutenant Governor's presence in his customary manner, saying, "We are happy to have worshiping with us this evening Lieutenant Governor Y." Minister G made no reference in his welcome to the Lieutenant Governor's candidacy or the election. Minister G's actions do not constitute political campaign intervention by Church P.

Example 2: Minister H is the minister of Church Q, a section 501(c)(3) organization. Church Q is building a community center. Minister H invites Congressman Z, the representative for the district containing Church Q, to attend the groundbreaking ceremony for the community center. Congressman Z is running for reelection at the time. Minister H makes no reference in her introduction to Congressman Z's candidacy or the election. Congressman Z also makes no reference to his candidacy or the election and does not do any fundraising while at Church Q. Church Q has not intervened in a political campaign.

Example 3: Church X is a section 501(c)(3) organization. X publishes a member newsletter on a regular basis. Individual church members are invited to send in updates about their activities which are printed in each edition of the newsletter. After receiving an update letter from Member Q, X prints the following: "Member Q is running for city council in Metropolis." The newsletter does not contain any reference to this election or to Member Q's candidacy other than this statement of fact. Church X has not intervened in a political campaign.

Example 4: Mayor G attends a concert performed by a choir of Church S, a section 501(c)(3) organization, in City Park. The concert is free and open to the public. Mayor G is a candidate for reelection, and the concert takes place after the primary and before the general election. During the concert, S's minister addresses the crowd and says, "I am pleased to see Mayor G here tonight. Without his support, these free concerts in City Park would not be possible. We will need his help if we want these concerts to continue next year so please support Mayor G in November as he has supported us." As a result of these remarks, Church S has engaged in political campaign intervention.

Voter Education, Voter Registration and Get-Out-the-Vote Drives

Section 501(c)(3) organizations are permitted to conduct certain voter education activities (including the presentation of public forums and the publication of voter education guides) if they are carried out in a non-partisan manner. In addition, section 501(c)(3) organizations may encourage people to participate in the electoral process through voter registration and get-out-the-vote drives, conducted in a non-partisan manner. On the other hand, voter education or registration activities conducted in a biased manner that favors (or opposes) one or more candidates is prohibited.

Like other IRC section 501(c)(3) organizations, some churches and religious organizations undertake voter education activities by distributing *voter guides*. Voter guides, generally, are distributed during an election campaign and provide information on how all candidates stand on various issues. These guides may be distributed with the purpose of educating voters; however, they may not be used to attempt to favor or oppose candidates for public elected office.

A careful review of the following facts and circumstances may help determine whether or not a church or religious organization's publication or distribution of voter guides constitutes prohibited political campaign activity:

- whether the candidates' positions are compared to the organization's position,

- whether the guide includes a broad range of issues that the candidates would address if elected to the office sought,
- whether the description of issues is neutral,
- whether all candidates for an office are included, and
- whether the descriptions of candidates' positions are either:
  - the candidates' own words in response to questions, or
  - a neutral, unbiased and complete compilation of all candidates' positions.

The following are examples of situations where churches distribute voter guides.

Example 1: Church R, a section 501(c)(3) organization, distributes a voter guide prior to elections. The voter guide consists of a brief statement from the candidates on each issue made in response to a questionnaire sent to all candidates for governor of State I. The issues on the questionnaire cover a wide variety of topics and were selected by Church R based solely on their importance and interest to the electorate as a whole. Neither the questionnaire nor the voter guide, through their content or structure, indicate a bias or preference for any candidate or group of candidates. Church R is not participating or intervening in a political campaign.

Example 2: Church S, a section 501(c)(3) organization, distributes a voter guide during an election campaign. The voter guide is prepared using the responses of candidates to a questionnaire sent to candidates for major public offices. Although the questionnaire covers a wide range of topics, the wording of the questions evidences a bias on certain issues. By using a questionnaire structured in this way, Church S is participating or intervening in a political campaign.

Example 3: Church T, a section 501(c)(3) organization, sets up a booth at the state fair where citizens can register to vote. The signs and banners in and around the booth give only the name of the church, the date of the next upcoming statewide election, and notice of the opportunity to register. No reference to any candidate or political party is made by volunteers staffing the booth or in the materials available in the booth, other than the official voter registration forms which allow registrants to select a party affiliation. Church T is not engaged in political campaign intervention when it operates this voter registration booth.

Example 4: Church C is a section 501(c)(3) organization. C's activities include educating its members on family issues involving moral values. Candidate G is running for state legislature and an important element of her platform is challenging the incumbent's position on family issues. Shortly before the election, C sets up a telephone bank to call registered voters in the district in which Candidate G is seeking election. In the phone conversations, C's representative tells the voter about the moral importance of family issues and asks questions about the voter's views on these issues. If the voter appears to agree with the incumbent's position, C's representative thanks the voter and ends the call. If the voter appears to agree with Candidate G's position, C's representative reminds the voter about the upcoming election, stresses the importance of voting in the election and offers to provide transportation to the polls. C is engaged in political campaign intervention when it conducts this get-out-the-vote drive.

Business Activity

The question of whether an activity constitutes participation or intervention in a political campaign may also arise in the context of a business activity of the church or religious organization, such as the selling or renting of mailing lists, the leasing of office space, or the acceptance of paid political advertising. (The tax treatment of income from unrelated business activities follows.) In this context, some of the factors to be considered in determining whether the church or religious organization has engaged in prohibited political campaign activity include the following:

- whether the good, service, or facility is available to the candidates on an equal basis,
- whether the good, service, or facility is available only to candidates and not to the general public,
- whether the fees charged are at the organization's customary and usual rates, and
- whether the activity is an ongoing activity of the organization or whether it is conducted only for the candidate.

Example 1: Church K is a section 501(c)(3) organization. It owns a building that has a large basement hall suitable for hosting dinners and receptions. For several years, Church K has made the hall available for rent to members of the public. It has standard fees for renting the hall based on the number of people in attendance, and a number of different organizations have rented the hall. Church K rents the hall on a first come, first served basis. Candidate P's campaign pays the standard fee for the dinner. Church K is not involved in political campaign intervention as a result of renting the hall to Candidate P for use as the site of a campaign fundraising dinner.

Example 2: Church L is a section 501(c)(3) organization. It maintains a mailing list of all of its members. Church L has never rented the mailing list to a third party. The campaign committee of Candidate Q, who supports funding for faith-based programs, approaches Church L. Candidate A's campaign committee offers to rent Church L's mailing list for a fee that is comparable to fees charged by other similar organizations. Church L rents the list to Candidate A's campaign committee, but declines similar requests from campaign committees of other candidates. Church L has intervened in a political campaign.

Web Sites: The Internet has become a widely used communications tool. Section 501(c)(3) organizations use their own web sites to disseminate statements and information. They also routinely link their web sites to web sites maintained by other organizations as a way of providing additional information that the organizations believe is useful or relevant to the public.

A web site is a form of communication. If an organization posts something on its web site that favors or opposes a candidate for public office, the organization will be treated the same as if it distributed printed material, oral statements or broadcasts that favored or opposed a candidate.

An organization has control over whether it establishes a link to another site. When an organization establishes a link to another web site, the organization is responsible for the consequences of establishing and maintaining that link, even if the organization does not have control over the content of the linked site. Because the linked content may change over time, an organization may reduce the risk of political campaign intervention by monitoring the linked content and adjusting the links accordingly.

Links to candidate-related material, by themselves, do not necessarily constitute political campaign intervention. All the facts and circumstances must be taken into account when assessing whether a link produces that result. The facts and circumstances to be considered include, but are not limited to, the context for the link on the organization's web site, whether all candidates are represented, any exempt purpose served by offering the link, and the directness of the links between the organization's web site and the web page that contains material favoring or opposing a candidate for public office.

Example 1: Church P, a section 501(c)(3) organization, maintains a web site that includes such information as biographies of its ministers, times of services, details of community outreach programs, and activities of members of its congregation. B, a member of the congregation of Church P, is running for a seat on the town council. Shortly before the election, Church P posts the following message on its web site, "Lend your support to B, your fellow parishioner, in Tuesday's election for town council." Church P has intervened in a political campaign on behalf of B.

Example 2: Church N, a section 501(c)(3) organization, maintains a web site that includes such information as staff listings; directions to the church; and descriptions of its community outreach programs, schedules of services, and school activities. On one page of the web site, Church N describes a particular type of treatment program for homeless veterans. This section includes a link to an article on the web site of O, a major national newspaper, praising Church N's treatment program for homeless veterans. The page containing the article on O's web site does not refer to any candidate or election and has no direct links to candidate or election information. Elsewhere on O's web site, there is a page displaying editorials that O has published. Several of the editorials endorse candidates in an election that has not yet occurred. Church N has not intervened in a political campaign by maintaining a link on O's web site because the link is provided for the exempt purpose of educating the public about its programs; the context for the link, the relationship between Church N and O and the arrangement of the links going from Church N's web site to the endorsement on O's web site do not indicate that Church N was favoring or opposing any candidate.

Example 3: Church M, a section 501(c)(3) organization, maintains a web site and posts an unbiased, nonpartisan voter guide that is prepared with the principles discussed on pages 12 and 13 of this publication. For each candidate covered in the voter guide, M includes a link to that candidate's official campaign web site. The links to the candidate web sites are presented on a consistent neutral basis for each candidate, with text saying "For more information on Candidate X, you may consult [URL]." M has not intervened in a political campaign because the links are provided for the exempt purpose of educating voters and are presented in a neutral, unbiased manner that includes all candidates for a particular office.

Consequences of Political Campaign Activity

When it participates in political campaign activity, a church or religious organization jeopardizes both its tax-exempt status under IRC section 501(c)(3) and its eligibility to receive tax-deductible contributions. In addition, it may become subject to an excise tax on its political expenditures. This *excise tax* may be imposed in addition to revocation, or it may be imposed instead of revocation. Also, the church or religious organization should correct the violation.

Excise tax. An initial tax is imposed on an organization at the rate of 10 percent of the political expenditures. Also, a tax at the rate of 2.5 percent of the expenditures is imposed against the organization managers (jointly and severally) who, without reasonable cause, agreed to the expenditures knowing they were political expenditures. The tax on management may not exceed $5,000 with respect to any one expenditure.

In any case in which an initial tax is imposed against an organization, and the expenditures are not corrected within the period allowed by law, an additional tax equal to 100 percent of the expenditures is imposed against the organization. In that case, an additional tax is also imposed against the organization managers (jointly and severally) who refused to agree to make the correction. The additional tax on management is equal to 50 percent of the expenditures and may not exceed $10,000 with respect to any one expenditure.

Correction. Correction of a political expenditure requires the recovery of the expenditure, to the extent possible, and establishment of safeguards to prevent future political expenditures.

Please note that a church or religious organization that engages in any political campaign activity also needs to determine whether it is in compliance with the appropriate federal, state or local election laws, as these may differ from the requirements under IRC section 501(c)(3).

Unrelated Business Income Tax (UBIT)

Net Income Subject to the UBIT

Churches and religious organizations, like other tax-exempt organizations, may engage in income-producing activities unrelated to their tax-exempt purposes, as long as the unrelated activities are not a substantial part of the organization's activities. However, the net income from such activities will be subject to the UBIT if the following three conditions are met:

- the activity constitutes a trade or business,
- the trade or business is regularly carried on, and
- the trade or business is not substantially related to the organization's exempt purpose. (The fact that the organization uses the income to further its charitable or religious purposes does not make the activity substantially related to its exempt purposes.)

Exceptions to UBIT

Even if an activity meets the above three criteria, the income may not be subject to tax if it meets one of the following exceptions: (a) substantially all of the work in operating the trade or business is performed by volunteers; (b) the activity is conducted by the organization primarily for the convenience of its members; or (c) the trade or business involves the selling of merchandise substantially all of which was donated.

In general, rents from real property, royalties, capital gains, and interest and dividends are not subject to the unrelated business income tax unless financed with borrowed money.

Examples of Unrelated Trade or Business Activities

Unrelated trade or business activities vary depending on types of activities, as shown below.

Advertising

Many tax-exempt organizations sell advertising in their publications or other forms of public communication. Generally, income from the sale of advertising is unrelated trade or business income. This may include the sale of advertising space in weekly bulletins, magazines or journals, or on church or religious organization web sites.

Gaming

Most forms of gaming, if regularly carried on, may be considered the conduct of an unrelated trade or business. This can include the sale of pull-tabs and raffles. Income derived from bingo games may be eligible for a special tax exception (in addition to the exception regarding uncompensated volunteer labor covered above), if the following conditions are met: (a) the bingo game is the traditional type of bingo (as opposed to instant bingo, a variation of pull-tabs); (b) the conduct of the bingo game is not an activity carried out by for-profit organizations in the local area; and (c) the operation of the bingo game does not violate any state or local law.

Sale of merchandise and publications

The sale of merchandise and publications (including the actual publication of materials) can be considered the conduct of an unrelated trade or business if the

items involved do not have a substantial relationship to the exempt purposes of the organization.

Rental income

Generally, income derived from the rental of real property and incidental personal property is excluded from unrelated business income. However, there are certain situations in which rental income may be unrelated business taxable income:

- if a church rents out property on which there is debt outstanding (for example, a mortgage note), the rental income may constitute unrelated debt-financed income subject to UBIT. (However, if a church or convention or association of churches acquires debt-financed land for use in its exempt purposes within 15 years of the time of acquisition, then income from the rental of the land may not constitute unrelated business income.)
- if personal services are rendered in connection with the rental, then the income may be unrelated business taxable income, or
- if a church charges for the use of the parking lot, the income may be unrelated business taxable income.

Parking lots

If a church owns a parking lot that is used by church members and visitors while attending church services, any parking fee paid to the church would not be subject to UBIT. However, if a church operates a parking lot that is used by members of the general public, parking fees would be taxable, as this activity would not be substantially related to the church's exempt purpose, and parking fees are not treated as rent from real property. If the church enters into a lease with a third party who operates the church's parking lot and pays rent to the church, such payments would not be subject to tax, as they would constitute rent from real property.

Whether an income-producing activity is an unrelated trade or business activity depends on all the facts and circumstances. For more information, see IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*.

Tax on Income-Producing Activities

If a church, or other exempt organization, has gross income of $1,000 or more for any taxable year from the conduct of any unrelated trade or business, it is required to file IRS Form 990-T, *Exempt Organization Business Income Tax Return*, for that year. If the church is part of a larger entity (such as a diocese), it must file a separate Form 990-T if it has a separate EIN. Form 990-T is due the l5th day of the 5th month following the end of the church's tax year. (IRC section 512(b)(12) provides a special rule for parishes and similar local units of a church. A specific deduction is provided, which is equal to the lower of $1,000 or the gross income derived from any unrelated trade or business regularly carried on by such parish or local unit of a church.) See Filing Requirements on page 22.

Download IRS publications and forms at www.irs.gov or order free through the IRS at (800) 829-3676.

Employment Tax

Generally, churches and religious organizations are required to withhold, report, and pay income and Federal Insurance Contributions Act (FICA) taxes for their employees. Employment tax includes income tax withheld and paid for an employee and FICA taxes withheld and paid on behalf of an employee. Substantial penalties may be imposed against an organization that fails to withhold and pay the proper employment tax. Whether a church or religious organization must withhold and pay employment tax depends upon whether the church's workers are employees. *Determination of worker status* is important. Several facts determine whether a worker is an employee. For an in-depth explanation and examples of the common law employer-employee relationship, see IRS Publication 15-A, *Employer's Supplemental Tax Guide*. If a church or a worker wants the IRS to determine whether the worker is an employee, the church or worker should file IRS Form SS-8, *Determination of Employee Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, with the IRS.

Social Security and Medicare Taxes — Federal Insurance Contributions Act (FICA)

FICA taxes consist of Social Security and Medicare taxes. Wages paid to employees of churches or religious organizations are subject to FICA taxes unless *one* of the following exceptions applies:

- wages are paid for services performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his or her ministry, or by a member of a religious order in the exercise of duties required by such order,
- the church or religious organization pays the employee wages of less than $108.28 in a calendar year, or
- a church that is opposed to the payment of Social Security and Medicare taxes for religious reasons files IRS Form 8274, *Certification by Churches and Qualified Church Controlled Organizations Electing Exemption From Employer Social Security and Medicare Taxes*. Very specific timing rules apply to filing Form 8274. It must be filed before the *first* date on which the electing entity is required to file its first quarterly employment tax return. This election does not relieve the organization of its obligation to withhold income tax on wages paid to its employees. In addition, if such an election is made, affected employees must pay Self-Employment Contributions Act (SECA) tax. For further information, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Withheld employee income tax and FICA taxes are reported on IRS Form 941, *Employer's Quarterly Federal Tax Return*. Some small employers are eligible to file an annual Form 944 instead of quarterly returns. For more information about employment tax, see IRS Publication 15, *Circular E, Employer's Tax Guide*, and IRS Publication 15-A, *Employer's Supplemental Tax Guide*. *See also*, IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*. See the instructions to Form 944 for more information.

