

DOES YOUR CHURCH OWE INCOME TAXES?

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Most church executives are aware that the church is exempt from federal income tax. But many of them make the mistake of applying this general rule across the board. As with virtually all tax rules, exceptions exist. This article is designed to give the church executive where the church may owe income taxes. Since this is a complicated topic, please do not take any actions without consulting with a competent nonprofit tax professional.

HISTORY

When the income tax was first enacted, no income taxes were imposed on nonprofit organizations. But when a major university bought the largest producer of spaghetti in the U.S. to make it exempt from taxes, Congress decided that some exceptions to the general tax exemption should apply. In 1954, Congress enacted what is known today as the unrelated business income tax, or UBIT for short. A church owes income taxes if it has income that is (1) from a trade or business (2) regularly conducted that is (3) not substantially related to their exempt purpose. Notice that fundraising has no bearing on this issue. If General Motors were to decide to give away its profits, it would not turn into a tax exempt organization. No matter how well intentioned as a fundraiser, the UBIT rules still apply. The best general rule I have found is this: If your church is competing with a business, then UBIT applies. By the way, the church must have \$1,000.00 of gross business income before a tax return (Form 990T) is due. Taxes are only paid on the net income from the activity.

Since so many churches are financing their real estate acquisitions, Congress decided to create another income source that is subject to income tax: debt financed property. Anytime real estate that is subject to a purchase money mortgage is rented or leased to third parties (including another nonprofit or church) then the income is subject to tax. Also, any rentals from personal property are also subject to taxes.

EXCEPTIONS TO UBIT

Though the three elements described above apply to an income source, one must still consider the exceptions to the general rule. First, passive income such as interest is not subject to tax. Nor is income from the sale of donated goods subject to tax. Goods and services that are provided for the convenience of the church's members are also not taxable. Sale of services that are substantially performed by volunteers is also still exempt from tax. Finally, rent from real estate that is not debt financed is generally not subject to tax.

PRACTICAL APPLICATIONS

Let's take several common examples from my church files and apply the above general rules to them.

BOOKSTORE: If the bookstore only sells books, tapes and CDs that further the message of the church, then the income is not subject to tax. On the other hand, if the bookstore sells gift items or aspirin, then sales from those items will result in taxes being owed. Besides these rules, if the bookstore keeps the same hours as B. Dalton, prices its books like B. Dalton, or in general competes with B. Dalton, then all the profits from the bookstore operation will be taxed.

MEALS AND DRINKS: Many churches enjoy meals together, charging their members for the meal. The taxation of this issue will be determined by the scope and regularity of food service. If the meals are only for the convenience of the members (such as before a service or mass), then the convenience exception will apply and the income will not be taxed. The convenience exception will also apply to the vending machine income. On the other hand, if your church food service operates “restaurant hours,” then the income is subject to tax.

WEDDINGS, FUNERALS, ETC. Many churches charge for the use of their facilities for weddings, funerals and anniversary parties. If the fee is solely for the use of the facility, then it is not subject to tax, unless the church is debt financed property. If the church is debt financed property, then the church may avoid taxes if the event is religious, such as a wedding. If the event is secular and the church is debt financed property, then the church must pay taxes on the rents received.

ADVERTISING IN CHURCH BULLETINS, GROCERY AND PHONE CARDS: The general rule requires taxation of all advertising revenue. If a business pays for an ad in the Sunday bulletin, then the revenue is taxed. But, again, exceptions may save the day. If the bulletin is composed, printed and distributed by volunteers, then the all volunteer exception will allow the revenue to escape taxation. Another rule may also help: donor recognition. The church may recognize donors in its bulletin because donor recognition is not advertising. What is the difference? Donor recognitions simply list the name address and phone numbers of the donor. Advertising contains slogans and calls for action, such as “call for the best service in town.” Donor recognition tells the nature of the donor’s business, such as “a local Christian bookstore.” Many times advertising will contain logos and other product identification, such as “your local Ford dealer.” While a technical discussion is necessary before fully understanding the nuances involved, the church should decide whether it wants a advertising bulletin or a donor recognition bulletin and structure it accordingly. By the way, some commercial companies will provide a fee to your church to use their bulletins where they have sold advertising. These payments are also subject to tax.

Every major grocery chain has a program to help their communities. They assign your church a code. Each time that code is entered, the grocery chain contributes one percent (1%) of that sale to the church. Long distance companies were the pioneers in this area. If the church promotes the cards in any way with paid staff, then the IRS considers the payments commissions for directing customers to that business. The payments are

taxable. On the other hand, if all aspects of the cards are handled by volunteers, then the volunteer exception will allow the payments to escape taxation.

DAY CARE/SCHOOLS: Many churches operate day care centers or schools. These are considered substantially related to the church's exempt purpose or serve an exempt purpose themselves. So no taxes are due.

Charter schools may be different. If a church hires an outside company to manage or operate the school, then the net fees may be unrelated business income subject to tax.

Sometimes the church will lease its facilities to a day care operator. If the church is not providing any personal property, the rent is not taxable. However, if the church provides any personal property, such as desks, chairs and toys, the answer may change. If the personal property's value is significant, then the rent is probably all or partially taxable.

TRAVEL: Some churches sponsor educational travel. For example, your church sponsors a trip to the Holy Land to instruct parishioners about the place of the Bible. If the primary purpose is truly educational, then no tax is due. On the other hand, if the trip includes free days or days with only a few hours of formal instruction, then taxes are due. The general rule: If the trip contains any elements of fun, then taxes are due. The rules are complicated, so check with a competent tax adviser before booking the trip. Same rules apply to missions trips if they have significant fun days.

CONCLUSION

The church must be alert to its many revenue sources. By careful planning, the church can avoid most adverse tax consequences. The church must constantly monitor its activities and consult with nonprofit tax professionals when new income sources appear.

By the way, since churches do not generally file income tax returns, the statute of limitations runs forever. By filing a tax return (though it shows no tax liability), the church starts the statute of limitations. With a filed return, the normal statute of limitations is three years. Some churches choose to file Form 990T annually simply to close the door on those old years so IRS cannot assess taxes for all the mistakes since Noah.