Federal Unemployment Tax Act (FUTA)

Churches and religious organizations are not liable for FUTA tax. For further information on FUTA, see IRS Publication 15, *Circular E, Employer's Tax Guide*, and IRS Publication 15-A, *Employer's Supplemental Tax Guide*. See also, IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*

Special Rules for Compensation of Ministers

Withholding Income Tax for Ministers

Unlike other exempt organizations or businesses, a church is not required to withhold income tax from the compensation that it pays to its duly ordained, commissioned, or licensed ministers for performing services in the exercise of their ministry. An employee minister may, however, enter into a voluntary withholding agreement with the church by completing IRS Form W-4, *Employee's Withholding Allowance Certificate*. A church should report compensation paid to a minister on Form W-2, *Wage and Tax Statement*, if the minister is an employee, or on IRS Form 1099-MISC, *Miscellaneous Income*, if the minister is an independent contractor.

Parsonage or Housing Allowances

Generally, a minister's gross income does not include the fair rental value of a home (parsonage) provided, or a housing allowance paid, as part of the minister's compensation for services performed that are ordinarily the duties of a minister.

A minister who is furnished a *parsonage* may exclude from income the fair rental value of the parsonage, including utilities. However, the amount excluded cannot be more than the reasonable pay for the minister's services.

A minister who receives a *housing allowance* may exclude the allowance from gross income to the extent it is used to pay expenses in providing a home. Generally, those expenses include rent, mortgage payments, utilities, repairs, and other expenses directly relating to providing a home. If a minister owns a home, the amount excluded from the minister's gross income as a housing allowance is limited to the least of the following: (a) the amount actually used to provide a home; (b) the amount officially designated as a housing allowance; or (c) the fair rental value of the home. The minister's church or other qualified organization must designate the housing allowance pursuant to official action taken *in advance* of the payment. If a minister is employed and paid by a local congregation, a designation by a national church agency will not be effective. The local congregation must make the designation. A national church agency may make an effective designation for ministers it directly employs. If none of the minister's salary has been officially designated as a housing allowance, the full salary must be included in gross income.

The fair rental value of a parsonage or housing allowance is excludable from income only for income tax purposes. These amounts are *not* excluded in determining the minister's net earnings from self-employment for Self-Employment Contributions Act (SECA) tax purposes. Retired ministers who receive either a parsonage or housing allowance are not required to include such amounts for SECA tax purposes.

As mentioned above, a minister who receives a parsonage or rental allowance excludes that amount from his income. The portion of expenses allocable to the excludable amount is not deductible. This limitation, however, does not apply to interest on a home mortgage or real estate taxes, nor to the calculation of net earnings from self-employment for SECA tax purposes.

IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*, has a detailed example of the tax treatment for a housing allowance and the related limitations on deductions. IRS Publication 525, *Taxable and Nontaxable Income*, has information on particular types of income for ministers.

Social Security and Medicare Taxes — Federal Insurance Contributions Act (FICA) vs. Self-Employment Contributions Act (SECA)

The compensation that a church or religious organization pays to its ministers for performing services in the exercise of ministry is not subject to FICA taxes. However, income that a minister earns in performing services in the exercise of his ministry is subject to SECA tax, unless the minister has timely applied for and received an exemption from SECA tax.

Payment of Employee Business Expenses

A church or religious organization is treated like any other employer as far as the tax rules regarding employee business expenses. The rules differ depending upon whether the expenses are paid through an accountable or non-accountable plan, and these plans determine whether the payment for these expenses is included in the employee's income.

Accountable Reimbursement Plan

An arrangement that an employer establishes to reimburse or advance employee business expenses will be an accountable plan if it meets three requirements: (1) involves a business connection; (2) requires the employee to substantiate expenses incurred; and (3) requires the employee to return any excess amounts.

Employees must provide the organization with sufficient information to identify the specific business nature of each expense and to substantiate each element of an expenditure. It is not sufficient for an employee to aggregate expenses into broad categories such as travel or to report expenses through the use of non-descriptive terms such as *miscellaneous business expenses*. Both the substantiation and the return of excess amounts must occur within a reasonable period of time.

Employee business expenses reimbursed under an accountable plan are: (a) excluded from an employee's gross income; (b) not required to be reported on the employee's IRS Form W-2, *Wage and Tax Statement*; and (c) exempt from the withholding and payment of wages subject to FICA taxes and income tax withholdings.

Non-accountable Reimbursement Plan

If the church or religious organization reimburses or advances the employee for business expenses, but the arrangement does not satisfy the three requirements of an accountable plan, the amounts paid to the employees are considered wages subject to FICA taxes and income tax withholding, if applicable, and are reportable on Form W-2. (Amounts paid to employee ministers are treated as wages reportable on Form W-2, but are not subject to FICA taxes or income tax withholding.)

For example, if a church or religious organization pays its secretary a $200 per month allowance to reimburse monthly business expenses the secretary incurs while conducting church or religious organization business, and the secretary is not required to substantiate the expenses or return any excess, then the entire $200 must be reported on Form W-2 as wages subject to FICA taxes and income tax withholding. In the same situation involving an employee-minister, the allowance must be reported on the minister's Form W-2, but no FICA or income tax withholding is required. For further information see IRS Publication 463, *Travel, Entertainment, Gift and Car Expenses*.

One common business expense reimbursement is for *automobile mileage*. If a church or religious organization pays a mileage allowance at a rate that is less than or equal to the federal standard rate, the amount of the expense is deemed substantiated. (Each year, the federal government establishes a standard mileage reimbursement rate.) There are no income or employment tax consequences to the reimbursed individual provided that the employee substantiates the time, place, and business purposes of the automobile mileage for which reimbursement is sought. Of course, reimbursement for automobile mileage incurred for personal purposes is includible in the individual's income.

If a church or religious organization reimburses automobile mileage at a rate exceeding the standard mileage rate, the excess is treated as paid under a non-accountable plan. This means that the excess is includible in the individual's income and is subject to the withholding and payment of income and employment taxes, if applicable.

In addition, any mileage reimbursement that is paid without requiring the individual to substantiate the time, place, and business purposes of each trip is included in the individual's income, regardless of the rate of reimbursement.

No income is attributed to an employee or a volunteer who uses an automobile owned by the church or religious organization to perform church-related work.

Recordkeeping Requirements

Books of Accounting and Other Types of Records

All tax-exempt organizations, including churches and religious organizations (regardless of whether tax-exempt status has been officially recognized by the IRS), are required to maintain books of accounting and other records necessary to justify their claim for exemption in the event of an audit. See Special Rules Limiting IRS Authority to Audit a Church on page 26. Tax-exempt organizations are also required to maintain books and records that are necessary to accurately file any federal tax and information returns that may be required.

There is no specific format for keeping records. However, the types of required records frequently include organizing documents (charter, constitution, articles of incorporation) and bylaws, minute books, property records, general ledgers, receipts and disbursements journals, payroll records, banking records, and invoices. The extent of the records necessary generally varies according to the type, size, and complexity of the organization's activities.

Length of Time to Retain Records

The law does not specify a *length of time* that records must be retained; however, the following guidelines should be applied in the event that the records may be material to the administration of any federal tax law.

Records of revenue and expenses, including payroll records.	Retain for at least four years after filing the return(s) to which they relate.
Records relating to acquisition and disposition of property (real and personal, including investments).	Retain for at least four years after the filing of the return for the year in which disposition occurs.

also important for
organization to
tax law to avoid losing its
exempt status by engaging in activity
violates the Internal Revenue Code.

Filing Requirements

Information and Tax Returns — Forms to File and Due Dates

Churches and religious organizations may be required to report certain payments or information to the IRS. The following is a list of the most frequently required returns, who should use them, how they are used, and when they should be filed.

Returns	*Who Should Use Them*	*How They are Used*	*When to File*
Form W-2 ***Wage and Tax Statement*** **Form W-3** ***Transmittal of Wage and Tax Statement***	Organizations with employees.		Furnish each employee with a completed Form W-2 by January 31; and file all Forms W-2 and Form W-3 with the Social Security Administration (SSA) by the last day of February.
Form W-2G ***Certain Gaming Winnings*** For more information on reporting requirements for gaming activities, see IRS Publication 3079, *Gaming Publication for Tax-Exempt Organizations.*	Any charitable or religious organization, including a church, that sponsors a gaming event (raffles, bingo) must file Form W-2G when a participant wins a prize over a specific value amount.	The requirements for reporting and withholding depend on the type of gaming, the amount of winnings, and the ratio of winnings to the wager.	For each winner meeting the filing requirement, the church or religious organization must furnish Form W-2G by January 31; and file Copy A of Form W-2G with the IRS by February 28.
Form 941 ***Employer's Quarterly Federal Tax Return*** ***or*** Form 944 Employer's Annual Federal Tax Return	Small employers that have been notified by the IRS to file Form 944 (see form instructions) may use that form; other employers required to file must use Form 941.	Use Form 941 or 944 to report Social Security and Medicare taxes and income taxes withheld by the organization, and Social Security and Medicare taxes paid by the organization.	See form instructions for due dates.
Form 945 ***Annual Return of Withheld Federal Income Tax***		If a church or religious organization withholds income tax, including backup withholding, from non-payroll payments, it must file Form 945.	File Form 945 by January 31. This form is not required for those years in which there is no non-payroll tax liability.
Form 990 ***Return of Organization Exempt from Income Tax*** **Form 990-EZ** ***Short Form Return of Organization Exempt From Income Tax*** **Form 990-N (electronic postcard),** ***Electronic Notice for Tax Exempt Organizations Not Required to File Form 990 or 990-EZ.***	Generally, all religious organizations (see exceptions to file Form 990 below) must file Form 990, Form 990-EZ or Form 990-N.	For tax years 2008 through 2010, the thresholds for determining whether an organization should file Form 990, 990-EZ or 990-N will vary. See www.irs.gov/eo for the specific thresholds.	Form 990, 990-EZ or 990-N must be filed on or before the 15th day of the 5th month following the end of the organization's tax year. Form 990-N must be electronically filed.
	Exceptions to file Form 990, 990-EZ and 990-N The following is a list of some of the organizations that are not required to file Form 990, 990-EZ or 990-N. ■ Churches (as opposed to "religious organizations," defined earlier) ■ Inter-church organizations of local units of a church ■ Mission societies sponsored by or affiliated with one or more churches or church denomination, if more than half of the activities are conducted in, or directed at, persons in foreign countries ■ An exclusively religious activity of any religious order See the form instructions for a list of other organizations that are not required to file.		

Returns	*Who Should Use Them*	*How They are Used*	*When to File*
Form 990-T ***Exempt Organization Business Income Tax Return*** For more information on unrelated business income, see Unrelated Business Income Tax (UBIT) on page 16.	Churches and religious organizations.	Churches and religious organizations must file Form 990-T if they generate gross income from an unrelated business of $1,000 or more for a taxable year.	Form 990-T must be filed by the 15th day of the 5th month after the organization's accounting period ends (May 15 for a calendar year accounting period).
Form 990-W ***Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations***	Churches and religious organizations.	If the tax on unrelated business income is expected to be $500 or more, the church or religious organization must make estimated tax payments. Use Form 990-W to compute the estimated tax liability.	
Form 1096 ***Annual Summary and Transmittal of U.S. Information Returns***	Churches and religious organizations.	Use Form 1096 to transmit Forms 1099-MISC, W-2G, and certain other forms to the IRS.	Form 1096 must be filed by February 28 in the year following the calendar year in which the payments were made.
Form 1099 - MISC ***Miscellaneous Income*** See the *Instructions for* Form 1099-MISC for details.	Churches and religious organizations.	A church or religious organization must use Form 1099-MISC if it pays an unincorporated individual or entity $600 or more in any calendar year for one of the following payments: gross rents; commissions, fees, or other compensation paid to non-employees; prizes and awards; or other fixed and determinable income.	Churches or religious organizations must furnish each payee with a copy of Form 1099-MISC by January 31; and file Copy A of Form 1099-MISC with the IRS by February 28.
Form 5578 ***Annual Certification of Racial Nondiscrimination for a Private School Exempt from Federal Income Tax*** For information on racial and ethnic nondiscriminatory policies, see Revenue Procedure 75-50, 1975-2 C.B. 587 at www.irs.gov.	A church or religious organization that operates a private school, whether separately incorporated or operated as part of its overall operations, that teaches secular subjects and generally complies with state law requirements for public education.	A church or religious organization must file Form 5578 to certify that it does not discriminate based on race or ethnic origin.	Form 5578 must be filed on or before the 15th day of the 5th month following the end of the organization's taxable year (May 15 for a calendar year). If an organization files Form 990 or Form 990-EZ, the certification must be made on Schedule A (Form 990 or Form 990-EZ).
	Note: It is not considered racially discriminatory for a parochial school to select students on the basis of membership in a religious denomination if membership in the denomination is open to all on a racially nondiscriminatory basis. Further, a seminary, or other purely religious school, that primarily teaches religious subjects usually with the purpose of training students for the ministry, is not subject to the racially nondiscriminatory requirements because it is considered to be a religious rather than an educational organization.		
Form 8282 ***Donee Information Return***	Churches and religious organizations.	A church or religious organization must file Form 8282 if it sells, exchanges, transfers, or otherwise disposes of certain non-cash donated property within three years of the date it originally received the donation. This applies to non-cash property that had an appraised value of more than $5,000 at time of donation.	The church or religious organization must file Form 8282 with the IRS within 125 days of date of disposition of the property; and furnish the original donor with a copy of the form.
Treasury Form 90.22.1, Report of Foreign Bank and Financial Accounts	See form instructions	See form instructions	See form instructions

Charitable Contributions — Substantiation and Disclosure Rules

Recordkeeping

A church or religious organization should be aware of the recordkeeping and substantiation rules imposed on donors of charities that receive certain quid pro quo contributions.

Recordkeeping Rules

A donor cannot claim a tax deduction for any contribution of cash, a check or other monetary gift made on or after January 1, 2007 unless the donor maintains a record of the contribution in the form of either a bank record (such as a cancelled check) or a written communication from the charity (such as a receipt or a letter) showing the name of the charity, the date of the contribution, and the amount of the contribution.

Substantiation Rules

A donor cannot claim a tax deduction for any single contribution of $250 or more unless the donor obtains a contemporaneous, written acknowledgment of the contribution from the recipient church or religious organization. A church or religious organization that does not acknowledge a contribution incurs no penalty; but without a written acknowledgment, the donor cannot claim a tax deduction. Although it is a donor's responsibility to obtain a written acknowledgment, a church or religious organization can assist the donor by providing a timely, written statement containing the following information:

- name of the church or religious organization,
- date of the contribution,
- amount of any cash contribution, and
- description (but not the value) of non-cash contributions.

In addition, the timely, written statement must contain one of the following:

- statement that no goods or services were provided by the church or religious organization in return for the contribution,
- statement that goods or services that a church or religious organization provided in return for the contribution consisted entirely of intangible religious benefits, or
- description and good faith estimate of the value of goods or services other than intangible religious benefits that the church or religious organization provided in return for the contribution.

The church or religious organization may either provide separate acknowledgments for each single contribution of $250 or more or one acknowledgment to substantiate several single contributions of $250 or more. Separate contributions are not aggregated for purposes of measuring the $250 threshold.

Disclosure Rules that Apply to Contributions

A contribution made by a donor in exchange for goods or services is known as a *quid pro quo* contribution. A donor may only take a contribution deduction to the extent that his or her contribution exceeds the fair market value of the goods and services the donor receives in return for the contribution. Therefore, donors need to know the value of the goods or services. A church or religious organization must provide a written statement to a donor who makes a payment exceeding $75 partly as a contribution and partly for goods and services provided by the organization.

Example 1: If a donor gives a church a payment of $100 and, in return, receives a ticket to an event valued at $40, this is a contribution, and only $60 is deductible by the donor ($100 - $40 = $60). Even though the deductible amount does not exceed $75, since the contribution the church received is in excess of $75, the church must provide the donor with a written disclosure statement. The statement must: (1) inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of money (and the fair market value of any property other than money) contributed by the donor over the value of goods or services provided by the church or religious organization; and (2) provide the donor with a good-faith estimate of the value of the goods or services.

The church or religious organization must provide the written disclosure statement with either the solicitation or the receipt of the contribution and in a manner that is likely to come to the attention of the donor. For example, a disclosure in small print within a larger document may not meet this requirement.

Exceptions to Disclosure Statement

A church or religious organization is not required to provide a disclosure statement for *quid pro quo* contributions when: (a) the goods or services meet the standards for *insubstantial value*; or (b) the only benefit received by the donor is an *intangible religious benefit*. Additionally, if the goods or services the church or religious organization provides are *intangible religious benefits* (examples follow), the acknowledgment for contributions of $250 or more does not need to describe those benefits.

Generally, intangible religious benefits are benefits provided by a church or religious organization that are not usually sold in commercial transactions outside a donative (gift) context.

Intangible religious benefits include:

- admission to a religious ceremony
- de minimis tangible benefits, such as wine used in religious ceremony

Benefits that are not intangible religious benefits include:

- tuition for education leading to a recognized degree
- travel services
- consumer goods

IRS Publication 1771, Charitable Contributions: Substantiation and Disclosure Requirements, provides more information on substantiation and disclosure rules.

Order Publication 1771 free through the IRS at (800) 829-3676.

Special Rules Limiting IRS Authority to Audit a Church

Tax Inquiries and Examinations of Churches

Congress has imposed special limitations, found in IRC section 7611, on how and when the IRS may conduct civil tax inquiries and examinations of churches. The IRS may only initiate a *church tax inquiry* if an appropriate high-level Treasury Department official reasonably believes, based on a written statement of the facts and circumstances, that the organization: (a) may not qualify for the exemption; or (b) may not be paying tax on an unrelated business or other taxable activity.

Restrictions on Church Inquiries and Examinations

Restrictions on church inquiries and examinations apply only to churches (including organizations claiming to be churches if such status has not been recognized by the IRS) and conventions or associations of churches. They do not apply to related persons or organizations. Thus, for example, the rules do not apply to schools that, although operated by a church, are organized as separate legal entities. Similarly, the rules do not apply to integrated auxiliaries of a church.

Restrictions on church inquiries and examinations do not apply to all church inquiries by the IRS. The most common exception relates to routine requests for information. For example, IRS requests for information from churches about filing of returns, compliance with income or Social Security and Medicare tax withholding requirements, supplemental information needed to process returns or applications, and other similar inquiries are not covered by the special church audit rules.

Restrictions on church inquiries and examinations do not apply to criminal investigations or to investigations of the tax liability of any person connected with the church, e.g., a contributor or minister.

The procedures of IRC section 7611 will be used in initiating and conducting any inquiry or examination into whether an excess benefit transaction (as that term is used in IRC section 4958) has occurred between a church and an insider.

Audit Process

The following is the sequence of the audit process.

1. If the *reasonable belief* requirement is met, the IRS must begin an inquiry by providing a church with written notice containing an explanation of its concerns.

2. The church is allowed a reasonable period in which to respond by furnishing a written explanation to alleviate IRS concerns.

3. If the church fails to respond within the required time, or if its response is not sufficient to alleviate IRS concerns, the IRS may, generally within 90 days, issue a second notice, informing the church of the need to examine its books and records.

4. After issuance of a second notice, but before commencement of an examination of its books and records, the church may request a conference with an IRS official to discuss IRS concerns. The second notice will contain a copy of all documents collected or prepared by the IRS for use in the examination and subject to disclosure under the Freedom of Information Act, as supplemented by IRC section 6103 relating to disclosure and confidentiality of tax return information.

5. Generally, examination of a church's books and records must be completed within two years from the date of the second notice from the IRS.

If at any time during the inquiry process the church supplies information sufficient to alleviate the concerns of the IRS, the matter will be closed without examination of the church's books and records. There are additional safeguards for the protection of churches under IRC section 7611. For example, the IRS cannot begin a subsequent examination of a church for a five-year period unless the previous examination resulted in a revocation, notice of deficiency or assessment, or a request for a significant change in church operations, including a significant change in accounting practices.

Glossary

Church. Certain characteristics are generally attributed to churches. These attributes of a church have been developed by the IRS and by court decisions. They include: distinct legal existence; recognized creed and form of worship; definite and distinct ecclesiastical government; formal code of doctrine and discipline; distinct religious history; membership not associated with any other church or denomination; organization of ordained ministers; ordained ministers selected after completing prescribed courses of study; literature of its own; established places of worship; regular congregations; regular religious services; Sunday schools for the religious instruction of the young; schools for the preparation of its ministers. The IRS generally uses a combination of these characteristics, together with other facts and circumstances, to determine whether an organization is considered a church for federal tax purposes.

The IRS makes no attempt to evaluate the content of whatever doctrine a particular organization claims is religious, provided the particular beliefs of the organization are truly and sincerely held by those professing them and the practices and rites associated with the organization's belief or creed are not illegal or contrary to clearly defined public policy.

Integrated Auxiliary Of A Church. The term *integrated auxiliary* of a church refers to a class of organizations that are related to a church or convention or association of churches, but are not such organizations themselves. In general, the IRS will treat an organization that meets the following three requirements as an integrated auxiliary of a church. The organization must:

- be described both as an IRC section 501(c)(3) charitable organization and as a public charity under IRC sections 509(a)(1), (2), or (3),
- be affiliated with a church or convention or association of churches, and
- receive financial support primarily from internal church sources as opposed to public or governmental sources.

Men's and women's organizations, seminaries, mission societies, and youth groups that satisfy the first two requirements above are considered integrated auxiliaries whether or not they meet the internal support requirements. More guidance as to the types of organizations the IRS will treat as integrated auxiliaries can be found in the Code of Regulations, 26 CFR section 1.6033-2(h).

The same rules that apply to a church apply to the integrated auxiliary of a church, with the exception of those rules that apply to the audit of a church. See section Special Rules Limiting IRS Authority To Audit A Church on page 26.

Minister. The term *minister* is not used by all faiths; however, in an attempt to make this publication easy to read, we use it because it is generally understood. As used in this booklet, the term minister denotes members of clergy of all religions and denominations and includes priests, rabbis, imams, and similar members of the clergy.

IRC Section 501(c)(3). IRC section 501(c)(3) describes charitable organizations, including churches and religious organizations, which qualify for exemption from federal income tax and generally are eligible to receive tax-deductible contributions. This section provides that:

- an organization must be organized and operated exclusively for religious or other charitable purposes,
- net earnings may not inure to the benefit of any private individual or shareholder,
- no substantial part of its activity may be attempting to influence legislation,
- the organization may not intervene in political campaigns, and
- the organization's purposes and activities may not be illegal or violate fundamental public policy.

These requirements are set forth in greater detail throughout this publication.

Help From The IRS

IRS Tax Publications to Order

The IRS provides free tax publications and forms. Order publications and forms by calling toll-free (800) 829-3676, or download publications and forms from the IRS Web site at www.irs.gov. The following list of publications may provide further information for churches and other religious organizations:

Publication 1	*Your Rights as a Taxpayer*
Publication 15	*Circular E, Employer's Tax Guide*
Publication 15-A	*Employer's Supplemental Tax Guide*
Publication 334	*Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*
Publication 463	*Travel, Entertainment, Gift, and Car Expenses*
Publication 517	*Social Security and Other Information for Members of the Clergy and Religious Workers*
Publication 525	*Taxable and Nontaxable Income*
Publication 526	*Charitable Contributions*
Publication 557	*Tax-Exempt Status for Your Organization*
Publication 561	*Determining the Value of Donated Property*
Publication 571	*Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations*
Publication 598	*Tax on Unrelated Business Income of Exempt Organizations*
Publication 910	*Guide to Free Tax Services*
Publication 1771	*Charitable Contributions: Substantiation and Disclosure*
Publication 3079	*Gaming Publication for Tax-Exempt Organizations*
Publication 4221-PC	*Compliance Guide for 501(c)(3) Public Charities*
Publication 4573	*Group Exemptions*
Publication 4630	*Exempt Organizations Products and Services Navigator*

Congress has enacted spe
applicable to churches

IRS Customer Service

Telephone assistance for general tax information is available by calling: IRS Customer Service toll-free at (800) 829-1040.

EO Customer Service

Telephone assistance specific to exempt organizations is available by calling: IRS Exempt Organizations Customer Account Services toll-free at (877) 829-5500.

EO Web Site

Visit the IRS Exempt Organizations Web site at www.irs.gov/eo.

Stay Exempt - Tax Basics for 501(c)(3)s - a free on-line IRS workshop covering tax compliance issues confronted by small and mid-sized tax-exempt organizations, available at www.stayexempt.irs.gov.

EO Update

To receive IRS EO Update, a periodic newsletter with information for tax-exempt organizations and tax practitioners who represent them, visit www.irs.gov/eo and click on "EO Newsletter."

Congress has enacted special tax laws applicable to churches, religious organizations, and ministers in recognition of their unique status in American society and of their rights guaranteed by the First Amendment of the Constitution of the United States. Churches and religious organizations are generally exempt from income tax and receive other favorable treatment under the tax law; however, certain income of a church or religious organization may be subject to tax, such as income from an unrelated business. It is also important for a church or religious organization to understand the tax law to avoid losing its tax-exempt status by engaging in activity that violates the Internal Revenue Code.

Publication 1828 (11-2009) Catalog Number 21096G Department of the Treasury **Internal Revenue Service** www.irs.gov

Deputized Fund-Raising

by Dan Busby

Deputized fund-raising is practiced by many ECFA members, particularly mission agencies and evangelistically oriented ministries. The practice is sometimes referred to as "self-supported," "deputational," or "staff support raising."

The concept is a wholesome and effective alternative to traditional fund-raising methods. "It utilizes those most intimate and involved with the charitable program to present funding needs not to strangers but primarily those who know their competence and character," says George R. "Chip" Grange, Gammon & Grange.

Under the deputized fund-raising approach, the charity generally determines an amount each staff member is responsible to raise. Funds raised are often recorded in a support account for each worker. Charges are made against the support account to fund the staff member's particular sphere of the organization's ministry. These support account charges may include amounts for the charity's overhead expenses.

Even the IRS has acknowledged that deputized fund-raising is a widespread and legitimate practice and the contributions properly raised by this method are tax deductible. This acknowledgement appeared in their Technical Instruction Program for Fiscal Year 1999, designed specifically for IRS agents.

How does a charity properly raise funds using the deputized concept? The IRS proposes two general tests to determine whether a tax-deductible contribution was made to or for the use of a charitable organization, or if a gift is a non-deductible pass-through to a particular individual who ultimately benefited from the contribution:

- The first test is whether the contributor's intent in making the donation was to benefit the organization itself or the individual. This is called the "intended benefit test."
- The second test is whether the organization has full control of the donated funds and discretion as to their use, so as to ensure that they will be used to carry out its functions and purposes. This is called the "control test."

But how does a charity know if the "intended benefit" and "control" tests have been met? Unfortunately, the IRS provides little guidance on these tests. Charities, with advice from their CPAs and attorneys, have no choice but to design their action plan without any bright-line test, or clear safe harbors. Let's take a closer look at the two tests:

- **Intended benefit test.** In the 1999 Technical Instruction Program, the IRS has provided the following suggested language for use in donor receipts to help clarify the record of the true intentions of a donor at the time of the contribution:

> "This contribution is made with the understanding that the donee organization has complete control and administration over the use of the donated funds." Thus, use of this language should provide strong evidence of both donor intent and organizational control in the deputized fund-raising context.

But *when* should a donor understand whether to make a gift to a charity that has complete control and administration over his or her gift? ECFA suggests that the best time for this understanding to occur is at the point of solicitation—before the gift is ever made. Truthfulness in fund-raising is one of ECFA's basic tenets. And using the suggested wording at the point of solicitation is the best way to communicate the pertinent facts to the prospective donor *before* the donation is made.

"Deputized fund-raising is a wholesome and effective alternative to traditional fund-raising methods."

In February 2000, the IRS formally indicated that the following language in *solicitations* for contributions, with no conflicting language in the solicitations and no conflicting understandings between the parties, will help show that the qualified donee has exercised the necessary control over contributions, that the donor has reason to know that the qualified donee has the necessary control and discretion over contributions, and that the donor intends that the qualified donee is the actual recipient of the contributions:

"Contributions are solicited with the understanding that the donee organization has complete discretion and control over the use of all donated funds."

• **Control Test.** The IRS uses the phrase "discretion and control" with respect to a charity's obligation over deputized funds. Informally, the IRS has stated that discretion and control may be evidenced by such factors as adequate selection and supervision of the self-supported worker, and formalizing a budget that establishes the compensation and expenses of each deputized individual. Establishing compensation and expense reimbursements with reference to considerations other than an amount of money a deputized fund-raiser collects is very important. For a complete list of the factors indicating adequate discretion and control, see the box in the next column.

The following is a review of issues that should be considered by ministries using the deputized fund-raising approach:

• **Determine how to put donors on notice that you will exercise discretion and control over the donations.** Using the IRS recommended language in solicitations—written or verbal—*and* on receipts makes good sense to us at ECFA.

• **Be sure your organization consistently communicates with your donors.** Eliminating written conflicts between solicitation letters (including "prayer" letters), donor response forms, deputized worker training materials, receipts and other related documents can be accomplished by a careful review of your current documents. It is also important to establish procedures to insure that the reviews are ongoing. The more daunting task is the proper training and continuing reinforcement to self-supported workers of the need to clearly and consistently communicate the discretion and control concept to donors.

• **Use appropriate terminology when communicating with donors.** Since the organization should not commit that contributions will be paid as salary or expenses to a particular person, self-supported workers should

Factors Demonstrating Control and Discretion Over the Deputized Fund-Raising Process

According to the February 2000 IRS statement, charities that receive revenues through deputized fund-raising—through individual missionaries, staff members, or volunteers conducting grass-roots fund-raising to support the organization—can demonstrate control and discretion by the following factors:

- Control by the governing body of donated funds through a budgetary process;
- Consistent exercise by the organization's governing body of responsibility for establishing, reviewing and monitoring the programs and policies of the organization;
- Staff salaries set by the organization according to a salary schedule approved by the governing body. Salaries must be set by reference to considerations other than an amount of money a deputized fund-raiser collects. There can be no commitments that contributions will be paid as salary or expenses to a particular person;
- Amounts paid as salary, to the extent required by the Internal Revenue Code, reported as compensation on Form W-2 or Form 1099-MISC;
- Reimbursements of legitimate ministry expenses approved by the organization, pursuant to guidelines approved by the governing body. Reimbursement must be set by considerations other than the amount of money a deputized fund-raiser collects;
- Thorough screening of potential staff members pursuant to qualifications established by the organization that are related to its exempt purposes and not principally related to the amount of funds that may be raised by the staff members;
- Meaningful training, development, and supervision of staff members;
- Staff members assigned to programs and project locations by the organization based upon its assessment of each staff member's skills and training, and the specific needs of the organization;
- Regular communication to donors of the organization's full control and discretion over all its programs and funds through such means as newsletters, solicitation literature, and donor receipts; and
- The financial policies and practices of the organization annually reviewed by an audit committee, a majority of whose members are not employees of the organization.

never imply the opposite, verbally or in writing. A donor may indicate a preference that a gift to a charity be used to support the ministry of a certain individual, and the charity may track the dollars based on the preference. But the organization and the deputized worker should refrain from any inference that the contributions will be paid as salary or expenses to the worker. This is a fine line but one that should be observed.

• **Avoid passing amounts raised by a particular worker to that worker.** Since the organization should not commit that contributions raised by a particular worker will be paid to the worker as salary, fringe benefits and expense reimbursements, it is important that the organization's practices match the commitment. If every dollar raised by a worker for the organization is spent on the worker, this is indicative of the organization's lack of discretion and control over the funds.

Clear communication with donors about the discretion and control issue not only places the donor on notice, it serves to reinforce this concept in the mind of the deputized worker. Too often, self-supported workers assume they have an element of personal ownership of funds that they raise for the charity. For example, when the worker leaves the employment of charity A, he may mistakenly believe that the balance in his account will be transferred to charity B, where he will be employed. While a transfer to charity B may be appropriate, it is not required.

Scott Holbrook of Gospel Missionary Union believes "the key issue is the education of self-supported workers, both new candidates and the veterans." Doug Haltom, with OMS International, agrees: "Our greatest challenge remains training the self-supported workers that they are raising money for the ministry of OMS, and impacting their donor communication behavior."

Reprinted from
FOCUS on Accountability

Excerpted from *2003 IRS Exempt Organization CPE, Topic D, Employment Tax Update - Review of Current Litigation*

By Debra Kawecki and Leonard Henzke

Introduction
An employer must generally withhold income taxes, withhold and pay social security and Medicare taxes, and pay unemployment tax on wages paid to an employee. An employer does not generally have to withhold or pay any taxes on payments to independent contractors.

Misclassification of exempt organization employees as independent contractors often leads to substantial loss of revenue to the government and loss of social security benefits to Exempt Organizations staff.

Common Law Rules
To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. All evidence of control and independence must be considered. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered.

Facts that provide evidence of the degree of control and independence fall into three categories:

I. Behavioral control,
II. Financial control, and
III. The type of relationship of the parties

Introduction to Behavioral Control Factors
Factors that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of instructions and training the business gives the worker.

Factor: Business Instructions to Employees
An employee is generally subject to the business' instructions about when, where, and how to work. Examples of types of work instructions include:

- when and where to do the work,
- what tools or equipment to use,
- what workers to hire or to assist with the work,
- where to purchase supplies and services,
- what work must be performed by a specified individual, and
- what order or sequence to follow.

The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

Factor: Training Given Employees

An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Financial Factors Control
Facts that show whether the business has a right to control the business aspects of the worker's job include:

- *The extent to which the worker has unreimbursed business expenses*. Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services they perform for their business.
- *The extent of the worker's investment.* An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status.
- *The extent to which the worker makes services available to the relevant market.* An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.
- *How the business pays the worker.* An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.
- *The extent to which the worker can realize a profit or loss*. An independent contractor can make a profit or loss.

Type of relationship.

Facts that show the parties' type of relationship include:

- *Written contracts* describing the relationship the parties intended to create.
- *Whether the business provides the worker with employee-type benefits*, such as insurance, a pension plan, vacation pay, or sick pay.
- *The permanency of the relationship*. If a worker is engaged with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that there was intent to create an employer-employee relationship.
- *The extent to which services performed by the worker are a key aspect of the regular business of the company*. If a worker provides services that are a key aspect of the employer's regular business activity, it is more likely that the employer will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

2010 Mission Administration & Finance Conference

Orlando, Florida
February 13, 2010

Funding Missionary Ministries Accountability and Tax Compliance Issues

Gregg Capin, CPA, Partner
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The session will highlight important U.S. tax compliance issues pertaining to exempt organization resources, contributions, ministry expenses, and other related areas as well as recent developments.

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You may request the following by email:

- Department of Treasury Letter Concerning Deputized Fund Raising
- Revenue Ruling 63-252 Concerning Gifts to Support Charitable Work in Foreign Countries
- Revenue Ruling 66-79 Concerning Gifts to Support Charitable Work in Foreign Countries

I. BACKGROUND ON EXEMPT RESOURCES

Exempt organizations are the recipients of public trust and must fulfill fiduciary responsibilities. Therefore, reasonable procedures must be established to assure that all funds are used to fulfill the exempt purposes of the organization and are in accordance with any donor stipulated purposes.

A. Resources

Fiduciary responsibility extends to all exempt resources including:

- ◊ **Assets** - including their use and disposition.

- ◊ **Support (contributions)** - including cash and non-cash gifts, donated goods and materials, the use of facilities, and legacies and bequests (whether from individuals, corporations, partnerships, trusts and estates, foundations, or other nonprofit organizations).

- ◊ **Revenue (earned income)** - including sales, fees, rentals, tuition, investment income, government grants, and royalties.

- ◊ **Personnel** – including recruiting, training, assignment and supervision of employees, contractors and volunteers.

The intended purpose for use of specific resources will affect the implementation of the fiduciary responsibility. For instance:

- o Resources used for investments, fund raising or a business activity should be managed to generate income for the organization. Profitability (consistent with legal and ethical standards) would typically be an important measure of effective management in these areas.

- o Resources used to accomplish the exempt purposes of the organization should be managed to accomplish the educational, religious, or charitable purposes of the organization. Students educated, evangelistic out-reaches held, or meals served might be appropriate measures of effective management for exempt purpose expenditures.

Confusion of responsibility for employees supported by deputized fund raising and the employee's associated expenses sometimes results in less concern for assignment or expenditures. An organization may be less vigilant regarding expenditure, "because the missionary raised the money." Such an attitude is not consistent with the tax law or general fiduciary obligations.

B. Use of Resources

Resources must be used exclusively for exempt purposes. This is a fundamental provision of tax law, as well as state law, as set forth in an exempt organization's articles of incorporation and bylaws. There is an absolute prohibition of any part of an organization's resources inuring to the benefit of private individuals.

Private benefit ordinarily pertains to activity or resources that benefit individuals outside of an organization not in furtherance of its charitable purposes. Whereas, **private inurement** occurs when an insider receives a benefit that is not in furtherance of, or is incidental to, the organization's 501(c)(3) purposes.

I. BACKGROUND ON EXEMPT RESOURCES, continued

B. Use of Resources, continued

Appropriate use of exempt resources includes:

1. Compensation of workers

Compensation of workers, whether employees or independent contractors, must be **reasonable for the services rendered** and must be **properly reported for tax purposes.**

Documentation should be maintained to verify reasonable control over domestic and international workers including: personnel files, job descriptions, employment agreements, supervision information, progress reports, and performance evaluations.

2. Business expenses

Payment of business (ministry) expenses should be supported by **adequate accounting records and substantiation to demonstrate that they fulfill the organization's exempt purposes.**

(See Exhibit A - Business Expenses & Accountable Plan Rules)

3. Benevolence and scholarships

Benevolence and scholarships must fulfill an **exempt purpose** of the organization and be made pursuant to a **program** of the organization for any payments made directly to and in support of the poor and needy or as scholarships to qualify.

Payments should only be made from a general fund or benevolence or scholarship fund. Contributions may not be stipulated for specific recipients without jeopardizing the deductibility of the contribution.

Organizations should maintain policies under which the benevolence or scholarship program is administered including: adequate criteria to determine individual need, documentation of need including external verification, assignment of personnel or a committee to approve requests, reasonable limits of support per person during a specified time period, and coordination with other organizations providing aid or scholarships.

Scholarships

To provide assistance with education, organizations may provide certain scholarship assistance. This requires careful compliance with tax laws and regulations. Policies and practices should be reviewed by tax counsel as any changes in policy or practice occur.

Three distinct areas of the tax law must be addressed:

- ***Guidelines must be established to protect the contributor's tax deduction*** (this may not be an issue unless designated giving is accepted to a scholarship fund).
- ***Only certain payments are nontaxable as qualified scholarships***. Amounts that do not qualify as scholarships (food and lodging expenses, for instance) are permissible, though taxable.
- ***Special rules must be followed if dependents*** of employees may receive a scholarship, to keep the scholarship from being considered taxable income to the employee.

I. BACKGROUND ON EXEMPT RESOURCES, continued

B. Use of Resources, continued

3. Benevolence and scholarships, continued

Protecting the Contribution Deduction
The contribution deduction requires the gift be "to or for the use of" a charitable entity (I.R.C. 170(c)), not an individual. To qualify, the gift must be to a church or other qualified not-for-profit organization and under its control. It may be designated for a scholarship fund, but ***a gift designated for a specific individual will not qualify***.

The deductibility standards regarding scholarship related contributions are more stringent than those approved by the IRS for deputized fund raising. For instance, a donor contributing money for a worker supported by deputized fund raising routinely knows who the worker is before they give. In contrast, knowledge of the recipient of a scholarship making the gift for the scholarship would create substantial risk that the contribution would be disallowed (*C.W. Bauer*; Rev. Rule 79-81).

Five guidelines for protecting the contribution deduction:

- ***The organization determines all scholarship recipients*** through the use of a scholarship committee.
- ***The organization has a well-published policy*** that it determines the recipients, according to its own policies, and that it expressly rejects any effort to honor a donor's recommendation(s).
- ***Scholarship recipient selection and the amount they will receive are not based on funds contributed with donor preferences.***
- ***The criteria for scholarship qualification are in writing.***
- All scholarship policies contain the following statement: "***Scholarships are awarded without regard to sex, race, nationality or national origin***."

Qualified Scholarships
Only a candidate for a degree can exclude amounts received as a scholarship. A qualified scholarship is any payment to or for the student if it is for "tuition and fees" or for enrollment or "fees, books, supplies and equipment" required for specific courses (I.R.C. 117(b)(2)). It is not necessary for an organization granting a scholarship to confirm that it will be used only for qualified uses. The person receiving the scholarship must report excess amounts as taxable income.

Employee Dependent Scholarship Programs
Generally, scholarships for employee dependents will be considered taxable compensation to the employee unless they meet precise guidelines found in Revenue Procedure 76-47, 1976-2 CB 670. A few of the requirements of that Revenue Procedure include:

- ◊ The program must not be presented as a benefit of employment by the organization.
- ◊ Selection of beneficiaries must be made by an independent committee.
- ◊ Selection must be based solely upon substantial objective standards that are unrelated to the employment of the recipients or their parents and to the employer's line of business.
- ◊ Generally, not more that 25% of eligible dependents may be recipients of scholarships.

I. BACKGROUND ON EXEMPT RESOURCES, continued

B. Use of Resources, continued

4. Grants

As contrasted with programs conducted directly by an organization and its personnel, grants may be made to other organizations to further the organization's exempt purposes.

Grant recipients may be related or unrelated charities and may be domestic or foreign organizations.

Grant administration and control procedures will vary based upon grant materiality (amount and significance), the nature of the grant recipients operations, and the nature of the relationship between the granting organization and the grant recipient.

Grant administration and control procedures should include:

- ◊ **Pre-grant due diligence** - including documentation of 501(c)(3) status for U.S. charities, information about the recipient's operations and personnel, information about the project or work and proposed use of funds, and information about how the proposed grant will further the grantor's exempt purposes.

- ◊ **Determination of grant recipients** - including determining eligibility of recipients if funds are granted to an organization which in turn makes disbursements to other individuals or entities.

- ◊ **Written grant agreements** - including specific terms, expected results, timing of funds remittances, consequences of noncompliance with grant terms including cessation of future funding and/or the return of grant funds, and specified accountability (including appropriate provisions such as written progress reports, required accounting or financial statements, provision for internal or independent audit and inspection of records, on-site inspection of programs by grantor personnel).

- ◊ **Approval of grants and grant budgets** - by the governing board or through board policy including the subsequent comparison of actual financial results with the budget.

- ◊ **Authorization of funds expenditures** - including board delegated control over the receipt and disbursement of funds for activities having prior approval and budgetary authorization.

- ◊ **Determination of compliance** - with administration policies and grant agreement specifications (supervision and evaluation).

For international grants when an organization receives significant donor restricted funding, it is better for the organization to include at least some grant funds from its general operating budget to demonstrate control over the grants and participation in the exempt purpose expenditures.

I. BACKGROUND ON EXEMPT RESOURCES, continued

C. International Grant Making

U.S. tax law allows the making of grants by a U.S. tax exempt organization to recipients in other countries if they further the U.S. organization's tax exempt purposes. However, tax deduction rules and anti-terrorist laws make such grants more complicated.

1. Tax Issues

The general rule is that only donations to a U.S. tax exempt organization are tax deductible. Contributions by a U.S. taxpayer to a foreign organization are not tax deductible.

A U.S. charity may not act merely as a conduit of funds for a foreign recipient because it would result in indirect contributions to a foreign organization being treated as tax deductible when they would not have been if made directly to the foreign entity.

The key issue is whether the domestic charity retains control over the funds and discretion as to their use so as to ensure that the funds granted will be used to carry out the functions and purposes of the domestic organization.

Indicia of the presence of such control and discretion include the following:

- ◊ The domestic organization, through its board or officers, pre-approves a foreign grant after reviewing the grant request in some detail (and perhaps even after a field investigation of the activities of the requesting foreign organization);
- ◊ Periodic accounting of grant funds are given to the domestic organization by the foreign organization recipient, or the domestic organization periodically reviews or audits the financial statements of the foreign organization;
- ◊ ***The domestic organization can refuse grants that are requested from foreign organizations;***
- ◊ ***The domestic organization retains the right to withdraw approval of a grant and perhaps even to receive a refund of any unexpended grant funds;***
- ◊ Funds granted are from the general fund of the domestic organization and are not from funds that have been earmarked by donors for a particular foreign project or foreign recipient;
- ◊ ***If a donor has made a request regarding the use of his or her donation,*** a disclaimer is given by the domestic organization in the solicitation or receipting of that donation regarding the responsibility and authority of the domestic organization to (i) exercise control over the funds, (ii) withdraw approval of a grant if it is in the best interests of the domestic organization to do so, and (iii) redirect the funds in furtherance of its exempt purposes as it deems appropriate;
- ◊ The domestic organization has a variety of charitable or religious activities underway in the foreign country to which the grant is being directed;
- ◊ A written agreement is in place between the domestic organization and the foreign organization recipient as to the use of the funds;

I. BACKGROUND ON EXEMPT RESOURCES, continued

C. International Grant Making, continued

1. Tax Issues, continued

◊ Continuous field investigations occur to ensure that the grant money is used in accordance with the terms of the agreement or within the parameters of the grant request and award;

◊ Grant monies are used for specific projects in furtherance of the domestic organization's exempt purposes, and are not used merely for general administrative expenses of the foreign organization recipient;

◊ The domestic organization only releases grant funds for specific projects on an as needed basis; and;

◊ If grant funds are received by a foreign organization recipient, which in turn makes disbursements to other organizations or individuals, the domestic organization making the grant determines the eligibility of the ultimate recipients of the funds.

All of the above indicia will seldom be present. However, the more of these characteristics that are present, the more likely that the IRS would view the grant as being under the control and discretion of the domestic organization. ***The IRS has placed more emphasis on the first four indicia***.

The following are possible controls and accountability measures for grants:

◊ Written progress reports
◊ Required accounting or financial statements
◊ Required internal or independent audits and inspections
◊ On-site program inspections by grantor personnel
◊ Retention of discretion as to when the fund will be remitted based on administration policies and grant agreements, including the policy and practice of refusing conditional or earmarked gifts that create an obligation to remit the funds immediately
◊ Adequate oversight (supervision) and review (program evaluation) of compliance with administration policies by the governing board and/or the organizations independent auditors

(See Exhibit B for sample forms for making grants)

I. BACKGROUND ON EXEMPT RESOURCES, continued

C. International Grant Making, continued

2. Avoiding Grants to Terrorists

Executive Order 13224, issued shortly after September 11, blocks the assets of persons designated as foreign terrorists and prohibits U.S. persons from engaging in transactions with them, or for their benefit. The ban explicitly includes charitable contributions of funds, goods, or services. The Executive Order also bars transactions with additional persons identified by either the Secretary of State or the Secretary of the Treasury, and, most sweepingly, with persons who are "otherwise associated" with ***listed persons***.

Several U.S. government agencies have created lists of known or suspected terrorists, as has the United Nations and the European Union. The Treasury Department's Office of Foreign Assets Control maintains the Specially Designated Nationals (SDN) list, the most comprehensive US list. It is available at: http://www.treas.gov/offices/enforcement/ofac/sdn/

Any organization, domestic, international, religious or secular might potentially violate the ban on funding or otherwise assisting known or suspected terrorists. There are no exemptions.

Consider the following steps to evaluate your situation and respond appropriately:

- ◊ ***Identify all funds remitted as grants to other entities or individuals*** (those who are not employees, independent contractors, or business service providers);
- ◊ ***Document risk that your granted funds will wind up in the hands of terrorists;***
- ◊ ***Devise and implement an appropriate anti- terrorism compliance program;***
- ◊ ***Document the steps you have taken.***

Some observers have noted that grantmakers making a large numbers of relatively small grants in donor-advised or matching gift programs may be particularly at risk. Many of these grantmakers rely on the donor to be knowledgeable about the charity to which the grant is directed and they do little due diligence beyond verifying the proposed grantee's status as a public charity. Grantmakers that follow this practice should weigh the desirability of additional compliance steps. List checking, in particular, may be a necessary part of this plan.

The government's primary concern has been with grants to foreign organizations. Given the weight of government concern, grantmakers that are making grants in countries other than the United States should consider the need to implement additional controls to prevent grants from being diverted for improper purposes.

Depending on the outcome of their risk assessments, grantmakers may need to add ***list checking*** to their existing control programs. Even so, reasonable due diligence checks are far more likely to detect and prevent any diversion of funds, whether for terrorism or simply for personal gain.

I. BACKGROUND ON EXEMPT RESOURCES, continued

C. International Grant Making, continued

2. Avoiding Grants to Terrorists, continued

The Council on Foundations suggests the following as one approach to due diligence:

- ✓ Review organizational documents and financial statements of the FRO (**f**oreign **r**ecipient **o**rganization), if available.
- ✓ Obtain information about the FRO's involvement with prior charitable programs, including references from reliable sources (advisory boards and other nongovernmental organizations).
- ✓ Identify the person who will administer the grant and obtain information on his/her qualifications (or the CEO of the FRO, in the case of a general support grant).
- ✓ Obtain information about the FRO's internal controls and accounting procedures for grant funds, including oversight mechanisms for charitable projects.
- ✓ Enter into a written grant agreement with the FRO restricting the use of grant funds for charitable purposes.
- ✓ Require periodic narrative and financial reports on the FRO's use of grant funds.
- ✓ In the case of multi- year grants, disburse grant funds on a periodic basis, requiring a report on the use of funds already granted before making the next disbursement.
- ✓ Where practicable, identify a reliable in-country party that could assist with grant administration and on-site monitoring, if necessary.
- ✓ Conduct a site visit by the grantmaker or a person acting at the grantmaker's request when reasonably justified by the circumstances of the grant, the size of the disbursement, and the cost of a visit.

These are suggestions, not an exclusive list. Grantmakers have a variety of effective methods for obtaining information and verifying that grant funds are used for their intended purpose. The informal systems that characterize some smaller grantmakers may be as effective as, or more effective than, a more formal program to gather information. But all international funders should review their procedures, consider the possibility that their grants could be diverted, and decide whether additional safeguards are needed either in general or in the case of particular grants.

D. Charitable Contributions

Charitable contributions are only deductible under U.S. tax law if given "to and for the use" of a "qualified" tax-exempt organization to be used under its control to accomplish its exempt purposes. "Qualified" organizations are domestic 501(c)(3) organizations.

To be deductible, charitable contributions must be unconditional and without personal benefit to the donor.

Charitable contributions are commonly provided as either:

- ◊ **Unrestricted** – gifts received without donor stipulations, designations, or use limitations
- ◊ **Donor restricted** – gifts stipulated, limited, designated or preferenced by the donor for a specific exempt purpose or for a specified period of time rather than gifts that are for any exempt purpose of the organization.

I. BACKGROUND ON EXEMPT RESOURCES, continued

D. Charitable Contributions, continued

The term "donor designated" is often used by not-for-profit organizations. Specific words, however, have a legal meaning that may be unintended by many. The IRS is concerned about excessive donor control resulting in a conduit of funds to specific individuals or other entities. This may result in the denial of tax deductibility for the contributions or in the worst case denial of exempt status of the organization.

Gifts to support an organization's exempt purposes and programs are generally tax deductible within the limits prescribed by the law. To be tax deductible, the organization must exercise full control (administrative) over the funds to ensure that they fulfill its exempt purposes and programs. The organization also has responsibility to honor donor preferences or stipulations for particular exempt purposes.

Designating or "earmarking" for a specific individual or a foreign charity are not charitable contributions, and under accounting rules would likely be treated as "agency" transactions rather than contributions, absent the explicit and unilateral power to redirect.

1. Gifts "designated or earmarked" for specific individuals or entities

Gifts that are designated or earmarked for a specific individual are not deductible as charitable contributions. This is true whenever the donor has specified, by name, the person to receive the gift, with few exceptions (such as the support of an orphan or needy child selected by the organization rather than the donor). Gifts designated for specific entities may not be deductible until remitted to that entity (the donee is acting as agent for the donor) and gifts to foreign entities are not deductible.

2. Gift in support of worker's ministries (Deputized Fund-raising)

Gifts in support of the ministry/charitable activities of a specific worker, such as missionary support, are tax deductible contributions to an organization if they are not donor designated for personal use or under individual (rather than organizational) control. The funds must be controlled by the organization to be expended only as needed for reasonable compensation and business (ministry) expenses.

Although giving through an organization to earmarked individual is not tax deductible, and conduit organizations operated to facilitate such are not tax exempt, contributions to a qualified organization for use in its exempt purposes and programs that are not earmarked for an individual are tax deductible.

Deputized fund-raising was recognized, and in at least some forms approved by the IRS in the 1950s and 60s. After decades of little attention, in the 1990s the IRS issued an adverse private letter ruling, challenged organizations' exemptions, and denied contribution deductions. The IRS appeared to believe that gifts in support of deputized fund-raising (traditional missionary ministry support) might represent non-deductible gifts to individuals rather than charitable gifts to an exempt organization. It consistently favored a "pooled" approach or system.

Meetings and communications with the IRS by resulted in a letter, issued in February 2000, in which the IRS acknowledged that deputized fund raising was compatible with tax exemption of the organization and tax deduction of the donor's contributions if proper control exists. The following discusses key provisions that must be carefully considered.

The IRS has identified two essential principles:

1. The donor must intend to make a gift to the organization, not to the individual.
2. The organization must fully control the funds to accomplish its exempt purposes.

I. BACKGROUND ON EXEMPT RESOURCES, continued

D. Charitable Contributions, continued

2. Gift in support of worker's ministries (Deputized Fund-raising), continued

If either of these principles is missing, the donor's gift does not qualify for tax deduction. If the organization receives substantial support from deputized fund-raising of contributions that do not qualify, it may lose its tax-exempt status.

The IRS acknowledged that although tracking by an organization of funds raised by an individual missionary, staff member, or volunteer may show that contributions are earmarked, the organization may show that it has full control by the totality of the facts and circumstances.

The IRS suggested language to be included in solicitations that would help show that the organization has the necessary control: assuming that there is no conflicting language in other materials or understandings between the parties: "***Contributions are solicited with the understanding that the donee organization has complete discretion and control over the use of all donated funds.***"

Duties of control inherent for tax exempt organizations do not conflict with what may, from an accounting standpoint, be considered donor restricted for particular exempt purposes. The IRS concern is that gifts not be controlled or directed to particular individuals, but under organizational control for one or more exempt purposes.

Organizations should review practices and take the following action:

- ◊ Adopt the recommended language (noted above) for all solicitations and donor receipts.
- ◊ Develop training for workers communications reinforcing ministry control of resources.
- ◊ Review communications with donors (including prayer letters, newsletters, solicitation literature and donor receipts) to remove statements or assurances inconsistent with the recommended language and control elements.
- ◊ Utilize a board approved budgetary process for compensation and expenses of workers.
- ◊ Periodically review all programs and policies of the organization, including those relating to supported workers.
- ◊ Conduct thorough screening of potential workers based on qualifications established relating to exempt purposes and not related to the amount of funds that may be raised.
- ◊ Assign supported workers to programs and project locations based upon assessment of individual skills and training and the specific needs of the ministry.
- ◊ Set annual compensation levels for all workers (maximum compensation) based on reasonable compensation assessments for similar organizations. Set salaries based on a salary system approved by the board, with consideration of factors other than the amount of money raised.
- ◊ Review financial policies and control practices to assure that control elements exist and are well documented. Among these controls should be the approval of work-related expenses, approval of general and overhead allocations, and the ability to redirect funds within the ministry's operations in the event a worker is terminated or the worker's ministry is changed.
- ◊ Be certain that there are no commitments that contributions will be paid to a particular person.
- ◊ Be certain that all elements of compensation are properly reported on required forms.
- ◊ Be certain that all reimbursements of ministry expenses are approved, based on policy guidelines approved by the board, with considerations other than the amount of money raised.
- ◊ Review practices that cause payments for missionary salary and work funds to vary based on the amount of funds available. This should include both active missionaries and retired workers. (A workers support "pooled" is most advisable.)

I. BACKGROUND ON EXEMPT RESOURCES, continued

D. Charitable Contributions, continued

3. Personal Gifts

Foreign missionary organizations may handle personal gifts transmitted from one individual to another as a convenience, due to international mail and currency transmittal difficulties. However, it is advisable for personal gifts not to be handled by the organization.

Personal gifts are not deductible for tax purposes and donors should be clearly advised in any receipt or acknowledgment. Exempt organizations should not use exempt resources for personal gifts because this violates exempt purpose use and represents either private benefit or inurement.

Special consideration must be given to gifts given by individuals or churches that are earmarked for an individual as a "personal gift." **Generally, personal gifts are those made between close friends and family members**. In the context of relationships established or maintained as part of ministry, such as by missionary support-raising, the nature of such payments is much harder to characterize as "personal" and likely are not.

The impact may not merely be the ability of the individual or need of the church to receive a charitable contribution deduction but also the characterization of income to the recipient. Tax cases have provided that such payments are taxable income to the recipient because "the transfers arose out of …relationship with the members…presumably because they believed he was a good minister and they wanted to reward him."

Policies should be established concerning personal gifts, love offerings, honorariums, etc. ***Although some individuals and churches may indicate that certain payments are personal gifts, the organization should determine whether they are to be treated as support gifts and whether any remittance should be treated as taxable compensation.***

II. SPECIFIC ISSUES

A. Outfit, Work, or Equipment Costs

Common items include:

- Clothing
- Household items
- Food and cooking equipment, utensils, or supplies
- Furniture
- Equipment (camera, VCR's, computers)

Of the commonly reimbursed outfitting costs, clothing is almost always considered to be personal and should be treated as compensation if reimbursed from ministry funds. The only exception is uniforms and other special use garments that cannot be used personally on a day-to-day basis. Furniture and equipment may be either mission owned or personally owned.

If furniture and equipment is mission owned, they should be treated as mission assets and, in the event of any sales or disposition, the mission should receive the proceeds. Any personal use should be treated as compensation based on the fair value. If such assets are transferred or retained personally after initial purchase, the fair value at the date of transfer should be reported as compensation or reimbursed by the individual.

If such assets are personally owned, any amounts expended from ministry funds should be treated as compensation. Business use may be subject to reimbursement as appropriate.

Important issues include:

◊ Personal items should be treated as compensation to avoid private benefit or inurement that would constitute excess benefit.

◊ Compensation not properly reported is subject to penalties.

◊ Noncash compensation, such as personal use of mission property, should be reported at its fair value (examples include autos and housing).

◊ Furniture and equipment should be consistently treated as mission or personal (mission owned assets should be part of the mission records, costs to maintain should be paid from mission funds, and personal use reimbursed or treated as compensation at fair value).

◊ Outfit items to be personally received and owned may be treated as foreign earned income if a policy is established that such benefits are only earned if the person serves a certain term on the foreign field of service and the costs are treated as a loan that is repayable in event of not fulfilling the service requirements. Then the compensation may be reported either during the initial period of service or prorated over the term of service.

II. SPECIFIC ISSUES, continued

B. <u>Tax Rules for Specific Costs</u>
The following costs are identified as either:

TPE = Taxable personal expense (if mission paid must be reimbursed or treated as taxable)
NTB = Nontaxable business expense
NTM = Nontaxable moving expense
RBE = Reimbursable business expense
TC = Taxable compensation

1. Missionary passport & visa – NTB
2. Dependent passport & visa – TPE
3. Clothing or household furnishings – TPE
4. Moving clothing, household and dependent travel (when meet qualified move requirements) – NTM
5. Travel and transporting missionary or goods on temporary business assignments – NTB
6. Travel and transporting dependents & goods – TPE (in limited cases NTB)
7. Missionary education to further ministry needs – NTB
8. Other missionary education – TPE
9. Education of children – TPE
10. Travel and transportation of parents or children for children's education – TPE
11. Personal use of mission owned asset – TC
12. Business use of personally owned asset – RBE
13. Transfer or purchase of asset by mission for missionary as personal asset – TC
14. Family related or vacation travel from foreign residence – TPE
15. Domestic help including maids, cooks, gardeners, etc. – TPE

"NTB" expenses maybe reimbursed as "RBE" (subject to organization policy), if paid by missionary. Reimbursements can only be non-taxable if reimbursed under an accountable reimbursement plan.

(See Exhibit A - Business Expenses & Accountable Plan Rules)

II. SPECIFIC ISSUES, continued

C. Spousal/Dependent Travel

Reimbursements of travel expenses for a spouse (the same rules apply to other dependents, too) may qualify as nontaxable working condition fringe benefits if:

- ◊ The travel of the spouse or dependent is for a bona fide business purpose.
- ◊ The employee substantiates the time, place, amount, and business purpose of the travel under an accountable business expense reimbursement plan.

If there is a bona fide purpose and accountable plan payments, no taxable income will result; ***if there is no such bona fide purpose or no accountable plan substantiation, the expenses will have to be included as income on the employee's Form W-2 or on a Form 1099 for the volunteer or independent contractor.***

What is a bona fide business purpose? IRS ruling and court decisions over many years indicate that the following criteria are critical factors:

- ◊ The spouse's function must be necessary, i.e., result in desired business benefits to the organization.
- ◊ The spouse's contributions to the organization must be those which cannot efficiently be performed (or performed at all) by the taxpayer's employee alone.
- ◊ The spouse's services must augment the employee's purpose for the trip.
- ◊ The benefit to the organization's business or activities must be substantial.

Options for handling expense reimbursements. Nonprofit organizations and other employers are presented with two options: (1) Determine that there is a bona fide business purpose for spousal travel, or (2) Concede that there is not a bona fide business purpose for spousal travel and treat these expenses as taxable income to the employee or volunteer.

Documentation is necessary to establish a bona fide business purpose. If the organization determines there is bona fide business purpose for the travel, the presence of certain factors will help ensure that the spouse's presence is significantly helping to carry out a related (to the tax-exempt purpose) function of the mission. Here are some key elements to consider:

1. Document the purpose for spousal attendance by having written requirements for the spouse such as functions which must be attended, roles which must be served etc. during the meetings, and actively put these requirements into practice.
2. Include the spouse in ministry as well as social functions.
3. Reflect the spouse's business role and mandatory presence in employment contracts and meeting minutes.

If possible, pay the spouse something for his or her services (such payments would, of course, be taxable as compensation).

II. SPECIFIC ISSUES, continued

C. Spousal/Dependent Travel, continued

Example #1 – Missionary A, his wife (who is not an employee of the mission) and their six-year old daughter travel by air to present missions at a church convention. Missionary A and his wife were both appointed for missionary service by the mission even though only Missionary A is an employee. The mission pays for or reimburses their travel expenses. Missionary A's wife's presence on the trip has a bona fide business purpose (because she appears on the platform with Missionary A and she shares her personal testimony) and her expenses are not includible in Missionary A's income. There does not appear to be a bona fide business purpose for the attendance of their daughter at the convention. Therefore, her incremental costs are includible in Missionary A's income, including airfare and meals.

Example #2 – Same facts as #1 except Missionary A, his wife and daughter travel by auto on a deputational circuit representing the employing mission. The spouse is an active participant in the appearance at churches. Since Missionary A's wife's presence on the trip has a bona fide business purpose, her expenses are not includible in Missionary A's income. There does not appear to be a bona fide business purpose for their daughter to accompany them. Therefore, her incremental costs are includible in Missionary A's income. However, since they are traveling by car, there is no requirement to include any auto expense. There are probably no incremental housing expenses for the daughter. Therefore, the incremental meal and other costs would be the only taxable element.

Example #3 – Same facts as #1 except the daughter is 16 years old and actively participates in the promotion of missions with her parents. Since there is a bona fide business purpose for the daughter's travel, her expenses are not includable in Missionary A's compensation.

D. Funding Reimbursed Business Expenses

Many missionary organizations use a single support account or individual fund to disburse both taxable and nontaxable payments to workers who raise support for their ministry activity. Tax exempt organizations should exercise management and controls necessary to assure that business expenses meet the accountable plan rules in order to avoid being treated as compensation.

Expense reimbursements and contributions to fund them are problematic when:

- ◊ A single support account or fund, derived from tax receipted contributions is used to manage both taxable and nontaxable payments to workers (i.e. compensation and reimbursed business expenses), and the compensation of the worker varies based on the availability of the funds in the accounts.
- ◊ Management exercises little or no authority or budgeting over disbursements from support accounts.
- ◊ Expense reimbursements are made first, reducing available compensation.

II. SPECIFIC WORK FUNDS ISSUES, continued

D. Funding Reimbursed Business Expenses, continued

To avoid problems, management should exercise adequate control over support accounts by implementing one of the following procedures:

- ***Treat payments as taxable compensation first***, reducing available funds to reimburse expenses.
- ***Make standard assessments*** against contributions that are transferred into the organization's general operating fund and operating budget for expense reimbursements.
- ***Partition support accounts*** between funds that may be used for compensation and those available for expense reimbursements. Procedures should be documented that once set aside the funds cannot be used to fund deficiencies in the other account, incoming funds should be allocated in accordance with the policy.

E. Automobile Expense Reimbursement

There are two distinct valuation situations for employees of foreign mission organizations:

- ◊ The reimbursement of mileage driven by an employee on behalf of the mission, using the employee's own automobile.
- ◊ The valuation and reimbursement or taxation of personal miles driven by an employee in a mission automobile.

Employee Automobile & Mission Mileage
Employees who drive their own vehicles on behalf of the mission may be reimbursed tax free under three distinct programs:

1. They may be reimbursed **actual costs**.
2. They may be reimbursed on a **cents-per-mile** basis.
3. They may be reimbursed using a **Fixed and Variable Rate** (FAVR) allowance.

Actual costs
The actual expenses of operating a personal automobile for mission activities may be reimbursed. These would include depreciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and license and registration fees.

Expenses other than those directly related to specific business trips, however, must be allocated between business and personal use of the vehicle. Thus, the cost of most repairs, depreciation, license and registration would require an allocation based on the proportion of ministry related miles to total miles driven. This could certainly be done based on annual mileage. If ministry and personal usage were consistently proportioned through the year, a shorter period could be used.

The missionary could take depreciation on a five year, straight-line basis, regardless of the cost of the vehicle or the proportions of personal and ministry use.

II. SPECIFIC ISSUES, continued

E. Automobile Expense Reimbursement, continued

Employee Automobile & Mission Mileage, continued

Cents-per-mile

The cents-per-mile method uses a rate established annually by the IRS in December for the following year. For 2010, the rate is 50 cents per mile. Included in the cents-per-mile rate are all operating and fixed costs of the automobile. Such items as depreciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and license and registration fees are included in operating and fixed costs for this purpose.

For valuing a missionary's ministry use of his personal automobile, the cents-per-mile appears to be available worldwide. There is no geographic restriction in the Revenue Procedure. There is no way to adjust the rate, however.

For valuing mission use of a personal vehicle, a mission could choose to reimburse less than the authorized amount. There is no provision for adjusting the cents-per-mile rate upward in a country where gasoline or other costs were more expensive. Thus, if a missionary owns a vehicle, and drives it to do mission work in January, 2010, the mission may reimburse the missionary at the rate of 50 cents per mile, regardless of which country the missionary is in.

The cents-per-mile rate may be used for any automobile, regardless of its value, when valuing mission use of a personal vehicle.

Fixed and variable rate

A FAVR allowance allows an employer to more closely tailor a reimbursement program to the specific expenses being incurred by its employees. There are important limitations in the Revenue Procedure:

a) There must be at least 5 employees using a FAVR allowance (they may have different allowances).
b) At no time in the calendar year may a majority of the employees covered by a FAVR allowance be management employees.
c) There must be a reasonable expectation that each employee to be covered by the plan will drive 6,250 or more miles in the year on the employer's business.
d) Each employee covered must drive at least 5,000 miles on the employer's business.
e) The exact procedures for determining the fixed amount and variable amount, schedule of payments, record keeping, and repayment of excess amounts must be followed.

The FAVR allowance option appears to be limited to the United States ("base locality", the region used for determining expenses, is defined as a region in the United States). The FAVR allowance might be useful for missionaries using their own automobiles on deputation.

Foreign Application

Only actual costs or cents-per-mile may be used outside of the United States.

The cents-per-mile method is permitted and easy to use, but in higher cost countries will not fully reflect actual costs of the missionary. Even in the United States, it reflects low cost assumptions regarding automobile expenses. We speculate that the IRS did not really expect that employers would use it internationally, but simply does not care if they do.

Reimbursing actual costs tends to be a cumbersome process, if it means reimbursement beyond direct gasoline expense.

II. SPECIFIC ISSUES, continued

E. Automobile Expense Reimbursement, continued

Employee Automobile & Mission Mileage, continued

Foreign Application, continued

As an example of actual costs, we believe the following process would meet the requirements:

The missionary keeps a log of all miles driven, and receipts for all out-of-pocket expenses. On a monthly basis, the missionary totals up the expenses (example: $400 for gas, oil change and minor repair), multiplies them by the ministry percentage of total miles (example: 700 for mission and 300 personal is 70% mission) and submits the ministry portion for reimbursement (example: $280). Very large expenses might use a six-month average ministry mileage percentage, to even out monthly variance. Annually, the missionary would submit a reimbursement request for depreciation based on total mileage for the year. At that point, the mission would sum the total operating expenses for the year and adjust the total annual mission mileage reimbursement to correct for monthly variances. The depreciation expense reimbursement would provide a cushion to make necessary adjustments.

Several mission clients have adopted a more creative approach for using the actual cost method, essentially creating a well documented, field specific cents-per-mile rate. These are used in fields where a number of missionaries are regularly driving their own vehicles for the mission. We have not seen any rulings approving it however. Such a system might be challenged if noticed by an IRS auditor. We believe, however, this to be a defensible position with a reasonable potential for prevailing. The following is an example of such a system:

> The mission organization regularly (at least annually) collects automobile expense data for the field, including maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and license and registration fees. In addition, it collects sufficient information on all the missionaries' vehicles to calculate depreciation expense. Using this expense information, the mission organization develops its own estimate of an actual/cents-per-mile cost to operate a vehicle in the field. The mission reimburses missionaries for mission use of their personal vehicles based on this estimate.

Mission Automobile & Personal Mileage

An employee who uses a mission owned or leased automobile for a personal trip must either reimburse the mission for the use of the vehicle, or have the value of the use reported as taxable income. The same valuation methods may be used either to determine the amount that must be reimbursed, or must be reported as income (Regulation § 1.61-21(b)).

Regulations provide three methods for valuing personal use of a mission provided vehicle:

- **General valuation**
- **Lease value**
- **Cents-per-mile**

II. SPECIFIC ISSUES, continued

E. Automobile Expense Reimbursement, continued

Mission Automobile & Personal Mileage, continued

General valuation
Under the general valuation method, the value is the fair market value of the missionary's usage, meaning the amount the missionary would have had to pay for comparable vehicle usage in an arm's-length transaction (Reg. § 1.61-21(b)). This is not the employer's cost. Where rental cars are readily available, it would be comparable to the amount a car rental company would charge to rent an automobile for the missionary's use.

The general valuation method may be used anywhere.

Lease value
The lease valuation method bases the lease value on the value of the car when first made available to the employee. For an automobile provided to a missionary for a long period, the initial value continues in effect for the first four years before the vehicle is revalued. For an automobile provided for 30 or more days but less than a year, the annual lease value is prorated by dividing the number of days of availability by 365. For an automobile provided for less than 30 days, the value is also prorated, but the number of days of availability is multiplied by four and then divided by 365 (Reg. § 1.61-21(d)(2)&(4).

The valuation under the lease value method includes insurance and maintenance. It does not include gasoline and oil. If the employer provides these in the United States, Mexico, or Canada, the value may be increased by 5.5 cents per mile. An alternate provision for those countries and the only provision for other countries would be to add the cost of providing these to the lease value (Reg. 1.61-21(d)(3)).

Where a vehicle is assigned to a missionary on long term basis, the lease valuation method easily accommodates allocation between mission miles, and personal miles.

The lease valuation method can be used anywhere.

Cents-per-mile
The cents-per-mile method uses the rate established annually by the IRS in December for the following year is used. For 2010, the rate is 50 cents per mile.

Included in the cents-per-mile rate are all operating and fixed costs of the automobile. Such items as depreciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and license and registration fees are included in operating and fixed costs for this purpose.

For valuing personal use of mission vehicles, if the mission does not provide gasoline, the cents-per-mile rate is reduced by 5.5 cents per mile (Reg. § 1.61-(e)(3)(ii)(A)).

For valuing personal use of a mission owned automobile, the cents-per-mile rate is available in the United States, its territories, and possessions, in Canada, and in Mexico. In other countries, the cents-per-mile method may be used if the employer does not provide gasoline and oil by reducing the rate by 5.5 cents per mile. If the employer provides gasoline and oil, the rate may be used if the employer reduces the rate by 5.5 cents per mile and adds the actual cost of gas and oil to the rate (Reg. § 1.61-(e)(3)(ii)(B)).

II. SPECIFIC ISSUES, continued

E. Automobile Expense Reimbursement, continued

Mission Automobile & Personal Mileage, continued

Cents-per-mile, continued

Example: In Country A (not the United States, Mexico, or Canada), the mission allows missionaries to use mission vehicles for personal use. The cost of gasoline is $3.00 a gallon, and the vehicles used by the missionaries get about 20 miles to the gallon. The cents-per-mile cost of gasoline would be 15 cents per mile. The mission could value personal miles in 2010 at the rate of 65 cents per mile.

There may be a practical limitation on the use of the cents-per-mile rate in some other countries. Unless the same or comparable vehicle could have been leased on a cents-per-mile basis, the value of the availability of the vehicle cannot be computed by applying a cents-per-mile rate to the number of miles the vehicle is driven (Reg. § 1.61-21(b)(4)).

However, the cents-per-mile rate may not be used when valuing personal use of mission automobiles if the value of the vehicle is more than the maximum depreciation for a luxury automobile during its first five (5) years, when first made available to an employee (Reg. § 1.61-(e)(1)(iii)). The value in 2010 is $15,300 (Revised limit issued annually in March-April).

For foreign applications, all three valuation methods may be used.

For longer periods of personal use of a mission automobile, or where a mission vehicle is permanently assigned to a specific missionary, the lease value method may be the most useful method. It does not require local market evaluations and does not have any maximum value on the vehicle.

In developed areas, for short-term use, the general valuation method may be very useful, since a call to a local car rental agency would provide a quick fair market value. In areas where commercial car rentals are not readily available, developing comparable values will be more difficult.

For short term use where the vehicle value is less than the allowed limit, and there is any possibility of renting an automobile on a cents-per-mile basis, the cents-per-mile method with an adjustment for gasoline prices provides a fairly simple approach to valuing personal use of a mission vehicle.

Several mission clients have adopted a more creative approach, essentially creating a well documented, field specific cents-per-mile rate. These are used in fields where a number of missionaries are regularly driving mission vehicles for personal miles. We have not seen any rulings approving it however. Such a system might be challenged if noticed by an IRS auditor. We believe, however, this to be a defensible position with a reasonable potential for prevailing. The following is an example of such a system:

II. SPECIFIC ISSUES, continued

E. Automobile Expense Reimbursement, continued

Mission Automobile & Personal Mileage, continued

Foreign Application, continued

The mission organization regularly (at least annually) collects automobile expense data for the field, including maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and license and registration fees. In addition, it collects sufficient information on all the missionaries' vehicles to calculate depreciation expense. Using this expense information, the mission organization develops its own estimate of the cents-per-mile cost to operate a vehicle in the field. Because this valuation must reflect fair value, not cost, a commercial profit margin based on the local economy might also be needed. The missionaries reimburse the mission for personal use of their mission vehicles based on this estimate, or the amount is reported as compensation.

Cents per mile rate summary

There are important differences in how the cents-per-mile rate is used, depending on whether it is mission use/personal automobile, or personal use/mission automobile. The differences are highlighted below.

Attribute	Mission Use/Personal Auto	Personal Use/Mission Auto
2010 Rate	50 cents per mile	50 cents per mile
Cost Included	All operating and fixed costs	All operating and fixed costs
Source	Established by IRS in annual Revenue Procedure	Established by IRS in annual Revenue Procedure
Geographic Scope-basic rate	World-wide	United States, Canada, Mexico
Geographic Variations	Same rate, world-wide	Gasoline price adjustment in other countries
Provision of gasoline	Basic rate covers gas provided by employee	Rate reduced (5.5 cents per mile) if employee provides gas
Comparable rentals required	No	Yes
Maximum value on automobile	No	Yes; $15,300 in 2010

Conclusion

How do we reimburse a missionary when he drives his own car in the field? Or, how much must a missionary reimburse the mission for use of a mission vehicle to go on vacation in the field?

To minimize confusion, we recommend mission organizations establish two distinct policies:

1. **Reimbursement Policy for Mission Use of Personal Vehicles**
2. **Reimbursement/Taxation Policy for Personal Use of Mission Vehicles**

II. SPECIFIC ISSUES, continued

F. Medical Needs Assistance Options

Missionaries and their families have medical needs, some of which are difficult to address in a traditional medical plan. This section describes some options that may be useful, or not useful, in some situations: The format is a checklist, and consequently includes some of the usual suspects.

Many of these are described in more detail on the ECFA website. Go to http://www.ecfa.org/HomePage.aspx and look for the document entitled: "Health Insurance and Medical Expenses".

1. **Medical insurance plan through insurance company.** Even with increased costs, many organizations continue to find traditional or modified insurance plans useful. This is particularly true for missionaries assigned to foreign countries, where medical expenses tend to be less.

2. **Health Savings Account/High Deductible Health Plan.** These seem to be increasing in number. Healthy employees often like them, since the HSA provides a continuing benefit in future years, regardless of other changes in the medical program. The employee can claim a tax deduction for their own HSA contribution, or it may be funded through a cafeteria plan program, which avoids social security tax on the contribution amount. Because it is a new program, more care is required in setting up, and communicating to employees. A number of organizations have eased employees into such programs with additional assistance with HSA contributions in the initial year.

3. **Self-insured medical plan.** While quite different from a tax perspective, practically this type of program must follow similar rules as an insured plan. The ability to adjust coverage may provide more flexibility, but often contracts with stop-loss carriers limit that flexibility.

4. **Medical expense reimbursement plan** (or "Health Reimbursement Arrangement" in IRS lingo). Such plans are required to be in writing, and to not discriminate in favor of highly compensated employees. Since the statute's definition of "highly compensated" is the highest paid 25% of employees, 25% of every employer's work force is highly compensated. An HRA cannot selectively benefit an employee without providing the benefit to others, and the provision that allows a specific benefit must be adopted before the person incurs the expense.

5. **Medical expense reimbursement for non-highly compensated employees.** An old regulation allows reimbursement of medical expenses, without a plan. The statutory provision requiring a written document for avoiding taxation of highly compensated employees does not expressly prohibit covering medical expenses of non-highly compensated employees, nor does the specific requirement that the plan be adopted before the expense is incurred. "Highly compensated" employees for this purpose are the highest paid 25%.

6. **Contributions for Specific Medical Expense.** Sometimes a donor may send a check, requesting it be used for a specific medical need, or contributions may be solicited for a specific, named missionary's medical need. Rationales for the tax deductibility of such contributions seem weak. There is an identified person for whom the gift is intended. It is outside the policy driven compensation/benefit model that supports the IRS approval of deputized fund raising. It is outside the church benevolence fund model.

II. SPECIFIC ISSUES, continued

F. **Medical Needs Assistance Options,** continued

7. **Personal Gift/Newsletter Programs.** A missionary may participate in a newsletter program. This would be a program where the missionary receives a newsletter regularly listing sick individuals, and sends in his share, and then he has a need, he communicates it and receives funds for it. Such programs do not qualify for Internal Revenue Code provisions for medical plans. An organization's payment for a missionary's participation would be taxable income to the missionary. In a small mission (particularly for HQ personnel, perhaps), the premium savings may out-weigh the tax cost and risks associated with the voluntary nature of the program.

8. **Foreign Medical Care Encouragement.** Several missions have policies which encourage obtaining medical care outside of the US, where medical costs may be substantially less. Encouragement may include favorable deductible and co-pay arrangements.

G. Distinguishing Moving and "Business" Travel Expenses

Mission organizations typically reimburse the expenses of missionary employees for travel in several distinct situations:

- Travel during deputation or other fund raising efforts. This would include the initial fund raising by a missionary, and renewal or supplemental fund raising efforts.
- Initial travel to the missionaries assignment from their pre-employment residence, or their previous assignment (this might be either in the US, or to a country outside of the US);
- Travel from the missionary's assignment to the missionary's primary fund raising location (often, but not necessarily the missionary's historical home place.). This could be from a foreign location back to the US.
- Travel from the primary fund raising location back to the missionary's assignment.

Reimbursement for all this travel should be non-taxable, but different tax rules may apply in different situations, requiring different documentation, and having different implications for dependent travel, and reimbursement of meals and lodging.

The Internal Revenue Code has two distinct sets of rules for travel reimbursements that may apply to the above situations:

1. Travel pursuant to a move from a prior residence to a new residence, to perform services at the location of the new residence will be non-taxable (IRC 217).
2. Travel expenses away from home temporarily on business are non-taxable (IRC 161 & 274).

II. SPECIFIC ISSUES, continued

G. <u>Distinguishing Moving and "Business" Travel Expenses</u>, continued

A trip cannot qualify for both, so the rationale for reimbursing travel expenses should be determined before reimbursement is made. There are substantial differences between the two:

Travel as Moving Expense	Travel as Business Expense
Commute from old residence to new work location must be 50 miles farther than commute from new residence to new work location	No distance requirement.
No retention requirement.	Must retain tax home at prior location, while on trip.
An employee must work at new location more than 39 weeks during 12 months following move. An independent contractor must work at new location more than 78 weeks during 24 months following move	Must intend to work at new location less than 12 months before returning to the old location, and must in fact work less than 12 months before returning to prior location
Travel expenses of dependents (non-employee spouse & children) reimbursable tax free regardless of services they provide to ministry	Travel expenses of dependents (non-employee spouse & children) only reimbursable tax-free if they perform bona-fide services for ministry on trip.
Lodging included	Lodging included
Meals not included	Meals included
Per diem cannot be used.	Per diem can be used.
Auto mileage expense limited to 16.5 cents a mile in 2010	Auto mileage expenses limited to 50 cents per mile in 2010

Typically, the rules are applied as follows, though specific situations may fall in different categories:

Travel during initial deputation/fund raising	Business expense
First trip from initial fund raising or a historical home to work location	Move
Travel from work location back to principle fund raising location/historical home—9 or fewer months for deputation	Business trip
Travel from work location back to principle fund raising location/historical home—12 or more months for deputation	Move
Travel from work location back to principle fund raising location/historical home—9-12 months for deputation	Business trip, or move, depending on other circumstances
Travel back to the US at end of ministry service outside of country	Move (assuming organization has policy of paying for such moves)

III. OTHER TAX AND REPORTING MATTERS

A. Automatic Excess Benefit Rules

The IRS uses the phrase "automatic excess benefit" to describe any transactions where (a) a benefit is provided to a disqualified person, (b) the benefit is taxable, and (c) the benefit is not reported on the person's tax return, the person's Form W-2 or Form 1099MISC or the organization's Form 990. Substantial penalties are owed by individuals who receive automatic excess benefits. The IRS is currently looking for violations involving automatic excess benefits.

"Disqualified person" sounds like a terrible thing to be, but as used with the excess benefit tax, it does not mean they have done anything wrong. A "disqualified person" is normally a good person, important to the organization, and worthy of honor (and protection) by the organization.

Who is a disqualified person? This is anyone who was in a position to exert substantial influence over the nonprofit at any time during the five years preceding an excess benefit transaction.

***Some people are automatically disqualified persons**:*

- Voting members on the governing board
- President, CEO or COO, treasurer or CFO (or person filling these roles, regardless of formal title)
- Any person who has been in any of these position in the 5 years prior to the transaction.
- Family members (spouses, siblings, spouses of siblings, ancestors, descendents and spouses of descendents) of any person who is a disqualified person.

Because of the family and five year aspects, a missionary in the field, without any current top level responsibility might be a disqualified person.

Amounts reimbursed to a disqualified person under an accountable reimbursement program that meets the requirements of Regulation §1.62-2(c) (ARP) are not considered a benefit to the person for purposes of the excess benefit law. Similarly, reimbursement of medical expenses under a qualifying HRA are not an automatic excess benefit.

Recent IRS enforcement efforts have taken the position that if a reimbursement (a) does not comply with the accountable expense reimbursement rules, and (b) is not reported as compensation, it is automatically an excess benefit. If a medical expense were paid through a taxable method, and not reported, it would be subject to the same rationale as unreported expense reimbursements made outside of an ARP.

Reimbursements that should be reported, but are not, are treated as excess benefits, even if the amount of the unreported taxable reimbursement would have been reasonable compensation, if reported.

The regulation describes several ways of reporting an economic benefit as compensation for this purpose:

1. The organization reports the economic benefit as compensation on a Federal tax information return with respect to the payment (e.g., Form W-2) or with respect to the organization (e.g., Form 990).
2. The recipient disqualified person reports the benefit as income on the person's Federal tax return (e.g., Form 1040).
3. Reporting the compensation on Form 990 is also an option, if the organization files Form 990, and the disqualified person's is in a position where their compensation is reported on Form 990.

Penalties for an automatic excess benefit are the same as for a true excess benefit: refund of the full amount plus interest, and 25% of the amount (or 200% if refuse to refund it when demand made by the IRS). Since the primary problem with automatic excess benefit is the failure to report, however, all penalties and refund requirements can be avoided by filing an amended Form W-2, Form 990, or Form 1040 before the IRS contacts the organization or individual.

III. Miscellaneous Tax Issues, continued

B. Vehicle Donation Rules

Congress added a new tax law for tax deductions of vehicle donations beginning January 1, 2005. The IRS has now issued specific guidance and a Form 1098-C.

A vehicle under the law is a (1) motor vehicle manufactured primarily for use on public streets, roads or highways, (2) a boat, or (3) an aircraft.

For contribution deductions of $500 or less, the rules have not changed.

The tax deduction of a vehicle for more than $500, plus the timing and content of the organization's acknowledgement, depends on whether the organizations sells, uses, or materially improves the vehicle:

1. If the charity sells the vehicle without using the vehicle in any significant way (or without improving the vehicle), the amount of the charitable deduction cannot exceed the gross proceeds from the sale, or the donor's basis, which ever is less.

2. If the charity keeps the vehicle for its own use or makes material improvements in it, the donor can claim the FMV.

3. If the charity sells the vehicle at a price significantly below fair market value (or gives it away for free) to a needy individual in direct furtherance of its exempt purpose, the donor can claim the FMV.

All acknowledgements, and the report to the IRS, require the name and taxpayer identification number of the donor, and the vehicle identification number. Other information and time limits vary based on the use of the vehicle.

If the organization sells the vehicle, it must provide the donor within 30 days of selling the vehicle a written acknowledgement, containing the following additional elements:

- A certification that the vehicle was sold in an arm's length transaction between unrelated parties,
- The gross proceeds from the sale, and
- A statement that the deductible amount may not exceed the amount of such gross proceeds.

If the organization uses or materially improves the vehicle, it must provide the donor within 30 days of receiving the vehicle a written acknowledgement, containing the following additional elements:

- A certification of the intended use or material improvement of the vehicle and the intended duration of such use, and
- A certification that the vehicle would not be transferred in exchange for money, other property, or services before completion of such use or improvement.

A material improvement would include major repairs to a vehicle, or other improvements to the vehicle that improve the condition of the vehicle in a manner that significantly increases the vehicle's value. Cleaning the vehicle, minor repairs, and routine maintenance would not be material improvements.

III. Miscellaneous Tax Issues, continued

B. Vehicle Donation Rules, continued

If the charity sells the vehicle significantly below FMV, or gives it away, to a needy individual, it must provide the donor within 30 days of receiving the vehicle a written acknowledgement, containing the following additional elements:

- A certification that the donee organization will sell the vehicle to a needy individual at a price significantly below fair market value (or, if applicable, that it will give the vehicle to a needy individual), and
- The sale (or gift) will be in direct furtherance of the donee organization's charitable purpose of relieving the poor and distressed or the underprivileged who are in need of a means of transportation.

Substantial penalties were added for charities that make fraudulent certifications, or fail to provide a complete certification.

The same information provided in the acknowledgement to the donor must also be provided to the IRS. Form 1098-C will be used for this purpose. Form 1098-C has multiple parts, with Copy A going to the IRS, copies B & C serving as the donor's acknowledgement, and Copy D being kept by the organization. The donor's acknowledgement does not have to be Form 1098-C, but it will be convenient for many organizations, and help assure that all relevant information is provided.

The Notice did not address the ability of an organization to transfer a donated vehicle to an employee as compensation. The statute does not appear to allow use of a donated vehicle as compensation to an employee, since such a transaction does not fit any receipting/certification option. The vehicle is not being used by the organization; it is not being sold to an unrelated party (an employee would commonly be considered a "related party") and it is not being given to a person in need. Pending specific authorization by ruling or regulation, such a transaction should be avoided.

An organization could retain ownership of the vehicle, and assign it to the employee for the employee's use. Tax rules associated with such an assignment would be those described above for any employer provided vehicle.

A vehicle donation late in the calendar year that the organization plans to sell, but has trouble selling, may create problems for the donor. It should not be an issue if the sale by the organization occurs early in the next year, since the date of the donation would be determined by when ownership passed to the organization, not the sale date. If the sale of the vehicle extends beyond the due date for the donor's tax return for the year of the donation, however, the donor cannot claim a deduction, and will have to file an amended return when the vehicle sells, and the organization issues the certificate.

Copies of Form 1098-C for information purposes may be obtained from the IRS website, at www.irs.gov

C. Working with Canadian Organizations

Many missions work with Canadian organizations, or even have related organizations in Canada. Canadian nonprofit tax law is different in many respects from US nonprofit tax law. A Canadian ministry has much less flexibility in how it accomplishes its ministry activities than a US ministry. Failure to adhere to the Canadian requirements may result in revocation of the Canadian ministries tax exemption.

The most commonly applicable issue is the requirement that a Canadian ministry be engaged in doing its ministry, and not simply making grants. A Canadian ministry can only make grants to another Canadian registered charity (with minor exceptions). It cannot make grants to a US or other foreign charitable or religious organization.

The Canadian Revenue Agency describes the relevant tax law this way:

The *Income Tax Act* permits a registered charity to carry out its charitable purposes, both inside and outside Canada, in only two ways.

1. It can make gifts to other organizations that are on the list of **qualified donees** set out in the *Income Tax Act*.

   Qualified donees include Canadian registered charities, certain universities outside Canada, the United Nations and its agencies, and a few foreign charities (see the end of this brochure for a complete listing).

2. It can **carry on its own charitable activities**. In contrast to the relatively passive transfer of money or other resources involved in making gifts to qualified donees, carrying on one's own activities implies that the Canadian charity is an active and controlling participant in a program or project that directly achieves a charitable purpose.
   Examples of this type of activity include:
   - awarding scholarships to students selected by the registered charity, based on criteria it has adopted and applied;
   - supplying low-cost housing to needy individuals; and
   - providing medical services to the sick.

The *Income Tax Act* does not allow a registered charity to carry out its purposes by handing over its money or other resources to another organization (that is not a qualified donee).

Yet it may not be practical for the charity to meet its "own activities" test by operating abroad using its own employees or volunteers directly funded by that charity. However, it can work with or through other organizations providing it employs certain structured arrangements that allow it to retain direction and control over the use of its resources.

Working with Canadian Organizations

How can a registered charity use intermediaries to carry on charitable activities?

A registered charity can carry on its charitable activities through intermediaries such as an agent, a contractor, or any other body. It is preferable for the charity to put in place a formal agreement with this intermediary body.

Note that employees, volunteers, or other representatives under the direct control of the charity do not require a formal agreement to act on behalf of the charity.

Agents

A registered charity can appoint an agent to act as its representative in carrying out specifically identified tasks on behalf of the charity.

Examples
A Canadian relief organization ships food and clothing to a stricken country and appoints local individuals or organizations to act as its agents in distributing the supplies in accordance with its instructions.

A charity involved in development work appoints an organization outside Canada to conduct a specific project under the ongoing direction and control of the charity.

Note - Registered charities should carefully consider how they structure these arrangements, as the existence of an agency relationship may expose them to significant liability for the acts of their agents. Even where there is no formal agency agreement in place, a court can still attach liability to a registered charity if it finds from the circumstances that an implied agency relationship exists.

Contractors

A registered charity can also carry out its charitable activities by contracting with an organization or individual in another country to provide needed goods and services.

Example
Before providing irrigation equipment for an agricultural project, a Canadian registered charity:

- commissions a soil analysis from a local university;
- contracts with a for-profit business in the country to deliver, install, and maintain the equipment; and
- contracts with a government agency to provide instructional or other services required to make the project a success.

Before engaging agents or contractors, it is important that the registered charity have a clear idea of the charitable project or program it is trying to achieve, and how it will be conducted from beginning to end.

This will allow the charity to give precise instructions to its agents or contractors.

How can a registered charity carry on charitable activities jointly with others?

A registered charity can also pursue its objectives outside Canada using one of the arrangements described below.

Joint ventures

A registered charity and other entities that may not be qualified donees can decide to pool their resources to establish and operate a charitable program.

The charity will be considered to be carrying on its own activities providing it is an active partner exercising a proportionate degree of control in the venture, **and** it can clearly establish that its share of responsibility is at least proportional to the level of funding it contributes to the program for:

- long-term planning;
- day-to-day decision-making; and
- financial commitments.

Example
A Canadian church joins with churches in other countries to operate a joint missionary venture. If the Canadian charity provides 25% of the funding for the project, its representation on the venture's governing board should constitute approximately 25% of the voting strength, and it should have approximately 25% of the decision-making power for the venture as a whole.

Guidelines for establishing that a Canadian charity is actively involved in a joint venture are set out below.

Co-operative partnerships

Sometimes a registered charity works side by side with other organizations and with the people it is trying to assist so that together they may achieve a particular project. The various organizations do not necessarily pool their resources to carry out the project as in joint ventures, but instead each of the partners takes responsibility for a particular aspect of the project.

Example
A Canadian charity dedicated to providing care for the sick joins with charitable, non-profit, or business organizations from Canada and elsewhere, together with the people of the target community and the host government, to build and operate a medical clinic in an isolated area. The Canadian charity volunteers to take responsibility for one or more aspects of the project.

Provided it is actively involved in the aspect of the project it selected, and is not just giving its funds to one of the other organizations working on the project, the charity will be carrying on its own charitable activities.

Note - There are disbursement quota implications, as described below, if the tasks undertaken by the Canadian charity, although essential to the completion of the project, are not **directly** charitable. This would be the case, for example, if it agrees to provide the administrative services for the project.

Exhibit A

BUSINESS EXPENSES & ACCOUNTABLE PLAN RULES

The most advantageous method for workers to deal with business expenses is to be directly reimbursed for business expenses under an accountable reimbursement plan, thus avoiding income reporting and the related tax deductions on the individual's tax return. This is especially true now that employee business expenses may be deducted on Schedule A only to the extent they exceed 2% of adjusted gross income.

1. Nonreportable business expenses

Reimbursements paid to an employee must meet the requirements of an accountable reimbursement plan (ARP) or they must be added to the employee's wages for income tax and social security tax purposes, and amounts paid are subject to tax withholding requirements.

If the ARP requirements are met, the amounts paid are not reported as earnings by the employer and the employee does not deduct them for tax purposes on their personal tax return.

In order for expense reimbursements to be excludable from income of the employee, they must meet the requirements of an ARP, including:

a. Employer Established Plan
The employer must establish and operate the accountable reimbursement plan. An employee cannot be reimbursed tax free simply because they submit expense records. While a plan does not have to be in writing, having a formally established, written plan facilitates proving its existence to the IRS if challenged, and provides a structure for describing employer specific requirements.

b. Reimbursement of Expenses
The accountable plan must reimburse expenses in addition to the regular compensation. An employer and employee cannot simply substitute tax-free reimbursements for compensation the employee otherwise would have received. Even informal agreements that an employee will receive what ever is not used for expenses, or will have their compensation reduced by expenses may invalidate the ARP. An invalid ARP results in taxable reimbursement of legitimately documented expenses.

c. Business connection
The ARP must only reimburse for deductible business expenses (see 3 and 4) and specifically identify the reimbursement or expense payment, keeping these amounts separate from other amounts (such as wages).

b. Substantiation
The employee must provide an adequate accounting (see 5) with documentation (see 6), within a reasonable period of time. As a guideline for what is a reasonable period of time, the IRS has set a safe harbor rule for substantiation of 60 days after expenses are paid or incurred.

c. Return of excess amounts
The ARP must require that excess amounts advanced, allowed, or reimbursed be returned within a reasonable period of time. As a guideline for what is a reasonable period of time, the IRS has set a safe harbor rule for advances, not more than 30 days before the anticipated expenses are paid or incurred, and for the return of excess amounts, within 120 days after expenses are paid or incurred.

So it is important to be certain that, if possible, business expenses are provided for by an employer under an ARP to avoid income reporting requirements.

Exhibit A, continued

BUSINESS EXPENSES & ACCOUNTABLE PLAN RULES, continued

2. Reportable business expenses

The following items must be reported at year end as income to an employee on their Form W-2:

a. Expenses which were not paid under an accountable reimbursement plan.
b. Employer payment of employee personal expenses.
c. Payments in excess of actual employee business expenses.
d. Payments in excess of allowable IRS limits.

These payments may also be subject to withholding requirements, FICA and Medicare taxes.

Unreimbursed employee business expenses are miscellaneous itemized deductions subject to the 2% of adjusted gross income limitation on the deduction. They are claimed as a deduction by the employee filing Form 2106 and Schedule A along with their Form 1040.

3. Deductible expenses/Tax-Free Reimbursement

If an expense would qualify as a business expense deduction of an employee, it can also qualify as a tax-free reimbursement under an ARP. For meals and entertainment expenses, an ARP may reimbursement expenses at a 100% that would only be deductible at 50%. Since *deductibility* and *tax-free reimbursement* (if there is an ARP) are the same, this article mostly uses *deductibility*.

Deductions for entertainment, transportation, office and other customary business expenses are appropriate whenever they meet the "ordinary and necessary" test (Code Sec. 162).

The expense must be "ordinary and necessary" in the employee's carrying on his employment. The determination of what is "ordinary and necessary" is based on a factual examination of the particular expense. Basically, expenses are held to be "ordinary and necessary" if they can be expected to arise in the particular business, and are appropriate and helpful to the development or conduct of a business.

Commuting expenses between a taxpayer's residence and a business location with the area of his tax home are never deductible. However, transportation from an employee's residence to temporary minor assignments may be deductible. Spousal travel expenses are not deductible and reimbursements for these should be reported as income to the employed spouse, unless the traveling spouse is performing assigned duties for the employer that is bona fide and significant.

4. Travel, meals, and entertainment expenses

The following three conditions must be satisfied for traveling expenses, such as transportation, meals and lodging, to be considered a business expense:

a. The expense is ordinary (reasonable) and necessary as a traveling expense.
b. The expense is incurred while away from home (away from the general area of his tax home for a period substantially longer than an ordinary day's work, reasonably requiring rest or sleep), except for business entertainment expenses.
c. The expense is incurred in the pursuit of business (Code Sec. 162(a)(2), Reg. Sec. 1.162-2).

BUSINESS EXPENSES & ACCOUNTABLE PLAN RULES, continued

It should be noted that business meals are only deductible if they are "directly related" or "associated with" the active conduct of as taxpayer's trade or business.

In addition, the business meals and business entertainment deduction is now limited to 50% of the actual cost. However, an employer may reimburse the employee tax-free under an ARP at 100%, as long as the employer only claims a deduction for 50% against the employer's taxable income. Unless the expense is associated with UBI, an exempt organization would not have any taxable income, but an exempt organization can still reimburse tax-free at 100% under an ARP.

5. Adequate accounting is required

For there to be "adequate accounting," the records must include:

a. Amount.
b. Date (and time for some purposes) and place of the travel, meal or transportation.
c. Business purpose of the expense.
d. Business relationship of persons entertained or fed.

A fuller description is provided on the exhibit, excerpted from IRS Publication 463.

6. Documentation Requirements

Some common documentation issues and requirements are:

a. All lodging expenses must be documented by a receipt, unless a per diem plan is used.
b. Receipts are required for any other expense of $75 or more.
c. Credit card statements may be used to provide key elements of the accounting, such as the place and date and replace the receipt requirement. For a tax-free ARP, however, the employee must supplement the statement with documentation of other elements.
d. Meal per diems. The IRS has established standard per day amounts that taxpayers may use as an optional deduction for meal expenses incurred while away from home on business travel. US rates are listed in IRS Publication 1542 and are available on the internet at: *www.gsa.gov* . Foreign rates are on the internet at: *http://www.state.gov/m/a/als/prdm/* The use of the allowance is optional and does not relieve taxpayers of the obligation to document the time, place, and business purpose of the travel.
e. Meal and lodging per diems. The IRS has established standard per day amounts also for combined meal and lodging expenses. Rates for specific locations are listed in Publication 1542, or the web sites listed above. For combination meal and lodging per diems in the US, the IRS has also established a simpler two tier system. The daily amounts for 2010 are $258 in high-cost areas and $163 for all other locations. (See IRS Publication 1542 for a listing of high-cost areas.) Documentation must include time, place, and business purpose of the travel.

When using a per diem, or mileage for automobile usage, an employer may adopt a lower amount than the maximum IRS authorized amount.

Exhibit A, continued

BUSINESS EXPENSES & ACCOUNTABLE PLAN RULES, continued

7. Adequate records for auto use

An account book, diary, log, statement or expense, trip sheet, or similar record prepared at or near the time of expenditure or use is certainly the best method of substantiating the business use of a vehicle and the best method of maximizing and protecting this deduction.

8. Business use of personally owned autos

A self-employed individual or an employee who uses his personal car for business purposes can generally deduct the actual cost allocable to business use or use the optional standard mileage rate.

The optional maximum standard mileage rate is 50 cents per mile for 2010. This method includes a provision for straight-line depreciation on the car and cannot be used if depreciation was claimed on the car under any method other than the straight-line method in the past or if the special expensing deduction of Code Sec. 179 has been utilized.

Exhibit A, continued

Table 4. How to Prove Certain Business Expenses

(Excerpted from IRS Publication 463 TRAVEL, ENTERTAINMENT, GIFT, AND CAR EXPENSES)

If you have them you must keep records that show details of the expenses for the following elements.

	Amount	**Time**	**Place or Description**	**Business Purpose and Business Relationship**
Travel	Cost of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories such as taxis, daily meals for traveler, etc.	Dates you left and returned for each trip and number of days spent on business.	Destination or area of your travel (name of town, or other designation).	Purpose: Business purpose for the expense or the business benefit gained or expected to be gained. Relationship: N/A
Entertainment and Meals (when not traveling)	Cost of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.	Date of entertainment. (Also see Business Purpose.)	Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. (Also see Business Purpose.)	Purpose: Business purpose for the expense or the business benefit gained or expected to be gained. For entertainment, the nature of the business discussion or activity, if the entertainment was directly before or after a business discussion: the date, place, nature and duration of the business discussion, and the identities of the persons who took part in both the business discussion, and the entertainment activity.

Exhibit A, continued

	Amount	Time	Place or Description	Business Purpose and Business Relationship
Gifts	Cost of gift	Date of gift	Description of the gift	Relationship: Occupations or other information (such as names, titles, or other designations) about the recipients that shows their business relationship to you. For entertainment, you must also prove that you or your employee was present if the entertainment was a business meal.
Transportation (Car)	Cost of each separate expenses, the cost of the car and any improvements, the date you started using it for business, the mileage for each business use, and the total miles for the year.	Date of the expense. For car expenses, the date of the use of car.	Your business destination (name of city, town, or other designation).	Purpose: Business purpose for the expense. Relationship: N/A

You should keep adequate records to prove your expenses or have sufficient evidence that will support your own statement. You must generally prepare a written record for it to be considered adequate. This is because written evidence is more reliable than oral evidence alone. However, if you prepare a record in a computer memory device with the aid of a logging program, it is considered an adequate record.

Exhibit B

PRE-GRANT INQUIRY

(For Internal Use)

This form is to be completed before this ministry makes any grant to a foreign organization which is not a controlled or closely affiliated organization. The purpose is to establish the fact that prior to the grant, this organization conducted an inquiry concerning the potential grantee complete enough to give a reasonable man assurance that the grantee will use the grant to accomplish this organization's exempt purposes.

1. Name of proposed grantee: _____

2. When the organization was founded:_____

3. Essential institutional character and function or purpose of the proposed grantee (e.g., educational institution, hospital, Christian mission, church, or denomination):

_____

4. Names and titles of chief personnel of the proposed grantee:

_____

5. Summary of previous grants or other assistance (if any) made by this organization to proposed grantee, including whether proper use of grants was made and whether required reports were filed with this organization:

_____

6. Summary of grants awarded by other organizations to the proposed grantee including the amount of the grant, date awarded, and the purpose of the grant:

_____

_____

Specific Foreign Grant Questions:

7. If organizing document (Articles of Incorporation or equivalent) is not in English, obtain English translation. Indicate date obtained: _____

8. Has the applicant provided evidence that it qualifies under the laws of its country as a charitable organization, which generally would qualify as tax exempt under the laws of the United States?

   Describe the evidence, with reference to attachments:

   _____

Exhibit B, continued

PRE-GRANT INQUIRY FOR FOREIGN GRANTS
(For Internal Use)

All Organizations:
9. References (minimum of two):

Name and relationship to applicant:_____
Date of contact, nature of contact, and information provided: _____

Name and relationship to applicant:_____
Date of contact, nature of contact, and information provided: _____

10. Has the applicant been checked against Department of State, and other list of suspected terrorist organizations?
Indicate date checked, and result: _____

11. Brief summary of knowledge of this organization based on prior experience or other information readily available, concerning the prior history and experience of the proposed grantee and its chief personnel including the grantee's activities and practices (or reference to specific documents in this organization's files covering these points):

Conclusion:
Brief statement of basis for conclusion that the proposed grantee will use the grant for the proper purposes (or reference to specific documents in this organization's files covering these points).

Date

Organization Officer

Exhibit B
FOREIGN GRANT TERMS, CONDITIONS AND UNDERSTANDINGS

GRANTEE:
GRANT AWARD:
DATE:
_____ (herein, "Ministry") is awarding this grant contingent upon the following conditions:

The purpose of the grant (together with all income earned upon investment of the grant proceeds) is

_____

as outlined in your proposal of _____
(or if there were no proposal, as described on the attached exhibit, which is incorporated into this agreement).

The grant period for expenditure of these funds will commence on the date of this agreement and end on _____. Extension of the grant period may be made in unusual circumstances, but only upon the express written authority of the Ministry made pursuant to a request received before the expiration of the original grant period.

Any portion of the funds not used within the grant period and/or for the purpose stated above, must be immediately returned to the Ministry.

You are required to provide the Ministry with immediate notification of any significant changes in your organization's structure or operation, if you are unable to expend the grant for the purpose described above, or if any expenditure from this grant has been made for any purpose other than those for which the grant was intended.

You are required to submit a full and complete written report by _____ on the manner in which these grant funds were spent and the progress made in accomplishing the purpose of the grant. This report shall supply sufficient information as necessary for the Ministry to determine that the funds were used for the intended purposes.

You are required to indicate the grant funds separately on your books of account, maintain an accurate record of the funds received and expenses incurred under this grant in accordance with generally accepted accounting principles, and retain such books and records for at least four years after the completion of the use of this grant award.

You will permit the Ministry, at its request, to have reasonable access to your files, records and personnel for the purpose of making such financial audits, verifications or program evaluations as it deems necessary concerning this grant award.

No part of the grant funds is to be used to carry on propaganda, or otherwise attempt to influence legislation, or to influence the outcome of any specific public election.

Any violation of the conditions set forth above will require a refunding to the ministry of any amounts subject to the violation. The Ministry reserves the rights to discontinue, modify, or withhold any payments due under this grant award or to require a refund of any unexpended grant funds if, in its judgment, such action is necessary to comply with the requirements of any law or regulation affecting its responsibilities under this grant award.

The above conditions are understood and accepted:

Signature:_____ Organization: _____

Title:_____ Date: _____

Updated 12/03/09

KEY FEDERAL TAX FIGURES

	In 2009 and Returns for 2009	In 2010 and Returns for 2010
Standard Deductions	Married-Joint return $11,400 Head of Household 8,350 Single 5,700 Married-Separate ret. 5,700	Married-Joint return $11,400 Head of Household 8,400 Single 5,700 Married-Separate ret. 5,700
Personal & Dependent exemption amount	$3,650	$3,650
SECA (OASDI & Medicare) rate	15.3%	15.3%
FICA (OASDI & Medicare) rate	7.65%	7.65%
OASDI Maximum compensation base	$106,800	$106,800
Annual Gift Tax Exclusion	$13,000	$13,000
Foreign Earned Income Exclusion	$91,400	$91,500
Maximum annual contribution to defined contribution plan	$49,000	$49,000
Maximum salary deduction for 401(k)/403(b)	$16,500	$16,500
401(k) & 403(b) Over 50 "catch up" limit	$5,500	$5,500
Maximum income exclusion for NQ plans in 501(c)(3) organizations (IRC 457)	$16,500	$16,500
IRA Contribution limit	$5,000	$5,000
IRA over 50 "catch-up limit	$1,000	$1,000
Highly compensated employee limit	$110,000	$110,000
Earnings Ceiling for Social Security (applies to employment before full retirement age (FTA); special formula in full retirement age year)	Below FTA: $14,160 Over FTA: None	Below FTA: $14,160 Over FTA: None
Standard Per diem: Lowest rates in continental USA	Lodging $70.00 Meals & Incidentals $39.00	Lodging $70.00 Meals & Incidentals $46.00
IRS High/Low substitute per diem system (Effective October 1)	High $256 Low $158	High $258 Low $163
Maximum automobile value for using cents-per-mile rate to value company provided automobile	$15,000	$15,300 (est.)
Business mileage rate	55.0 cents per mile	50 cents per mile
Moving & medical mileage rate	24.0 cents per mile	16.5 cents per mile
Charitable mileage rate	14 cents per mile	14 cents per mile
Maximum value of reimbursement of business expenses (other than lodging) w/o receipt	$75.00	$75.00
Threshold for filing 990 electronically	$10 million assets & 250 information returns	$10 million assets & 250 information returns
Threshold for required filing Form 990T	$1,000 gross UBI	$1,000 gross UBI
Threshold for required filing of Form 1099-MISC (payment for most personal services)	$600.00	$600.00
Minimum contribution and maximum cost of token	Minimum gift: $47.50 Maximum cost: $9.50	Minimum gift: $48.00 Maximum cost: $9.60
Maximum value of de minimus benefit	2% of gift, but max. $95.00	2% of gift, but max. $96.00

Exhibit D

Bibliography

Resources available from the IRS website at: www.irs.gov :

Forms 2555 and 2555 EZ, *Foreign Earned Income* and their instructions.

Form 673 *Statement For Claiming Benefits Provided by Section 911 of the Internal Revenue Code*

IRS Publication 54: *Tax Guide for U.S. Citizens and Resident Aliens Abroad*

IRS Publication 513 *Tax Information for Visitors to the U.S.*

IRS Publication 514: *Foreign Tax Credit for Individuals*

IRS Publication 515: *Withholding of Tax on Nonresident Aliens and Foreign Entities*

IRS Publication 519: *U.S. Tax Guide for Aliens*

IRS Publication 597 *Information on the United States-Canada Income Tax Treaty*

IRS Publication 686 *Certification for Reduced Tax Rates in Tax Treaty Countries*

IRS Publication 901 *U.S. Tax Treaties*

IRS Publication 1828: *Tax Guide for Churches and Religious Organizations*

IRS Publication 3833: *Disaster Relief*

General Exempt Organization Information on IRS Web:

Life Cycle of a Public Charity: http://www.irs.gov/charities/charitable/article/0,,id=122670,00.html

Life Cycle viewed as a flowchart: http://www.irs.gov/pub/irs-tege/pclifecyclechart.pdf

The Life Cycle tool provides access to many of the IRS publications and forms associated with exempt organizations. The areas we would recommend focusing on for a broad overview of NPO tax compliance are:

- Compliance Guide Pub 4221
- Unrelated Business Income Tax
- Charitable Contributions Substantiation and Disclosure Requirements Pub 1771

Exhibit D, continued

Resources available from the Social Security Administration website at http://www.ssa.gov/ :

2010 COLA Information: - Benefit, Tax and Wage-Indexed Changes for 2010;

International Agreements, Payments Outside the United States, and Social Security in Other Countries (http://www.ssa.gov/international/)

Evangelical Council for Financial Accountability

Website at: http://www.ecfa.org/

The ECFA website has an extensive archive of policy forms, articles and other materials that relate to the tax, financial and legal issues of Christian ministries.

Books

Church & Clergy Tax Guide-2010, by Richard Hammer (Christianity Today International: available at www.churchlawtodaystore.com) This is an excellent resource for digging into particular areas in more depth. Mr. Hammar provides numerous examples from case law and goes into designated giving in some depth. Available in a searchable pdf file as well as in book format.

*Church and Nonprofit Tax & Financial Guide-2010*by Dan Busby (Zondervan: available at http://www.ecfa.ws/)

Minister's Tax & Financial Guide-2010 by Dan Busby (Zondervan: available at http://www.ecfa.ws/)

Donor Restricted Gifts Simplified, by Dan Busby (ECFA: available at http://www.ecfa.ws/)

Dan Busby's books provide a straightforward, easy to understand resource. They are especially useful for beginners though the forms and other aids can be useful at any level of knowledge. The book on donor restricted gifts may be the only resource attempting to address all of the issues raised by donor expectations or requests for use of funds.

Internal Control over Financial Reporting — Guidance for Smaller Public Companies, by the Committee on Sponsoring Organizations (AICPA: available at https://www.cpa2biz.com/index.jsp)

Not for Profit Audit Committee – Best Practices by Warren Ruppel (Wiley)

Sarbanes Oxley for Nonprofits, A Guide to Building Competitive Advantage, by Peggy M. Jackson & Toni E. Fogarty (Wiley: available at https://www.cpa2biz.com/index.jsp)

Internal Controls, Guidance for Private, Government, and Nonprofit Entities by Lynford Graham (Wiley)

DEPARTMENT OF THE TREASURY
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Many religious, charitable, and other organizations that qualify for tax deductible contributions use a practice known as "deputized fundraising" to support their activities. Deputized fundraising consists of paid staff, and/or volunteers conducting grass roots fundraising to support the organization. This practice has occasionally been controversial because of the tendency on the part of some fundraisers to represent that contributions will only be used to support the work of the individual doing the fundraising. In such cases, the nature of the transaction may become blurred and donors may be led to believe that the organization is a mere conduit and that contributions will automatically be allocated to the fundraiser. Although private giving through an organization to earmarked individual recipients is not deductible, and conduit organizations operated to facilitate such private giving are not tax-exempt, unearmarked contributions to a religious, charitable or other qualified organization for use in its charitable program are deductible.

Rev. Rul. 62-113, 1962-2 C.B. 10, provides guidance regarding potential conduit giving, stating that the test of whether a gift is intended by a donor for the use of the organization and not as a gift to an individual is whether "the organization has full control of the donated funds, and discretion as to their use, so as to insure that they will be used to carry out its functions and purposes." The purpose of the following questions and answers is to clarify the application of the control test in the context of organizations that utilize deputized fundraising.

1. Question: If an organization otherwise described in IRC 501(c)(3) and IRC 170(c)(2) receives substantially all of its revenues through deputized fundraising, i.e., through individual missionaries, staff members, or volunteers conducting grass-roots fundraising to support the organization, can the organization be described in IRC 501(c)(3) and IRC 170(c)(2)?

1. Answer: Yes, the organization can be an organization described in IRC 501(c)(3) and 170(c)(2) if it has full control of the donated funds and has

discretion as to use of the funds. Control and discretion can be shown by the following factors:

- Control by the governing body of donated funds through a budgetary process;

- Consistent exercise by the organization's governing body of responsibility for establishing, reviewing, and monitoring the programs and policies of the organization;

- Staff salaries set by the organization according to a salary schedule approved by the governing body. Salaries must be set by reference to considerations other than an amount of money a deputized fundraiser collects. There can be no commitments that contributions will be paid as salary or expenses to a particular person;
- Amounts paid as salary, to the extent required by the Internal Revenue Code, reported as compensation on Form W-2 or Form 1099-MISC;

- Reimbursements of legitimate ministry expenses approved by the organization pursuant to guidelines approved by the governing body. Reimbursement must be set by considerations other than the amount of money a deputized fundraiser collects;

- Thorough screening, of potential staff members pursuant to qualifications established by the organization, and that are related to its exempt purposes and not principally related to the amount of funds that may be raised by the staff members;

- Meaningful training, development, and supervision of staff members;

- Staff members assigned to programs and project locations by the organization based upon its assessment of each staff member's skills and training. and the specific needs or the organization;

- Regular communication to donors of the organization's full control and discretion over all its programs and funds through such means as newsletters, solicitation literature, and donor receipts; and

- The financial policies and practices of the organization annually reviewed by an audit committee, a majority of whose members are not employees of the organization.

2. Question: If the facts are the same as in question 1, except that, in the organization's discretion, substantially all the contributions received by the organization are tracked for internal accounting purposes as having been raised through the efforts of a missionary, staff member, or volunteer and are generally used to pay for the reasonable salary or other reasonable and necessary organization-related expenses of the designated individual, can the organization be described in IRC 501(c)(3) and IRC 170(c)(2)?

2. Answer: Although such tracking by an organization may show that contributions are earmarked for a particular individual and that the organization is not retaining discretion as to the use of funds, the organization may by the totality of the facts and circumstances demonstrate that it has full control of, and discretion over the use of, the donated funds so as to ensure that they will be used to carry out the organization's functions and purposes, and thus be an organization described in IRC 501(c)(3)) and IRC 170(c)(2).

3. Question: What language would the Internal Revenue Service suggest should be included in a solicitation by an organization described in IRC 501(c)(3) and IRC 170(c)(2) for a contribution raised through deputized fundraising in order to make it clear to the donor that all contributions are under the complete control of the recipient organization and are subject to the organization's discretion for use consistent with its exempt purpose?

3. Answer: For a contribution to be deductible under IRC 170, the donor must intend that the contribution be to or for the use of a qualified donee organization, such as one described in 170(c)(2). The following language in solicitations for contributions, with no conflicting language in the solicitations and no conflicting understandings between the parties, would help show that the qualified donee has the necessary control over contributions, that the donor has reason to know that the qualified donee has the necessary control

and discretion over contributions. and that the donor intends that the qualified donee is the actual recipient of the contributions:

> Contributions are solicited with the understanding that the donee organization has complete discretion and control over the use of all donated funds.

Sincerely,

David W. Jones

David W. Jones
Chief, Review Branch
Exempt Organizations